

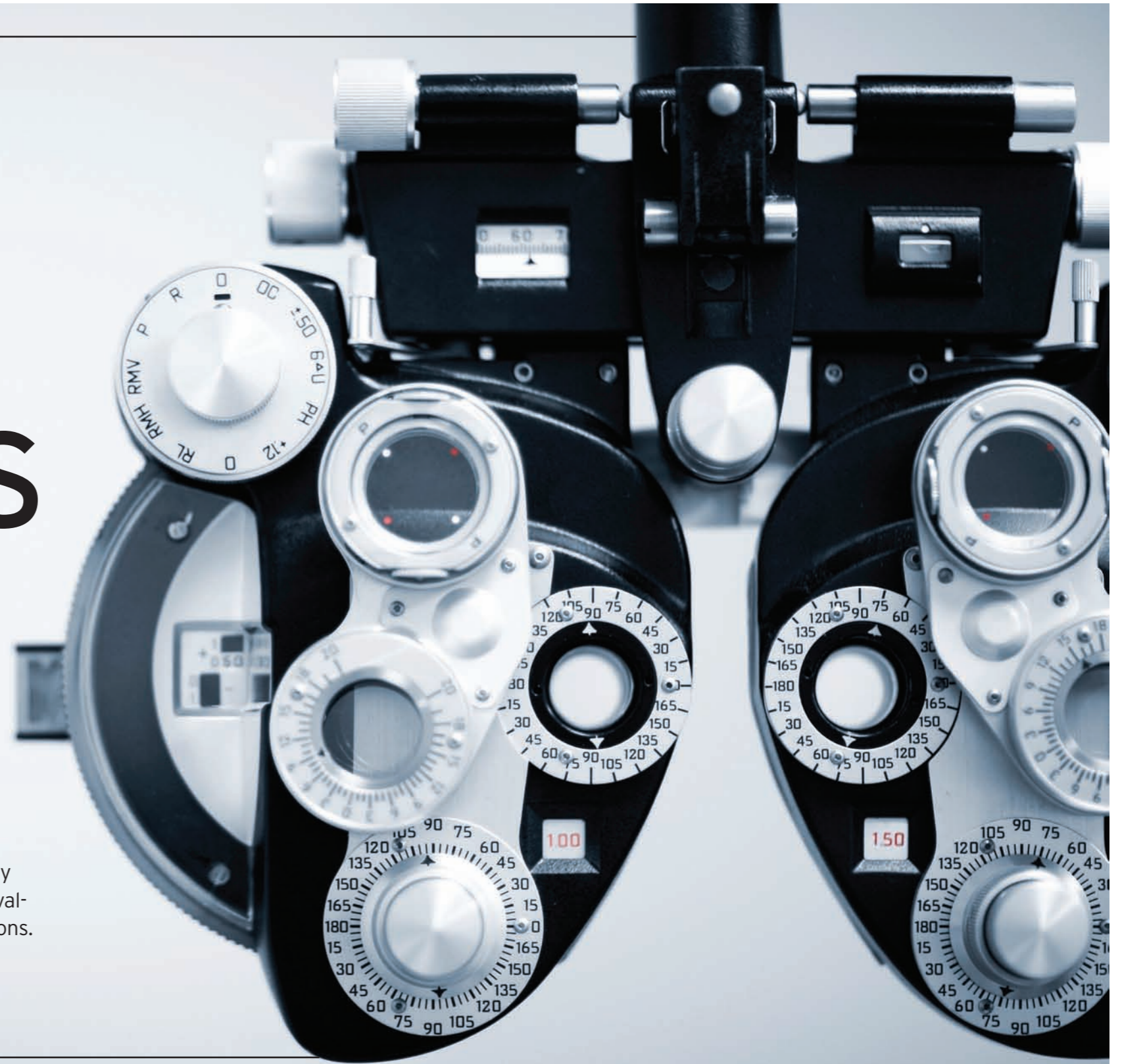
# DRIVING PRECISION INTO VALUATIONS

As the mortgage industry focuses on quality collateral value, technology is pushing accuracy to new levels.

