

A Vision for Valuation: Automated Valuation Models and Appraisal Practice

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Introduction:

As AVMs have gained increasing market acceptance, appraisers have been left out of the valuation process. AVMs have garnered an ever-increasing share of the marketplace, but appraisers have been unable to offer a meaningful alternative, and the entire industry has essentially been bifurcated, with AVMs on one side and appraisers on the other.

AVMs were constructed to offer stand-alone collateral valuation solutions. The role of appraisers was never considered or even contemplated. At present the AVM world is at an impasse, unable to garner more than the 20% of the greater collateral valuation market share that it has taken five years to attain. The reason: regulators and lenders are concerned about accuracy and the appropriateness of AVM values without the interaction with an appraiser. Lenders and regulators agree that the best solution is an appraiser who can utilize the technological tools to provide accurate and timely appraisals to the lender.

Discussions with industry experts reveal that the availability of an interactive, appraiser-influenced product would open a floodgate of acceptance by appraisers, and additionally, satisfy lender demands for an AVM that is utilized and interpreted by an appraiser.

The AVM Marketplace

Real estate is the last digital frontier-the last major component of the economy to take advantage of the standardization of data and the technological innovation that has subsumed other sectors of the economy. Thomas Friedman, in his 2005 book "The World is Flat" discusses how the world is being flattened by various drives towards technology and standards. These same two drivers-data standardization and technological innovation, are flattening the real estate world, and by extension, the valuation terrain.

Data standards and technology have reached a tipping point, and the drive towards wrenching the estimated \$1 trillion in cost efficiencies will cause both chaos and opportunities to those who can provide a meaningful solution to the industry. Industry experts estimate that the overall drive towards data and process standardization will be tectonic in impact and scope.

The valuation segment of real estate is the critical driver to understanding the marketplace. Lenders rely on collateral valuation to quantify risk and to hedge potential losses. If real estate has lagged other industries in its drive to integrate technological and data standardization, then valuation itself is the final frontier.

Lender Acceptance of Valuation Technology

Change has defined the status quo for virtually all business and organizational structures in recent years, and the appraisal industry is the focal point for changes that are ongoing within the financial services and informational service sectors of the economy. AVM's continue to offer some of the strongest opportunities for lending institutions to decrease costs and increase the speed at which financial transactions are processed. The future will likely bring an increased usage and reliance on AVMs, as accuracy increases, and the geographic coverage is expanded.

AVMs have historically been utilized in second mortgage and equity lending transactions, with limited usage in the first mortgage sector. The historical reluctance to use this product for first mortgages is due to the uncertainty of the reliability of the product in high loan-to-value situations. With the competitive pressures placed on lenders to process transactions more rapidly and at lower cost, however, some of the early reservations to AVM reliance have been mitigated.

Though AVMs have grown to become the accepted market alternative to traditional appraisals, and are widely used, very little is generally known about their internal operations by those who lend billions based on the values they generate. Recent efforts to standardize and independently test these automated systems show the concern and desire to improve real estate valuation tools.

Automated processes are generally inadequate for the majority of residential houses in the country. Vendors of AVM products and industry insiders know that such products, given current technology, are reliable without human interaction for only 30%-35% of the market. This would indicate that while a portion of the market can be valued using this type of technology, there are limitations without professional intervention.

Additional factors help drive whether a loan can be made and the terms of the loan. Local, professional input remains essential to an accurate and actionable valuation. Interactive and automated tools in the hands of professionals such as appraisers and Realtors would overcome the current limitations of AVM technology and provide better valuations and expanded coverage, leading to wider market acceptance.

Public Acceptance of Valuation Technology: Consumer Valuation Products

In addition to the valuation tools provided by AVM providers to lenders, there have been a number of plays over the last several years designed to provide valuation or pricing information to consumers. The majority of these involve a cost or affinity advertising. A more recent model has emerged, which involves a more automated solution without exchanging consumer data. These sites include entrants such as Zillow, RealestateABC and others. These sites utilize many of the same underlying premises that drive AVMs, but without any need to provide validation or measures of accuracy to the consumer.

