Appraisal Buzz interview

About Kathy Coon, SRA

As the chief appraiser and director of Appraisal Quality Control at FNC, Coon consults lenders in the detection of faulty or fraudulent appraisals. A member of the Appraisal Institute, Coon has served on its board of directors and executive committee, as well as chair of the education committee, and chair of the Residential Appraisal Board. Coon is also a member of the Mortgage Banker Association's Fraud and Ethics subcommittee. She is responsible for creating the rules included in FNC's GAAR® (Generally Accepted Appraisal Rules®), which provide an automated review of appraisals for both compliance and risk issues. Coon assisted the FBI in one of the largest flipping scams in the country, and has served as an expert witness for mortgage lenders in mortgage fraud cases. She has 25 years of appraisal experience.

Buzz: The FBI announced that reported mortgage fraud losses hit more than $1 billion in 2005. What's the most common type of mortgage fraud?

Coon: Far beyond any other more spectacular, headline-grabbing fraud, fraud resulting from the simple appraisal, in which the appraiser intentionally inflates a property value, collectively accounts for more than 50 percent of all mortgage fraud. Appraisal fraud ranges from obviously false values to nudging the value up a few thousand in response to lender or mortgage broker pressure to make the deal. Many appraisers don't even think of this as fraud, but that's definitely what it is. This type of fraud—one appraisal at a time—is almost impossible to track, unlike the stats that are available for the larger fraud cases that have been reported and prosecuted.

Following simple appraisal fraud is property flipping, in which a property is bought and quickly flipped to a new buyer at a much higher price. These scams get a lot of attention, and are the ones we hear about in the press. The success of these scams depends on industry insiders to willingly participate—primarily the appraiser.

After that, straw buyers, a scheme in which the real buyer is different than the person reported as providing the funds for the purchase, usually to hide some serious fraud. Then, identity theft – stealing a person's Social Security number and credit history to obtain a loan and then default on it.

Property flippers, straw buyers, and identity thieves get a lot of attention in the mainstream and industry press. It's like an episode of Law and Order – you have bad guys and you have victims. But, the common thread through all these fraud schemes is the appraisal report with an inflated value. Without the appraisal report, the loan would not be approved, and the criminals could not get away with their con. Even identity theft is somewhat dependant upon a falsified appraisal. Regardless of whether the loan was based on a stolen identity, if the value in the appraisal is accurate, there would be minimal loss to the lender. However, in most of these cases, the loans have been based on appraisals with inflated values.

As appraisers, that really puts us in the driver's seat. We are the gatekeepers. We are the first line of defense. Unfortunately, that also puts appraisers in a very high-pressure situation when a mortgage broker or loan officer wants us to hit a predetermined number in order to make the loan, no matter what the true value of the property is.

Buzz: How do some appraisers inflate values on the report without attracting attention from the reviewer or underwriter?

Coon: Several ways. They might omit prior sales history, including prior sales, listings, or expired listings. When an appraiser finds a prior sale or listing (minimal one year prior to current appraisal date), he is **required** not only to report this number, but also **analyze** differences between that number and the current appraised value.

An appraiser might also use comparables from other market areas that are superior, and make no adjustments or only minimal adjustments. Location, location, location—you have always heard this. It remains true that location is the most important factor in the value of property. It is almost never acceptable for an appraiser to use comparables from another market area when comparables are available within the subject's neighborhood. And, some appraisers falsify information in the appraisal so that it looks right and is not questioned during the underwriting process.

Buzz: You've testified in several mortgage fraud cases, and also worked on the biggest property flipping scheme in history. What was your role in that case?

Coon: An appraiser in Houston was implicated as part of a massive flipping and straw-buying scheme involving an entire family who owned both real estate companies and a mortgage brokerage and defrauded lenders of millions in the mid to late 1990s. Eight people were charged in the case in all. All of them pled guilty except for the appraiser, who denied the charges and the case went to trial. He basically claimed he didn't inflate the values of the flipped properties with the intent to defraud the lender; he said he just made a lot of mistakes. The appraiser did about 80 appraisals for this family on straw buyer properties. Initially, some of his work was caught when my appraisal office was assigned to do some field reviews by a particular lender. We notified the lender of the gross overvalued properties and the appearance that these were flips. Later, I worked as a consultant with the FBI, reviewing his additional appraisals to determine the extent of the problems. The appraisal reports clearly showed more than just a few mistakes. I also worked with the prosecutors in preparing for the trial.