In the happy-go-lucky years of the housing boom, determining the value of a property for a mortgage origination wasn't that big of a deal. After all, in the days of rapid price appreciation, any valuation estimate at origination was sure to be outdated and undervalued in a matter of a year or two, if not a few months in some of the hottest housing bubble markets.

Well, we all know how that worked out. Today, the mortgage industry has put a spotlight on valuations—and the demand for exact property values goes well beyond new purchase and refinance mortgage originations.

BY AUSTIN KILGORE



The secondary market investors holding mortgage-backed securities are demanding loan-level data to determine what the loans that make up their investments are really worth.

Other investors, looking to make a profit off heavily discounted “scratch and dent” pools of loans, need pinpointed values to determine how much they can recoup if they take on an inventory with more dings than a car lot after a hail storm.

Servicers, too, are relying on valuations, as they face the prospects of executing a two-pronged attack to the wave of foreclosures sweeping the United States. On one side, servicers need exact valuations as they administer widespread loss mitigation and foreclosure avoidance programs to keep delinquent and underwater borrowers in their homes. When those efforts fail, REO shops need meticulous data on distressed properties in a market where pricing houses has become more art than science.

During the boom, lenders relied heavily on esoteric collateral valuation products, typically broker price opinions, over traditional appraisals, according to Mark Linné, executive vice president for education and analytics at San Jose, Calif.-based AppraisalWorld, a provider of technology services for appraisers, appraisal management companies and lenders.

But now, financial institutions are demanding the valuation industry bring together data, technology and new methods in a paradigm shift Linné calls “Valuation 2.0,” in a position paper of the same name. Linné is the lead editor of “Visual Valuation,” a collection of papers and research the Appraisal Institute published in August, where the article appeared.

According to Linné, the appraiser industry blames technology advances, particularly automated valuation models, for a decline in their business. And while he writes that the first generation of AVMs created in the 1990s were constructed to offer stand-alone

collateral valuation solutions, it’s actually BPOs that are responsible for the lion’s share of appraisers’ revenue loss, Linné argues.

“Appraisers performing URAR/Form 1004 (single-family full appraisals) for \$400, and requiring five days to deliver, must consider how they can compete with a BPO provided in two days for \$75-\$100,” Linné wrote.

There’s been a wall between traditional appraisals and automated solutions, John Walsh said in an interview with *Mortgage Technology*. Walsh is president of San Diego-based real estate information services firm MDA DataQuick.

“Lenders have looked at one or the other, but they will begin looking to use both,” Walsh said.

“One of the issues with valuations is that lenders get a valuation on a property—whether it’s a BPO or appraisal—but they don’t believe them,” Walsh added.

DataQuick has a product called Collateral Validation, a tool that automatically vets an appraisal or BPO report. As Valuation 2.0 continues to take off, appraisers can be part of the evolution or be on the outside looking in, Linné continues. Mortgage lenders have made a flight to quality in valuations. The technology response to this new demand for precision are what’s called alternative valuation products—interactive, and often appraiser-influenced, services that combine data and analytics with the human resources to further drive accuracy.

“By embracing AVM and modeling technology, valuation professionals will be able to take advantage of their local market knowledge and reap substantial financial rewards,” he said.

As Darius Bozorgi, president and CEO of Veros, said in this issue’s *Mortgage Technology* Q&A, hybrid processes are the future of valuation services.

“It’s not going to be sufficient anymore in the future to say, ‘I took this one product and based a decision on it with blinders on and without considering any other available data,’ because everybody knows there is other data available,” Bozorgi said.

## Understanding AVMs

AVMs are computer programs that derive valuations based on a set of conditions inputted into the system.

The early AVMs created in the 1990s were one of two types. Index AVMs take the last known sale and apply an appreciation or depreciation calculation. Hedonic AVMs are based on regression techniques the valuation industry first used as early as the 1920s.

Hedonic regression breaks down building characteristics—bedrooms, bathrooms, lot size and other variables—to derive comparative valuations of properties in a specific geographic area. Hedonic AVM modelers write algorithms to build artificial intelligence that make decisions based on the property dataset.

