

# *Three Legs of the* **Appraisal Management Stool**

BY ADAM CALVERY

**Lenders need a common-sense approach to collateral valuation policy that embraces three key components: regulatory compliance, quality assurance and fraud management. This three-legged-stool approach can keep valuation risk at bay.**

**T**here's no question that the appraisal industry has been turned on its head by the many unintended consequences of the Home Valuation Code of Conduct (HVCC). However, while the spotlight is stolen by discussions of appraisal management companies (AMCs) versus appraisers or unfair fee splits, there's another little-noticed consequence to ponder: Mortgage lenders are forgetting that prudence in the appraisal management field requires more than simply complying with the HVCC. ■ Value pressure is down from the heady days of the boom, but that likely would have happened with or without the HVCC as buying power evaporated in the credit crisis. Regulation alone neither solved the problem nor will prevent the next round of abuses. ■ It's valuable, then, to look at traditional regulatory compliance as just one leg of a stable "three-legged stool" of collateral valuation policies, with the other two being proactive quality assurance and fraud management. All three need to be employed in common-sense fashion as part of a comprehensive approach to risk factors affecting every institution. ■ "Common sense" means that they can't be treated as mere checklist

items in a policy review. They have to drive actual daily lending behavior, in balance with each other and consistent with safe and sound banking policy.

### **Traditional alphabet-soup compliance**

Today, collateral valuation is affected by a wide variety of “alphabet soup” agencies, policies and laws. The most common abbreviation heard today is the HVCC. However, the Federal Housing Administration’s (FHA’s) recent guidance (Mortgagee Letter 09-28) on appraiser independence—often mistakenly cited as “FHA adopting the HVCC”—threw another variation on appraisal management into the mix.

To make matters still more interesting, the *Interagency Appraisal and Evaluation Guidelines*—issued jointly by the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit

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Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA)—affect appraisal policy even more broadly.

Add to that the Gramm-Leach-Bliley Act (GLB), which affects security, privacy and record-keeping, and which expressly covers appraisals. And finally, the Federal Housing Finance Agency (FHFA) recently issued rules regarding required submission of appraisal reports in MISMO® extensible markup language (XML) format under its Uniform Mortgage Data Program, with the first portions to be implemented by Jan 1, 2011. If you think about this in terms of the time required to change workflows to accommodate those data requirements, that’s right around the corner.

And one more thing: As this article goes to press, Congress is expected to eliminate the HVCC and replace it with “something else” as part of the financial reform legislation package.

Yes, it’s a mess. The best way to approach the interwoven policies is to find the commonalities and the differences. Then craft a set of policies that meet the strictest standards in each overlapping area and take into account the unique areas covered only by one set of governing standards. A short list of areas to check in your organization might look like the following:

■ **Appraiser-independence protection:** Do you have strict written policies in place to ensure that appraisers are not coerced by either direct value pressure or by

the threat—real or implied—of blacklisting for future work, even if not by your own staff but by an AMC? Do you audit your real-world practices? The Interagency and FHA rules are most vocal on this issue.

■ **Interaction of commissioned parties with appraisers:** FHA is most clear on this issue, stating that anyone with a commissioned interest should be banned from directly or indirectly influencing the choice of an appraiser or the suitability of a valuation report. So, a loan officer e-mailing an AMC staffer with directions for a desired outcome is not a firewall at all; it’s pressure by proxy.

Using double-blind software as middleware prevents a loan officer or third party from even knowing how to affect the outcome. The double-blind curtain should not only obscure the appraiser from the commissioned parties, but it should prevent *ad hoc* written communication of any kind, instead forcing the commissioned parties to use checkbox-driven forms with the other parties. There is then no checkbox for “this appraisal is too low.”

■ **Appraisal and management fee schedules:** FHA is most strict on ensuring that fees paid for the management of the process and the appraisal itself are separately reasonable and customary. Lenders using outside AMCs should demand quarterly “fee split” accounting reports of all appraisal transactions sorted by county, and compare those with statistical analyses such as a la mode’s Appraisal Fee Reference™ ([www.mercuryvmp.com/afr](http://www.mercuryvmp.com/afr)).

■ **Electronic inbound receipt of appraisals:** Both the GLB regulations and FHFA’s upcoming data standards dictate data compliance. Generally speaking, if you or even your AMC ever receive appraisals via traditional e-mail, you’re violating GLB’s Safeguards Rule. (And GLB requires institutions to ensure their supply chain is in compliance.)

