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Comparing Valuation Measures

Posted By *Matt Whiteley* On January 19, 2014 @ 9:21 pm In Headlines,Print Features,REO,Technology | No Comments

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Special Print Feature, originally appeared in the August 2013 issue of* DS News *Magazine.
By Steve Albert, Ernie Durbin, and Tami Rund

Without question, accurate valuation data is critical to your business, but how do you determine which method to use for the most-conclusive results?

Valuation is a meticulous and calculated science with multiple facets as well as risks stemming from new regulations, morphing market dynamics, and evolving investor and consumer demands. Despite all the variables that can come into play, proper valuation has never been more critical to the mortgage and real estate markets.

Any industry professional can tell you the importance of working with accurate valuation data, but with a number of options to choose from, how can you ensure you're using the valuation method best suited for a particular scenario or transaction and the one that will produce the most accurate results?

We called on three valuation experts to help put the industry's principal valuation techniques into perspective—appraisals, broker price opinions (BPOs), and automated valuation models (AVMs). So here's the skinny on the pros, cons, and ideal applications of each technique, directly from the valuation pros themselves.

The Value of Appraisals

By Steve Albert, Allstate Appraisals

When comparing different property valuation methods, a question that is often asked is: When is it appropriate to save time and money at the potential cost of accuracy and reliability? On one end, there are tried-and-true appraisals that involve a thorough inspection from a licensed or certified appraiser whose opinions are subject to specific and enforceable guidelines. On the other end, there are computer-generated AVMs that produce value indications at a fraction of the cost and practically none of the time relative to an appraisal but provide no recourse to the intended user if those results are not reliable. In the middle, there are BPOs that reflect some human judgment but are less scientific and narrower in scope than appraisals. With BPOs, the user has little to no

recourse for incorrect or unreliable valuations.

Few disagree that an appraisal prepared by a competent appraiser familiar with the subject property type and neighborhood is the most reliable of these three methods. Unlike brokers or AVMs, certified residential appraisers must complete, at minimum, 2,500 hours of actual appraisal experience in addition to a minimum 200 hours of approved coursework and a state examination; they must also abide by the Uniform Standards of Professional Appraisal Practice (USPAP). In addition to USPAP, they must adhere to other industry guidelines, all designed to help ensure appraisals are developed and communicated in a manner that promotes and maintains a high level of public trust by stressing accuracy and mitigating any bias. However appraisals are more expensive and time-consuming relative to nontraditional valuation tools. In fact, that is what drives the shift to faster and cheaper alternatives, circumstances permitting.

Appraisals are best used as a valuation tool during first mortgage originations, litigation-support situations, valuation of atypical or outlying properties, or any other time when the valuation is used as a basis to make major financial or other collateral-based decisions. A BPO prepared by a competent and highly experienced broker can be an extremely valuable tool in certain circumstances; however, it is less scientific than an appraisal and is performed by non-appraisers. In addition to an inexpensive value estimate, the BPO is also a good choice for clients who merely want market data, photos, and property condition verification quickly and inexpensively. But a BPO is not an appraisal. It is a less expensive way of gauging residential property values in which the broker does not have to adhere to any appraisal guidelines or hold any certification or formal training in property valuation.

The appraiser wears many hats and assumes responsibility for all of them. Beginning with a visit to the subject property, the appraiser must competently measure the home as well as observe and measure the subject's overall quality, condition, functional utility, and market appeal. The appraiser must also be familiar with the neighborhood in which the property is located in order to select the most appropriate and comparable sales and apply market-supported adjustments for all material differences between the appraised home and the comparables. An appraiser must be familiar with all factors influencing property values and marketability in the defined subject neighborhood and measure the specific impact on the subject property's value for each. For example, any external influences on a property's value such as proximity to a major arterial street or non-residential property use in close proximity (i.e., a gas station or shopping center) must be addressed and accurately measured insofar as its impact on value.

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reliability, and accountability are more pronounced than ever, these qualities are more important than ever
—Steve Albert, AllState Appraisals

All this must be done without bias or advocacy whatsoever. Plus, the appraiser assumes liability for the accuracy and reliability of his or her appraisal for many years after the report is delivered to the client. All of these factors combined result in a level of reliability of a competently prepared appraisal typically much higher than that reflected in an AVM or BPO but, again, at a higher cost and longer turn time.