Second-generation AVMs that came on the market at the turn of century sought to combine the hedonic and index methods into a comprehensive AVM to calculate an accurate value. In addition, new algorithms led to the creation of AVM products that take the distressed condition or REO status of a property into consideration when calculating the value.

The common thread across all AVMs is the data backbone of the technology. As third-generation AVMs come to market, the type of data and frequency that data is updated differentiates one AVM provider from another.

Walsh said his firm has 30 employees dedicated to data compilation. Combined with third-party vendors that sell data to the company and individual contractors



sent to retrieve public records on behalf of DataQuick, there are as many as 100 people working to keep the company's AVM up-to-date.

An emerging trend in AVM datasets is the use of multiple listing service prices for active houses on the market. A number of AVM providers now include MLS data, which they obtain through licensing agreements with various MLS providers.

MLSListings, a nonprofit consortium of eight Northern California Realtor associations recently launched its Realtor Valuation Model, which combines various location-specific public and historic records with licensed, current MLS data.

The RVM gets the MLS data from its member groups and adds public and historic records from Realtors Property Resource, a wholly owned subsidiary of the National Association of Realtors that provides a national database of the public and historic data.

MLSListings says the RVM's use of MLS data creates automated estimates superior to the AVM valuations that are derived solely from public records.

## Technology in Appraisal Management

Developments in valuation technology go beyond tools to help appraisers improve accuracy. The Home Valuation Code of Conduct led to the well-documented rise in lenders' use of AMCs.

But it also led to an increase in the use of appraisal management software platforms that let lenders maintain appraisal independence, while avoiding inappropriate contact between loan officers and appraisers.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ended the controversial HVCC, but new standards were recently introduced to maintain appraisal independence.

Developers of appraisal management software are readying themselves

for the new changes and say they will be a boom for their businesses.

The new regulations that Fannie Mae and Freddie Mac created with the Federal Housing Finance Agency are substantively similar to the HVCC. Before the interim rules were released in late October, executives at appraisal management software companies were making adjustments to their products.

Appraisal independence is a hot-button topic among originators and vendors. Perhaps the biggest change in the new policy is that the policy will be federal law, with penalties for



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violators. HVCC was a government-sponsored enterprise policy—the result of a settlement Fannie, Freddie and the FHFA made with the office of New York State attorney general Andrew Cuomo to avoid investigation into GSE valuation policies.

The HVCC prevents the GSEs from purchasing a mortgage if the loan officer was involved in selecting the appraiser. If there is a violation, the lender must buy back the mortgage.

The penalty for violating any provision in the new regulations is enforced by a stiff fine—\$10,000 per day until

the first offense is rectified, \$20,000 for subsequent violations.

"The lenders are going to take that as a serious penalty and if there are any violations they could run up a huge tab," said Jennifer Creech, president of Orange, Calif.-based software developer InHouse Inc., and its sister firm, InHouse Solutions, an AMC.

The challenge lenders face with both HVCC and its replacement policy is proving they are in compliance.

Software platforms that grew in prominence in response to the HVCC already have the capability to automatically create audit trails to track compliance. Software companies said changes to their platforms will be minimal—mostly nuanced enhancements of features already included in their products.

The new regulations now apply to all mortgages—not just those purchased by the GSEs. Lenders that hold loans on their books or write jumbo or other nonconforming loans will have to comply with the regulations.

The new regulations will be more strongly enforced, too. The GSE-Cuomo agreement called for the GSEs to form the Independent Valuation Protection Institute to perform oversight and enforcement of the HVCC.

That never happened. Dodd-Frank puts that responsibility on the 20-year-old Appraisal Subcommittee of the Federal Financial Institutions Examination Council, the independent agency comprised of six federal housing and finance entities that regulates state-level appraisal agencies.

When HVCC took effect, many turned to AMCs to maintain compliance. But Dodd-Frank creates additional regulations for AMCs, which software executives said will increase their costs. That makes software options a more attractive choice.

