

# Mortgage Banking

ONLINE LENDING

## *The Online Bandwagon*



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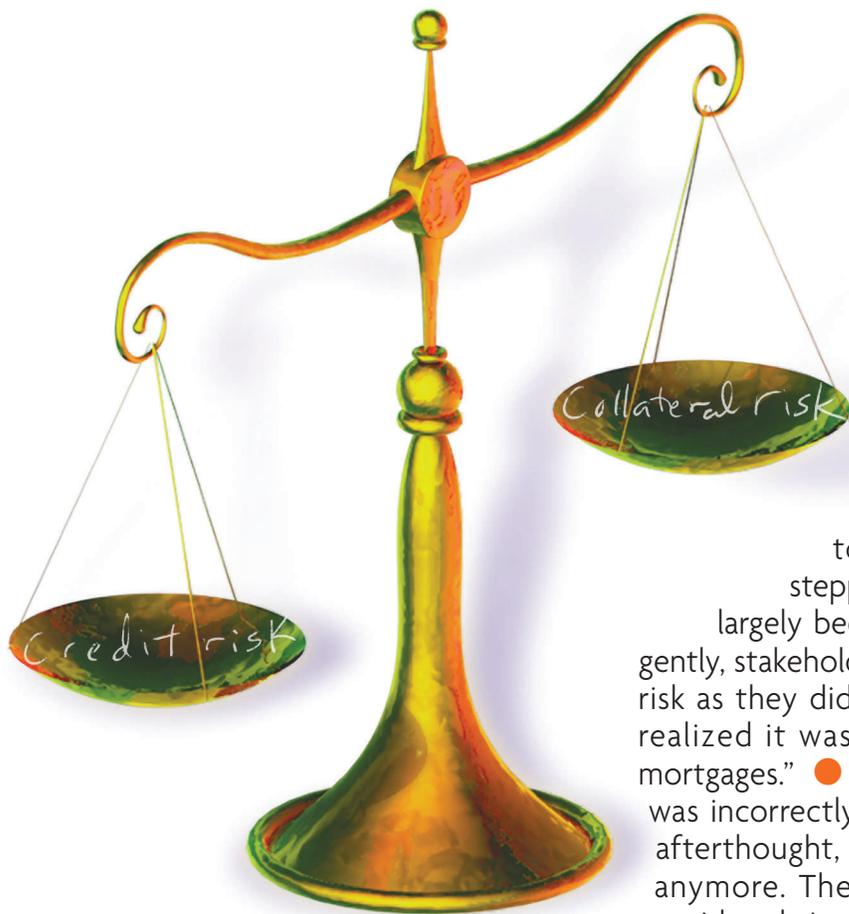
**FRANK AND KANJORSKI**

**SURVIVING SMALL—PART TWO**

# Weighing Risk

By STEVE BERGSMAN

**Veros Real Estate Solutions started in the automated valuation model (AVM) business, but now sees itself in the mortgage collateral risk-management business. Their timing couldn't be better.**



In the aftermath of the subprime meltdown and the subsequent liquidity crisis beginning in the summer of 2007, there has been a lot of post-trauma analysis laying blame hither and yon over the mortgage landscape. ● Darius Bozorgi, co-founder, president and chief executive of Santa Ana, California-based Veros Real Estate Solutions, has his own theory on the matter. He has focused on the industry's lack of attention to collateral risk. In many regards, he notes, mortgage banking had gravitated toward credit-based underwriting and side-stepped collateral valuation. ● "Collateral risk has largely been ignored," says Bozorgi. "Or, to put it more gently, stakeholders didn't put as much emphasis on collateral risk as they did on credit risk. In hindsight, the market has realized it was not the optimum way of thinking about mortgages." ● The problem has always been that collateral was incorrectly viewed as a secondary consideration or an afterthought, Bozorgi adds. ● "That's not going to work anymore. The collateral side of the equation has to be considered simultaneously with the credit side of the equation. When they are looked at together, originators and investors can make much better and more profitable decisions," he says. ● Bozorgi has a reputation for being a bit of an intellectual in the risk-analysis sector of the mortgage industry, a field that began decades ago with automated valuation model (AVM) technology. There is no doubt Veros has done its part to promote and improve what Bozorgi calls enterprise risk management. One forum that Veros has used

ILLUSTRATION BY BRYAN LEISTER

effectively to educate the industry is the annual Predictive Methods Conference (PMC), an event his company founded and has been sponsoring since 2000. In 2007, PMC attracted a record 480 attendees.

