Appraisal Debate Could Affect Prices

Kenneth Harney

The Nation's Housing

WASHINGTON — A controversy is brewing in the nation's capital that could affect the market value of thousands of new and resale homes across the country, including your own.

Although the debate has not been public, and its participants are sheepish about making it so, it involves a key issue for anyone who owns or buys real estate: the methods and standards used to determine the "appraised value" of a home.

Appraisals are essential ingredients in most American home purchases and sales. Without an independent, professional opinion of a home's true market worth, lenders typically won't lend a dime for a mortgage. If an appraiser concludes that a house priced at $90,000 isn't really worth more than $80,000, prospective buyers are going to have a tough time convincing a lender to give them the size mortgage they need.

The reverse can be true, too. If an appraiser concludes that a house is worth $100,000 — but in fact its correct market value is $80,000 — a lender could easily over-mortgage the place. In the event of a later foreclosure, the lender would be left holding the bag. The sale of the foreclosed property could bring in thousands of dollars less than the original loan—spilling fresh red ink on the lender's ledger.

The value determination by appraisers, in short, involves big bucks. Their accuracy and methods are of intense interest to mortgage lenders, home builders, realty brokers and others who depend on them.

One of the nation's two largest and most influential lenders, the Federal Home Loan Mortgage Corp. (Freddie Mac), isn't satisfied with the accuracy of home appraisals it sees, however. In a letter to building and finance industry executives, a copy of which was obtained by this reporter, Freddie Mac's vice president for mortgage operations revealed that the huge, congressionally chartered lender is considering significant changes in the standards it imposes on appraisers nationwide.

Most importantly, wrote Leady Seale, Jr., Freddie Mac is thinking of insisting that appraisers use a "cash equivalency" approach designed to discount the market values of homes to account for financing incentives of any sort that accompany the sale transactions. These incentives include relatively common techniques such as seller-assisted, cut-rate financing, builder buydowns and other interest-rate subsidies. They also include less common come-ons such as free automobiles, vacations, cash rebates, zero-coupon bonds, free furniture and prepaid taxes.

Under the current standards used by Freddie Mac and many other large lenders, appraisers often do not properly account for these incentives, charged Seale in his letter. As a result, the appraisal on any given home "includes the value of the creative financing as well as the value of the real estate.

"Thus," wrote Seale, "the appraisal is inflated and improperly reflects the true value of the real estate involved."

To remedy this, Seale proposed shifting Freddie Mac to a new set of standards requiring appraised values stated "in terms of cash or in terms of financial arrangements equivalent to cash." The new approach would also require appraisers to determine "the most probable price" that a house would bring in a competitive and open marketplace, rather than "the highest" price it could bring — the traditional appraisal norm.

Translated into laymen's terms, Seale's new rules for appraisals would work something like this: Say you're planning to buy a new $125,000 house that comes with cut-rate special financing arrangements subsidized by your builder. Let's say, too, that the cash value of those arrangements could be calculated at somewhere between $5,000 and $8,000, depending on your assumption. Under a pure cash-equivalency appraisal approach, your house would be appraised for resale, not at $125,000, but $5,000 to $8,000 less.

Or let's say you bought your house four years ago at the height of the go-go creative financing boom. If an appraiser determined that $10,000 of the price you paid should actually be attributed to financing concessions, your market value could be cut by that amount. Although Seale was unavailable for comment, his proposal triggered sparks among key housing and finance leaders last week.

The executive vice president of the National Association of Home Builders, Kent Colton, said that although his organization was "sympathetic to the goal of more accurate appraisals," any abrupt shift to a cash-equivalency standard could "seriously disrupt" the sales and marketing programs of many homebuilders who offer financing incentives to consumers.

David Maxwell, chairman of Freddie Mac's crosstown rival, the Federal National Mortgage Assn. ("Fannie Mae"), said a cash-equivalency standard "isn't practical" because the required financing data on homes neither exists in sufficient quantity nor can it be gathered without great cost.

Robert Johnson, head of the National Association of Review Appraisers and Mortgage Underwriters, had the most pointed comment: Change in appraisal techniques won't solve the problem of poor appraisals experienced by many lenders, said Johnson.

"You've got to change your appraisers first, and use only ethical ones," he said.