

The Shape of Things to Come.
Charles B. Warren, ASA

Maybe five or more years ago I pointed out to Fannie that appraiser identity theft and mass production of appraisal wallpaper was going to be a problem. Didn't get me a job. Far from it. But it happened. The extent of the problem is still unknown but the minuscule enforcement staff at Cal OREA reports that they are working on a large number of appraisal "boiler room" cases.

An appraisal boiler room is part of what I call the 7% solution. If 60% of appraisers recently polled feel that they have been asked, and presumably refused, to do unethical things, and if 33% of appraisers are trainees who don't know any better, then 7% of appraisers are making lots of money doing those things while employing that 33%. I mean, where's the value added in appraisal services if you can't "do the deal" in internet time? The OREA investigator speaking at a recent conference waxed nostalgic about his time in lending when appraisers were regarded as the eyes and ears of the bank, to say nothing of its last line of defense. How 20th century.

By contrast, the head of OTS appraisal enforcement wouldn't even talk to me about recidivist chief appraisers and others. I sat at a lunch presentation. At the head table was a guy who had been chief appraiser at an institution with a 98% default and maybe 50% loss rate. He had then gone on to another which had also failed. Like Chaucer's 'perfect gentle knight' whose campaign ribbons included the sack of Constantinople, there are any number of these folks who have made a career out of facilitating failed institutions' appraisal departments. Said head of appraisal enforcement retired before the bubble even started to leak badly. Timing is everything.

So much for the history. How about some future history? I recommend "A Demon Of Our Own Design" by Bookstaber. He starts off by modestly disclaiming responsibility for the Crash of '87 and the LTCM meltdown, but admits to having been "in the vicinity". He likes and is good at things which are susceptible to modeling. He's a "quant". He writes about the challenges of modeling and particularly model testing. Did the model work or fail because it was correct and complete, or because the analyst got lucky or unlucky? How, in the real world, can you know what you don't know? That's a koan for quants. You can almost read the trepidation between the lines when he writes about mortgages, mortgage backed securities and their derivatives. This seems to be another universe from (relatively) simple schemes like the carry trade, or yield curve arbitrage. And one of the things he didn't even mention is that the security behind these loans which is supposed to

make them "safe as houses" is unknown. Unknown because the evaluation has been mass produced by the ignorant to serve the greedy.

Nothing wrong with greed, per se, but loan underwriting has lost its checks and balances. There is nobody in the chain of "the deal" who has any interest beyond making it and making the associated fees. The final investor buys the product ignorant of anything beyond its quoted price on Wall Street. Even that investor is probably executing a trading strategy for a hefty fee. While banks and thrifts did most of the lending, there was some pretty good regulation and enforcement. Not perfect; we had the S&L bust. Now that most of the residential lending is done by mortgage companies for sale to secondary markets the supervision amounts to oversight. Oversight as in "an inadvertent omission or error"; the small staffs of the Department of Corporations and OREA are totally inadequate to the task.

Maybe the underlying security is meaningless in today's fully liquid market, but what happens in event of default? We're already seeing a few subprime deuces flutter off the house of cards. Eventually somebody will have to get down to the dirt. What they will find is anybody's guess.

The last time house lending tanked was forty years ago. It was ugly then and will probably be no less ugly now.

Just to put forth an idea, what stake does a borrower have in a house to which they only just moved, and only bought in order to get a \$50,000 payoff from the seller? How is this any different than a 100% car loan where the buyer got a few thousand dollars "cash-back"? Probably the only difference is there won't be a repo man who can be "Gone In 60 Seconds". Does anybody suppose that the quants analyzing a decade or so of mortgage history will capture this in their pricing models? Could this have something to do with Fannie's travails at properly accounting for the value of their loan book? So. Why should house loans be priced any cheaper, have lower interest rates, than car loans?

We haven't even talked about the 8% solution. What happens when long term rates go to 8% and all those 4% ARMs start going up? What happens if unemployment is also 8%...? One thing pretty sure, if you're an honest appraiser the world will not beat a path to your door for the answer. The job title has been devalued.