

Among rule based systems there are two themes. One is supervisory; rule makers make and enforce rules. The other is adversarial. Contestants agree on rules which may be enforced to insure fair or equal play. The first is weak because there are almost always more players who have an interest in evasion than there are referees to catch them. The second is robust because there are usually about equal interests at stake.

An example of the first is arms control. Saddam Hussein exploited the limitations of even the most stringent arms control regime. An example of the second is the Geneva Accord. Few countries flout the Geneva Accord because it is in their interest to see it applies to them as well as their adversaries.

Let's take a less fraught pair of examples relating to sport. Sailboat racing has two sets of rules. One is related to handicapping boats depending on their different design characteristics. The second is related to conduct on the race course. The first is supervisory and the second adversarial.

Sailboats are faster or slower depending on a number of factors, principal of which are waterline length, weight, power and stability. Since I have been involved in racing boats there have been a succession of clever rules which were devised by brilliant people with the intent of making a formula that reliably handicapped the differences between different boats. They have all degenerated into encouraging the construction of rule-based boats. In other words, instead of equalizing the scoring of a disparate fleet of boats, they have resulted in construction of a more or less homogenous fleet optimized to the rule. There are lots of smart naval architects and racers with the money to encourage them to try to outsmart the rule. As the weaknesses of the rule usually lead to odd boats, one rule succeeds another. The International Offshore Rule was thoroughly discredited by the disastrous losses of boats designed to it in the Fastnet Race of 1979. Hope triumphs over experience, however, and it has had several successors.

Conduct on the race course is obviously adversarial. It is governed by published rules which are internationally recognized. They start with basic sorts of things. In general boats to your right have the right of way. You must avoid collision. If you don't, beside possibly being liable for repair costs, you will very probably be disqualified from the race. This rule regime is pretty stable. Every five years the rule making committee takes a look at how they've worked and makes some small amendments. They also work pretty well in practice. Any contestant may protest any other for an infringement. The decision is made speedily, usually the night after the event, and locally, at the race-sponsoring yacht club, by a committee of peers, members of a knowledgeable race committee. The immediacy and certainty of the process as well as the high probability of its outcome yields a high level of compliance. Even at high profile events there are usually few protests. There is an appeal process, too. Appeals are read carefully both by serious competitors and by the racing rules committee in its periodic rule revision process.

The tenet that I draw from these examples is that transparent adversarial rules are robust. My suggestions that relate to the proposed OCC, OTS, FDIC, etal. appraisal rules are made with that in mind.

Within the context of lending, appraisal is part of the underwriting process. Its role as a cross-check has been degraded as the system has had no room for cross-checks. The way to make money was to make loans.

Not making loans was not making money. In the event, because everybody acted that way, now everybody is losing incredible amounts of money. That was predictable.

Now, specifically, the proposed rule only "allows" the sale contract to be shared with the appraiser. Let us suppose that the lender chooses not to, but orally informs the appraiser of a sale price. There have been sales in the last cycle in which as much as 15% of the nominal price was immediately rebated to the buyer. Presumably that rebate would be in the contract. How likely would it be that the lender would report it orally at the same time as the nominal gross price?

The assumption here is that purchase appraisals are a large problem. Of course they may be. But refinance and construction appraisals have absolutely no direct reference to the market. Purchases do, the buyer and the price. In general buyers are not stupid. Unless there is some tangible incentive to do otherwise they will pay a fair price. In home resales my experience is that is true over 90% of the time. Allowing lenders to deprive appraisers of that source of information is not going to improve the underwriting process.

It is a good idea to make appraiser independence a major goal of the rule. There are probably two simpler ways to do that. The first is to put appraisal in the audit department of the institution rather than loan origination. The second is to require selection of contract appraisers by a random or sequential process from licensed appraisers in a geographic area.

The assumption behind the proposed rule is that taking the appraisal quality decision to the highest level will improve the result. This is not universally so. Had a memorable termination interview in which the corporate head of underwriting informed me that my job as reviewer was to rubber stamp all appraisals as acceptable. The quality control decision was his. This interview was held in the presence of the corporate counsel who almost apologetically confirmed that policy was consistent with the wishes of the president-CEO. Maybe the result would have been the same if I had been responsible to the chief auditor.

But the follow up on that internal determination is to homogenize the contract appraisals so that none undermine the generation of fee income.

Another memorable conversation I had was with a review appraiser of an ex-client. It turned out that I had really angered one of their borrowers and that was why I wasn't getting any more work from them. If appraiser selection was either sequential by license number or random in a geographic area, that sort of homogenization would be difficult if not impossible.

Additional standards in excess of licensure is a dangerous concept. Yes, achieving, for instance, senior membership in an appraisal organization is worthy and hopefully represents an advance in knowledge and general expertise over licensure. Similarly, course work related to specialized topics may improve suitability for some assignments. But unless such standards are explicit and externally verifiable, others, such as the willingness and ability to please the client, may also weigh in the balance to the detriment of quality.

Here's a little one. Photos of the property securing the loan are now available from several online databases. The moment of time that these images capture is often poorly defined. If photos are going to be any sort of assistance to evaluating collateral, there has to be some assurance that they represent the property at a time contemporary with that decision.

Automated Valuation Models (AVMs) are another slippery problem. They have proved out for property taxation. But property taxation is an adversarial game. Using AVMs for lending is going to be a supervisorial game. Nobody makes money by saying no. AVMs will allow the

proliferation of bad decisions faster than they can be detected let alone suppressed by a limited number of supervisors. This assumes that the supervisors will be as technically qualified as those who will seek to evade supervision. Imagine pitting a GS13 with an MBA against a team of math PhDs with bonus plans. Remember the Unibomber is a math PhD.

Assessed value is a stronger reed. Assessment is adversarial. The assessor wants an accurate value. The property owner wants a low one.

Presumably the local jurisdiction wants a high one, but can't usually explicitly say so. With the exception of states like California, those interests come out with a pretty well equalized result. Yes, the relationship of assessed value to market value will vary for many reasons. But it may not be necessary for the lending institution to evaluate that. It is probably evaluated at the state level to oversee and supervise assessment generally. It may also be a matter of public record at the local level. If the institution is to be tasked with relating assessed value to market value, the rules better be explicit, and the measures for doing so better be related to publicly available information.

This is a bit outside the scope of property appraisal, but reference to rating agencies to determine the quality and value of real estate based securities seems a bit quaint. Perhaps verification that there is a market maker, a liquid market and the price of the securities might be more to the point.

Sincerely,

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