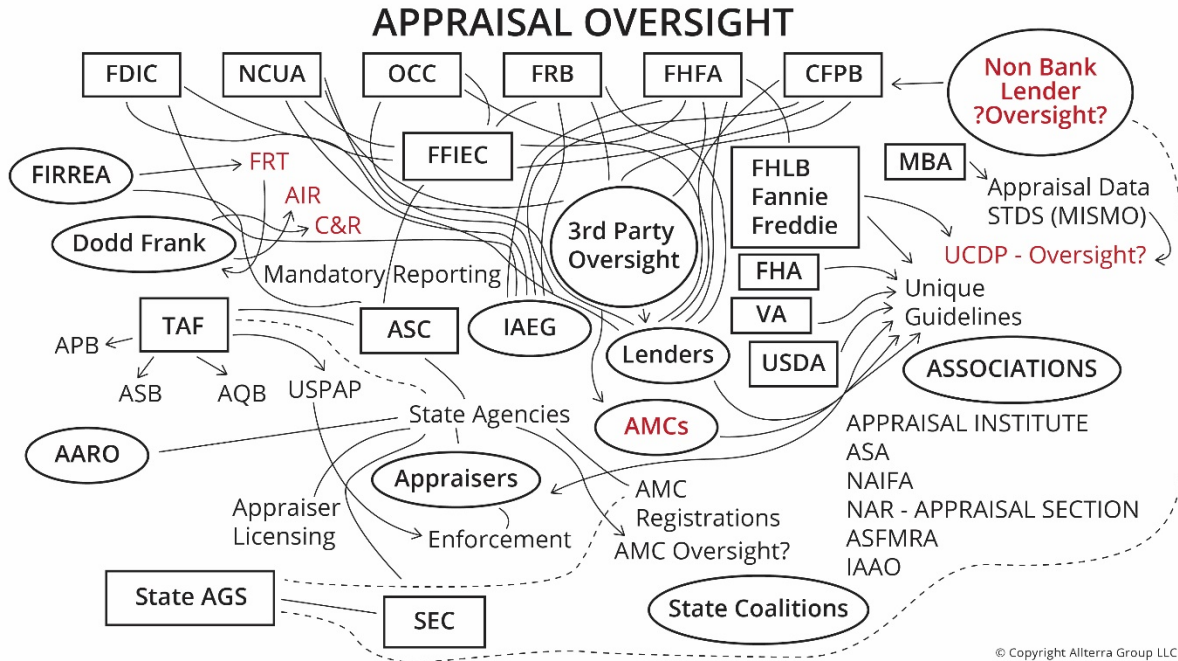


Modernizing Appraisals: A Regulatory Review and the Future of the Industry  
 Testimony of Joan N. Trice, SRA  
 Before the Subcommittee on Housing and Insurance  
 November 16, 2016

Chairman Luetkemeyer, ranking member Capuano and members of the Subcommittee on Housing and Insurance, thank you for the opportunity to share my thoughts regarding “Modernizing Appraisals: A Regulatory Review and the Future of the Industry”.



Today, all stakeholders suffer from an appraisal regulatory regime that is outmoded. The housing finance crisis shed a bright light on the systemic failures of the appraisal process. The structural flaws of the regulatory schema reveal a system whereby no one was held accountable. This illustration of the current regulatory structure says it all.

It should be no surprise that given the above diagram, that the appraisal industry is being highly scrutinized. It is entirely dysfunctional. It is time for a “big and bold” plan to overhaul the system.

The appraisal profession needs a single authority to take ownership of the policy, process, practice, and procedures and the people. National licensing is needed with oversight at the state level. States must adopt a standardized process for investigation and adjudication of any disciplinary actions. Peer review and rehabilitation of the appraiser should occur at the state level.

This new entity should not carry forward any of the legacy agencies that exist today. The times calls for a fresh, holistic solution to replace the disjointed, ineffective structure that currently exists. Repeal FIRREA and replace it with this new independent agency.

Independence is the cornerstone of the appraisal process. HVCC and subsequently the AIR (appraisal independence requirements) components of Dodd Frank left an indelible mark on the appraisal profession. For the past 9 years practically every stakeholder has done their best to avoid compliance with AIR.

