



SDW Mortgage Industry Discussion Paper

Creative Solutions Needed! The Changing Appraisal Market

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November 1, 2006

Executive Summary

Just as neighborhoods have a life-cycle and go through periods of growth, decline, and renewal, the real estate appraisal industry in the US is in a pro-longed period of decline. Residential appraisers are consistently losing market share from AVMs and other alternative valuation suppliers. Lender pressure to hit values is at an all time high and is compromising the independent nature of the appraisal process. Lender volume is moving away from the first mortgage market due to higher interest rates and the slow down of the refinance boom and this volume is being replaced by HELOC lending that relies heavily on automated and quick response valuations rather than more standard appraisal products.

The appraisal community must develop new ways to compete for declining market share. Product creativity and recognition of customer needs are required for appraisers to survive in this changing market. The overused adage of “thinking outside the box” has never been more relevant or essential than in the situation that appraisers find themselves in today.

This discussion paper chronicles the very significant problems that appraisers need to confront and overcome, in order begin a much needed renewal and growth period. It addresses the need for new innovative appraisal techniques and supplies the case study of Zaiio Corporation that embraces the technique called “Pre-Appraising” that works to overcome existing issues in current industry trends.

The Changing Market

Changes in the Mortgage Lending Process

The Appraisal Industry was founded in the early 1900's as a service industry to lenders, in the aftermath of financial crisis and large volumes of bad loans. The founding principles of the profession were based on several core values including independence, integrity, quality, and accuracy with one of the overall objectives being to help lenders to identify the value of real estate used as collateral for a loan.

Since that time, the mortgage industry has changed considerably. In the past, borrowers obtained a loan to purchase their home with the goal of paying it off as quickly as possible in order to own the home "free and clear". Over the years, properties have gained substantially in value and homeowners have become more sophisticated investors. Home equity lines of credit (HELOC) loans have become popular and are easily obtained as homeowners tap into their equity for other investments, home improvements, or additional purchases such as automobiles, college education, or a vacation home. These loans are largely based on the homeowner's credit rating and ability to pay, as it is assumed that there is a large amount of equity available based on the amount of the first mortgage and the current value of the home. Lenders compete for this business by promising quick cash and therefore need a fast valuation product so that the loan can be booked and closed as quickly as possible.

As a result, lenders have turned away from traditional appraisal products and now rely heavily on AVMs to determine LTV on HELOC loans. As property values increase, flexibility and the lower risk of HELOC lending has become more attractive to both lenders and borrowers and has taken a large share of the lending market. In 2005, equity loan origination increased 35% and this trend is expected to continue.

High volumes of first mortgages are produced in times of low interest rates. However, the HELOC market remains less sensitive to interest rate fluctuations as the loan amounts are lower and homeowners turn to updating or expanding their existing homes when interest rates rise. So, when interest rates rise, the first mortgage business slows and HELOC loans become more prevalent. This creates a substantial business slow down for the appraisers as the HELOC lending that increases at this time does not provide much valuation work for the appraisal community.

In recent years mortgage lending has become a highly competitive business. Lenders compete with a variety of loan products, interest rates and customer service, which includes the ability to close the loan quickly. Borrowers have become more experienced in the process with the advent of quickly falling interest rates that result in "serial refinancing" as well as being barraged with television and mail campaigns offering a variety of options for obtaining home financing. Lenders have learned that they need to capture the borrower's attention and close the loan quickly so that the borrower will not be tempted to shop the loan elsewhere. The longest portion of the lending process is the appraisal, particularly in busy times, where the appraiser is not even able to set an appointment to see the property for weeks at a time.

Another major change in the mortgage industry has been the increasing popularity of wholesale lending. This process involves a mortgage broker who puts the loan together for the borrower and then submits it to a lender who funds the loan. Before funding, the loan goes through a re-underwriting process that includes some kind of appraisal review, anywhere from an AVM to a field inspection. Speed is essential in this process as the mortgage broker needs to know quickly whether the loan will be funded or if he will need to find another lender for the package. Frequently alternative valuation products are used by the lender in the review process as an AVM or real estate agent performing a BPO has a much quicker turn time than is typically provided by an appraiser.

