Reprint of Wall Street Journal Article, August 12, 2011
for Forest Hills by Lester Martin
Forest Hills Communications

Judgment Call:
Appraisals Weigh Down Housing Sales

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William Maxwell is an expert in finance. He's a professor at Southern Methodist University's business school, has co-authored a book on high-yield debt and spent years calculating values of financial markets.

Yet there's one valuation he can't understand: the appraisal of his Dallas home.

In August 2010, Mr. Maxwell's home was appraised at $790,000 as part of a mortgage refinancing. Yet this past spring, when he tried to sell the four-bedroom home for $756,500, the appraisal commissioned by the buyer's lender, Bank of America Corp., came up with a value of $730,000. Mr. Maxwell said the appraisal killed the sale.

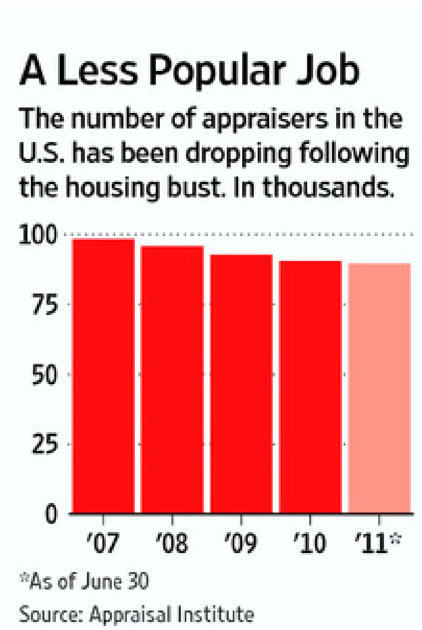
WSJ's Nick Timiraos reports many analysts believe low appraisals are one factor weighing on the housing market and recovery of the sector. AP Photo/Seth Perlman.
Journal Community

Weak appraisals are "driving down the real-estate market," Mr. Maxwell says. Saying the appraisal process "borders on buffoonery," he's appealing his home's valuation to the Texas regulator.

One of the conclusions from the housing bust: The appraisal system was broken. One of the conclusions some have drawn from the struggling recovery since then: The appraisal system is still broken, but in a different way.

There is little doubt that home values have depreciated sharply in recent years for the most basic of economic reasons: excess supply of homes on the market and weak demand. But some realtors, home-sellers and economists believe low-ball appraisals also are undermining a housing recovery.

Appraisals are supposed to be unbiased assessments of a property's value. The housing bubble that burst a few years ago was inflated, in part, by overly generous appraisals. Now, lenders are pressuring appraisers to come in with lower estimates, some real-estate professionals say. Banks also are using less-experienced appraisers, who often don't appreciate factors that make a home worth more, they say. And valuations are being heavily influenced by distressed sales priced at a discount to the rest of the market.

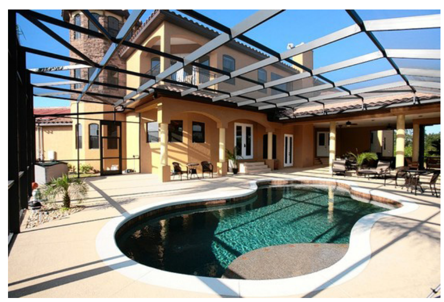


Lenders are "instructing appraisers to be a little conservative, and that responsibility on the one hand is seen as credit tightening and, on the other, as exacerbating the housing problem," says Columbia Business School economist Chris Mayer. A research paper last year titled "How Much Is That Home Really Worth?" by economist Leonard Nakamura at the Philadelphia Federal Reserve also cited a downward bias in appraisals.

This 7,000-square-foot house on four acres in Orlando, Fla., was appraised by the builder for $1.2 million in 2008.

It went under contract for $650,000.

But another appraisal valued it at just $380,000.



Disputes over valuations are rising. The National Association of Realtors said that 16% of realtors surveyed reported a cancellation in June of this year, and chief economist Lawrence Yun blamed the unusually large number on low appraisals. In June of 2010, only 9% of those surveyed reported a cancellation.

A survey by the group earlier this year found that 10%-12% of members had a contract canceled last year as a result of a low appraisal; 10%-13% had a contract delayed; and 16%-20% reported that the sales price was negotiated lower due to a low appraisal.

Not everyone agrees the appraisal system is broken. The Mortgage Bankers Association, an industry trade group, concedes that appraisals are conservative but says they need to be, partly to protect the banks from future problems with investors who buy mortgages. "There's an extra note of caution," said Steve O'Connor, a senior vice president at the association.

And some appraisers say homeowners are just having trouble facing reality. "It's the market. It's not the changes" in the appraisal process, says Charles MacPhee, a partner with Buttler Appraisals LLC.

Mr. MacPhee's company performed an appraisal in Decatur, Ga., last year that drew ire. John and Michelle Pennie were about to give up on selling their house last spring when an offer came in—just in time to qualify for the 2010 federal tax credit.

The two sides agreed on a sale price of $365,000, with the Pennies paying $8,000 in closing costs. “We were ecstatic,” Mr. Pennie says.