Appraisal is truly the weak link and our current policies and systems continue to diminish the important role that appraisers play in the housing finance ecosystem. Discussions of shortages, poor quality, cost, delayed delivery of appraisals, and the de minimus threshold are all code for efforts to further diminish the role of the appraisal process.

The events of the presidential election offer a cautionary tale. Big data failed. Models failed. Bias and lack of independence by the analysts failed. Fannie Mae and Freddie Mac would have you believe they hold all of the marbles. Once again they are competing with each other by reducing appraisal requirements. This is a race to the bottom. We've seen this movie before and we know how it ends. Do not think for a minute that you can replace appraisers with push button technology. Appraising is part art and part science. Create a system, whereby well trained, ethical appraisers have access to reliable data and afford them the independence to play their important role.

If Congress is truly serious about the safety and soundness of the housing finance system, then there is only one clear path for the appraisal process to thrive—establish a single authority over real estate appraisal.

The white paper entitled “Reengineering the Appraisal Process, Revisited” explores in greater detail solutions to bolster the appraisal profession. Thank you for the opportunity to share with you my thoughts on this important topic.

# Reengineering the Appraisal Process

July 4, 2016

Joan N. Trice

## Introduction

One of the leading causes of the largest housing finance crisis in history was the failure of the appraisal process to produce credible appraisal reports and to identify risks. We are fast approaching the ninth year anniversary of Fannie Mae and Freddie Mac being placed into conservatorship. The Government Sponsored Enterprises (GSEs), for the most part, were the custodians of the appraisal process.

An indelible moment in the history of the appraisal profession was the imposition of the Home Valuation Code of Conduct (HVCC) upon the Government Sponsored Enterprises (GSEs) and their then regulator, Office of Federal Housing Oversight (OFHEO) by the New York Attorney General's (NYAG) office.

The signing of this agreement in 2008 was essentially an admission that appraisal independence had been violated. The GSEs reliance upon "reps and warrants" for appraisals from their servicer sellers was revealed to be a major vulnerability. There was "trust" without the all-important second phase of "verify".

It was generally not known that Fannie Mae and Freddie Mac did not receive appraisal files with the loan origination files. The GSEs securitized trillions of dollars of loans, collateralized loans based upon, in part the valuation, without any verification of a single data point from the appraisal. This is how Uniform Collateral Data Portal (UCDP) was borne. The NYAG and Fannie Mae and Freddie Mac's regulator agreed to launch an appraisal repository to begin the process of monitoring appraisal quality to satisfy the demands for adherence to appraisal independence.

Appraisals are an integral part of the housing finance system. Some of the challenges in the appraisal process have been improved with components of Dodd Frank and new guidance from the Federal Financial Institutions Examination Council (FFIEC) agencies. The regulatory schema is complicated and the oversight is lacking or uneven at best. Order out of chaos could be established with the transition to a single valuation regulator with a clear set of rules and standards.

The appraisal process needs to be structurally reorganized within a single authority. This new regulator, The Collateral Risk Foundation would establish a Collateral Valuation Advisory Committee comprised of multiple housing stakeholders and a Valuation Board comprised of regional chief appraisers to better serve dynamic markets.

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## Failures of the Appraisal Process

The problems that plague the appraisal profession are many and complex. It is time to modernize and rethink the practices, policies and procedures for appraisals. Many of the failures of the current the system emanate from a regulatory schema that is complicated and ineffective. Data and technology infrastructure is woefully lacking. We also failed to provide oversight of the people-part of the process to remove bad actors from the system.

### Date & Technology

Given that residential real estate is the largest asset class in the world, it is astounding that so little information is available on the very “sticks and bricks” that are the underlying collateral for a mortgage loan. There is no inventory of U.S. real estate; no national database. And because of that lack of aggregated data and transparency there remains little confidence demonstrated by private secondary market participants to invest in mortgage backed securities.

Even today, loan applications collect loads of information on the borrower but nothing beyond a postal address on the property. Appraisers are sent appraisal requests for a single family loan that may, for example, be multiple homes on a single deeded 10 acre lot, one well and septic with a commercial auto body garage. No one on the front end qualified the property. This makes TILA- RESPA Integrated Disclosure (TRID) difficult to comply with and places blame on the appraiser for delays and/or for the delivery of a report that will never be pristine. It is the property, not the appraiser, at fault in this scenario.