Ultimately, the intended use of the valuation should determine which valuation method is relied upon. The more accuracy and accountability required, the more human involvement is needed. If there is a situation when human involvement is needed, it is usually better to spend more time and money on a full appraisal. To most, the cost of the appraisal is insignificant relative to the risk of potentially losing thousands of dollars or more as a result of reliance on something less. No single valuation tool or method is always the best or worst, and many lenders utilize a combination of all three in their lending-related decisions each day.

Often, the method is not as important as the person behind it. As in any profession, there are competent and incompetent participants. I have seen BPOs as well as AVMs that were more reliable than full appraisals on the same property when the appraisal was performed by a poorly trained appraiser. Valuations come down to experience, skill, and ethics. In an industry where accuracy, reliability, and accountability are more pronounced than ever, these qualities are more important than ever in assessing value in today's marketplace.

Brokered Assessments
By Ernie Durbin, Valuation Vision

Valuation products are arrayed on a continuum of collateral risk assessment. There are many factors that determine where a product belongs on this continuum; the most important, however, is human judgment. Generally speaking, the more human judgment involved in a valuation product the lower the risk. Human judgment, however, comes at a premium both in terms of dollars and time. In the continuum of valuation products, BPOs are somewhere in the center.

The lowest-cost alternative is clearly a fully automated product such as an AVM. However, relying on the value of an AVM, which assumes average condition and no particular external influence, is risky in the default space. At the other end of the spectrum is a full interior appraisal by a certified real estate appraiser. Although possibly the least risky,

appraisers are expensive and can take a long time to complete their reports. Quicker and less expensive, BPOs provide an opinion of price from a local market real estate professional. These professionals may not be as highly credentialed as an appraiser, but they know the market and the appropriate price point to sell a property. BPOs provide the professional human touch absent in automated valuation products and are usually faster and less costly than a certified appraiser.

BPOs are a main staple of valuation in the default and servicing space. In this arena collateral decisions must be made quickly on hundreds of properties simultaneously. Full interior appraisals are ideal, but they can take weeks to receive and cost three or four times more than an agent's price opinion. BPOs are demonstrably faster and less expensive than an appraisal but still involve a local real estate professional.

Real estate agents are not trained valuation professionals, but they have a keen sense for price. With their local market knowledge, agents select recent comparable sales and competitive listings from the subject's immediate marketplace. While appraisers typically use comparable sales that occurred in the past, agents include the sales and emphasize properties currently competing with the subject. This results in a forward-thinking product versus a historical value. Distressed properties will need to be sold in the future, making forward-thinking valuations critical.

Agents also have access to market metrics delivered by the local multiple listing service (MLS). These professionals include this data in their reports, detailing local market trends such as housing supply and market direction, for example. Local market expertise and the interpretation of market direction are foundational to the default decision-making process. When this local MLS data is gathered by a real estate professional, it is head and shoulders more valuable than automated metrics provided on a regional basis.

A picture is worth a thousand words, and interior BPOs typically have numerous photos. These photos support agent commentary regarding condition and marketability. Pictures reveal repairs needed to make the subject marketable or highlight attributes that make the subject stand out. Agents also image external influences that may impact the property's marketability. In addition, some BPO vendors supply aerial photographs of the subject and all of the comparable properties. When triaging hundreds of default properties at a time, recent photos are vital to assessing collateral risk.

Some BPO vendors are leveraging the local market knowledge of the real estate professional and enhancing his or her input with technology. Enhanced BPOs are enriched with additional data streams from AVMs, repair estimators, cost services, and rental data. These "super" BPOs provide agent opinions supplemented with analytical data, reducing

the overall risk by providing more information for decision-making. The output of these advanced BPOs is both a normal portable document and an XML stream for seamless transmission to the client's proprietary data systems.

