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'Mind-Numbingly Simplistic' Appraisal Process Must Be Brought Up To Date

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By David B. Moore

Among the handful of primary culprits for the current credit crisis-which includes Alan Greenspan's Fed, Wall Street "innovators," reckless community bankers, and irresponsible real estate speculators, among others-includes an outdated appraisal process for single-family residences that is in dire need of overhaul.

The current appraisal process for single-family residences is so mind-numbingly simplistic, rendering values almost entirely contingent upon the vagaries of the buying public's animal spirits, that one wonders how it has managed to survive in tact over the years.

Specifically, the current appraisal process for single-family residences requires the appraiser to value the subject property by merely comparing it to recent sales of other comparable homes (the "comps," in real estate parlance). Unfortunately, the process is only slightly more complicated than that.

This process played a critical role in creating the distortions in pricing that persist today in many markets. The reason, of course, is that easy money (i.e. low interest rates and meager down payment requirements) flowing from Wall Street led to a positive feedback loop for home prices-low rates and loose terms made buying a home easier, thereby artificially increasing the demand for housing. As demand outstripped supply, home prices increased and appraisal comps went into the stratosphere, resulting in a reflexive cycle of price appreciation which fed on itself. At the peak of the housing bubble in 2005 many single family residences in coastal markets were trading at twice the ratio of price-to-rent that had marked "normal" real estate markets in the past.

Clearly the use of comparable sales - with no thought whatsoever given to potential rental income-is a flawed approach to appraising single-family residences. The economics of substitution, after all, suggests that house prices should not increase at a faster rate than local rents (which, in turn, tend to track increases in household income). In fact, house prices have historically mean-reverted to price-to-rent ratios that vary by market. That house prices began divorcing themselves from such ratios in certain markets as early as 2002 should have been a warning that a bubble was fomenting and that there was something wrong with the appraisal process. (Full disclosure: I wrote an article on this subject titled "The Housing Bubble and Me: A Financial Odyssey" for FinancialSense.com in September 2003.)

The solution to this problem is to tie single-family residential appraisals to these properties' imputed rents (an "income approach"). Just as commercial and multi-family real estate appraisals use rental/lease income as a primary valuation component, so should home appraisals.

The vast majority of housing markets across the country have reams of available data regarding local residential rents. This data can be easily incorporated into a formula for estimating the probable rent for a house, which would serve as an input for determining its appraisal value. (Condominiums are even easier to value using an income approach as they are merely apartments that people own.)

An example follows. Let's assume that a credit union is underwriting a typical 2,000 square foot home. Let's further assume that the average rent in the market for apartments of all types is $0.75/square foot/month. Applying $0.75/square foot/month suggests potential rental income of $1,500/month for the house in question. Assuming that the long-term mean-reverting value of housing in the market is 10x average annualized rent, we get to an appraisal value of $180,000 for the home in our example.

Each local market would have to address its own unique economic characteristics and historical price-to-rent relationships in coming up with a usable formula. But this is not rocket science.

There is more than enough available data to tie home appraisals to imputed rents, as opposed to some pie-in-the-sky number generated merely by taking into account what a group of (potentially) greater fools is willing to pay for similar properties.

Importantly, no appraisal process is perfect. As we will undoubtedly discover over the next few years, many commercial and multi-family real estate properties were not properly appraised during the first half of this decade, and higher loan charge-off rates will serve as testament to this fact.

But the degree of error in these appraisals will be a fraction of the error that we have seen in the single-family residential arena. Consequently, the appraisal process for single-family residential homes must move out of the Stone Age and begin taking imputed rents into consideration.

The additional cost of appraisals - which will certainly increase - will pale in comparison to the losses avoided by both home buyers and their lenders.

Mr. Moore is the Managing Partner of Marathon Financial Ventures I, LP, a private equity fund specializing in bank and thrift investments. For info: www.mch-inc.com

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