August 17, 2011

The Editor
The Wall Street Journal
1211 Avenue of the Americas
New York, NY 10036

Sent Via Electronic Mail: wsj.ltrs@wsj.com

Dear Editor:

We are contacting you in reference to an article written by S. Mitra Kalita and Carrick Mollenkamp that appeared in *The Wall Street Journal* on Friday, August 12, entitled "Judgment Call: Appraisals Weigh Down Housing Sales."

As the Congressionally-authorized organization that establishes appraisal standards and appraiser qualifications in the United States, we feel compelled to address several aspects of the article that we feel should be clarified for your readers.

First and foremost, it is critical to understand that appraisers do not *establish* property values; they simply reflect the actions of buyers and sellers in the marketplace. An appraiser's job is to "mirror the market" by analyzing competing homes that have sold, are in the process of selling, or are available for sale. One key component in appraisal theory is the *Principle of Substitution*, which essentially states that *knowledgeable* and *typically motivated* buyers would not pay more for a property if similar properties are available in that marketplace at a lower price.

In appraisals performed for federally-regulated financial institutions (where most of the funds for home loans come from), appraisers are required to base their opinions of *market value* on a specific definition[1], which consists of the following criteria:

> *The most probable price which 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:*
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> *(1) buyer and seller are typically motivated;*
> *(2) both parties are well informed or well advised, and each acting in what he or she considers his or her own best interest;*
> *(3) a reasonable time is allowed for exposure in the open market;*

[1] *Interagency Appraisal and Evaluation Guidelines*, December 10, 2010

(4) *payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
(5) *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.*

The article states "One of the conclusions from the housing bust: The appraisal system was broken. One of the conclusions some have drawn from the struggling recovery since then: The appraisal system is still broken, but in a different way." The article also quotes Columbia Business School economist Chris Mayer as saying, "Lenders are 'instructing appraisers to be a little conservative, and that responsibility on the one hand is seen as credit tightening and, on the other, as exacerbating the housing problem.'" It is important to recognize that all state licensed and certified real estate appraisers in the U.S. are required by the *Uniform Standards of Professional Appraisal Practice* (*USPAP*)[2] to be independent, impartial, and objective, and to perform assignments without bias. Furthermore, as alluded to in the article, the federal Dodd-Frank law enacted in 2010 mandates appraiser independence, and establishes penalties for lenders and other parties who attempt to unduly influence an appraiser.

In most home purchase transactions, this mandated impartiality can often mean that the appraiser is the only participant that doesn't have any "skin in the game." In other words, virtually all of the other parties to the transaction only benefit if a sale is ultimately consummated. This often makes the appraiser an easy target for disgruntled parties to the transaction. In *any* market, there are buyers who may pay more for a property than it is actually worth. This may be due to a buyer's lack of knowledge about a marketplace, a particular fondness for a property, or a whole host of other factors.

The article also refers to the increasing presence of appraisal management companies (AMCs) in the industry, stating, "The result has been that appraisers with less experience or who are unfamiliar with a community – but who work cheap – are getting assignments while more experienced appraisers are going out (of) business. That, say critics, is producing appraisals that are less accurate." The article goes on to quote Leslie Sellers, immediate past president of the Appraisal Institute, as saying, "The people doing it are the ones who cut overhead to (the) bone, are working out of basements and many of them are not properly educated." Although we believe this is true to a certain extent, we are also aware that a large percentage of appraisers that have left the business in the recent past are those with *less* experience; those that had entered the appraisal profession only within the last few years. In fact, many trainee and licensed appraisers left the business because they were unable to successfully obtain certified status, which many clients and user groups (including <u>all</u> appraisals done for the Federal Housing Administration – FHA) began requiring as their minimum qualification level for real estate appraisers.