"We wanted to educate the industry; we wanted to pull back the curtain from all the black-box talk about how AVM tools work," he says about the genesis of the conference. "We came out of the gate with white papers on how to test AVMs, and taught the industry how to rip them apart. It was vital that our market and our customers understand the strengths and weaknesses of the tools."

The concept of the PMC was promotion and education. That's now important because interest from the mortgage industry is very high, says David Rasmussen, Veros' senior vice president of sales. "Verifying value and quantifying risk is so much of a concern these days that people have an active interest in getting and understanding valuation tools. When the market was going up, no one cared about accuracy, consistency or additional insights. Now, in today's market, everyone is looking for a more efficient, more accurate and risk-conscious way of doing business. High-quality automated tools fit nicely with the changing market," he says.

### Industry evolution

On a basic level, AVM technology provides an estimate of value for a property using computer modeling. Veros supports the notion that the technology supporting the collateral side of the underwriting equation lags behind the credit side by at least five to 10 years, which is why the company chose to focus so strongly on collateral risk.

AVMs are not without critics. In a July 2006 issue paper released by the Mortgage Bankers Association (MBA) on the subject of automated valuation models, AVMs were defined as "models that calculate a value for a residential real property by accessing data from commercially available databases of real estate public records." Further, AVMs are designed to provide instant property valuation, thus speeding one of the slowest steps in the origination cycle.

The MBA paper had two general criticisms of AVMs. First, it noted, many lenders believe AVMs entail greater risk of inaccuracies because the underlying data may lag changes in the market and there is no physical inspection of the property done by the appraiser.

There is, of course, some debate on this issue. "The weaknesses concerning AVMs that have been cited are actually the same weaknesses in regard to full appraisals," notes Michael Freeman, executive vice president of consumer credit risk with First Horizon National Corporation, Memphis, Tennessee.

He adds, "One of the criticisms of AVMs is that they rely so much on market data and the trends in market data, when historic trends may not indicate future trends. The appraiser does the same thing. An appraiser is not going to have access to any more information than what the AVMs use."

The second criticism, according to MBA's issue paper, is that there is little standardization in the AVM industry, and valuation results and confidence scoring from different AVMs can vary depending on the models used.

"That's the problem with the entire industry," exclaims Freeman.

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company.

"There is a lack of consistent methodologies for evaluating results. You have more robust critiques of AVMs than you have of appraisals, so everyone is running around trying to validate AVMs, but no one is running around trying to validate appraisals—and a lot of shoddy appraisal work was done over the last couple years," says Freeman.

When *Mortgage Banking* talked with Freeman, he had only been at First Horizon for four months, having spent many years with HSBC North America Holdings Inc., Charlotte, North Carolina. Freeman used Veros at HSBC on its mortgage business, and intends to bring in Veros products at First Horizon.

"Where I'm heading is to use Veros to check the loans we already originated," he says. "I can take advantage of other things in their offerings, but this is the first place I need Veros."

AVMs were originally used to augment or occasionally replace the traditional appraisal process, or perform quality control, but over time the product became more sophisticated, and some lenders began using them to perform risk analysis in secondary market and servicing acquisitions.

As Bozorgi points out, dependable AVMs were a real boon to the mortgage industry, as lenders could use these computerized models to perform quality control on large subsets of deals and find discrepancies between an appraiser's report and valuations as predicated by the AVM model. AVM tools are now employed in many facets of the mortgage business, from pre-origination marketing strategies, throughout the entire origination chain, into the secondary markets, securitization of mortgage-backed securities (MBS) and asset-backed securities (ABS) loan pools and servicing. AVMs were first successfully applied in the origination of second liens but have more recently been applied to first liens, but to a much lesser degree.