Some of the new consumer portals make the argument that consumers can determine their own values, thus diminishing the role of Realtors and appraisers. The implicit argument is that Realtors and appraisers are not needed to determine the value of a home. Some sites allow a user to determine the value of a given residential property and refine the value by adjusting the data. And therein is the problem. While the concept of interactivity sounds good at first, in actuality, it can lead to a number of problems. By interacting with the data, the value can actually get worse. By adjusting the information on their house, consumers are substituting their emotions and beliefs for the realities of the marketplace. A consumer could actually grossly inflate or deflate the value dramatically, without knowing the precise impact. In the hands of knowledgeable lenders, appraisers or Realtors, as a piece of the decisioning process, automated products may be appropriate. In the hands of a consumer without a background in real estate-the outcome could be disastrous. Can an automated process endanger the public good?

One possible outcome of this process is that consumer backlash could undermine confidence in the entire collateral valuation and pricing process. How will consumers be able to compare and contrast the validity of

a valuation output? Free sites or automated sites have the potential to give appraisers and Realtors a black eye and a bad name.

Fully automated valuation solutions, rather than providing enlightenment for consumers, may potentially provide a product that will lead to confusion, heightened expectations on value and pricing, and ultimately, undermine the value of true expertise. It makes a complex process seem unduly easy, and diminishes the need for expertise and reasoned analysis. Consumers have no means of gauging the accuracy of automated products, no means of validating the output. Without independent validation, how reliable can this be, how are a consumer's interests served? Will consumers be misled? There is a potential danger in turning information into mis-information. What can consumers do about it? Continue their reliance on professionals. Realtors and appraisers are the profession that consumers depend upon. To change this dynamic could be potentially disastrous.

There is no doubt that technology and information, readily available, is critical to developing valuation. But we must always consider, as appraisers and Realtors must, the public good. Policy makers and real estate professionals have a duty and responsibility for the public good. That is how the Realtor and appraisal professions developed. What responsibility do free, automated sites have? Responsibility cannot be disclaimed quite so easily. Rather than making valuation data more available, sites such as these make valuation a gimmick, creating more confusion due to lack of context, and diminishing the role of the professional. It is that professional, in tandem with other providers, who ensure the stability of our nation's financial infrastructure.

The Development of Actionable Values

Valuation tools must provide sufficient information to a user to understand the dynamics of any given valuation situation. Attempting to replace or diminish the role of a regulated group of professionals with a value estimate that fails to provide an actionable value, does not further efficiencies in the real estate transaction process.

Market value is rarely easy, oft-times difficult to ascertain. Currently, appraisers and Realtors provide this function to the marketplace, taking property data, sales data, market conditions, and their own knowledge of local markets to refine a property value. A current industry concept refers to Expedited Actionable Values (EAV). This concept relates to the ability to use a value throughout a real estate transaction. It makes sense to consider that a valuation, to be reliable, must also be something that other parties can agree to and use in a decisioning process. Lenders rely on actionable information to make decisions to lend on trillions of dollars of real estate every year. Appraisers are the lynchpin in the process by providing the actionable value upon which all parties rely.

Lenders rely on actionable information to make decisions to lend on trillions of dollars of real estate every year. A consumer coming in the door of their local bank with a consumer-site derived value would not be able to garner a loan. If the product is not considered to be reliable in this instance-what is its value? In order to have long-lasting success and market acceptance, a valuation must be reliable, stable, and have the ability to convince others that it is an objective and independently derived analysis of market conditions. Free consumer-targeted products offer none of these at present.

So how does this dynamic get changed? How does the real estate collateral valuation question get answered? By connecting the valuation professional with the benefits of the technology and data elements that have driven the consumer products and the lender products. When the best blending of both technology and valuation expertise is melded-consumers benefit from a best practices perspective.

Working With AVMs:

Appraisers have been reluctant to embrace AVMs for a number of reasons. The more significant reason, it is suggested, is the lack of an appropriate and comprehensive framework for interacting with, analyzing and drawing conclusions from that data. It should be recognized, however, that the statistical methodology and mass appraisal technology has always been available to appraisers. Because of the encroachment in the appraisal world by AVM vendors, however, appraisers have not embraced the technology or the techniques. A further problem is that there are no turn-key solutions available to appraisers. The construction of even a

local AVM is remarkably difficult, requiring significant skill-sets and data costs that are beyond the reach of most valuation professionals.