In this high speed Internet world, consumers have come to expect instant response. Competitive pressure forces lenders to recognize this customer expectation. Appraisers must respond to their client needs as well. Technology appears to have been able to speed up traditional appraisal methods as much as possible. Demand for additional increases in accuracy and decreases in turn time are now calling for more creativity on the part of the appraisal profession.

Lack of Changes in the Appraisal Industry

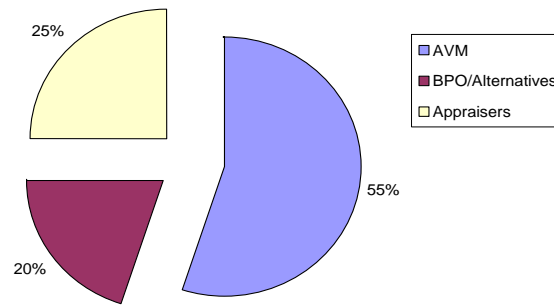
While mortgage lending has been evolving over time, there has been little response from the appraisal community to changing client needs. Since the birth of the appraisal profession, industries have changed considerably with the advent of the assembly line, the business concept of “mass standardization”, and development of computers and new technologies, all with the goal of better and more efficiently serving the needs of their customers. While Ford and McDonalds taught us that mass standardization works, Mercedes and other premium brands taught us that it is possible to mass produce yet also achieve high quality.

However, the appraisal community still uses the production concepts established for the industry in the early 1900’s, appraising one property at a time, with the turn time of that work product extending substantially with any increase in volume. The industry-wide production process often forces customers to wait 7 days or longer for delivery of a residential appraisal, failing to meet the client’s legitimate business needs.

There are three significant signs that indicate immediate change within the appraisal industry is necessary:

- *Lender pressure is at an all time high which compromises the independence and integrity of appraisers*
- *For residential lending purposes, appraisers no longer able to compete on the basis of quality, independence and accuracy - but rather on the basis of speed, price, and willingness to hit numbers.*
- *Appraisers may have experienced a loss of as much as 75% market share over the past 10 years*

Valuation Market Share



Based on discussions with appraisal management companies, who do a substantial amount of today's valuation volume, it is estimated that approximately 55% of their valuation orders are now fulfilled by Automated Valuation Models (AVMs), while another 20% are fulfilled by Broker Price Opinions (BPOs) and other non-appraiser solution providers. This indicates that in the past 10 years, appraisers, as a group, have lost about a 75% market share.

In the past 10 years, the failure of appraisers as an industry to change and adapt has led to significant decline in market share. Ten years ago appraisers enjoyed nearly 100% market share. This meant if a lender, attorney, consumer, or other customer truly wanted to know the value of real estate, they would simply hire an appraiser. In contrast, today appraisers as a group receive about 25% of all valuation requests.

This loss of market share may not be readily apparent, as many appraisers see the market as being primarily full appraisals for first mortgage purposes. However, due to the changes over time, the following must also be considered in loss of market share:

- HELOC loans are now being done by AVMs with some portion going to BPO products. These were previously done by full appraisals or drive-by appraisal products. The percentage of lending being done with HELOC and second mortgage loan products is increasing, particularly with the drop in volume that the market is experiencing for first mortgage refinancing.
- Appraisal reviews, previously done as desk or field reviews or by drive by appraisal products, are now more often being done by AVMs. This percentage of work done by AVMs is increasing as the wholesale/mortgage broker business increases and pressure continues for a quick decision..

With 75,000 licensed appraisers competing for a smaller piece of the pie each year, the only possible outcome for appraisers has been to compete on either price or speed of delivery, which leads to continuous declines in price

levels and ever decreasing research time. Speed of delivery often results in lower quality work and lower job satisfaction among appraisers who are forced to burn the midnight oil to get their reports out the door.

Now that AVMs and other non-traditional appraisal products are gaining in popularity, these trends will continue, and most certainly will lead to a further erosion of the traditional appraisal product market share. If appraisers as a group have in fact lost 75% market share in only 10 years, how many more years will it take before appraisers lose the remainder? Technological advancement will continue to assert some capacity to generate an instant value, accurate or not. Can licensed appraisal expertise develop a new and vital role to help tune emerging technology?