The article also states, "Others complain that appraisers are using foreclosures and other distress sales as comps when coming up with estimates." In marketplaces where many of the properties that are bought *are* distress sales (e.g., foreclosures, bank-owned properties, short sales, etc.), it is not only permissible for appraisers to consider and potentially use these sales as "comps," but

[2] *USPAP* is developed, amended, and promulgated by the Appraisal Standards Board of The Appraisal Foundation, as authorized by Congress.

appraisers are *required* to determine the impact this activity is having in the marketplace. This is due to the fact that distress sales may very well impact the value of more "conventional" sales, because many buyers are reluctant to pay more for a property than the price level set by the distress sales (note the reference to the *Principle of Substitution* made previously). And if the number of distress sales (or properties available for sale that could be considered distress) becomes so significant in a marketplace that it represents the only activity occurring, the distress activity actually *becomes* the marketplace.

In some markets appraisers can document a "bifurcated" marketplace. That is, a market where home sale activity occurs at the distress level, as well as activity occurring *above* the distress level. In these bifurcated markets, it may be more likely that the appraiser's opinion of market value may meet or exceed a home's pending sale price. However, that does not relieve the appraiser of the obligation to consider and analyze the distress sales.

Lastly, the article states, "Another complaint is that appraisers are increasingly relying on automated valuation models, or AVMs…" While it may be true that some appraisers utilize AVMs as one tool in assisting them at arriving at an opinion of market value, it should be made clear that very few appraisers <u>rely</u> on AVMs when developing appraisals. Some lenders or user client groups may opt to utilize AVMs – some as *preliminary* indicators of value prior to ordering an appraisal – but it is generally <u>not</u> the appraiser that utilizes information collected and analyzed from AVMs when performing appraisal assignments.

While it may certainly be true that some parties are frustrated when an appraisal does not meet their needs to consummate a transaction, the independence of the appraiser is seen by many as a benefit, in many cases preventing an individual from overpaying for a home. Just because two parties agree on a price for a property, it does <u>not</u> mean that price represents the *market value* of the property (see the *Definition of Market Value* referenced previously). We believe the appraiser's impartiality is an appropriate and needed "check and balance" for these transactions.

We greatly appreciate the opportunity to comment on this article, and are hopeful you will be able to share our sentiments with your readers.

Sincerely,

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POLITICS | AUGUST 12, 2011

Judgment Call: Appraisals Weigh Down Housing Sales

By S. MITRA KALITA And CARRICK MOLLENKAMP

William Maxwell is an expert in finance. He's a professor at Southern Methodist University's business school, has co-authored a book on high-yield debt and spent years calculating values of financial markets.

Yet there's one valuation he can't understand: the appraisal of his Dallas home.

In August 2010, Mr. Maxwell's home was appraised at $790,000 as part of a mortgage refinancing. Yet this past spring, when he tried to sell the four-bedroom home for $756,500, the appraisal commissioned by the buyer's lender, Bank of America Corp., came up with a value of $730,000. Mr. Maxwell said the appraisal killed the sale.

WSJ's Nick Timiraos reports many analysts believe low appraisals are one factor weighing on the housing market and recovery of the sector. AP Photo/Seth Perlman.

Weak appraisals are "driving down the real-estate market," Mr. Maxwell says. Saying the appraisal process "borders on buffoonery," he's appealing his home's valuation to the Texas regulator.

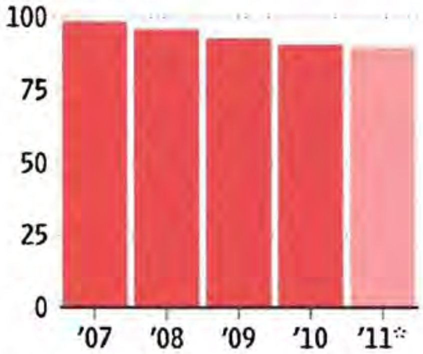
One of the conclusions from the housing bust: The appraisal system was broken. One of the conclusions some have drawn from the struggling recovery since then: The appraisal system is still broken, but in a different way.

