CATC Collateral Assessment & Technologies Committee

January 20, 2009

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW,
Washington, DC 20551

RE: *Proposed Interagency Appraisal and Evaluation Guidelines - Docket No. OP-1338*

To whom it may concern:

On behalf of the Collateral Assessment Technology Committee (CATC) of the Real Estate Information Professionals Association, I want to thank you for the opportunity to comment upon the recently published Proposed Interagency Appraisal and Evaluation Guidelines that have been submitted for public comment ("Proposed Guidelines"). The CATC, composed of AVM providers and related industry participants, was chartered to promote the education and awareness of alternative collateral assessment tools and technologies; including AVMs, fraud detection tools, collateral scoring, forecasting applications and derivatives thereof. In these efforts, CATC places a premium, above all others, on the transparent and objective evaluation, implementation and application of these tools.

CATC applauds the efforts of the Agencies (as that term is defined in the Draft Guidelines) for developing and seeking comments on the Proposed Guidelines. In developing any document of this type the temptation exists to become overly prescriptive. Such temptation, if followed, could lead to several significant unintended consequences. The Agencies have successfully created a set of guiding principles and expectations for safe and sound lending practices that permit individual organizations to exercise their own business models given their own particular views of risk and risk management. To facilitate the development of these business models, more can be done to clarify practices that the Agencies should expect from their lending constituents. This letter discusses these concerns along with our suggestions. In addition, CATC released in January 2009 the Second Edition of its "Best Practices in Automated Valuation Model (AVM) Validation" paper. This document, available online at www.catconline.com, is incorporated as part of

our comments by this reference, and is attached to this letter for your convenience, as a supplement to CATC's response to the Proposed Guidelines.

Many of our comments and suggestions below (and certainly the CATC Best Practices document) focus on Proposed Guidelines language with respect to use and validation of an Automated Valuation Model (AVM). However, many of CATC's comments are equally applicable to any valuation method, product or service.

Risk management procedures for AVMs:

CATC's greatest criticism of the Proposed Guidelines is the continued compartmentalization of valuation products and services. Expectations that should be equally applicable to all valuation approaches seem to be arbitrarily highlighted in singular reference to AVMs. At the outset of Appendix B, the Proposed Guidelines state as follows:

> An institution should demonstrate that an evaluation alternative, such as an automated valuation model or tax assessment valuation, provides a reliable estimate of the collateral's market value as of a stated effective date prior to the decision to enter into a transaction. Further, the institution should establish criteria for determining the extent to which an inspection of the collateral is necessary to determine that the property is in acceptable condition for its current or projected use.
>
> An institution's policies and procedures also should address the use of multiple tools or methods for valuing the same property or to support a particular lending activity. These procedures should specify criteria for ensuring that the institution uses the most credible method or tool. An institution should not select a method or tool solely on the basis that it provides the highest value. Examiners will review an institution's policies, procedures, and internal controls to ensure that evaluation alternatives are appropriate and consistent with safe and sound lending practices.

While CATC certainly agrees with these principles, we believe that they are not limited to AVMs or, for that matter, to any *single* valuation approach. They apply equally to *all* valuation approaches and should be the cornerstone of any institution's collateral risk management policies and procedures in selecting a valuation methodology.

While the Agencies correctly refer to an institutions obligation to determine "the extent to which an inspection of the collateral is necessary to determine that the property is in acceptable condition for its current or projected use," this statement conflicts with language under "Evaluation Content" in the Proposed Guidelines (on page 33 of our

printed copy). The Agencies reference to the minimum requirement that an evaluation "provide an estimate of the property's market value in its actual physical condition" should instead clarify the institution's obligation to establish criteria for determining the extent to which an inspection of the collateral is necessary, *if any*, to determine collateral risk. Where the institution's policy dictates a physical inspection of a property in conjunction with a specific transaction a property inspection report may be used in conjunction with the AVM report.