In Spain for example, the borrower submits physical characteristics including square footage, any recent additions, permits, improvements and receipts of the property and recent photographs. The information is transmitted to several appraisers who bid on the property. The client weighs the experience, fee and delivery and places the order. It is worthy to note that in Spain the educational requirement for appraisers is that of an engineer, a six year degree. And they are compensated at an equivalent of approximately \$800 per assignment.

### Structural Defects

The Appraisal Subcommittee (ASC) was established according to Financial Institutions Reform and Recovery Act (FIRREA) Title XI in 1989. The ASC provides for the federal oversight of state appraisal agencies. These state agencies are responsible for licensing of appraisers and oversight. On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and

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Consumer Protection Act of 2010 (Dodd-Frank Act) that includes amendments to Title XI. Dodd Frank added new responsibilities to state agencies that included the registration and oversight of Appraisal Management Companies (AMCs).

Appraisal Management Companies (AMCs) proliferated post HVCC when it was assumed that the use of an AMC created a firewall between loan production and the appraiser. Unfortunately it would appear that some banks as well as non-bank lenders established their own AMCs to control the appraisal process and thwart appraisal independence. The oversight of AMCs is now a responsibility of the state appraisal agencies that are ill equipped to handle such a tremendous responsibility. We have merely offloaded the risk now to third party entities under the watch of agencies who have little funding or skills to do so. The numbers of illegitimate businesses that have been established to pervert the system is an unquantifiable risk event in the making. Appraisal independence problems have not been eliminated, they have just been redirected.

From the vendor side of the equation legitimate AMCs are systematically punished by a system where they will be required to register in each state through a different system and process, each with a new set of fees, renewal dates and unique state laws. This is an untenable system where the bad actors can flourish and honest, competent private enterprises get punished. The unintended consequences of this system have yet to be fully played out. As of this date 38 states have AMC registrations in place.

The Appraisal Subcommittee (ASC) is an independent agency that is a subcommittee of the Federal Financial Institutions Examination Council (FFIEC). This has created an inverted pyramid. The ASC reports to the FFIEC whereas ideally an appraisal agency should be independent of the bank regulators and should be promulgating a set of standards and rules by which banks and non-bank lenders should comply.

Modern housing finance is a national activity, not a local one, yet we have a regulatory schema that appears to be neither effective nor scalable. Licenses should be issued at a national level, with local oversight. This oversight needs to be evenly applied. Many lessons can be learned by a review of other systems that do work. In Germany, for example, what is equivalent to state boards monitor the work product of each licensee and offer guidance and mentorship programs to elevate the quality of appraisals. If a licensee fails to improve through these mentorship programs and education they are removed from the system.

Fannie Mae and, to a lesser degree, Freddie Mac bear some responsibility for the breakdown of the appraisal process. The appraisal process is essentially owned by the GSEs. In a void with no central authority Fannie Mae became the de facto standard bearer for the valuation profession. Regardless of the ultimate

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## Reengineering the Appraisal Process

future of the GSEs, the appraisal process should be established in an independent entity.

### Process, Practice, Policy

There are two fundamental reasons for the breakdown in the appraisal process. First, the definition of “market value” is highly flawed. A lot of blame has been placed upon appraisers for failing to report credible values during the crisis. Appraisers have simply been asked to produce an estimate of “market value” as currently defined. The second issue is the reporting format itself. The current residential appraisal report forms, dictated by Fannie Mae and Freddie Mac, are archaic in every sense of the word.

### **Definition of Market Value**

The debate over the challenges created by the definition of market value has been increasing but only in the subtext. This definition was promulgated in 1989 in FIRREA. The definition prior to the Savings & Loan Crisis included language that used “highest probable price” rather than “most probable”.