### Veros evolution

Eventually, the risk-evaluation tools became more complicated, and companies such as Veros expanded offerings to include not only automated valuations but fraud and risk detection, portfolio analysis, forecasting and next-generation risk-management platforms.

Today, Veros is far from an AVM-only company. With direction from its customers and partners, Veros now offers products and solutions such as:

- *Collateral scoring and fraud analysis.* Analyzes, detects and identifies high-risk properties and market-area transactions for scoring, routing and review.

- *Valuation forecasting.* Provides valuation forecasting up to 18 months into the future on a metropolitan statistical area (MSA), county and ZIP-code level across property types and price tiers.

- *Risk-based approach to valuation.* Identifies and quantifies valuation risk specific to a residential lending transaction.

- *Collateral risk management.* Advanced enterprise risk-management platform to administer, process and audit the full spectrum of collateral risk products and policies, including AVM cascades, broker price opinions (BPOs) and appraisal products.

- *Automated valuation review.* Fully automated management of entire order and workflow process surrounding the review of valuation products and services.

● *Risk-based default management.* Increased performance and efficiencies in default management through more proactive identification and analysis of at-risk loans and more accurate determinations of optimal course of action.

● *Hybrid products.* These solutions bridge the gap between fully automated tools and traditional valuation products, and include AVM-assisted appraisals, AVMs plus digital photos, and inspection reports on subject property delivered at the time of an AVM order.

Loan origination work originally dominated the AVM space, but lenders are now finding they need comprehensive collateral risk solutions. “We are looking for clients that can use AVMs all the way from origination through the entire scope of collateral risk management,” says Sue Potteiger, Veros’ vice president of business development.

Often lenders start with one Veros product and then expand on that with different offerings.

Although the name First National Bank of Arizona (FNBA) might suggest a more local financial institution, the Scottsdale, Arizona-based firm boasts retail mortgage operations in Arizona, California, New Mexico and Nevada, and until recently it had wholesale and correspondent loan channels nationwide.

“I use Veros quite a bit on the back end for loss mitigation,” says Renea Aderhold, FNBA’s senior vice president of risk management. “Anything we bring back in-house, whether it is a performing loan or not, we utilize it. We originally started with the AVM product on the back end with quality control—we always test the products we are going to use on the front end [by first trying them] on the back end.”

Now, Aderhold uses VeroPHOTO for back-end loss-mitigation efforts and repurchase requests. “They actually contract with someone who will go take a picture of a property within 28 hours of request. It’s especially helpful because, although we are located in Arizona, we have operations throughout the country, and it’s not often we go to places like Ohio,” she says.

Smart companies find advantages during periods of adversity, observes Dean Blake, Veros’ vice president of corporate strategy. “Companies that we are talking to are saying, ‘How do I leverage this mortgage environment to my advantage?’ ‘How do I find ways to originate loans efficiently?’ The next step is to take current technology beyond AVM and into risk management. There are some very strong tools for default management or [for] getting a better idea of collateral and forecasting.”

## Platforms

Think of it this way, says Brooks Ballentine, Veros’ senior vice president of real estate solutions: The company first developed in the AVM space, then began doing variations on AVM, including indexing models and early forecasting, but in the last few years Veros veered firmly into risk management.

As an example, the company offers robust enterprise decision-management platforms, so investors or lenders can more effectively control the underwriting and servicing. Ballentine says, “We can make sure the numbers are correct and then add value to that by returning to our clients such metrics as to where the market is going, where it

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has been and what the risk factors [are].”

