

Appraisers

By 2007, the housing bubble had begun to burst, and home prices were in steep decline.¹ By 2009, the value of residential real estate continued to plummet.² The question many people are asking is, where did all the value in residential real estate go? Considered in this chapter is role of the home appraisal process played in the housing bubble collapse.

APPRAISAL DEFINED

An appraisal is: “[An opinion of [t]he most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions [for a] fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.”³

Every parcel of real estate, regardless of whether is residential or commercial, has a monetary value. It is the job of the real estate appraiser to formulate an opinion of that value by attempting to pinpoint what a typical buyer would pay to a typical seller of a similar property.

The home appraisal process requires several stages. The first stage is to walk through the property to be appraised. At this stage, an appraiser will notice such things such as recent upgrades or remodeling. The appraiser is also looking to gauge the overall quality and condition of the property. While the appraiser is not an inspector, they do also consider potential issues such as water in the basement or cracked

foundations. The appraiser will measure, take pictures, and walk the perimeter of the property. Following this walk-through, the appraiser will have a good idea of what characterizes the property, the neighborhood, and the overall appeal of the subject property.

The actual appraisal is prepared by comparing a subject property home to other similar, recently sold, homes in the same neighborhood. Then, after considering differences between the homes, the appraiser will make adjustments to the sales price of the similar homes, or "comps." This is a key stage of the process because the comps will ultimately define the value of the subject property. If the appraiser picks comps that sold on the high end, then the subject property will end up with a higher appraised value. If the appraiser picks lower priced comps, then the value of the subject property will be lower. This is where the appraiser's experience, technique, and prudence are critical. This is also where the temptation to use high-value comps comes into play. If an appraiser picks comps based on a sales price, rather than comparability, the appraisal will be inflated. After picking the comps and making the adjustments, the appraiser comes up with a final opinion of value.

PROBLEMS WITH APPRAISALS

A number of different factors can go into compiling an appraisal. In considering all the stages and steps of an appraisal, one can appreciate how mistakes, sloppiness, and lack of foresight can have a big impact on the final result. And, of course, the final result is what the bank depends on to make a considerable financial decision.

A predominate cause of an appraisal being called into question is a belief that the property has been overvalued.⁴ Most often, the client will assert that they paid too much for a property due to a bad or a negligent appraisal. Less frequently, an appraiser is sued for undervaluing the property. For example, in *Gay v. Broder*, an appraiser evaluated the value of the property to be less than the purchase price, which prevented the appellant from obtaining a VA loan.⁵ This forced the homeowner to obtain conventional financing, to his disadvantage. The homeowner sued the appraiser, claiming negligence, recklessness, and breach of the appraisal agreement.⁶ In another case, pending as of this writing, a bank filed suit against a real estate appraiser for allegedly inflating values on appraisals and then passing on the appraisals to the bank who then closed the loans on the properties in question.⁷ The homes went into foreclosure shortly after the closings and the bank lost approximately \$630,000.⁸

Simple errors can cause an appraisal to be called into question. Most appraisers use software that will help guide them through the actual writing of the report. However, there is still plenty of room for errors, such as putting the wrong date on an appraisal. This error, understandable as it may be, can have a tremendous influence on the subsequent transaction.

Improper zoning can also be an issue. If an appraisal indicates that the zoning is single family residential but it turns out to be commercial, the entire opinion contained in the appraisal will most likely be way off. For example, in *Sadtler v. Jackson-Cross Co.*, a homeowner hired a real estate appraiser to assess some land.⁹ In his appraisal, the appraiser misclassified the proper zoning of the property, gave an incorrect opinion as to how many tracts could be subdivided, and was sued due to that error.¹⁰

The use of comparables that are dissimilar to the subject can lead to a faulty appraisal. In *Barry v. Raskov*, the property being appraised was a residence.¹¹ The first comparable did not exist, and the second was a nursery school that was sold for its value as a business. The third comparable was stated as being 3,000 square feet and listed as having sold for \$375,000.¹² It was later determined that this third property was half the size claimed and that it sold for only \$175,000.¹³

Drive-by appraisals also pose a problem. Occasionally, an appraiser will be ordered to simply do an exterior inspection from a public street.¹⁴ This becomes problematic because in order to complete an appraisal of this type, the appraiser has to make a number of assumptions that are critical to the final outcome of the appraisal.

