

What Do We Know About Lender Risk?

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A Research Paper Review

of

How Much Is That Home Really Worth?

Appraisal Bias and House-Price Uncertainty*

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How much is that home really worth?¹ Mr. Nakamura's paper turns up the heat on biased appraisals as being one source of our ongoing mortgage problems. While much of the research on which the author's thesis is based has made valuable contributions to understanding the role of appraisals, his underlying premise reveals fundamental issues with the way risk is exacerbated or checked. It also suggests that something more than conventional wisdom may be needed to counter the next asset/lending bubble.

The paper does not equivocate; it states that "One of the safeguards, the appraisal, failed to perform its role of limiting mortgages to the underlying value of the houses"

and that "...appraisals have been biased upward, making mortgages riskier. Now a reverse risk is at work: The bias is going the other way, causing home valuations to be underestimated, possibly making new mortgages harder to obtain."

Apparently appraisals have quite a lot of influence on lender risk. However, appraisals are being used in the lending process in a way that renders them nearly meaningless,² and that dealing with the way appraisals are performed given conventional wisdom and regulatory perspectives on risk will accomplish nothing to reduce systematic risk, counter the rise of the next price bubble, or improve current down market conditions.

Appraisers are charged with interpreting the current market and concluding market value on the date of the transaction, as the price a typical buyer and seller would agree on, neither under compulsion to buy or sell. When the entire market has become skewed – it was badly so in 2005 – then discovering what the market would pay at that time was nearly useless as a lender risk metric. It is the value of the property at the time of default and foreclosure that should be the lender's principal concern. If the 2005 transaction price were shown to be far above the property's long-term value, then it should be clear that there was a chance (close to a certainty) that it would return to the lower value. For this reason, risk to the lender during bubble conditions is extremely high. By the same token, if market pricing is below its long-term value, as it may be for many markets at present, then value is likely to increase from its depressed state, and risk to the lender would be relatively low. The relationship of price to long-term value can have a huge effect on risk.

This time relationship between current price and likely (future) foreclosure value suggests that our understanding of risk is exactly backward, and that the appraisers are being asked the wrong question.

The author makes the observation that: "During the recent housing boom, housing market participants lost sight of the importance of the down payment, in many cases

¹ [Http://www.philadelphiafed.org/research-and-data/publications/business-review/2010/](http://www.philadelphiafed.org/research-and-data/publications/business-review/2010/)

² Current market appraisals are indeed required to reveal fraud, overbids and any other nonmarket conditions. But this is more of a policing or quality control function that benefits underwriting; it still says nothing about long-term risk (given that the loan is not made to a fraudulent borrower).

because house prices kept rising so consistently. If house prices rise continuously, the down payment may not matter...In the U.S., during the six years from the end of 1999 to the end of 2005, house prices rose at an annual rate of 11.3 percent (according to the Case-Shiller U.S. House-price index). During that period, on average, house-price appreciation created more than a 20 percent margin of safety in two years' time. During this period, it appeared as if mortgages made with no down payments were reasonable investments." He continues: "In more normal times, when prices aren't rising quite so quickly, the precise value of the home on the market, and whether it will be sufficient to repay the mortgage, is crucial information for the mortgage lender, since it influences both the likelihood that the mortgage will lose value and how the mortgage lender will approach legal options if the borrower falls behind in payments."

The point to be made is that expectation of a continued 11.3 annual increase in home value created the perception that risk had been reduced. The opposite is true: risk was drastically increased, because the growth rate was not sustainable. Whether this was appreciated by regulators at the time remains unstated. It was clearly not appreciated by lenders, who behaved as if risk had been reduced to zero.

The author takes appraisals further to task for exacerbating the current down market, which is dominated by foreclosures. He observes that the current market is comprised largely of foreclosure sales, for which the seller has an incentive to move assets quickly rather than holding out for the best price. Thus, appraisals based on foreclosure sales that are "below the usual market price" are undesirable because they unnecessarily restrict mortgage lending. This is a markedly different perspective than the one reserved for rising markets. If the presence of foreclosure sales provides downward pressure on prices, what about the upward pressure provided by low mortgage rates and lax lending standards? It seems that prices were well above the "usual market price" in 2005, and yet appraisers were expected to regard such influenced transactions (more or less the entire market) as valid market price indications. The discussion is advocating for giving weight to one set of biasing influences while ignoring the other; in effect, advocating for a systematic, upward valuation bias.

A major difficulty in the entire argument is the standard of value. The market value standard used for federally-related transactions is mandated,³ and may be summarized as the price that a hypothetical buyer and seller would arrive at, neither under compulsion, and is applied as of a specific date. Whether compulsion associated with foreclosures, or price pressures brought on by low mortgage rates and lax lending standards is to be accounted for remains unclear. In order to evaluate the appropriateness of appraiser-concluded market values, the author makes repeated reference to a norm of some sort, described variously as the "usual market price," "true underlying value" and "intrinsic value." These are undefined, and have no real meaning in the context of

³ Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Title XI, Pub. L. 101- 73, 103 Stat. 183, 12 U.S.C. 3331 et seq. (1989) § 323.2(f)

snapshot market observations. They do, however, have a great deal of meaning if one considers value in a long-term context.

A broad take on long-term value can be extracted from 100 years' worth of data published by Robert Shiller, who makes the statement that home values in the U.S. have only kept pace with inflation; their real value has remained substantially flat for the period. Significant spikes in roughly 1979-1981 and 1988-1991 were followed by a return to this long-term trend. The spike that began in 2001 was enormous, but we are once again returning to the long-term trend.

Valuations based on long-term trends is not a new idea. It has been used for years in Europe, and a supporting valuation standard, "Mortgage Lending Value," is provided for in International Valuation Standards,⁴ and is discussed in a recent article appearing in RICS Property World.⁵

There is no reason that loans cannot be made in a way that allows markets to function regardless of price levels, as long as risk is properly allocated between the long-term level and current (excess or deficit) amount. Our current lending process, which is focused solely on short-term measurements of value, is entirely blind to systematic influences that can make very risky loans seem very safe when values are high, and inhibit lending due to misunderstood risk when values are low. The process is pro-cyclical, making asset bubbles and depressions worse, and drastically increasing risk to the financial system as a whole, not to mention homeowners who have been left confused and financially wiped out. Making use of long-term values for loan underwriting, in addition to short-term market observations, would clarify risk and provide a strong anti-cyclical influence. The real problem is not so much a matter of systematic or individual biased market value appraisals, but the lack of any long-term perspective. Fixing market value appraisals is not nearly enough.

⁴ International Valuation Standards Committee, IVS 2, Bases Other Than Market Value, 2007 Ed.

⁵ Webb, Dennis A., ASA, MAI, FRICS (Fall 2009) Toward Sustainable Finance: The Trouble With Asset Values, RICS Property World, (New York, RICS Americas): 9-11.