Viewpoint

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Rethinking Appraisals in a Modernized Housing Finance System

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Thank you for having me here today. On its website, the Collateral Risk Network (CRN) states that its purpose is to "[focus] on resolving the many challenges facing our profession…. With the inclusion of all stakeholders in the collateral valuation space to an open dialogue, we intend to find solutions to the current crises."

I welcome the invitation to be here today because I hope to contribute to the dialogue CRN seeks. Indeed, the appraisal industry faces many challenges today, and the housing finance system it serves is changing. In my remarks, I will describe some key changes taking place and invite you to join me in thinking through some of the possible implications of these changes for the challenges facing appraisers today.

I will begin with a brief review of recent history and the post-financial crisis changes in housing finance. These changes are far from complete and housing finance reform remains a critical legislative priority. While its timing remains cloudy, key structural elements are emerging. One thing missing is how the issues facing the appraisal industry, from appraisal content to its standards to its regulation, are changing to serve a revamped housing finance system.

I will not offer proposed solutions today, but I do hope to provoke debate and thought on the value-added proposition appraisers *could* offer in the future and how changes to the current system might better serve a future housing finance structure.

A Brief Look Ahead

Before proceeding, I should define what I mean by a future housing finance structure. I am thinking ahead to what the secondary mortgage market could look like in a post Fannie Mae and Freddie Mac conservatorship world. Think about it as a world not dominated by these two government sponsored enterprises (GSEs) and in which we have moved away from having taxpayers being the primary insurers of mortgage credit risk. Those two changes alone should challenge a lot of assumptions about whether the current appraisal system makes sense in the future.

One other note, I will focus my remarks on the conforming, conventional market served the past few decades by Fannie Mae and Freddie Mac. While much of what I have to say is applicable to other market segments, including the FHA market, for ease of presentation I intend to focus on this particular segment.

A Brief Look Back

This audience does not need a retelling of housing's central role in the recent financial crisis – you lived it. Many aspects of our housing finance system failed, and appraisers were far from immune to these failures. In particular, the episode saw:

- marked declines in the quality of many appraisers and appraisals,
- serious questions regarding appraiser independence, and
- numerous investigations revealing appraisal fraud.

For many of you, though, there is another side to this story. In this telling, many appraisers recognized what was going on, saw the train wreck ahead, yet either found their warnings ignored or were frustrated by a system in which neither lenders nor regulators provided a reliable means for appraisers to raise concerns. Wherever the truth lies among these views, I think we can agree that all these issues need to be addressed by any future system.

Since the Crisis – Some Steps Forward

After the financial crisis, Congress overhauled the financial regulatory system although it did not tackle the housing finance system in a comprehensive way. The Dodd-Frank Act codified appraisal independence rules but it did not make meaningful changes to the secondary mortgage market.

In the absence of legislation, some important steps to fix the problems of the past and build towards a future housing finance system have been underway. I would like to provide a selective summary of ongoing developments that I believe are germane to thinking about the role of appraisals in a future housing finance system.

Data Standardization

In May 2010, the Federal Housing Finance Agency (FHFA) announced a program of data standardization initiatives designed to reduce costs and enhance consistency in data submissions for loan originations,

appraisals, and loan servicing. The goal was to improve the consistency and quality of this data and establish technology requirements so that the data would be reported using industry-standard systems for electronic data reporting. Such data standardization enhances risk management as well, whether for Fannie Mae and Freddie Mac in conservatorship or for private market managers of mortgage credit risk via risk transfer transactions or in a post-conservatorship world.

The Uniform Appraisal Dataset (UAD) defines the required data on an appraisal and standardizes the data definitions and responses for a key subset of fields on the appraisal form. The Uniform Collateral Data Portal® (UCDP®) is the technology application that established a single portal for the electronic submission of appraisal data. Mortgage lenders and their agents (such as appraisal management companies) use the portal to deliver in electronic form the standardized appraisal data prior to loan delivery. So we now have operating a single industry standard for appraisal data and a single industry standard for its electronic reporting.

One thing this initiative did not do was to re-examine the content being submitted. I'll return to that issue a bit later.

Credit Risk Transfer Transactions

Since 2013, at FHFA's direction Fannie Mae and Freddie Mac have undertaken a series of credit risk transfer transactions to sell a certain amount of mortgage credit risk to private investors. These transactions portend a sea change in the financing of mortgages. Rather than Fannie Mae and Freddie Mac absorbing all of the mortgage credit risk beyond a borrower's down payment and private mortgage insurance (if any), these transactions draw private investors into pricing and managing some portion of mortgage default risk.