Non-Traditional Valuation Products Gain in Popularity

There are a variety of reasons why AVMs and other non-traditional products have successfully taken a large portion of market share from appraisers. These products have been able to successfully address client needs:

- Shortened turn times – AVMs and other products such as BPO's are performed more quickly than either a full appraisal or even the amount of time that an appraiser is willing to perform a drive-by appraisal. AVM's in particular have a significant speed of delivery advantage since their products are mass produced and essentially pre-manufactured prior to the transaction, and can be delivered instantly. AVM providers do an excellent job of collecting, evaluating, and reporting large amounts of real estate data in entire neighborhoods and cities.
- Low cost alternatives – Most of these newer products are priced substantially lower than the standard appraisal products, with a lower cost of production and therefore price advantage over appraisals.
- Operational Ease - AVM's can deliver products nationwide, while one appraiser may only cover a small geographic territory, making it necessary to manage a large fee panel to obtain national coverage. Lenders actually need thousands of valuations every day and would prefer to avoid personal interaction with thousands of appraisers if a trustworthy XML data pipe is available.
- Unbiased Valuations - Providers of these products accurately point out to their customers that an appraiser can be pressured and manipulated by a lender to hit numbers, while a computer model can not be manipulated to hit a desired number. Some lenders believe that more than 10% of appraisal reports are fraudulent or contain a measure of upward value pressure.

Appraisal Industry Response

Many appraisers view the lack of volume due to AVM usage as a major issue facing the appraisal industry today. Their response has primarily been to speak poorly about AVMs claiming them to be inaccurate and not appropriate for a large segment of the housing industry. However, these appraisers fail to recognize that the AVM products meet specific client needs that appraisers are unable to address – instant turn times with a value that is “good enough” for some uses. Full appraisals are overkill in many instances and the AVM can sometimes supply a better solution and, therefore, serve a useful market need.

Another major issue in the appraisal industry is lender pressure. While banking regulation and the lending industry in general are looking for solutions to this problem, it is difficult to manage appraiser independence, particularly in the world of wholesale lending. Thus, the response over the past ten years by appraisers has been to lobby (ineffectively) for legislation aimed at mortgage broker licensing and reducing lender pressure. The reality is that it is simply not possible to legislate honesty, integrity, and independence.

Appraisers as a group need to do a better job of understanding the root cause of their problems, so that they can mount an effective counter-attack in their effort to regain lost market share. The approach that the appraisal industry must take with regard to these issues must be pro-active, “new thinking”, and action based – addressing these issues up front in the process.

Root Cause of the Problems

There are several factors that work to create the problem of appraiser pressure. Individually or together they create a situation where the appraiser may be pressured to increase the value on the appraisal being done.

First and foremost is the issue of the loan agent or mortgage broker who is compensated based on the amount of the loan. It is always in his best interest to receive the highest appraisal possible. The higher the value, the higher the potential loan amount to be made, and the higher the commission.

The lending process in itself has some steps that can create the beginning of a valuation pressure situation. The “Good Faith Estimate” is a document that lenders are LEGALLY REQUIRED to provide to borrowers at first contact. The objective of the document is to disclose the estimated closing costs of a mortgage loan. Obviously this document is in the best interests of consumers and is unlikely it is going away any time soon.

In order to estimate loan closing costs, the lender must first estimate the size of the mortgage loan, and in order to do that, they must estimate the value of the real estate collateral. Since an appraisal is not yet available, borrowers and lenders often “guess” at the value. They have no choice but to “guess” because the law requires them to provide the Good Faith Estimate very promptly to the consumer.

The Good Faith Estimate must be provided at initial contact. Historically, lenders were not able to receive an accurate value estimate from an appraiser for approximately 7 to 10 days from time of order. At this point an AVM can be used to provide some guidance as to the value of the home. Either method for this initial value can be a source of problems for the appraiser – if either the borrowers guess or the AVM is incorrect.