For example, one of the Veros’ enterprise decision-management platforms is called VeroSELECT, which is used by lenders and investors to manage collateral policies. In a sense, the platform gives lenders control of collateral risk strategies with the secure selection, acceptance and management of services, vendors, users and the corporate proprietary business processes. It provides access to a full range of collateral risk solutions, including AVM products, broker price opinions, appraisal solutions, collateral fraud tools and prequalification solutions.

In April, Minneapolis-based GMAC-RFC announced it expanded the use of its own Propertywise<sup>SM</sup> AVM model, which runs on VeroSELECT. According to Susan Allen, director of collateral risk for GMAC-RFC, her com-

pany implemented new policies for the acceptance of AVMs and now requires that loans sold to GMAC-RFC on select waived appraisal programs conform to Propertywise specifications.

At the time of the announcement, Allen reported, “GMAC-RFC is looking to expand use of AVM-backed loan programs. In order to do so, GMAC-RFC has opted to use its automated controls for the acceptance of AVMs. As a result, we’re able to waive certain value warranties made by lenders selling loans to our company when they have provided us with a Propertywise AVM certificate.”

GMAC-RFC has been working with Veros since Veros was launched in the mortgage space, and then expanded the relationship significantly in 2004 and 2007, says Allen. “We began working with Veros based on the accuracy of their models. Over time, we were able to observe the consistency of Veros’ analytical approach and its focus on innovation. Veros understands our business and delivers quality solutions,” she says.

Sitting in place between AVM companies such as Veros and an end user like GMAC-RFC are independent model and valuation-testing companies, one of which is Simi Valley, California-based AVMetrics LLC, founded two years ago by Lee Kennedy, who is also its president and chief executive officer.

Kennedy estimates there are 11 major AVM companies in the market today, with most being part of either a government-sponsored enterprise (GSE) such as Fannie Mae and Freddie Mac, or larger firms such as Fiserv Inc., Brookfield, Wisconsin; TransUnion LLC, Chicago; or Fidelity National Information Services Inc., Jacksonville, Florida. There are just a couple of small independents like Veros, he says.

“There are enough AVMs in the market and enough performance differential between the AVMs that just from [a perspective of] business optimization, the user of AVMs really wants to know which AVMs perform best and at what price-tier levels,” says Kennedy.

“All origination products are going to come under more scrutiny to see what role they may have played in the overvaluation of properties,” says Kennedy. “The AVM end of the business will come out fairly clean on that. There is going to be a backlash against traditional appraisal processes because of inherent biases as this meltdown continues forward. This will probably mean more volume for AVMs because of its unbiased nature,” he adds.

As for Veros, Kennedy notes, “Veros is always pushing the envelope on product development and R&D [research and development].”

It has a very strong list of tools built around valuation modeling. It also has a very strong platform for integration and the use of those tools.”

### Forecasting

In 2003, Veros unveiled a product called VeroFORECAST that, as its name implies, is a forecasting tool. Bozorgi is quick to claim his company is the industry leader in predictive technology, and with VeroFORECAST he may have found the right vehicle to make that claim come to life.

At the time the product was introduced, Veros, using VeroFORECAST, predicted the top-10 hottest and coldest markets for home-price appreciation in the United States. Year over year, on average, says Bozorgi, VeroFORECAST has had an almost 70 percent correlation between predictions and actual results (calculated using  $r$ -squared).

In 2007, the company announced an enhanced version of VeroFORECAST that, according to the company, could predict future value according to property type, and at the core-based statistical area (CBSA), county and ZIP-code levels.

What should residents expect in the near future from some formerly hot markets? Without even rubbing a crystal ball, Eric Fox, Veros' vice president of technology, rattled off the prospects for two prior boom markets in the West—Phoenix and Orange County, California. The first should expect minus-5 percent growth for the next 12 months, he says. As for the Los Angeles suburb, Fox says to expect similar prospects of minus-4 percent to minus-5 percent growth, depending on property type.

How much reliance should the market place on VeroFORECAST numbers? “There have been companies in the past that have tried forecasting without too much success,” says Fox. “Veros is different, because our forecasting accuracy is better. We have been doing this for four years; we have compared our performance with that of our competitors, and our accuracy in general is much better,” Fox maintains.