In today's environment, collateral or valuation risk management policies are generally becoming more holistic in nature. In years past, the type of valuation services was determined by the loan silo to which the loan fell. CATC holds to the ideal that mortgage lenders and investors should more often rely upon a constellation of valuation services to help make optimal and well-reasoned decisions. One could certainly argue that had an institution had the benefit of something closer to a 360 degree view of collateral risk through the use of multiple valuation products, we would not find ourselves in our current situation.

No valuation method should be exempt from the principles set forth in the above paragraphs. The emphasis of this issue relative to AVMs may be understandable considering AVMs are still unfamiliar to some. Nevertheless, the presentation of this issue in the Proposed Guidelines could be interpreted as creating unwarranted double-standards. For example, why would an institution choose to use a 2055 on a loan in one point in time as opposed to a BPO on the same or other loan in another scenario? If an institution is "cascading" their appraisal orders across multiple appraisers (a frequently more common practice), why did the institution select appraiser A over appraiser B on a given loan? An October Research study suggested that there are many appraisers that are more than willing to increase a valuation when it comes to what is euphemistically referred to as "transactional pressure." Transactional pressure occurs when an appraiser feels compelled (based upon the prospect of future business; or lack thereof) to provide a specific value that helps to consummate the loan.

CATC would suggest that the above referenced paragraphs be moved under the "Appraisal and Evaluation Program" description (on Page 19 of our printed copy) of the Proposed Guidelines following the bullet point list and the paragraphs should be amended as follows:

> An institution should demonstrate that any valuation, including appraisals and evaluations, provides a reliable estimate of the collateral's market value as of a stated effective date prior to the decision to enter into a transaction. Further, the institution should establish criteria for determining the extent to which an inspection of the collateral is necessary to determine that the property is in acceptable condition for its current or projected use.

> An institution's policies and procedures also should address the use of multiple valuation tools or methods for valuing the same property or to support a particular lending activity. These procedures should specify criteria for ensuring that the institution uses the most credible method or tool. An institution should not select any valuation method or tool solely on the basis that it provides the highest value. Examiners will review an institution's policies, procedures, and internal controls to ensure that valuation management procedures are appropriate and consistent with safe and sound lending practices.

AVM performance & the de minimis threshold

No appraisal or other evaluation product has undergone the rigorous level of testing and scrutiny as AVMs. The performance of AVMs in both appreciating and declining markets has demonstrated their level of accuracy and the unbiased nature of their results when compared to other valuation techniques. Contrary to conventional wisdom this makes AVMs the most understood tool, in terms of valuation accuracy performance, available to lenders today. Experience has shown that, with all other performance factors held equal, loans underwritten with AVMs have outperformed similar loans underwritten utilizing appraisals or other evaluation methods.[1]

CATC recognizes the de minimus threshold for evaluations is set forth within FIRREA. Nevertheless, given the unbiased results from AVMs and their proven ability to deliver reasonable market value estimates, CATC encourages the adoption of a higher and more realistic de minimus threshold for the use of *proven* evaluations such as AVMs. In addition, CATC suggests that the Agencies encourage the use of other proven automated collateral assessment solutions which might be used in place of or in tandem with traditional appraisal products or other evaluations as a means to reduce risk. The mortgage and residential real estate landscape has changed significantly since the de minimus threshold was first established. CATC desires to work with FFIEC and its member institutions to establish a more current and realistic approach.

AVM Definition:

CATC recommends the definition of an Automated Valuation Model set forth in Appendix C of the Proposed Guidelines be amended as follows:

> **Automated Valuation Models** – A computer program that analyzes data to determine an estimate of the property's market value. Automated

[1] For a discussion of AVM performance in soft or declining markets, please see the 2004 CATC whitepaper on this topic titled "Systemic Risk in Residential Property Valuation Perceptions and Reality" available from www.catconline.com.

Valuation Models may include hedonic, index, blended and other approaches. Hedonic models use property characteristics (such as square footage, room count) on the subject and comparable properties to determine a value. Index models determine value based on changes in home prices over time that may include an analysis of repeat sales in the marketplace. Blended or hybrid models use multiple valuation methodologies.