The borrower frequently has an incorrect idea of the value of his home. When an appraiser comes in at a valuation lower than is expected, the borrower is placed in a position of having to borrow less money than he planned for. In addition, even if the valuation amount does not create a problem with regard to the borrower’s lending needs, there is now an implication that the home is worth less than the borrower expected and therefore the appraiser must be wrong. Between

homeowner ego and need for the highest possible loan amount, the appraiser will be pressured to “fix the incorrect value estimate”. The sad fact remains, that appraisers have lost the credibility and objectivity they once enjoyed as the most knowledgeable and trustworthy valuation source.

To mitigate the problems, lenders attempt to manage and control the appraiser by steering the appraiser towards the desired value estimate needed to either make the deal work, or arrive at the property value “guess” made for the purpose of estimating the closing costs.

Additionally, due to an increasingly competitive mortgage marketplace, lenders realize that consumers shop around and compare rates with other lenders, often instantly online. Upward value pressure can also be applied to simply reduce the Loan to Value ratio for more a favorable interest rate or easier lending terms. Thus, there is a compelling business need for a mortgage lender to promptly issue the Good Faith Estimate and form a business relationship with the borrower.

Therefore, there is a compelling business need for lenders to have an accurate and supportable value estimate at the beginning of the loan process. Since Appraisers as a group were not able to quickly provide an accurate or supportable value estimate up front, lenders opted to use AVMs and other alternative valuation products in order to meet their legitimate legal and business needs. That means fundamentally, that appraisers are not able to meet the legitimate needs of their lender clients.

A Solution for Appraisers

Appraisers must overcome the competitive advantages enjoyed by AVMs and other non-traditional products. In order to regain the confidence of customers and win back market share, appraisers need to return to the founding principles of their industry by improving quality and accuracy, restoring independence, and better serving the legal and business needs of their customers. Appraisers need to understand there are legitimate business needs to have an independent value estimate available immediately during the lending process.

More specifically, here are three concepts to be considered to overcome these problems:

1. Rethink the traditional valuation process – One option to consider is the “Pre-Appraising” model which involves the appraisal of a property by a licensed appraiser PRIOR to a transaction, restoring the independence of appraisers since there is no loan being made at the time the appraisal is being done. Some forms of Pre-Appraising also allow the appraiser to make their most detailed research and independent value estimate available to clients immediately when it is needed, thus meeting the client’s legitimate business need, and starting the loan process off with a correct understanding of the collateral value.
2. Employ technology in new ways - Borrow mass production and quality assurance techniques from other industries by utilizing the emerging software technology to the appraiser’s analytical advantage. In appraisal terms “Mass Production” is nothing more than an intense market research program and a controlled value measurement system for all listings and sales so that an appraiser is ready to deliver accurate research the moment a lender needs it. Databases, digital imaging and internet technologies that are today reducing the

appraiser's market share can be employed to enhance the appraisers market research and to help appraisers efficiently inspect and carefully track the value of every house in a city, rather than just one house at a time. Analyzing value trends in market groups leads to improved quality, consistency and a lower cost of production. In this way, appraisers can closely monitor changing values for every single property in a market.

3. Re-define "professionalism" - Deliver valuation reports that are higher quality, more accurate and more thorough than valuation reports delivered by AVM and non-traditional products. Appraisers need to prove once again that they have a better understanding of market conditions than real estate agents and computer algorithms.

Zaio Corporation - A Case Study

Zaio Corporation is a company that has introduced the concept of pre-appraising as a mass appraisal technique that allows the appraiser to become a local market expert. The ultimate goal is to increase an appraiser's research and market knowledge to such an extent that they can respond to a client as quickly as an AVM, without compromising the integrity and ethical standards of USPAP. The process involves photographing and physically inspecting all of the properties within a market area and developing a consistent property scoring technique that will allow every property to connect precisely with special software tools that monitor critical supply and demand trends.

The following is the process that Zaio Corporation and its affiliated appraisers are implementing to address the three concepts suggested above:

1. Re-thinking the traditional valuation process - *Pre-Appraising*

Zaio affiliated appraisers are required to inspect every home in their geographic territory at least once per year, an effort that takes about one month. Using Zaio technology the appraiser then produces a USPAP compliant appraisal for every property and posts the completed research into a database. The appraiser's copyright is acknowledged in the business model. Here are some interesting points.