Receipt of an appraisal should be either via automated services using secure transports, or by “click to download” links in e-mails. Also, all appraisals should be in XML format with first-generation PDFs embedded—exactly as they existed on the appraiser’s desktop—to ensure the PDF report matches exactly with the XML transmitted to FHFA’s portable document format (PDF) uniform data portal.

■ **Transmission of outbound documents used for appraisals:** GLB is quite strict regarding transmission standards, and the scope of consumer data protected is exceptionally large. Even an unsecured e-mail from a loan officer to an AMC stating that an appraisal needs to be ordered for a given address for a particular borrower is a violation. Yet, that and more—real estate contracts, for example—are transmitted in the open every day from loan officers to AMCs and appraisers via e-mail.

Use a third-party middleware system to securely place orders and upload documents to the appraisal case file to avoid potentially disastrous security intrusions. Oxford, Mississippi-based FNC Inc.’s Appraisal-Port ([www.fncinc.com](http://www.fncinc.com)) and a la mode’s Mercury Network ([www.mercuryvmp.com](http://www.mercuryvmp.com)) are examples of platforms that can be used with or without an AMC to solve these security issues.

■ **Uniform Standards of Professional Appraisal Practice (USPAP) or other violations imposed by actions or policy:** The interagency rules clearly instruct lenders that they may not engage in actions that force an appraiser to violate USPAP, though few lenders are aware of the scope of USPAP's restrictions on appraisers. The issue can be easily addressed with a mandatory instructional addendum attached to all orders, advising appraisers of the lender's obligations to USPAP compliance and with a violation-reporting mechanism delineated in the addendum.

■ **Disciplinary policy:** FHA in particular speaks to the issue of either threats of or implementation of disciplinary action against appraisers without written notice and justification. To set an independent standard, demand that any appraiser removed from your fee panel must also be reported in writing to the state appraisal board with citation of the specific USPAP violations that resulted in the removal. Unless an issue rises to that level, perhaps it's not a disciplinary action at all, but rather a retaliatory one. Again, auditing this process is a must, and statement of this policy in the client-specific instructions conveyed to the appraiser provides a valuable deterrent to those who might abuse it.

It's easy for front-line personnel to assume that many of these issues are infrequently addressed by regulatory audits, and there's little chance of a lapse rising to the level of regulatory trouble for the lender. There are two primary reasons why that kind of thinking must be combated at the executive level.

First, whether responding to an audit or even litigation, the best strategy is to show that your compliance is not just on paper, and that it's backed by proactive audits and commercial best efforts such as those noted here.

Second, the various regulations do indeed foster safe and sound mortgage banking and have a solid foundation in common sense. The decisions made by a lender's staff, and the valuations received on its collateral, will be aided by following these policies as part of a comprehensive approach to enhancing loan portfolio quality. And that's what leads directly to the importance of the second leg of the appraisal management stool—quality assurance.

#### **Quality assurance, rather than just quality control**

Quality assurance (QA) and quality control (QC) are terms usually used interchangeably, which is dangerous to any lender's operations.

In a nutshell, quality assurance is the human-driven activity that gives you confidence that you have an appropriate, improving process that is explainable and rational, and it results in a valuable specification of what the end result should be. QA is the domain of managers—it is strategic and it isn't always measurable. QA owns the question, "Does it make sense?"

Quality control, on the other hand, is a set of narrow tests that measure each copy of the product against acceptable variations from standards derived from the product's specifications. QC is generally performed by line-level people, is highly tactical and is always meas-

urable. QC owns the question, "Does it meet the specified criteria?"

Quality, as the term is applied to appraisal management today, is characterized by voluminous QC but not much QA at all.

Appraisals are scored against review rules, and very authoritative-sounding statistical analyses are kicked out showing how many appraisal reports were caught by the systems in place. Appraisers are given reams of additional forms to fill out, and more data to explain. Appraisals that meet the criteria are accepted, and those that fail are rejected. All must be well. The spreadsheets say so, right down to the Sixth Sigma.

Sound familiar? There was also a QC-only focus at the core of the recent lending and real estate market crisis. Shoddy loans passed through underwriting because they passed the QC tests: Documentation met

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the criteria, credit score was within range, down payment was acceptable and so on.

Millions of loans passed the QC checks and yet ultimately were failures, because the QA process—the safe-and-sound banking standards quality umbrella—was nearly non-existent. The QC standards were met, but they were set illogically low by a failed QA environment. The QA question of "Does it make sense?" wasn't even asked.