AVM Testing Best Practices:

As previously indicated, the detailed recommendations for the testing of AVM providers and AVM cascades are documented in the CATC "Best Practices" paper. This document has been recently updated to (1) reflect the growth in third parties involved in the AVM validation process and to (2) to include the suggested best practices that AVM users should consider as a part of their production and post production testing:

1. The growing and welcome spotlight on AVMs has helped demonstrate the positive contribution of AVMs to the collateral risk management landscape and solidify the AVM's role as one of the leading real estate valuation and risk management products and services. This spotlight has further led to the growth of relatively new markets centered on the testing and validation of AVMs. New market participants include third-party testing consultants and AVM test data providers. As with any new market (or new participant in an existing market), it is incumbent upon these individuals, organizations or agencies to establish independence and fully educate themselves on the products, services, policies and procedures to which they hold themselves out as experts or are charged with oversight. More importantly, stakeholders, new and established, must be able to identify potential conflicts of interest, and manage them appropriately. Further, as with any type of outsourced service, it is incumbent upon the AVM user to fully understand the processes and results as the responsibility for the outcome remains with the AVM user. The "Best Practices in Automated Valuation Model (AVM) Validation" document further discusses the roles and expectations of third-parties in the AVM validation process.

2. Procedures to validate the production experience against both cascade and individual test results compose the latest in enhancements to the AVM testing process. The AVM validation process does not end with the determination of which AVMs to use and the position of each AVM within the valuation cascades. Rather, appropriate AVM validation procedures now include most or all of the following procedures to be conducted immediately prior to placement in production and post-production:

Once the AVM cascade order has been established the cascade service provider needs to implement the cascade decisions into its system. The AVM user should verify that the cascade has been implemented correctly according to the AVM user's criteria. The AVM user needs to conduct periodic tests and audits to determine that the cascade order of the AVMs remains consistent.

In addition to the due diligence performed when constructing and analyzing AVM tests, it is suggested that test results should be compared to the AVM user's experience in production. Despite the best efforts to obtain "good records" for testing, some recent records that have closed or records scheduled to close may have already made it into an AVM's database. Unless best practices methodology, such as the "global removal" method is employed, an AVM's performance in a test may overstate that AVM's actual performance in production. For example, if an "arms length" purchase money transaction that was closed within the last 1-30 days was known to an AVM prior to the test, that valuation will be reflected in the AVM and the AVM will appear to have a very predictive value for that property. However, in production, due to the constraints on the use of data, that AVM will not have knowledge of knowing the most recent sale price and the accuracy/performance would not be as good as in a test.

This scenario can be quantified by regularly monitoring the production performance of the AVM cascade against expected performance based upon test results. If actual production performance does not meet the expectations of the test results, further research should be performed to diagnose why the discrepancy exists.

In addition, the "Best Practices" document outlines several steps that may be included in the AVM validation process, summarized as follows: (a) design of a test to solicit results consistent with risk tolerances and expected use; (b) preparation of an appropriate test sample and benchmarks; (c) pre-test due diligence of AVM providers and any third-party participants; (d) selection of test participants and third-parties; (e) completion of necessary documentation between the parties; (f) execution of the test within required parameters; (g) determination of analysis subset(s); (h) individual AVM model analysis; (i) determination of ranking functions for cascade development; (j) cascade simulation, testing and validation; (k) selection of appropriate AVMs and cascade platform providers; (l) AVM or cascade implementation; (m) AVM or cascade production testing and launch; and (n) procedures to validate production experience against both cascade and individual test results.

Many AVM users, either independently or with the help of CATC's Best Practices document have established sound and transparent testing methods that stand up to review by regulators and all other stakeholders involved. However, more education is still needed

about the pros and cons of various data sampling techniques and testing methods that are still in use. In particular, CATC encourages the Agencies to become more familiar with the "global removal" methodology as the most transparent method for an apples to apples comparison of AVM performance. CATC would welcome the opportunity to work with the Agencies to foster increased education and awareness around the use, testing, and validation of AVM products.

Thank you again for the opportunity to submit our comments and we look forward to working with the Agencies, users of our products and other industry stakeholders to help address these important issues.

Sincerely,

Jim Kirchmeyer
Chairman