AVMs were never designed to be used by appraisers. They were intended primarily to assist lenders in the collateral valuation process. The fact that appraisers do not use AVMs to any meaningful degree at present appears to lend credibility to the fact that there is a problem. The more significant reason, it is suggested, is the lack of an appropriate and comprehensive framework for interacting with, analyzing and drawing conclusions from that data. The problem is a system that does not include the appraiser at the front end. The appraiser becomes an afterthought in this process. AVM vendors, cognizant of push-back from various stakeholders, have attempted to meet the need by creating “integration” with an appraiser. This attempt has not been successful, because it transfers an unacceptable risk to the appraiser. It transfers a valuation without appraisal risk into a product that is expected by the market to represent a more reliable valuation.

AVM-Enabled Appraisal: Can Current Products Meet the Challenge?

Discussions with industry experts reveal that the availability of an interactive, appraiser-influenced product would open a floodgate of acceptance by appraisers, and additionally, satisfy lender demands for an AVM that is utilized and interpreted by an appraiser. By embracing the technology, valuation professionals will be able to take advantage of this knowledge integration, and provide substantial financial rewards. Valuation professionals will be able to leverage this technology towards other valuation processes, providing market opportunities throughout the fabric of the current appraisal profession.

The solution is getting appraisers (valuation professionals) more engaged in the system, the process and the solution. Appraisers cannot expect to be part of the solution if they are not involved in crafting these solutions. Appraisers have an opportunity to re-shape the discussion, to create a collaborative opportunity to develop a better product. A product that the market needs, wants and has an appetite for.

How do we convince appraisers that this is not a threat but an opportunity...why hasn't this message resonated more completely with the appraisal profession? Because ultimately, they do not believe it. Appraisers cannot see a reliable method of complying with USPAP and using an AVM.

Appraisers are not comfortable with AVMs that allow an appraiser only to agree with or reject a value, sign off and transfer liability. The model of transferring risk without commensurate and corresponding reward is an untenable recipe on a going forward basis.

Another question that has come up is what happens when an appraiser uses a non-USPAP compliant product in determining a value when they are subject to USPAP? This changes the discussion dramatically. Question: if we are reviewing a valuation output, why isn't this review under the purview of the review standards of USPAP. Answer: because it's not an appraisal. However, if an AVM is used as a core component in the development of a valuation opinion, then we begin to see the manner in which an AVM can be utilized in the valuation process.

A fundamental question becomes: how does an appraiser stay out of trouble when working (or thinking of working) with AVMs? What are the dangers in appraisers not understanding the full scope of liability inherent in working with AVMs?

A Flatter Valuation World: Opportunity Beckons

While the AVM provider field is dominated by a number of larger national providers, there are numerous opportunities for firms providing products that are related to and ancillary to the burgeoning AVM field, especially in providing more interactive and useful tools to the appraisal and Realtor communities.

Appraisers have been told that there is a convergence of forces within the market that stress automated valuation solutions that do not involve the appraiser. While there has been anecdotal advice as to the proper response to the changes in the market, none of this advice is specific enough to provide an avenue for success in the market for the average appraiser.

It is critical that the profession be proactive in encouraging interaction with broad-based model development. Potential collaborators must be identified, and coupled with communication, education and training. Courses covering automated valuation models (AVMs), beginning and advanced valuation modeling, and geographic information and spatial analysis topics are all critical. All of the education will enable students to achieve advanced technological competence that can be coupled with their local valuation expertise. Users must have a hand not just in shaping potential product and the data, but in designing the product. This interaction will draw a wide variety of potential collaborators: some will be genuinely motivated by the greater good, or find it satisfying to apply their professional knowledge to a broader audience.

Creating a collaborative environment permits a broader opportunity for innovation for potential uses. By opening up the availability of data, it will be possible to tap into and enhance a fast-growing valuation ecosystem. Following the lead of other mash-up oriented open source environments such as Google and Amazon, it is possible to envision a collaborative community that would include software companies, data providers and local appraisers to further develop valuation content that melds technology with local appraiser expertise.