Buzz: What were the obvious problems with his appraisals?

Coon: He used two of the most common tactics by which unethical appraisers overvalue a property. He did not report the sales history of the subject property, which was available in the local MLS. And, he selected comps that were in superior neighborhoods. He chose comps that, from the exterior photos, "appeared" to be similar to the subject but were in fact more custom homes, located in higher-priced areas. In fairness to the underwriters, it would have been difficult for them to have known that the values were inflated without the training to look for other clues, or flags on those appraisals. That's the problem that makes it so difficult for the lenders—the appraisers can write the appraisal report in a way that it will pass a quick review, by avoiding any obvious compliance violations.

Buzz: What happened?

Coon: He was eventually sentenced to almost 20 years in prison. Obviously his defense of just making a few mistakes did not work. The appraisal fees he collected were so exorbitant; it was hard to argue that he didn't know that there was something going on.

Buzz: That's quite a stiff sentence.

Coon: The scale of that case was so huge, the court was bound by sentencing guidelines related to the amount of money stolen. The verdict really got a lot of attention. Here we are a few years later and people are still talking about it.

Buzz: Why do these cases get so much attention? After all, there are lots of white collar crimes in every industry.

Coon: Yes, but even though the scam took place within the mortgage industry, its effects are much more widespread. In this case, the other parties involved admitted they could not have done this without the appraiser. That leaves a profound impression and clearly shows why the appraiser is so vital in the mortgage lending process. The losses in the lending industry affect everyone—not just the lender who originated the loan. These losses have a rippling effect, and impact every citizen to some degree.

As appraisers, we all need to realize that the stakes are very high here. Most of us are not going to get involved with criminals in a flipping scheme, but all of us have felt pressure from brokers or lenders before to hit a certain number. The majority of appraisers have lost business because we refused to do that, and many have given in and nudged that number up just a little bit. The pressure is horrible, but we have to remember that we can stand up and say, "No." It's our name, our reputation on the line. When an appraiser gets in trouble for inflating a value, none of those people are going to go with them. Whoever pressured the appraiser to produce this number isn't going to be there. Only the appraiser signs the appraisal report.

We have to take responsibility for ourselves and raise the standard. The good news is that there appears to be significant changes coming that will be more supportive of the appraisers. In particular, my prediction is that the highly ethical appraisers are going to be seeing a significant increase in the demand for their services.

Appraisal Buzz Interview with Kathy Coon, Part 2

Buzz: In the last interview, you mentioned that underwriters often cannot determine if the data on comparable sales is accurate. In addition to appraisers using comps that are not appropriate, are there any other "land mines" in the data, unknown to the lender?

Coon: In my opinion, the biggest land mine is the impact of financing concessions. Unlike other information, such as room count, square footage, etc., seller concessions are so difficult to verify since they are not found in public records or other databases. Appraisers are not getting the industry support needed to properly disclose and adjust for concessions.

Buzz: What are financing concessions? How do they work to inflate a home's value?

Coon: Financing, or seller concessions, are contributions by the seller to assist the borrower and include loan discount points, loan origination fees, buyer's closing costs paid by the seller, interest rate buy-downs, gift down payments or settlement assistance, and builder incentives and giveaways, among other things. These items do not add any value to the real estate; however, when they are included in the contract price for the sale of the house, and that price is supported by the appraisal, then indirectly the concessions affect value.

Buzz: What is the appraiser's responsibility here? How should appraisers deal with seller concessions in the appraisal report?

Coon: First, the appraiser should be analyzing the sales contract for the subject property. If substantial concessions exist, then it is doubtful that the market will support the price being offered. The appraiser does not make an automatic downward adjustment to the comps for the subject's concessions, but it is doubtful that the comps will support the inflated contract price. Unfortunately, most of the time the appraised value comes in at or above the contract price.

The appraiser's job doesn't stop with analyzing the sale of the subject. For any comparables that sold with seller concessions, these should be verified, reported, and adjusted for in the appraisal. Even if a property sold high due to the concessions, with the appraisal supporting the contract price, appraisers should deduct these concessions from the sales price when using it as a comp.

Buzz: What if seller concessions are not listed in the MLS? How does this make the appraiser's job even more difficult?