BPOs are the cornerstone valuation product of the default and servicing sector. They are ordered more frequently than appraisals because they are data-rich, fast, and less expensive. With invaluable local market information and recent images of the subject property, they are critical to the decision-making process. As a result, they are in a sweet spot, in between impersonal automated products and more extensive but expensive appraisals. BPOs are here to stay and new products using their reports as a platform evolve every day.

Automating Valuations

By Tami Rund, Asset Valuation & Marketing

In a span of less than 20 years, AVMs have evolved from an inexact technology tool used primarily to determine risk for collateralized loan purchases to a sophisticated analytical product widely used throughout the originating, investing, and servicing sectors of the industry.

Current uses for AVM and AVM cascade products include appraisal review, portfolio review and analysis, prequalification screening, securitization of residential mortgage-backed securities (RMBS) and asset-backed securities (ABS), loan underwriting (as outlined in the Interagency Appraisal and Evaluation Guidelines), and various loan servicing and asset management applications.

Lina Piedrahita of Resolute Asset Management uses AVMs along with a second-opinion BPO to validate market value. She states that the AVM "gives us a broader outlook of the market conditions, which we use to compare to the agent's valuations and support our marketing recommendation."

AVMs are a sophisticated risk management tool that can streamline the lending process, assist with reconciling value discrepancies, and help mitigate fraud risk, but the product does have its limitations. Without knowing the current condition of the property, the AVM value assumes "average" condition for the area; this is an obvious drawback when dealing with nonconforming properties in fair or poor condition and in neighborhoods with a large range of values.

AVM values are most accurate in urban and suburban homogenous neighborhoods. Without the eyes and ears of a professional, it is impossible to adjust for important locational factors that can exist within a one-mile radius. A property's view, proximity to commercial

buildings or railroad tracks, and the pride of ownership in the immediate neighborhood, among other factors, can cause extreme value shifts within a mini-market.

Some of the advantages AVMs have over other valuation methods, including appraisals and BPOs, are their immediacy, cost effectiveness, and the unbiased nature of the product; results are strictly analytical and not subject to pressure from lenders. The quality and accuracy of AVM products have been thoroughly tested by AVM producers, lenders, and third-party testing agencies.

The more recent addition of AVM "cascade" and "hybrid" products further expanded and strengthened the product's footprint. An AVM cascade provides the end user with the highest-rated report pulled from multiple products, improving accuracy and hit rate. Hybrid products typically include an exterior or interior inspection or BPO along with the AVM, providing the crucial property condition component to the AVM product.

Regulatory agencies first referenced analytical tools in a 2000 bulletin from the Office of the Comptroller of the Currency (OCC); AVMs themselves were first mentioned in OCC bulletins in 2004 and 2005. However, it was not until the 2010 Interagency Appraisal and Evaluation Guidelines that federal agencies validated the expanded use of AVM products. These guidelines— revised from the 1994 rules and issued by the OCC, Federal Reserve Board, FDIC, Office of Thrift Supervision, and National Credit Union Administration—lay out the framework for the appropriate use of appraisal and valuation products. According to the Interagency Guidelines, "An AVM may be used for a transaction provided the resulting evaluation meets all of the supervisory expectations in the 'Evaluation Development' and 'Evaluation Content' sections in the guidelines, is consistent with safe and sound banking practices, and produces a credible market value conclusion."

However, the Evaluation Development section of the guidelines warns against using a product that does not provide sufficient information and analysis to support the value conclusion. The guidelines read: "A valuation method should address the property's actual physical condition and characteristics as well as the economic and market conditions that affect the estimate of the collateral's market value. It would not be acceptable for an institution to base an evaluation on unsupported assumptions, such as a property is in average condition, the zoning will change, or the property is not affected by adverse market conditions."

Additionally, the Evaluation Content section specifies that, among other things, an evaluation must identify the location of the property, provide a description and its current and projected use, and describe the method used to confirm the physical condition of the property and the extent to which the inspection was performed.

The responsibility for determining an appropriate collateral valuation method and determining the risks associated with those methods lies squarely on the financial institution. It is important that each institution establishes internal policies and procedures governing appraisal, BPO, and AVM use and defines which supplemental products are required or recommended with each.

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—Tami Rund, Asset Valuation + Marketing