Since a number of computations are required to complete an appraisal, the potential for error is often high. It is the responsibility for the appraiser to double check their work; however, no one is perfect, and even small errors can have big consequences.

Most of the time, an appraiser will do a walk-through and be able to make the necessary observations. However, if there are obstructions present, then the appraiser will have no way to inspect the full property. The appraiser should do everything in their power to fully inspect; however, it is not always possible. Moreover, if there are material defects in the property that are obstructed, then the appraisal could be faulty.

Also, most of the time, residential properties are subject encroachments, such as utility easements or governmental right-of-ways. These are typical and rarely have an impact on value. However, sometimes the easements or encroachments are significant and do impact the final result. If the appraiser does not address these issues, then the appraisal could be faulty.

Not recognizing external obsolescence can also be an issue. Anything that could be a detriment to value that lies outside the property and cannot be fixed is considered incurable external obsolescence. Examples would include freeway noise, an unpleasant view (such as a parking lot), or even a persistent odor from a factory or sewer.

The appraisal process is designed to consider as many aspects of a property and then come to a supportable opinion of value. It is clear that this process is complicated and contains many different moving parts. During the housing bubble, many appraisal errors were attributed to oversight. However, New York state attorney general Andrew Cuomo "has accused appraisers of helping fuel the nation's foreclosure crisis by pumping up home values at the behest of lenders and other real estate professionals."¹⁵

APPRAISERS, REGULATIONS, AND HOUSING BUBBLES

Historically, the appraisal process worked quite well for the home buyers, home sellers, and the banks who loaned the money. However, that changed over time. During the 1980s, the savings-and-loan (S&L) disaster was eerily similar. In the S&L crisis, 2,912 federally insured financial institutions with combined assets of \$924 billion failed over a 15-year period.¹⁶ The S&L crisis was not very different from the crisis we face today.¹⁷ It was widely assumed at the time that a large portion of those gigantic losses experienced was due to poor, sloppy, and sometimes fraudulent appraisals. "Recognizing the breakdown in credit and appraisal processes as root causes, the federal banking agencies during the S&L crisis started to send a message to the nation's lending institutions that they must improve their credit and appraisal procedures."¹⁸

In an effort to avoid a similar situation in the current crisis, the federal government undertook sweeping regulations aimed specifically at appraisal practices. The final product of this effort was the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA).¹⁹ The primary goal of this legislation was to regulate the banks, mortgage brokers, and appraisers and stop the over-valuation of real estate. The primary tool it used was the Uniform Standards of Appraisal Practice. These standards require, among other things, that individual states develop and enforce uniform appraisal licensing practices. A key component of the licensing standards was a requirement that the appraisers agree to a code of conduct requiring that they remain objective and do not manipulate the value of their appraisals.

With such stringent new regulations, one might think that the appraiser would be the last person to turn to for unprofessional or fraudulent work, since if an appraiser is found to be engaging in sloppy or fraudulent work, he may lose his license. However, because appraisers are often the only link in the real estate transaction chain that has this licensing obligation, the act has proved to be ineffective.

THE REAL ESTATE DEAL

Because of this imbalance in licensing requirements, it becomes important to understand the relationships within a typical real estate deal. The home buyer hires a banker or mortgage broker from which to borrow the money. The banker in turn hires the appraiser to tell the bank how much they should lend, using the property as collateral. If the appraisal does not meet or exceed the agreed-upon sales price, the transaction often will not close. Typically, this failure is due to the fact that the buyer would have to make up the difference in cost with a cash payment at the closing. Because few can afford to bring substantial amounts of money to a real estate closing, an appraisal for less than the contract price would often kill a deal, thus depriving agents of their commissions as well as disappointing the buyer.

If an appraisal does not come in at the purchase price, or above it, the banker has a problem, which quickly becomes the appraiser's problem as well. This results in what some appraisers call "pressure" to "hit" the value.²⁰ The pressure to push for higher values is not limited to purchase transactions. The issues involved with refinancing mortgages are even more problematic in two significant ways. First, mortgage brokers are typically compensated by the fees,²¹ so that there is an incentive to push values higher. Second, there is no opposing party to the sale. This is important because in a sales transaction, there are competing interests regarding the price—the buyer wants a low price, and the seller wants a high price. Through negotiations, the final price is fixed even before the appraiser does his job.