*Market value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:*

- *buyer and seller are typically motivated;*
- *both parties are well informed or well advised, and each acting in what he or she considers his/her own best interest;*
- *a reasonable time is allowed for exposure in the open market;*
- *payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
- *the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*

Other countries have successfully implemented the concept of a sustainable lending value as opposed to market value. Values can be subject to wild fluctuations creating havoc in the mortgage lending environment as we have just experienced. The precept of a “mortgage lending value” decreases the impact on short-term volatility by focusing on sustainable values for the life of the mortgage loan.

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## Collateral Risk Foundation

The use of the term “price” within the definition “value” is an underlying problem. These two terms are not interchangeable. Mortgage lending should be based on value, not price. The perfect example is during the years preceding the mortgage meltdown, house prices in Las Vegas were inflating at a rapid rate. The role of the appraiser was to report three recent sales on a grid. That was easy. No fraud was involved for an appraiser to include three recent settled sales. Nowhere within the reporting format controlled by the GSEs, was the appraiser asked to identify any risks associated with such outrageous trends. It was fairly obvious that these trends were not sustainable.

Had a definition of a “mortgage lending value” been the promulgated definition, perhaps the bubble would have at least been moderated. Another safeguard would have been the application of the three approaches to value. Fannie Mae dropped the requirement for the appraiser to develop the cost approach in 2005. A redesign of the reporting format to include access to and analysis of broader market metrics would be a first step towards a more credible appraisal report.

## Solutions

There is not a singular challenge nor is there a monolithic solution to a reengineering of the appraisal process. The modern appraisal theory and practice was born out of the 1930s. Major catastrophic events seem to be the only influencer to the appraisal system. It has taken decades to grow and emerge as a fundamental and necessary component of the housing finance system yet it has taken less than a decade for Fannie Mae and Freddie Mac to systematically diminish and unravel the fundamentals of the appraisal process.

The current regulatory structure is complicated, and unresponsive. If the role of the appraisal community is to act as the “brakemen” to an overheated market the multiple regulatory entities today have not and cannot function in this manner.

The Collateral Risk Foundation's primary activities would be to:

- 1) create appraisal reporting formats
- 2) institute policy around the appraisal process
- 3) establish a data repository to warehouse all valuation reports
- 4) explore the science of collateral risk

## Structure

The Collateral Risk Foundation would establish a Board of Directors, from the various stakeholder groups, to govern the operations of the entity and provide oversight and control. The Collateral Risk Foundation could be an arm of a cabinet level agency of Real Estate Department (RED). RED could be the

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## Reengineering the Appraisal Process

agency that establishes the data standards and protocols for a national registry of all real estate with a unique geocoded identifier. This would establish the foundation for the “real estate super highway” that must be built.

The Collateral Risk Foundation could emulate the Federal Reserve with a board of regional chief appraisers, the Valuation Board. This would accommodate reporting at a regional and local level for real estate market risk indicators. Having measurable information in real time would allow lenders to offer products and services to consumers that are risk based.

The Collateral Risk Foundation could also support a Collateral Valuation Advisory Board comprised of the many stakeholders within housing finance to include the National Association of Home Builders, National Association of Realtors, Mortgage Bankers Association, American Bankers Association, the Appraisal Institute, US Mortgage Insurers, and capital markets participants and so on.

## Repository

The mission of creating a database of all appraisals would be to monitor risk and contribute to a broader housing finance ecosystem that ensures safety and soundness. By establishing data standards, improving the data collection and reporting by appraisers, and making available transactional level information, all stakeholders, including consumers, would benefit.

In addition to creating a repository for all appraisals, a credentials registry of appraisers should also be included. All actors in the transaction should be registered to monitor behaviors between appraisers, lenders, AMCs and so on. Access to these patterns of behavior helps to identify fraud and vulnerabilities to appraisal independence. Implicit in this credentials registry would be integration of an AMC Registry. All credentials would be validated at time of registry of a transaction. Such a system does exist at Clearbox. Clearbox is a credentials database of all licensed appraisers and all known AMCs. Each has been assigned a unique identifier.

A chain of title for all appraisals would be logged. If a loan is sold, access would be granted based upon permissions established by the seller. Much of the fraud and misadventures committed in the past had been based upon lack of transparency. Appraisal independence was grossly abused whereby lenders would order multiple appraisals until they could obtain one at a high enough number to satisfy the loan requirements. Mortgage Backed Securities (MBS) were essentially dark pools. Millions of dollars of loans within a portfolio were sold with little access to any data from the appraisal. This still transpires today including securities sold by the GSEs.