But the appraisal put the home’s worth at $327,000. And the deal ultimately collapsed. “Understandably in a declining market, you’re going to have declining appraisals,” Mr. Pennie says. “But when you have two parties who agree on a price, to then have an appraiser come in and make it $40,000 below…how do you ever get out of a falling market?”

For decades, appraising a home was both an art and a science, executed primarily by independent professionals who were experts on their local markets. Designed to protect both the borrower and lender, appraisals were based largely on selling prices of comparable homes. But appraisers also combed through property records and interviewed brokers, buyers, sellers—and even other appraisers. Banks selected the appraiser and often had influence over the outcome. Home buyers paid the fee.

In the aftermath of the housing bust, then-New York State Attorney General Andrew Cuomo sought to reform the appraisal industry by convincing Fannie Mae and Freddie Mac to bar loan officers, mortgage brokers or real-estate agents from any role in selecting appraisers. Besides combating inflated and sometimes fraudulent appraisals, the goal was to eliminate pressure on appraisers to provide estimates that match the contract price, which would increase chances that the mortgage loan would get approved. The sweeping Dodd-Frank financial-overhaul law that went into effect in 2010 went one step further to bolster appraiser independence by regulating both the industry and the fees they are paid.

Rather than hire appraisers whose work is known to them, banks now outsource their selection to appraisal-management companies, which are often units of other banks and financial companies. These appraisal-management companies take a sizable cut of the fee, leaving the appraisers under pressure to work faster and cheaper.

The result has been that appraisers with less experience or who are unfamiliar with a community—but who work cheap—are getting assignments while more experienced appraisers are going out business. That, say critics, is producing appraisals that are less accurate.

“We’ve lost the best quality appraisers,” said Leslie Sellers, the immediate past president of the Appraisal Institute, a trade group. “The people doing it are the ones who have cut overhead to bone, are working out of basements and many of them are not properly educated.” The Institute estimates there are currently under 90,000 certified appraisers, down from nearly 100,000 in 2007.

In Mr. Maxwell’s case, he says that the appraiser, Jim Applegate, works in Plano, a suburb 20 miles from Dallas, and was unfamiliar with Mr. Maxwell’s Dallas neighborhood of Lakewood, an affluent community near a picturesque lake. Mr. Maxwell also claims that Mr. Applegate improperly used less desirable homes as comparables, or “comps,” to arrive at a value. In a June 17 formal letter of complaint with the Texas Appraiser Licensing and Certification Board, which regulates the industry, Mr. Maxwell said that Mr. Applegate had used a home near an elementary school that encounters a lot of traffic. Mr. Maxwell’s home, by comparison, sits on a quiet, quarter-acre lot.

Calls to Mr. Applegate were returned by a Bank of America spokeswoman, who declined to comment on Mr. Maxwell’s situation. She did say the lender has received feedback from customers asking it to reevaluate “geographic competency in our appraisal reports.” She said efforts are being made to find appraisers who generally work within 15 miles of a property; if no appraiser is available, the company assigns alternate appraisers with local experience.

Others complain that appraisers are using foreclosures and other distress sales as comps when coming up with estimates. Because foreclosures tend to sell at big discounts from the actual value, some argue that shouldn’t be used.

At least four states—Illinois, Nevada, Missouri and Maryland—have considered legislation that would bar appraisers from using distress sales when drawing estimates.

Some economists disagree. They argue that foreclosures account for such a large share of housing sales that it’s perfectly acceptable to use them as comps, or to use them but adjust pricing accordingly. “A third of transactions are previously foreclosed homes. In some markets, it’s close to 50%,” said Columbia’s Mr. Mayer. “It would be one thing if you’re talking about throwing out a small number of transactions.”

Another complaint is that appraisers are increasingly relying on automated valuation models, or AVMs, computer programs that extrapolate home values based on reams of property data, and public and privately compiled databases. The industry began automating in the mid-1990s, but it wasn’t until a few years ago that AVMs took hold in a big way.

AVMs are most reliable when there are a larger number of typical transactions to observe. But during the housing slump, typical transactions have been scarce while distressed sales have been abundant.

One of the biggest complaints is that appraisers, in their haste, are overlooking or missing important elements that could add substantial value to a home.

Erin Wanner, a sales executive with Stirling Sotheby’s International Realty in Orlando, Fla., says one of her deals fell through when an appraisal came in 40% lower than expected. The property, a custom-built lakefront, 7,000-square-foot home on four acres was appraised by the builder in 2008 at $1.2 million. Ms. Wanner’s clients went under contract on the property for $650,000 in a short sale—one in which the bank agrees to receive less than the amount owed on the mortgage. The appraisal came in at $380,000.

“When I first heard it, I thought it was a joke,” Ms. Wanner says. She noticed that a guest house on the property and total lot size—as well as the number of fireplaces and its heated pool—weren’t included in the valuation, which would have sharply boosted the appraised value. She also thinks the appraiser wasn’t familiar enough with the community and may have used comparisons with less affluent houses nearby, such as homes situated on ponds versus lakes.

Ms. Wanner says appraisers today seem less knowledgeable. “Real estate is a neighborhood business,” she said. “One neighborhood can be hit, another can be flourishing.” She said the new laws prevent lenders and agents from contracting the appraiser directly, which has been especially frustrating. “Once we get the report, it states that individual’s opinion of value, and that’s that.”

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