In refinancing, there is only one party to the transaction, the homeowner (and his banker) and his only interest is in how high the appraised value can go. The more the value on a refinancing appraisal, the more the homeowner can borrow,²² thus the more the banker can profit.

In the past, none of this posed much of a systematic threat to the integrity of the U.S. housing stock, because ultimately the bank was

responsible to their shareholders for the amount of monies they lent. But, with the advent of securitization (banks selling their loans in bundles in the form of bonds), banks were no longer on the hook for losses due to defaults, and were free and clear once that loan was resold.²³

APPRAISERS AND PRESSURE

With the housing market in a steep correction,²⁴ the obvious question is, how did the values become so out of whack in the first place?

Appraisers have started to talk about the pressure from lenders to "make the deal." Some suggest that appraisers are being asked to create fiction in regards to home values. "Brokers, real estate agents and banks asked appraisers to do a lot of pretending during the housing boom, pumping up values while ignoring defects."²⁵ One appraiser who "was examining a suburban home a few years ago discovered 5 feet of water in the basement. The mortgage broker arranging the owner's financing asked him to pretend it wasn't there."²⁶

Being asked to overlook significant defects is only one way appraisers get pressured. Appraisers are also simply expected to "hit the number." As stated by Susan Wachter, professor of real estate at the Wharton School of the University of Pennsylvania: "There's always pressure for appraisers to 'hit the number,' but in the past cycle it became extreme. There are many stories of appraisers pressured to certify that the price a buyer was willing to pay for a particular property was what the property was actually worth."²⁷ This pressure can be subtle and come in the form of simply finding that they stop receiving work from the lender.²⁸ Without work, a license to appraise real estate does little to put food on the table.

"The honest appraisers saw that the situation was helping to drive housing prices beyond reason."²⁹ Such appraisers were soon warning "the potential for great financial losses to the economy if the penalties for pressuring appraisers were not enforced. The petition also complained that honest appraisers were being blacklisted. It drew 11,000 signatures."³⁰ The problem of inflated values has only grown because appraisers select recently sold properties on which to base their appraised values. So when recent comps that have been inflated are used in new appraisals, the new appraisal will also be inflated. So the problem not only continues, it snowballs out of control until there is an avalanche of overpriced homes and no one to buy them.

CURRENT ISSUES

With the benefit of hindsight, the damage inflicted by inflated values is easily discernible. Vast numbers of homes are in foreclosure, entire neighborhoods are in decline, and a huge number of properties are "underwater." "It is reported that more than 8.3 million U.S. mortgages or 20% of all mortgaged properties were saddled with negative equity at the end 2008, according to Loan Performance, a company that tracks mortgage data."³¹

The U.S. Treasury agrees, recently acknowledging that "[w]hile this crisis had many causes, it is clear now that the government could have done more to prevent many of these problems from growing out of control and threatening the stability of our financial system."³² Beginning on May 1, 2009, a new set of regulations aimed at safeguarding appraisals has been adopted by Fannie Mae and Freddie Mac. The new code bars loan officers, mortgage brokers, or real-estate agents from any role in selecting appraisers.³³ Without access to the appraisers, these individuals no longer can apply pressure, subtle or not.

These new regulations raise the question of whether real estate agents or mortgage lenders are to choose the appraisers. One method the banks are using is the outsourcing of the appraisal process, utilizing appraisal management companies (AMCs). Sometimes these AMCs are owned by the banks that are using them.³⁴ The AMCs maintain a list of appraisers whom they hire directly and then oversee during the entire appraisal process. It has been contended that the AMCs do serve some useful ends; however, they can potentially cause a decline in appraisal quality.³⁵ This is true because AMCs get as much work out of the appraisers as they can for as little fee as possible. This is a good business decision for the AMCs, but some allege the practice leads to the use of inexperienced and unqualified appraisers because they have to travel long distances to complete the appraisal. This is because the experienced appraisers in the immediate area will not work for 60 percent of their typical fee. "Many appraisers are struggling to survive on the fees paid by the AMCs," says Bill Garber, a spokesman for the Appraisal Institute, a trade group based in Chicago. Appraisers are being asked to work faster even as their fees are cut, and that conflict with the goal of getting reliable appraisals, he says.³⁶