In valuation today, that step can't be skipped. A process of real quality assurance handed down from the executive offices would start by asking specific questions, such as:

■ What will get us the most trusted appraisers—those who look out for our interests above and beyond the minimum checkboxes on a form?

■ What are the workload risk factors? Are a handful of our approved appraisers doing the vast majority of our assignments? Are they the best at advising us, or are they just the cheapest and hungriest?

■ If we pay our appraisers higher fees, do they give our work more attention and priority? Do we get higher quality?

■ Do we have a hostile relationship with our appraisers? If so, why? Are there examples of other lenders maintaining healthier relationships?

■ Is it possible that our QC processes in fact decrease the likelihood that our appraisers will be able to warn us about bad properties by "whacking the mole" anytime an appraiser tries to go beyond the checkboxes?

■ Are there anecdotal signs that we have a problem, such as arguments with Realtors®, borrowers and appraisers that can't be just dismissed as griping or advocacy?

A good place to start asking these questions (outside the boardroom) is to ask your own appraisers these things on a quarterly basis. There are numerous online services that allow you to immediately design a survey that gets you both narrative answers as well as statistical breakdowns of questions where you limit the responses. And remember, you're likely to get more honest responses with an anonymous questionnaire.

At first, you're likely to get an earful—but you'll also uncover gaping holes in your QA strategy and the logic behind your QC criteria. More important, you'll be able to design QC processes that really do uncover real quality problems, and which also will prevent the third leg—fraud prevention and detection—from being kicked out from under the stool.

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#### **Detering fraud before it happens, instead of after it's too late**

Appraisal fraud generally falls into three common categories: identity fraud, where the appraiser is either fictitious, unlicensed or otherwise misrepresented; document fraud, where the appraisal document itself has been modified by either third parties or internal staff to meet their needs; and value fraud, where the market value of the property has been skewed up or down (flipping or flopping) by the parties to directly profit from the sale or the loan.

Most lenders put in place systems to detect value fraud using public records data, automated valuation models (AVMs) and so on, but very few deter document or identity fraud before it ever occurs in the first place. However, here are some simple, free deterrent options.

■ **Authenticate all appraisers:** Require that all appraisers adopt true digital "authenticated" signatures issued by a certificate authority, such as a la mode's Sure-Docs for Appraisers™, instead of an easily faked picture of a signature. The system should require the appraiser to pass a challenge-response test based on questions pulled from a credit profile, which must match the appraiser credentials from the federal registry. Publicize the adoption of the authenticated system widely. Require your AMC to abide by digital authentication procedures at the appraiser-desktop level.

■ **Require locked, signed appraisal PDFs with serialization:** Assuming that fraud originates outside the lending institution or its partners is a mistake. Altering

an appraisal to remove negative comments or addenda, to change salient information such as dates, and of course to change the indicated market value, are document-level frauds generally committed within a lender's organization or even a lender's AMC.

To deter document fraud, require appraisals to be sent using change-detection technology. The best technique is for the report to generate a serial number and to store an escrowed snapshot of itself (or at least a "fingerprint") on a third-party tracking site at the time the appraiser originally transmitted the report. The report can then be quickly verified as authentic and unmolesated even after the most convoluted chain of custody.

■ **Require that document-fraud notices be in every report:** If the report contains a conspicuous cover sheet outlining its authentication protocols, then readers of the report are unlikely to attempt a change. (It's the digital equivalent of signs and cameras indicating that a physical security system is in place in your building.) Plus, investors are reassured by the same notices.

These deterrents obviously have to work in conjunction with your other fraud-control and quality-control processes as part of a holistic approach to deterring what you can, catching what you can't and managing the rest in a consistent fashion. This approach also has the benefit of aiding in the detection of non-malicious value fraud caused primarily by incompetence. Disciplinary action is usually simple in those cases, as the value deviation almost always follows USPAP violations.

#### **In conclusion, but not really**

Managing appraisal compliance, quality and fraud is a moving target: Each month brings new regulations, new factors and new threats. Lenders that approach each discipline separately, treating it as a static paper task that can be completed, will think they've achieved regulatory appraisal compliance, controlled appraisal quality and detected appraisal fraud—when in fact they've simply perched themselves, blindfolded, on a rickety one-legged stool.

Those who rely on a dynamic balance of all three, as more of an ongoing cultural quest than just a destination, will be there when the others fall. **MB**

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