Since 2013, these transactions have taken a number of structures. FHFA remains committed to expanding these risk transfer deals and Congress and the Administration appear to be fully supportive. Moreover, investors have enthusiastically embraced the transactions.

Common Securitization Platform

Since 2012, FHFA, Fannie Mae, and Freddie Mac have been working on a common securitization platform. This platform will replace Fannie and Freddie's proprietary securitization infrastructures. This new securitization infrastructure can be used in a post-conservatorship world to support mortgage securitizations with or without a government guarantee while using an array of risk sharing structures. Integral to the concept behind the platform is the vision that future mortgage securitizations will be supported by an integrated and prescribed set of data standards, disclosure standards, and uniform legal structures. You can see then that the work on data standards, including UAD, is one part of a larger construct for the future. Standardized data, combined with robust investor disclosures, contribute to an environment in which capital market investors may be willing and able to price and manage a substantial portion of mortgage credit risk in the future. This will not only reduce the burden on taxpayers, but it can reduce the pricing distortions in credit markets that affect where and how

capital is deployed in the economy. And, it may contribute to an overall lowering of mortgage default risk, thereby protecting more families from the anguish of foreclosure.

Legislative Developments

These developments I've just described are also being embedded in legislative proposals. Indeed, every major housing finance bill proposed the past few years included private risk-bearing of mortgage credit risk and a common securitization platform to replace Fannie and Freddie's securitization infrastructure.

Most recently, last month the Senate Banking Committee approved a set of regulatory reforms including provisions urging FHFA to expand credit risk transfer transactions and establish the common securitization platform as an entity separate from Fannie and Freddie.

A Future Housing Finance Framework

Notwithstanding this progress, much remains to be done before Congress enacts comprehensive housing finance reform.

We don't know when Congress will act to end the conservatorships nor can we say what the legal, regulatory, and institutional framework will be that replaces Fannie Mae and Freddie Mac. Yet we can say there appears a strong likelihood that the future housing finance system, post conservatorships, will rely to a far greater degree than before the crisis on private capital pricing and managing mortgage credit risk. The common securitization platform being developed today may provide a key infrastructure supporting future mortgage securitization, and that infrastructure in turn will rely on data standardization and data disclosures in order to attract investors back into the market.

Collateral Valuation in a Future Housing Finance System

Among the conditions I believe are necessary for private investors to price and manage mortgage credit risk is confidence in the value of the collateral supporting the mortgage. An arm's length market transaction between a willing buyer and a willing seller provides a market price. But it has been long understood from a risk management perspective that sales price alone is insufficient to understanding the risk of lending long-term on property serving as loan collateral. That is why lenders since the Great Depression have relied upon an independent opinion of property value in the mortgage underwriting process – an appraisal report.

Homebuyers and home sellers have a financial, and often an emotional, interest in the transaction. An appraisal report should provide the lender with an unbiased, professional opinion of value to support the credit decision in making a loan and to support the collateral risk assessment associated with that loan. Any assessment of mortgage credit risk depends upon an accurate assessment of collateral value and collateral risk even though the collateral itself is not the primary basis for the credit decision. That should rest upon the borrower's ability to repay the loan, an issue addressed directly by Dodd-Frank.

It used to be that an appraiser reached their opinion of value from three distinct approaches to estimating value – a sales comparison approach, a cost of replacement approach, and an income approach (what income the property may be able to produce in alternative use, for example, if rented). An independent, professional appraiser was trained not just in the process of estimating value from these approaches but in weighing data and factors associated with the property, the neighborhood, and the local market when reconciling these inputs to arrive at the final opinion of value.

Over time, this process has been curtailed. Most of you are better positioned than I to describe that history. In the wake of the savings and loan debacle, the financing of mortgages shifted away from balance sheet lenders such as savings and loans to the secondary market dominated by Fannie and Freddie. Thus, the standards set by these two companies in their selling and servicing guides became *de facto* rules for the industry. Moreover, the legislation in response to the savings and loan debacle tried to address what was seen at that time as a failure of the appraisal industry. The legislation gave us much of the regulatory and standard-setting infrastructure that remains today. Yet, the establishment of that regime predates the shift away from insured depository institutions in mortgage lending, particularly with respect to managing mortgage credit risk.

Our challenge then is to reconsider the appraisal – the process of developing the opinion of value – and the content of the appraisal report to serve the future underwriting, pricing, and management of mortgage credit risk. As I have already described, the future housing finance system will likely redistribute mortgage credit risk from its past configuration. That means that Fannie and Freddie (should they even exist in some form), as well as insured depository institutions and private mortgage insurance companies, may have different shares in managing mortgage credit risk than in the past. Moreover, the shift in this risk will be to private capital investors in a variety of forms, and potentially to the taxpayer, if there is a catastrophic risk fund established as part of ending the conservatorships.