There is little doubt that home values have depreciated sharply in recent years for the most basic of economic reasons: excess supply of homes on the market and weak demand. But some realtors, home-sellers and economists believe low-ball appraisals also are undermining a housing recovery.

Appraisals are supposed to be unbiased assessments of a property's value. The housing bubble that burst a few years ago was inflated, in part, by overly generous appraisals. Now, lenders are pressuring appraisers to come in with lower estimates, some real-estate professionals say. Banks also are using less-experienced appraisers, who often don't appreciate

A Less Popular Job

The number of appraisers in the U.S. has been dropping following the housing bust. In thousands.



*As of June 30

Source: Appraisal Institute

factors that make a home worth more, they say. And valuations are being heavily influenced by distressed sales priced at a discount to the rest of the market.

Lenders are "instructing appraisers to be a little conservative, and that responsibility on the one hand is seen as credit tightening and, on the other, as exacerbating the housing problem," says Columbia Business School economist Chris Mayer. A research paper last year titled "How Much Is That Home Really Worth?" by economist Leonard Nakamura at the Philadelphia Federal Reserve also cited a downward bias in appraisals.

Circle Pix

This 7,000-square-foot house on four acres in Orlando, Fla., was appraised by the builder for $1.2 million in 2008.

Circle Pix

It went under contract for $650,000.

Circle Pix

But another appraisal valued it at just $380,000.

Disputes over valuations are rising. The National Association of Realtors said that 16% of realtors surveyed reported a cancellation in June of this year, and chief economist Lawrence Yun blamed the unusually large number on low appraisals. In June of 2010, only 9% of those surveyed reported a cancellation.

A survey by the group earlier this year found that 10%-12% of members had a contract canceled last year as a result of a low appraisal; 10%-13% had a contract delayed; and 16%-20% reported that the sales price was negotiated lower due to a low appraisal.

Not everyone agrees the appraisal system is broken. The Mortgage Bankers Association, an industry trade group, concedes that appraisals are conservative but says they need to be, partly to protect the banks from future problems with investors who buy mortgages. "There's an extra note of caution," said Steve O'Connor, a senior vice president at the association.

And some appraisers say homeowners are just having trouble facing reality. "It's the market. It's not the changes" in the appraisal process, says Charles MacPhee, a partner with Buttler Appraisals LLC.

Mr. MacPhee's company performed an appraisal in Decatur, Ga., last year that drew ire. John and Michelle Pennie were about to give up on selling their house last spring when an offer came in—just in time to qualify for the 2010 federal tax credit.

The two sides agreed on a sale price of $365,000, with the Pennies paying $8,000 in closing costs. "We were ecstatic," Mr. Pennie says.

But the appraisal put the home's worth at $327,000. And the deal ultimately collapsed. "Understandably in a declining market, you're going to have declining appraisals," Mr. Pennie says. "But when you have two parties who agree on a price, to then have an appraiser come in and make it $40,000 below...how do you ever get out of a falling market?"

For decades, appraising a home was both an art and a science, executed primarily by independent professionals who were experts on their local markets. Designed to protect both the borrower and lender, appraisals were based largely on selling prices of comparable homes. But appraisers also combed through property records and interviewed brokers, buyers, sellers—and even other appraisers. Banks selected the appraiser and often had influence over the outcome. Home buyers paid the fee.

In the aftermath of the housing bust, then-New York State Attorney General Andrew Cuomo sought to reform the appraisal industry by convincing Fannie Mae and Freddie Mac to bar loan officers, mortgage brokers or real-estate agents from any role in selecting appraisers. Besides combating inflated and sometimes fraudulent appraisals, the goal was to eliminate pressure on appraisers to provide estimates that match the contract price, which would increase chances that the mortgage loan would get approved. The sweeping Dodd-Frank financial-overhaul law that went into effect in 2010 went one step further to bolster appraiser independence by regulating both the industry and the fees they are paid.

Rather than hire appraisers whose work is known to them, banks now outsource their selection to appraisal-management companies, which are often units of other banks and financial companies. These appraisal-management companies take a sizable cut of the fee, leaving the appraisers under pressure to work faster and cheaper.