"These regulations benefit a company like Global DMS because they're seeking to regulate the AMCs and that could rise their costs," said Vladimir

Bien-Aime, president and CEO of the Lansdale, Pa.-based software developer. "Down the road, this may drive more lenders to buy technology and manage their appraisals internally."

"We've got about 99% of it already covered," he added. "The reporting issues that will be created we can respond to in days. We don't see a major issue with any of the requirements."

Another compliance issue lenders face in the new regulations is a requirement that appraisers be paid a "reasonable and customary" fee for their services.

The legislation is vague in its definition of the term, making it a point of confusion. Dodd-Frank specifies that fee surveys and other research not conducted by AMCs can be used to gauge reasonable and customary fees.

Oklahoma City-based software developer a la mode released the first edition of its Appraisal Fee Report in the first quarter of 2010. It tracks the fees independent appraisers are paid over a revolving 12-month period on its Mercury Network appraisal management platform.

The reasonable and customary rules in Dodd-Frank have made that data more appealing to the industry.

"We've had a tremendous amount of interest from lenders and AMCs who want to look into this data," said Brad Eaton, the company's chief product officer.

Spokane, Wash.-based SharperLending has lender-appraiser communication and fee-tracking logs built into its Appraisal Firewall platform. It too has datasets of appraisal fees, and president and CEO David Black said the company will react quickly to the new Dodd-Frank regulations.

"Because of the niche that we serve it's easy for us," Black said. "Our technology achieves a lot of those objectives already."

Chicago-based AMC Solidifi operates a proprietary management platform in its operations. President Griff Straw said that when an AMC pays apprais-

ers a fair rate for their work, the AMC can better ensure quality in the valuation. The new regulations will help his company's prices compete with other AMCs that have tried to pay appraisers as little as half of what they would earn working directly with a lender.

He called the new policy a "backhanded endorsement" of Solidifi's business model.

"Our customers, the lenders, believe that you have to have quality appraisals," Straw said. "It's not about the guy who's the cheapest or will drive the farthest. This is not the time, in our fragile real estate market, to be scrimping on appraisals."

When HVCC took effect in May 2009, it boosted business for AMCs, but it also opened the door for technology developers to grow. Bien-Aime



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Global DMS

of Global DMS estimated that before HVCC, 40% of mortgage lenders used outside AMCs.

But after HVCC, there was a flight to AMCs. As much as 80% of the space was using the third-party companies—a "knee-jerk reaction" to the new policy, Bien-Aime said.

That's now changing, and lender-owned AMCs aren't just limited to the big banks—though Bien-Aime believes the connotation of lender-owned AMCs being associated with larger lenders will remain.

Lenders that implement appraisal management platforms can maintain control, costs and avoid fees, which increases overall revenue. He expects 60% of lenders to bring their appraisal management in-house by using a technology platform after the new rules take effect.

It's yet another way the technology sector strives to respond to the ever-changing regulatory environment in mortgage lending. For the companies that provide a great product to help lenders navigate the waters, the changes make for good business.

"No matter which way it goes, we seem to find ways to make money," Bien-Aime said. "Whether it's with AMCs or lenders, loans are getting done and we're working on both sides of the equation."

The broad-based evaluation of the role of valuations in mortgage lending will continue to lead to higher expectations from valuation professionals and the technology they use. Like the new appraisal independence rules, another policy, the GSE Loan Quality Initiative will raise the bar for appraisers.

A key component of that initiative is a new platform to submit electronic appraisal reports to Fannie Mae and Freddie Mac. The Uniform Collateral Data Portal will use Extensible Markup Language functionality to submit appraisal data that can be mined and gleaned for statistical information.

Veros is the developer that won the contract to build the platform. As Bozorgi said in the Q&A interview, the GSE initiative is further proof that all aspects of the mortgage market have come to realize the property valuations side of the mortgage origination carries the same level of importance as the credit side.

"The key to that, so far, has proven to be loan-level data as early in the process as possible and data that's in an electronic format that's standardized and capable of being readily analyzed quickly to identify risk," he said. **MT**