

# Foreclosures and the Appraisal Industry

**Moderator:** *Welcome to the Federal Reserve Bank of Atlanta's Foreclosure Response podcast series. I'm Odetta MacLeish-White with the Federal Reserve Bank of Atlanta. Today we're talking with K.C. Conway, subject matter expert with the Federal Reserve Bank of Atlanta and member of the Appraisal Institute.*

*Appraisals play a critical role in the sale of any home by establishing the value of the property in comparison with other, similar properties. An appraisal takes into account not only the physical condition of a property, but also its location in the immediate neighborhood and in the larger commercial and residential region, as well as its proximity to amenities, services, and educational institutions. An appraisal provides the basis for determining how much equity a property has accrued over time, an important consideration when it comes time to refinance or sell.*

*We have seen one impact of appraisals in the recent foreclosure crisis as some homeowners have found their properties appraising for less than their original purchase price. Unable to refinance or sell the home for a profit, these "upside down" mortgages have forced some families to stay in homes they struggle to afford. K.C., thank you for joining me today.*

**K.C. Conway:** Thank you, Odetta.

**Moderator:** *So, K.C., why are appraisals getting so much attention right now?*

**Conway:** The challenge for many folks today is, they purchased homes over the last two, three, four years and now they find themselves in the awkward predicament that the homes aren't worth what they were worth, and they have to refinance a mortgage, and now the value is an impediment to refinancing.

We've also seen the dramatic rise in the foreclosures, and the foreclosures have compounded the further decline in home prices. So getting value right is important to homeowners right now to refinance, and they're also important in terms of the stability of our banking system.

**Moderator:** *Didn't the passage of the Financial Institution Reform and Recovery Act [FIRREA] after the 1991 savings and loan crisis fix the problems with appraisals?*

**Conway:** Yes and no. We knew that we had an industry of appraisers who were not regulated, and so we did a fairly good job with that into the FIRREA Act, and that was mandated down to each of the states to implement state licensing at their own level. We forget that market conditions change and evolve. We had the advent of securitization and many of these nontraditional mortgage products that greatly impact value and appraisals. For example, in 2005, when homes were in short supply, the prices seemed to just keep going up and up every year. In Las Vegas they went up three times before the house was even built. And then when the market started to slow down, builders would put things like maybe a car in the garage to help you buy the house. Should the value of that car maybe have been deducted and separated from the value of the house? Absolutely. But there were things that were evolving and changing since we passed FIRREA that probably didn't keep pace with what was happening in the innovation of mortgages and financial products and things that could impact value. And so we need to go back and probably revisit and refresh all of that.

**Moderator:** *K.C., you've mentioned a few times the importance of independence between appraisers and perhaps lenders and mortgage brokers. Could you explain what you mean by independence and why it's so important?*

**Conway:** Absolutely. One of the consequences of the FIRREA legislation was we changed how appraisals were ordered. Instead of the borrower ordering the appraisal and taking it to the bank to get a loan, we thought it might be better for the bank who was lending the money to order the appraisal on the borrower's behalf, and that would create independence. Well, one of the things that evolved in this last credit cycle was we had the creation of nonbank entities and mortgage entities that were creating products like mortgages—these nontraditional and subprime products—and they didn't follow, or didn't have to follow, necessarily, the same rules as banks. And the independence is so important in the appraisal process because there are two things that we have to get right when we have a transaction involving real estate. Let's talk mainly about our home. And the two things are, first of all, we need to make sure that we get to own it—the title is correct. And so we spend a lot of money in the closing process, whether you were selling a house or getting a mortgage, to get title right—to make sure that we have it unencumbered and no one else is going to come back and say they own it. The second thing is we have to get value right because, if you don't get value right going in when you buy a property, you're going to struggle the rest of your ownership period trying to just get even. And so if we've removed from the consumer the right to order that appraisal, to review that appraisal and to have input, how do they know whether the appraisal truly is independent? Because right now the consumer only gets the appraisal, really, at the table when the transaction occurs.

**Moderator:** *K.C., how are issues with the appraisal industry affecting banks?*

**Conway:** Banks have made loans on these assets, and they have them on their books, and if now those properties aren't worth, not only what the consumer paid for them, but they're not even worth what the mortgage is stated, now the banks have a likely loss that they have to recognize. So the banks have to reserve additional funds for the probable loss of that mortgage. And they have to write it down so banks are not as profitable. And that's had a material role in the failure of many of our banks.