So, here is the key question: In such a world, what can an appraisal report tell the credit investor that enhances their knowledge and understanding of collateral value, and the risks associated with that collateral value, and how could that in turn enhance the market's stability and soundness? Stated differently, what is the potential value proposition of an appraisal report to credit investors that is superior to other data and information sources the investor might have access to apart from the appraisal report?

More Questions

As I stated at the outset, I am not here today with an answer to this key question. Instead, I hope to contribute to a more thoughtful discussion of the appraisal industry by digging deeper still, with more questions that go beyond the basic one I just set forth.

Question 1: Who is the customer?

Homebuyers are often surprised to find that, while they pay for the appraisal report and the outcome of that report may determine if they get the house, they are not the customers. While an appraisal provides some borrower protections, the customer has been the lender, or perhaps Fannie and Freddie.

But in the future, who will be the customer? I submit that in a world in which private capital market investors and institutions become the primary bearers of mortgage credit risk, we need to think of them as *a* customer, if not *the* customer. After all, collateral risk will be central to their credit decisions.

Question 2: What does the customer need? What should be the content of an appraisal report?

Since we are envisioning a world in which we are rethinking the customer, it makes sense to ask what does the customer need? Does the current content of an appraisal report serve their credit decision needs or is something else required? Moreover, does an appraiser have a value proposition in supplying that information? If credit investors can obtain the same or equivalent information from other sources – we live in a big data world today, after all – then what is the value proposition of an appraisal?

The importance of this content question cannot be overestimated. This is what will distinguish future thinking from living in the past. Just because Fannie and Freddie did not seek certain information in appraisal reports for their management of mortgage credit risk does not mean that other investors might not have different needs. This re-opens the question of whether a value opinion should be derived from three sources of estimation, not just one or two. It goes beyond that, though, to ask what more does a local, on-the-ground appraiser have to offer a global capital market investor who knows nothing of the idiosyncratic characteristics of a particular property, neighborhood, or local economy?

I am envisioning here at least two broad concepts.

First, can an appraiser create value for their customers by supplementing a single value opinion with a confidence interval, or a range, or some measure of distribution around that value opinion that enhances the credit investor's risk management? What would be the scale or standards upon which an appraiser can report some assessment of risk associated with the value? For example, how certain or uncertain is the appraiser about valuing this particular property, perhaps because of its condition or its unique features that make the value more or less sustainable than in surrounding properties? How can that be reported to the customer beyond a single estimate of value in a way that is useful for the customer's risk management process?

Second, is there information about the environment, including an outlook about the neighborhood, the local business environment, local municipal finances or the local infrastructure that are germane to understanding collateral risk? Would those measures capture for the customer situations such as recent unsustainable increases in local house prices or knowledge that a major local employer may soon leave town or may soon consolidate other operations into this location? Can the report incorporate how factors such as school quality, walkability, transportation costs, energy efficiency, and so on may affect the sustainability of the property's value? And could this information be reportable in a way that is useful to the customer's risk management process?

Surely recent advances in data availability, financial technology, and information technology should factor into this discussion.

Question 3: How do you get the data to the customer?

If we accept that a customer may not be party to the initial loan closing but will be the ultimate source of credit risk financing, there is both a timing and a transmission question here. Assuming we develop an improved content, how does that get provided to the customer? I believe that the Uniform Appraisal Dataset I mentioned earlier could be updated to reflect improved content and provides a basis for the standardization and reporting of information beyond that which is reported today. Presumably this data could be tied to loan level disclosures in mortgage securitizations.

Going further, this new system will have ongoing trading in mortgage credit risk positions. Does the notion of collateral valuation itself become an ongoing proposition, not just at time of sale? If so, what could be the role of appraisers in supporting that ongoing trade by updating collateral risk assessments?

Question 4: Who pays for it?

The homebuyer is a third-party payer in the current system. They primarily want the appraisal to not interfere with the sale. So, should we rethink the compensation framework, and who pays, to better align incentives and better recognize and reward quality? How do we do that?

Question 5: What about independence?

It seems a perennial challenge for the appraisal industry is ensuring independence. An independent view of value, one free from a financial interest in the transaction, is the whole point of having an appraisal. Yet, all sides in residential real estate at times want to influence this process. So, we have complicated rules, rules that keep getting more complicated and arguably reduce the overall quality and timeliness of many appraisals. While some rules are necessary, since we keep having this problem, can we think of better solutions?

