False appraisals may inflate prices Chicago Tribune, August 26, 2001

BYLINE: By Patrick Barta, The Wall Street Journal.

BODY:
Feeling good because your house is worth a fortune? Sorry to rain on your parade: It might not be worth as much as you think.

Home values in some major metropolitan areas have risen more than 10 percent annually during the past three years, with median sales prices hitting $152,600 in June, a record, according to the National Association of Realtors. During the 1980s and 1990s, home prices rose just 3.9 percent a year. There's little doubt that classic supply-and-demand issues are largely responsible for home prices' recent surge. The rising income of American workers, rapid population growth, and relatively low mortgage rates, which makes home buying more affordable for more families, have combined to boost demand. Meanwhile, constraints on builders have kept a lid on supply.

But some industry observers believe another factor is inflating home values: overly generous appraisals. Every time a home is financed or refinanced, it must be appraised by a professional to make sure the value isn't being overstated. In theory, appraisals reduce fraud, foreclosure risk and the possibility that buyers -- and lenders -- will get stuck with homes worth less than the mortgage amount.

Appraisers, however, say their mission is in jeopardy and the risk to the market is great, because they're under pressure to raise prices as high as possible so brokers and lenders can make more and bigger loans and thus collect more fees.

Richard Grace, a Shawnee, Okla., appraiser, says he and other appraisers are frequently encouraged to fudge the numbers. A case in point came earlier this year when he was asked to determine the value of a two-bedroom log house in rural Oklahoma. The buyer was willing to pay about $87,000 for the home, but Grace appraised it at $68,200, the value of comparable homes in the area. While it's common for home prices to rise in a healthy market, price increases that far exceed average price gains are suspect, he says.

Grace says he's lost business because of his low appraisal; the house later sold for close to its asking price after being appraised by someone else. Soon enough, warns Grace, other houses in the neighborhood "will be appraised at $85,000 instead of $65,000, and two or three transactions down the road, we'll have doubled where all the houses ought to be."

Richard D. Powers, an appraiser in Keene, N.H., says pressure he gets from mortgage companies is usually subtle. Once, he got a letter from a lender with the note: "Minimum value: $165,000." Another time, a mortgage banker instructed Powers to notify him before heading out to the home if he couldn't come up with a requested $105,000 estimate.

To some, this is the type of behavior that's characteristic of bubbles. The "upward spiral of prices becomes self-reinforcing," says Mark Vitner, an economist at First Union Corp. in Charlotte, N.C. Some believe home prices are beginning to act like technology stocks before the bubble burst last year, and Vitner says they're moving up so fast that any value seems reasonable.

So far, no one is predicting a major meltdown akin to what happened in the late 1980s and early 1990s, when inflated appraisals contributed to the pain of a real-estate slump that pushed thousands of homeowners into foreclosure. But if the economic slowdown turns into a protracted recession, lofty appraisals could exacerbate any economic problems.

Mortgage bankers and brokers say the value-inflation problem is overstated. They argue some appraisers are raising flags because they are afraid they will be made irrelevant by new computerized appraisal systems. Evidence of coercion is "at best anecdotal or hearsay," says Joseph Falk, president of the National Association of Mortgage Brokers.

But the appraisers may have a point. Rep. Jan Schakowsky (D-Ill.) has introduced a predatory lending bill that includes a provision making it illegal for lenders to coerce appraisers.

Why, you might ask, would lenders and brokers engage in practices that could undermine the health of their industry?

In the past, most mortgages were made by banks and savings and loans, which held most of the loans themselves. Now, however, more people are getting loans through mortgage brokerage firms, relatively unregulated operations that take applications from consumers before shopping them to lenders to get the lowest interest rates.

Since brokers at times collect fees based on loan size and have little or no stake in whether the mortgage defaults, they could be tempted to pressure appraisers to come up with bigger values. Similarly, traditional banks are increasingly selling loans they make to the secondary market. This theoretically would give traditional banks and lenders less reason to worry about whether an appraisal is correct, although lenders counter that they still retain liability for the loans in some cases.

A report issued this summer by Graham Fisher in New York, a securities research firm, noted that until recent years, many lenders were randomly assigned appraisers from "blind pools," in some cases operated by HUD. But the mortgage market has increasingly shifted away from using such pools, in part because it's faster and easier for lenders to simply call hand-picked appraisers directly. Changes of that sort, the report noted, have "jeopardized the soundness of the process and skewed real-estate prices."