**Moderator:** *The foreclosure crisis has manifested in different ways from region to region. Do these changing conditions affect appraisal*

*practices?*

**Conway:** The first wave that we went through really in the beginning in 2007 was the beginning of the subprime mortgages. And if you look at those states that had heavy reliance on subprime mortgages, where they represented a large part of the financing activity, those states tended to be the ones that had a high use of nonbank entities that were acting like mortgage lenders and creating these products and had more of the mortgage lenders interacting with the appraisers. And, as a result, the disconnect between the independence of the appraisal was greater. So the type of mortgage product and who was kind of overseeing it and regulated it also had a correlation into maybe the breakdown in the appraisal practices. Where you didn't have as much usage of subprime, the foreclosure process wasn't as bad, and as a result the decline in home prices wasn't as severe. The FBI does a very good job in looking at these concentrations and annual reports that they do in looking at the correlations and what drive that. One of the interesting ones that they found that's kind of a regional difference is this concept of "flipping," where an investor—could be a broker, could be an investor—would buy a property and they might sell it to a related party at a higher price to then sell it back to another related party for another higher price; then they'd get a mortgage on it and split the money up. And what they found is this practice was easier to take hold in those markets where there was heavy subprime usage because you didn't have as much of the true bank regulatory oversight. And the Sarasota *Herald-Tribune* did a really good analysis on this last year that shows where it was most concentrated.

The other two waves that we're seeing are these hybrid ARMs [adjustable-rate mortgages]. And so, wherever there was a lot of hybrid ARM usage, we're going to see kind of this second wave of rising foreclosures that will impact home prices more severely in those markets where that was a prevalent product.

The third wave that we are also starting to see set in right now that's going to be with us probably at least though next year is the one that results from job loss. And so, again, what you can do is look at those markets that are heavily impacted by job loss, and those are the states that are also having a higher third wave of foreclosures, which will further compound the decline in home prices and the impact in value.

**Moderator:** *As we close, K.C., what role should the appraisal industry play in the broader housing recovery? And, if you would, touch briefly perhaps on how appraisals might hinder the purchase of foreclosed properties.*

**Conway:** There are four or five items that I have personally identified as issues we have to address head-on, and the good news is these aren't complicated fixes. The first is we have to restore the independence issue in the appraisal process. If we can't believe what someone tells us is the value of a property, capital isn't going to want to come and lend on it, and people aren't going to want to invest in it. So we have to restore independence. We've tried it a number of different ways. Pre-FIRREA, we had the developers ordering the appraisal; they had the relationship with the appraiser and then they brought it to the bank, and that didn't exactly work. FIRREA and post the S&L crisis, we had the banks ordering the appraisals, or the lender ordering the appraisal, and dealing directly with the appraiser. Well, we've seen how fraud and abuses can impact there. The one element that we've not had in this whole process is the consumer, who has the most at stake. They're buying the asset. They ultimately have the most loss because they're also losing their equity if the investment isn't right.

The second issue is inspections. We have a situation where appraisers aren't required to inspect properties; they're only required to disclose that they didn't inspect the property. So this practice of allowing drive-by inspections, or not having full inspections, I think needs to stop at all levels, at the state level, the federal level, every funding level.

The third thing is we need to put teeth back in the importance of the review process; we need the checks and controls back there. So we need to move from more administrative kind of reviews, of just assuming it's done right, to using technology where we know things like where home flipping starts to rise that we use that as a radar antenna—that if we suddenly see home prices go up 10 or 20 percent a year, we need to at least ask why and make sure that it's not some mischief that's occurring.

The fourth thing that we need to do is, FIRREA was a good idea, met many of the issues coming out, but again it mandated to the states to do the state licensing of appraisers and the enforcement, and it was kind of an unfunded mandate. And you'll find in most states one of the reasons that we didn't see a lot of appraisers disciplined and sanctioned was the states didn't fund the investigations and enforcement arm. So we need to get serious about how that gets funded.

And the final issue is competency. FIRREA essentially said we need to regulate appraisers, and in that goal they kind of lowered the bar for appraisers. And certification is a higher form of licenser, a regulation of appraisers, that requires more training and more skill set, and then beyond that there are professional designations, like what I hold with the MAI. We need to raise the bar because one of the things that we're finding in the forensics of this process is it's more likely that, when we have a bad appraisal, it's due to incompetence more than it is fraud. And one of the actions that I would love to see is that the consumer be given the appraisal one to two weeks before a closing and given the right to review it for accuracy and to point out any errors or questions that the appraiser or lender would then have to answer.

**Moderator:** *K.C., thank you for joining us today.*

**Conway:** Thank you, Odetta.

**Moderator:** *This concludes our podcast. We've been speaking with K.C. Conway from the Federal Reserve Bank of Atlanta. For more podcasts on this topic and others, visit the Atlanta Fed's Web site at [www.frbatlanta.org](http://www.frbatlanta.org). If you have comments or questions, please e-mail [podcast@frbatlanta.org](mailto:podcast@frbatlanta.org). Thanks for listening.*