Coon: This is a huge problem for the appraiser. Reporting seller concessions should be mandatory in the multiple listing services, and we need the help of the real estate community to do that. The concessions are almost as important as the listing of the sales price, since some prices have been increased substantially just to allow for concessions. The appraisers are having a tough time tracking these down. They are required by USPAP, Fannie Mae, Freddie Mac, and the government agencies to properly verify, report, and adjust for seller concessions. In fact, the appraiser could be held accountable for an appraisal if the value is inflated due to concessions. Yet this data, especially for the comparables, is very difficult to obtain.

Buzz: Why is the seller concession information hidden? Or, if it is known, why do appraisers fail to adjust the comps properly?

Coon: Because everyone wants to build concessions into the contract price so they will be including in the loan. And, once again, appraisers are often pressured to support the contract price. Many are hesitant to come in below the contract price in a new home development for fear again of not getting any more assignments. The appraiser pressure problem again enters the picture. So, when you add this issue to the fact that seller concession data is not reported, but the appraisers can get into trouble by not handling concessions properly, you put appraisers in an impossible position.

Then, appraisers also confront the overall confusion about how to handle concessions. Some appraisers are misinterpreting the word "typical" as it is used in the definition of market value, thinking that if a lot of sellers are paying concessions – especially from new home builders in the same neighborhood – then these are "typical" and therefore should not be deducted. That's incorrect. Fannie Mae and FHA have both attempted to clarify the instructions to the appraisers. Any concession that has been built into and increases the contract price should be deducted when these sales are used as comps.

Buzz: Do you think the concessions have a negative impact?

Coon: Yes. Seller concessions included in a contract price impact the value of the subject property if the appraisal supports the contract price. These types of sales result in inflated sale prices in databases such as MLS. When those inflates sale prices are used as comps in other appraisals without deducting for the concession, it results in another inflated appraisal supporting an inflated contract price—there is a compounding effect. Further, these comps can impact the accuracy of the work product of other appraisers unaware of the concessions.

I consider seller concessions "land mines" because the lenders, secondary market, investors, etc. don't see them, so therefore they have no idea how many appraisals reflect inflated values. And, let's not forget the consumers. They are ultimately hurt by the inflated price paid for their homes. Ironically, these are the same consumers that needed help to buy their homes.

Buzz: Do you think concessions should not be allowed?

Coon: No, that's not the message here. Programs that will help individuals buy a home are needed. I'm not picking on the new home builders, either—they are vital to the real estate economy. There just has to be a better way. Allow the assistance of concessions, but don't confuse it with market value.

Buzz: So, in your opinion, what's the solution? How can the industry stop seller concessions from artificially inflating home values without putting appraisers in an impossible position?

Coon: It's contradictory and confusing for lenders to allow seller concessions in the contract price, which do not add any value to the real estate, and then hold appraisers responsible for determining the value minus concessions. As an appraiser, you just can't win.

First, we need the cooperation of the entire industry: appraisal organizations, government agencies, GSE's, NAR, consumer groups, etc., to reach a solution that still allows assistance but does not distort market value.

One suggestion: financing concessions *cannot be included* in the sales contract. The contracts should consist of the price paid for the real estate only; not the financial incentives. The lenders can still offer incentives to assist buyers, but it should be done as an agreement separate from the purchase transaction of the real estate. For example, suppose the contract for the purchase of a property is $100,000. The loan applied for is 95 percent of market value, or $95,000. Based on the creditworthiness of the applicant—or whatever criteria they so choose – the lender can provide financing for an additional $5,000 toward the closing costs. This now equates to a 100 percent loan. Or, the lender can provide the assistance as a side loan. In reality, lenders are already providing 100 percent loans and higher, by unknowingly financing the concessions through loans based on inflated property values. Since concessions are so prevalent in the industry these days, how accurate is the valuation of a portfolio?

Mandating that financing concessions be omitted from the sales price in the contract presents no downside to the lending industry. Using this method, the concessions would still be allowed to help borrowers obtain loans, but would not impact the true value of the real estate by confusing appraisers and obscuring values. The upside:

- Reduces inflated prices paid for real estate; which inadvertently results in inflated appraisals.
- Stops the corruption of databases by inflated sales that included concessions
- Increases accurate appraisals
- Increases accurate analysis of the basis for loans; decreases risk to the lender
- First time buyers and others in need of homeownership assistance would not find themselves with an "upside down" loan.

This is just a suggestion. As I mentioned, the entire industry needs to address this issue and come up with an acceptable solution. Currently, no one knows the extent of impact because the concessions are seldom disclosed. If the financial community in general knew how prevalent concessions are, and how much they are affecting valuations, this problem would be addressed. As of now, financing concessions remain land mines for lenders.