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The Repository would prevent these unsafe lending practices in the future. All stakeholders would have access to better information on the front end of a transaction. They would also be able to monitor markets in real time. The Repository would help restore confidence in the underlying valuations on loan portfolios and individual loans, and in the process help restore the public confidence in the financial services marketplace.

An examination of the European system reveals some interesting facts. Germany has experienced the lowest default rate of any country. In Europe there are a number of triggers for a new appraisal. While the Europeans have very different real estate markets, there are lessons to be learned. Any event triggers a new valuation. An event is considered:

- A non-performing loan
- Establishment of a REIT
- Purchase
- Refinance
- Portfolio transactions
- Syndications
- Taxation
- Securitization

### New Appraisal Forms

In order to have access to better data to be able to make better collateral risk decisions it would be necessary to deconstruct and rebuild the appraisal forms currently owned and controlled by Fannie Mae and Freddie Mac. The VA and FHA also adhere to the use of the GSE standard forms with a few addendums of their own.

The current forms do not address many of the data elements necessary for lenders, investors, insurers and rating agencies to perform adequate analysis of the underlying valuation and risk. There are also superfluous data points that need to be jettisoned. For example, it is doubtful that the identification of window type, such as double hung, is a meaningful data element for anyone. There are property characteristics however that are not collected that impact property risk. For example, the age of the roof, the age of the furnace, replacement windows, and other energy efficient items are not adequately addressed. In today's lending environment we place the highest risk borrowers in the highest risk properties. If we addressed this systemic problem we can create meaningful solutions. One might be to calculate a "reserves for replacement" adjustment to offset a potentially catastrophic repair.

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## Reengineering the Appraisal Process

A lot of the problems with the appraisal process begin with the form. It is the form that drives the process. One of the goals of the Collateral Risk Foundation would be to establish the business requirements of the new reporting format. The technical solutions would be developed by independent software companies to design field data collection applications, a smart form, regression tools, risk tools and modular reporting formats.

## Science of Collateral Risk

Collateral Risk is a term hardly mentioned in a post mortem analysis of the demise of the housing finance system. That could possibly be explained away by a lack of understanding and access to data. After all, we rely heavily on credit scores on the credit risk side of the equation.

Once the Repository of appraisals is established the possibilities for research and the development for collateral risk tools are endless. There would be the opportunities to harvest new construction costs, land costs, rental information, inventories, property characteristics and so on. From this information would come the ability to analyze trends and develop leading indicators, risk flags and collateral risk scores.

Rational policies and practices could be established based upon what is gleaned from big data. If it can be proven from the data that certain property types yield lower risk of default, new products could be developed and policy written to better assist the underserved markets.

The burgeoning science of Behavioral Economics tells us that consumers don't always behave rationally. We want to build a system that results in regulators writing rational policy and lenders making rational loan decisions. If a homeowner wants to pay a price for a home, regardless of the value, that should be their prerogative. But we should not allow a system to promote the inflation of appraised values at the expense of the health of the overall economy. Inflating values while simultaneously increasing Loan-to-Value ratios is a recipe for disaster. It produces a negative compounding effect of misaligned incentives.

## Conclusion

If the housing finance system is to move forward progressively and safely, solutions to the valuation component need to be put forth. In fact, while Congress prolongs the debate on the future of the GSEs it becomes increasingly apparent that a single regulator and authority over all things valuation is essential.

History is certain to repeat itself if we fail to recognize mistakes committed during the largest financial collapse ever. The failure of global economies was a fire

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sparked by the housing market meltdown. The housing crisis was caused, in part but certainly not wholly, by a collateral valuation process that was corrupted by:

- a lack of transparency
- lack of independence
- the systematic marginalization and dismantling of the appraisal process
- and weak oversight

In conclusion the Collateral Risk Foundation should be established to be that entity to be the independent, custodian of the appraisal process. A holistic solution serving all stakeholders would set us on the right path for returning confidence in the markets for consumers as well as investors.

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