The result has been that appraisers with less experience or who are unfamiliar with a community—but who work cheap—are getting assignments while more experienced appraisers are going out business. That, say critics, is producing appraisals that are less accurate.

"We've lost the best quality appraisers," said Leslie Sellers, the immediate past president of the Appraisal Institute, a trade group. "The people doing it are the ones who have cut overhead to bone, are working out of basements and many of them are not properly educated." The Institute estimates there are currently under 90,000 certified appraisers, down from nearly 100,000 in 2007.

In Mr. Maxwell's case, he says that the appraiser, Jim Applegate, works in Plano, a suburb 20 miles from Dallas, and was unfamiliar with Mr. Maxwell's Dallas neighborhood of Lakewood, an affluent community near a picturesque lake. Mr. Maxwell also claims that Mr. Applegate improperly used less desirable homes as comparables, or "comps," to arrive at a value. In a June 17 formal letter of complaint with the Texas Appraiser Licensing and Certification Board, which regulates the industry, Mr. Maxwell said that Mr. Applegate had used a home near an elementary school that encounters a lot of traffic. Mr. Maxwell's home, by comparison, sits on a quiet, quarter-acre lot.

Calls to Mr. Applegate were returned by a Bank of America spokeswoman, who declined to comment on Mr. Maxwell's situation. She did say the lender has received feedback from customers asking it to reevaluate "geographic competency in our appraisal reports." She said efforts are being made to find appraisers who generally work within 15 miles of a property; if no appraiser is available, the company assigns alternate appraisers with local experience.

Others complain that appraisers are using foreclosures and other distress sales as comps when coming up with estimates. Because foreclosures tend to sell at big discounts from the actual value, some argue that shouldn't be used.

At least four states—Illinois, Nevada, Missouri and Maryland—have considered legislation that would bar appraisers from using distress sales when drawing estimates.

Some economists disagree. They argue that foreclosures account for such a large share of housing sales that it's perfectly acceptable to use them as comps, or to use them but adjust pricing accordingly. "A third of transactions are previously foreclosed homes. In some markets, it's close to 50%," said Columbia's Mr. Mayer. "It would be one thing if you're talking about throwing out a small number of transactions."

Another complaint is that appraisers are increasingly relying on automated valuation models, or AVMs, computer programs that extrapolate home values based on reams of property data, and public and privately compiled databases. The industry began automating in the mid-1990s, but it wasn't until a few years ago that AVMs took hold in a big way.

AVMs are most reliable when there are a larger number of typical transactions to observe. But during the housing slump, typical transactions have been scarce while distressed sales have been abundant.

One of the biggest complaints is that appraisers, in their haste, are overlooking or missing important elements that could add substantial value to a home.

Erin Wanner, a sales executive with Stirling Sotheby's International Realty in Orlando, Fla., says one of her deals fell through when an appraisal came in 40% lower than expected. The property, a custom-built lakefront, 7,000-square-foot home on four acres was appraised by the builder in 2008 at $1.2 million. Ms. Wanner's clients went under contract on the property for $650,000 in a short sale—one in which the bank agrees to receive less than the amount owed on the mortgage. The appraisal came in at $380,000.

"When I first heard it, I thought it was a joke," Ms. Wanner says. She noticed that a guest house on the property and total lot size—as well as the number of fireplaces and its heated pool—weren't included in the valuation, which would have sharply boosted the appraised value. She also thinks the appraiser wasn't familiar enough with the community and may have used comparisons with less affluent houses nearby, such as homes situated on ponds versus lakes.

Ms. Wanner says appraisers today seem less knowledgeable. "Real estate is a neighborhood business," she said. "One neighborhood can be hit, another can be flourishing." She said the new laws prevent lenders and agents from contracting the appraiser directly, which has been especially frustrating. "Once we get the report, it states that individual's opinion of value, and that's that."

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