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Real estate: Let us now appraise appraisers and appraisals
By Curtis Seltzer

BLUE GRASS, Va.—Appraisers are being punched up in the courts and the press for not always providing honest real-estate valuations. What's going on? What exactly do appraisers do?

An appraiser forms an opinion of a property's current Fair Market Value (FMV) by judging its attributes in relation to recent selling prices of nearby comparable properties. Adjustments are made for differences between the target and the "comps" to arrive at a dollar valuation for the target.

Appraisers get into the buy-sell process during escrow, after the buyer and seller have agreed on price and terms. If the buyer wants a mortgage from an institutional lender, he should have a financing contingency in his contract that allows him to back out of the deal if acceptable financing cannot be arranged. That contingency often includes, among other items, a provision that the appraisal's FMV be at least equal to the agreed contract price. Accordingly, buyer, seller and lender become invested in having the appraiser hit that contract number.

The lender has a list of approved appraisers. Small lenders often allow the buyer to choose from among them. Large lenders generally assign appraisers. In either case, the buyer pays the appraiser for estimating the property's current market value. The main criticism of appraisers has focused on the practice of deliberately inflating FMVs. Inflation allows a buyer to borrow more than the property's true market worth. Appraisers are supposed to give honest and accurate valuations.

One version of inflation is a cash-back scheme, where the borrower puts the extra money not used for purchase in his pocket. If the buyer then defaults, the lender takes over a property that is likely to sell for less than the mortgage principal. Lenders don't like cash-back schemes. Buyers have been known to pay appraisers on the side for their cooperation.

The more common inflation criticism is that appraisers play ball with lenders, sellers and borrowers—all of whom want the appraisal to hit the contract price, which is often higher than an honest FMV.

A 2007 study by October Research reported that almost 90 percent of appraisers surveyed reported pressure for inflated valuations from lenders, real-estate agents, mortgage brokers, borrowers and others. Three-quarters reported "negative ramifications" -- blacklisting; fewer referrals; less business -- if they didn't play ball.

So what’s wrong with everyone working together toward the same end? What’s wrong with an appraiser adding phantom value when everyone wants it? From the seller’s perspective, it’s just fine. The sale goes through. From the buyer’s perspective, it looks fine, because the purchase goes through.

If, however, the buyer is being allowed to borrow too much in relation to the property’s real value and his ability to pay the note, then the mortgage payment and other expenses can easily swamp him in the muck of unpaid debt. When properties are purchased for more than they’re worth, a downturn in real-estate prices can make them worth less than the amount of principal owed on their mortgages. This is called, “being upside down,” which is not where any borrower wants to be.

From the lender’s perspective, lending more than a property’s true worth based on a pumped-up appraisal works only if the lender quickly sells the risky steroidal mortgage. Such lenders have turned themselves into middlemen between borrower and note buyer. They had no incentive to insist on honest appraisals. The higher the loan, the more they made on the flip. These lenders shifted the risk of loss from default to the guy who bought the loan.

Small lenders, country banks, credit unions and others -- those who kept their loans in their own portfolios -- did not play this game. Many big lenders did. Inflated FMVs lead to many buyers paying too much. The general public, one study estimated, paid about $135 billion for appraisal baloney -- phantom value -- in 2006 alone. As in a pyramid scheme, a few people were winning until everybody started losing.

Phony valuations also destabilize the entire mortgage market and, eventually, much of the economy. An economic downturn cascades through these tricked-up mortgages, which produces defaults and foreclosures, slows real-estate sales, tightens credit and clobbers those who bought the notes.

This is where America is today.

Appraisers are in the middle of this mess. Ethical appraisers -- those who follow state and federal law and the rules of their profession -- lose work to those who don’t. Once appraisers start giving in to pressure, it’s very difficult to stop.

With country property, several other appraisals can be involved in a purchase. Consulting foresters do cruises that estimate timber volumes and dollar values. Sellers can pressure foresters to inflate volumes to show more “money in the timber” than is actually there. Ethical foresters don’t do this. I’ve been given seller-paid-for cruises that more than doubled actual timber value. Inflation of 25 to 50 percent is not uncommon.

Mineral geologists estimate the volume of underground resources—minerals, coal, oil and gas. Bogus reports prepared for sellers that inflate the resource or fail to mention important discounting factors are not unknown. Farm appraisers are subject to the same pressures. Landowners may also lean on appraisers to come up with inflated values when they donate a conservation easement or historic-preservation easement. Higher valuations mean more tax benefits.

What can be done to protect appraisers—and, ultimately, consumers? Jennifer Wertz, a California appraiser, fought back on her own. She recently sued Washington Mutual Bank (WaMu), America's biggest thrift, alleging that she was blacklisted from work for not cranking up appraisals to the Bank's target number. States can investigate and sue. New York sued an appraisal company, First American, in November for doing what WaMu wanted.

Buyer-oriented real-estate organizations might bring legal and political pressure.
Professional groups -- appraisers, consulting foresters, geologists and others -- may be able to do more to stand up to lenders and sellers. At the same time, they should back up their own members better and enforce their own ethical codes.

Their standards are not the problem. Look at the Appraisal Institute's Code of Professional Ethics at www.appraisalinstitute.org; Click on About Us; Click on Ethics and Standards. Excellent information is also available from Appraisal Scoop at www.appraisalnewsonline.typepad.com

Perhaps code enforcement should be changed from a peer-review process to totally independent boards. It's always easy to say, "There oughta be a law." Well, maybe there oughta be. Many appraisers have been under pressure to choose between making a living and being honest. They need to help themselves, but they also need a hand.

Curtis Seltzer, land consultant, is the author of How To Be A DIRT-SMART Buyer of Country Property at www.curtis-seltzer.com. He holds a Class A residential contractor's license in Virginia and has lived in a now 90-year-old farmhouse for 25 years.

Contact: Curtis Seltzer, Ph.D.
Land Consultant
1467 Wimer Mountain Road
Blue Grass, VA 24413-2307
540-474-3297
curtisseltzer@htcnet.org

www.curtis-seltzer.com