- There is a difference between the "date of inspection" and the "effective date of appraisal". The appraiser discloses the past date of inspection in the report. Each time new comparable sales are evaluated, the effective date of appraisal is updated, and lenders are able to obtain "current" value estimates.
- Since property values can change over time due to changes either in market conditions or changes to individual properties, appraisers can extend the "shelf-life" of valuation products in the database by refreshing the database daily, weekly, or monthly with new sales data, and identifying changes to each property. Appraisers in the Zaio network aggressively track, monitor, and report changes in their market and to the properties in their geographic zone.
- The lender never has the chance to influence the appraised value since the "Pre-Appraisal" was completed by the licensed appraiser PRIOR to the transaction. This allows the appraiser to protect their independence, prevents lenders from pressuring an appraiser to hit a number, and also allows the appraiser to deliver accurate value estimates immediately at any time during the lending process

2. Employing technology in new ways – *Market tracking and adjustment techniques*

Using appraisal techniques that have remained largely unchanged since 1900, a typical appraiser might be able to inspect and appraise about 500 properties per year, driving to and from each property, one at a time. Zaio has developed a neighborhood focused inspection process. With the Zaio model, an appraiser can spend a week or more walking each street within the "zone" and recording observations about each property in a consistent ratings schema.

- The Zaiio model perceives that appraising one home at a time is very inefficient
- Zaiio affiliated appraisers inspect and evaluate every property and transaction in each zone using a PDA (handheld personal data assistant) loaded with photos and market data,
- Zaiio software and technology allows the appraiser to derive adjustments from his specific neighborhood “zone” and apply them to all properties where appropriate.
- The technology also allows for application of market derived changes

3. Improving quality and value accuracy

In order to address quality improvement improve quality and value accuracy, Zaiio appraisers are taking the following steps:

- Each appraiser in a national network is assigned a specific geographic area (Zone) where they serve as the exclusive local expert in that area to monitor changes in values over time. Appraisers establish a “baseline” of information by inspecting, photographing, and appraising every property in their zone.
- Zaiio has developed technology to establish a uniform property rating system known as “GeoScore” to facilitate comparisons among and between properties, sharing of information among appraisers in the network, and improved value estimate consistency.
- As a result of the site inspections, appraisers correct or complete parcel and property data that is often missing, incomplete or inaccurate. The appraisers also collect additional ratings for property or site factors that affect value. The correction of property data and enhancement of the data with additional data fields, can lead to a considerable improvement in the accuracy of value estimates.
- Appraisers then compile all their site verified data into a national database, which allows the appraiser to produce a higher quality valuation product, including charts, graphs, and trends that evaluate supply and demand, and support the adjustments in the sales grid.
- Zaiio’s business model does not seek to displace the appraiser. Rather, the appraiser and his site inspection is the “foundation” for a business plan that redefines the appraisal process. The appraiser has now expanded his focus to include more detailed research and documentation of market and value influences.

Conclusions

The problems facing the appraisal industry initially appear daunting, and as a result many small appraisal companies perhaps incorrectly conclude these problems are too complex or too difficult to overcome.

In a free-enterprise system, companies simply must adapt to changing market conditions in order to survive. Appraisers who do nothing are, in actuality, choosing to accept the status quo, and likely will additionally lose market share over the coming years to appraisers who are open to new valuation concepts and systems that utilize technology. Alternative market concepts such as the Zai plan can provide appraisers with a competitive advantage. Where appraisers once felt they could be outmoded by AVMs, it now appears that creative solutions for the appraisers can provide appraisers with a competitive advantage. Database management and advanced technology, with the help of a licensed local appraiser, can generate a collateral assessment tool that lenders can trust for both quality and turnaround time.

Customer service has become a major differentiator in today's market. The successful business model must pay attention to the essential and ever changing needs of the customer. The appraisal profession is no different than any other. Appraisers must recognize that as the lending market continues to become more competitive, lenders will have to address borrower needs. They are becoming more creative, rethinking the traditional lending models to include new loan products, employing new technology with regard to automated underwriting and valuation processes, and redefining their profession through Internet lending and centralized operations rather than traditional loan agents and storefronts. Mortgage lending is changing to meet the needs of today's borrowing public. The appraisal community must also rise to the occasion to reflect a changing business environment.