The Tipping Point for AVM-Enabled Appraisal: The Development of Standards

What are the challenges facing appraisers as they evaluate how they can work with AVMs? What are the practical considerations that an appraiser must face in evaluating the appropriateness of working with an AVM? At present, AVM vendors provide virtually no information that can be evaluated, and the appraiser must therefore pull in extensive external data to evaluate the output. The question of the sufficiency of the analysis is one that has precluded many to participate in this process. Some AVM vendors have suggested that an appraiser can test an AVM on their own, feel confident of the overall accuracy of the product, and then can say “yes” or “no” to the accuracy of the AVM output in subsequent assignments, without any external validation. Is this a viable model?

What are the practical problems of working with AVMs? How can an appraiser feel comfortable working with and interacting with valuation models? It is critical to consider the expectations of our professional peers-

but if no one is working with AVMs, what guidance can be given if there is no “peer” group to gauge what is and is not appropriate from a USPAP perspective? Who will provide guidance to appraisers, and what will it take to get appraisers to interact with AVMs? Will an appraiser ever be able to know enough about an AVM designed by a vendor to be able to use it?

Two different efforts are underway that may help in defining both standards and best practices in this area. Standards are a fundamental starting point for the development of best practices. Unless base levels of understanding of terminology, usage, testing and reporting are established, it is difficult to understand what constitutes acceptable best practices.

The first effort revolves around the development of process standards for AVMs. Two industry groups, the Joint Industry Task Force on AVMs (JITFAVM) and the Collateral Assessment Technology Committee (CATC) of the Real Estate Information Providers Association (REIPA), have been independently developing standards in many of these areas for the last several years. Though laboring on the same task, the two groups have not been able to take advantage of the opportunity to pursue the goals of best practices in tandem. In early 2006, the Mortgage Bankers Association (MBA), through its data standards affiliate MISMO (Mortgage Industry Standards Maintenance Organization), announced an interest in furthering efforts towards the development of an AVM Best Practices Work Group. This group could potentially provide a venue through which both JITFAVM and CATC may work with other stakeholders to determine which standards are applicable to vendors, lenders and appraisers. This is a fundamental shift in the current paradigm that could have a profound impact on the entire real estate marketplace.

A second significant effort in this area is the formation of the Technology and Appraisal Practice Shared Interest Group (TAPSIG) by the Appraisal Institute, the most significant player in valuation space. TAPSIG has undertaken to connect Appraisal Institute members with an interest in technology and has identified two critical issues as its focal points: AVMs and standards. This group will examine some fundamental concepts that will help to further the understanding of how appraisers will work with AVMs. One important role that this effort could facilitate, would be the development of a peer group that would be able to establish

and flesh out some of the more relevant issues surrounding the interaction of AVMs and appraisers. This would meet many of the requirements of the Uniform Standards of Professional Appraisal Practice (USPAP), and would help to alleviate the concerns of appraisers as they consider the opportunities that will present themselves.

Both TAPSIG and the standards for best practices developed by the MBA/MISMO AVM Best Practices Work Group could provide the first comprehensive overview that begins to address the issues of what an appraiser has to do in order to interact with more advanced valuation technology. It would eliminate many of the barriers towards constructive discourse, and further, provide an opportunity for all stakeholders to work together. The end beneficiary will be the consumer as better valuations at lower prices result.

Appraisers have an opportunity to re-shape the discussion, to create a collaborative environment and provide better services to their ultimate stakeholders-the public. The ongoing efforts of TAPSIG and the potential contributions of an MBA/MISMO AVM Best Practices Work Group, could demonstrate significant movement in a direction that favors all stakeholders. The market wants appraisers to participate in this process. And finally, appraisers appear to have a place at the table.

Mark R. Linné, MAI, CRE, CAE, ASA, FRICS, is considered one of the world's foremost experts in Automated Valuation Models (AVMs) and is the Director of Visioning Strategies for ValX, an interactive valuation technology provider and consultancy, which provides software, AVM development and validation consulting at a global level, with strategic business partners in the European Union, India and Asia. ValX and its senior management team includes some of the most recognized experts, authors, technology developers, and valuation experts in the world. ValX has developed a global reputation in both automated valuation systems and geographic information systems. ValX principals developed one of the nation's first AVMs in the mid-1990's, and the company has been actively involved in the field including the development of AVMs for the residential, commercial and agricultural marketplaces. ValX developed the technology for the nation's first interactive AVM, STAT, which debuted in multiple markets in 2005, and is slated for a nationwide roll-out to over 70 markets in 2006.

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