As one contribution to this particular issue, we should think about how transparency might be a partial antidote to the problems associated with biased work arising from appraisals made subject to outside influence or interference. I don't expect this to be a perfect solution, but perhaps publishing appraisal reports would help.

Another possible solution is to consider better aligning incentives, including compensation programs, between the appraiser and the credit investor. What if a public database of appraisals included appraiser identifiers? Could investors score the quality of each appraiser's work, thereby creating an incentive to hire and compensate high-quality appraisers? After all, a good appraiser protects the credit investor.

Question 6: How to resolve disputes?

At the end of the day, an appraisal is a human process that results in one person's opinion, however informed it may be by objective measures and techniques. Disputes and disagreements will still arise, and some relevant information may be overlooked or under- or over-weighted. It seems there is a fair amount of misunderstanding about who may communicate concerns about an appraisal's accuracy or completeness without its independence being undermined. As part of looking to the future, can we improve how to resolve such disputes?

Another form of dispute that involves appraisals has to do with reps and warrants. Egregious appraisal products and practices of the last decade inevitably led to disputes about value through the rep and warrant process between loan sellers and Fannie and Freddie. In the future, can most or all rep and warrant risk be eliminated with tools that resolve potential questions of collateral valuation at or near the time of loan origination rather than years later?

Question 7: What about privacy?

Privacy has at least two important contexts in the way I am framing these questions. First, if we make appraisals more transparent – that is, publicly available in whole or in part – what privacy issues does that raise for the property owner? Second, to the extent an appraisal report contains proprietary techniques or information developed by an appraiser, is there any reason to protect some aspects of the report? Such issues should be part of the discussion.

Question 8: Who should set the standards?

It seems to me reasonable to expect that the current regime, established in the wake of the savings and loan debacle more than a quarter of a century ago, may be ripe for updating or rethinking. Today, the Appraisal Foundation sets appraisal standards. Policymakers should take a close look at the current arrangement, especially since Congress authorized the Foundation's role in standard setting.

I have advocated in many other aspects of the housing finance reform debate for the benefits of a single set of industry standards. Whatever the outcome here, consistency around a single set of appraisal standards seems to me to be the desired outcome. Falling back to competing standard-setting bodies, or worse yet, 50 different state approaches, will not serve the efficiency or effectiveness of a *national* market for mortgage credit risk. But does ensuring a single, national standard require a different framework, perhaps even a federal rulemaking authority?

Question 9: How should appraisers and appraisals be regulated?

As with standard-setting, federal regulation is ripe for a rethink. Federal oversight is shared jointly by multiple bank regulators through the Appraisal Subcommittee. Yet banks themselves have long since given up a dominant role in managing mortgage credit risk. And with multiple regulators in charge, it may appear that no one is in charge. Certainly the existing regulatory structure did not prevent widespread problems in the appraisal world in the past decade. Moreover, even more so than in the late 1980s, this is a national credit market and the regulation of appraisals in support of this market needs a clear, single, federal regulator. While some may immediately question my own bias on this issue, it seems logical to me that the Federal Housing Finance Agency, or whatever its successor organization may be, would be a logical choice to centralize this regulatory responsibility. FHFA could be required to consult

with the banking regulators, but let's have one agency in charge and responsible for timely, effective oversight and require it to build true appraisal expertise.

More Questions and Issues Beyond the Scope of Today's Discussion

My intent has been to pose questions critical to rethinking collateral valuation practices that may best support a future housing finance system. I have left many other important questions for another day.

Conclusion

While the timing is uncertain and many critical details remain to be resolved, the country is moving towards a new housing finance structure that will redistribute the management of mortgage credit risk. Since appraisal reports are an important input into credit risk management, it is important that policymakers consider the role of appraisals in thinking about how this future system involving private capital may work. I have offered several issues to consider and numerous questions to ponder as part of that process.

My questions are not the only ones worth debating. But in the spirit of CRN's mission, let's get the discussion started. Furthermore, let's connect the discussion appraisers are having with themselves to the larger discussion of the future of housing finance that other market participants and policymakers are having. And lastly, let's not get stuck in thinking about how the system used to work, and trying to improve something through a rear-view mirror. Let's look ahead and ask what could be.

Thank you.

Bio: Ed DeMarco

Ed DeMarco is a Senior Fellow in Residence at the Milken Institute Center for Financial Markets and a Visiting Professor in the Owen Graduate School of Management at Vanderbilt University. From September 2009 to January 2014 DeMarco served as Acting Director of the Federal Housing Finance Agency (FHFA), the conservator for Fannie Mae and Freddie Mac and regulator of those companies and the Federal Home Loan Banks.