Granting the market “could” trust VeroFORECAST numbers, the question then becomes whether the market is in need of such a product.

“We are over the threshold,” Fox responds. “We do have a critical mass [of customers for the product], and that happened last year. Declining markets really woke a lot of people up. Now mortgage companies are asking the question, ‘If I loan on this property and I know my loan-to-value [LTV] is 80 percent, what risk do I carry [and] what can I expect my LTV to be 12 to 18 months from now?’”

In today's market, lenders are keen to know the future value of their collateral, Bozorgi adds, “and we believe there is no more accurate forecasting tool available in the industry.”

### Defying the odds

Bozorgi has been on the board of directors of the Real Estate Information Professionals Association (REIPA), Morrisville, North Carolina, and has been chairman of REIPA's Collateral Assessment & Technologies Committee, representing most of the nation's leading collateral assessment technology companies.

In March 2007, the October Research Corporation, a Richfield, Ohio-based company that provides market and regulatory information to the real estate and mortgage markets, named Bozorgi one of its “Top 40 Under 40” award winners in a program established to honor talented professionals in the title, appraisal and closing industries.

Bozorgi, who was 38 years old when the selection was announced,

could take odd pleasure in the announcement, considering the fact that before he became a Southern California technologist, he was an attorney who practiced civil litigation in Chicago. It was his uncle, Bijan Bozorgi, also co-founder and chief financial officer of Veros, who brought him to California and introduced him to the engineers and technology geeks who would create the software for Veros. “I came out to California, met with the people my uncle knew and got hooked,” Bozorgi says. “We both got totally hooked.”

The younger Bozorgi became attracted to the mortgage market because, as he says, “There was a void in the application of technologies to the collateral risk side of the business.” He adds, “We thought the AVM was a wonderful application for our technology.”

There was already a number of AVMs on the market, but the penetration and success of the early AVM firms was spotty—at best—even by 2001. Part of the problem, Bozorgi recalls, was that the first AVMs were, and many still are, single-method products. In addition, the AVMs initially were promoted “bottom-up”—more or less at the tail end of the mortgage process—to the appraisers. But appraisers felt then, and to some extent still do, that AVMs were competition.

Bozorgi decided to market Veros' products, top down, to the true end users—the lenders. Its first AVM product was introduced in 2002, and its first client was First U.S. Community Credit Union, San Diego. However, the client that put Veros over the top the very next year was Washington Mutual Inc., Seattle, which through a request-for-proposal (RFP) process liked what it saw in the Veros technology.

Bozorgi can only speculate why his company was successful early on. “We came out in the middle of the largest, unprecedented real estate boom in history, and lenders were just killing themselves trying to figure out how to deal with loans coming through the door,” he says.

Nevertheless, even today Bozorgi shakes his head in disbelief about his company's situation. “On paper, Veros should not exist, because we compete against some extremely large companies—many of which are Fortune 500. And we compete successfully. Much of the success definitely can be attributed to our partners. We work very closely with our customers at creating mutually beneficial and long-term relationships,” he says.

The company intends to export its predictive technology expertise to some non-mortgage sectors in the financial world, including institutional investors, mutual fund companies, fund of fund managers and hedge funds. Some of these non-mortgage tools have just begun to be rolled out by Veros.

With new products, expansion will come from other financial sectors and an increased use of risk-management tools by surviving mortgage lenders, says Bozorgi, who expects Veros to weather the mortgage meltdown quite well. In fact, he predicts Veros will expand over the next two years. “At minimum, we should at least double,” he says. “If we didn't do that, I would be very disappointed.”

Growth, he adds, will not compromise profitability.

Bozorgi believes the best way for his firm to reach its corporate goals is to remain a private company.

Except during the startup period, Veros has always been profitable, he adds. “Even in today's market, when companies are posting losses and going out business, we have been fortunate to have diversified enough that we can continue our success,” he says. **MBT**

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