Case Study: Why These Top-Ten Home Equity Lenders Replaced Traditional Exterior Appraisals with Hybrid Alternatives

By Mark Sennott

Executive Summary

The mortgage industry's acceptance of exterior hybrid appraisals is growing as more lenders adopt these hybrids to replace the benchmark, traditional 2055 exterior appraisal. *The reason:* Lenders are finding that traditional exterior appraisals cost too much, take too long and add no increased risk protection over a robust, properly controlled and quality-monitored hybrid exterior appraisal.

The purpose of this white paper is to present new evidence of this trend, based on the case studies of two, top-ten home equity lenders. Over a combined two-year period, these lenders tested and adopted the new hybrid models and other alternative valuation methods. The case studies involve the live production use and analysis of more than 14,000 hybrid appraisals completed in some 25 states.

The results show that the lenders who have allowed us to use this data – without mentioning them by name – have experienced significant benefits in using the hybrids. These benefits include:

- Substantial reductions in cost and overall turn times for appraisals. Per-unit appraisal costs for one lender declined by 48% and turn times were reduced by 44%.

- Based on audits, no additional risk in using the hybrids over traditional products was found as long as the hybrid used was (a) USPAP compliant and (b) carefully controlled and monitored as part of an overall valuation cascade.

- By integrating the hybrids into an overall valuation cascade and including an up--front, screening of hybrid appraisal assignments, the lenders gained increased operational efficiencies. One lender saw a 37% reduction in "wasted cycle time" due to elimination of unnecessary upgrades and wait times for multiple appraisals.

Background

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Before we present the results for the two lenders, it is important to talk a bit about what a hybrid exterior appraisal is or isn't. We also need to distinguish some hybrids from others and talk about where the hybrid products fit into the overall lender valuation process.

Of course, not everyone is happy about the dying off of the traditional appraisal. Some appraisers still resist anything that is not traditional. Other appraisers, however, have successfully adopted the new hybrid products as part of their business model. During the course of the two-year period, the number of appraisers embracing the new models grew substantially as the volume of the assignments grew.

What is a Hybrid Exterior Appraisal? Most industry experts would agree, a hybrid exterior appraisal engages a local, licensed appraiser to provide a USPAP compliant valuation via a desktop analysis. Prior to completing the analysis, the appraiser is furnished a third-party exterior inspection to provide information on the subject property's condition, conformity to the neighborhood and the market conditions in the neighborhood.

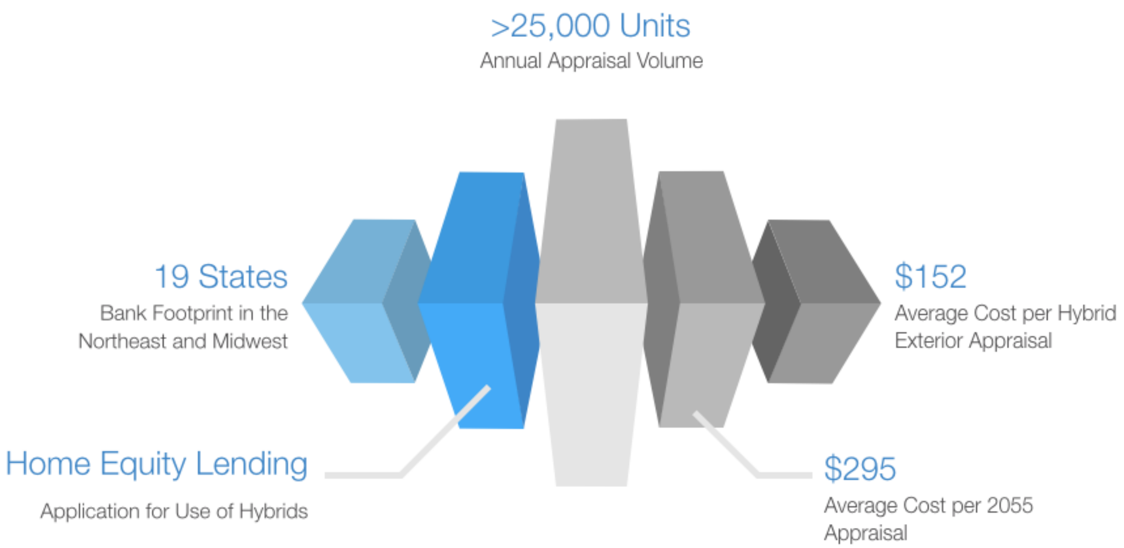
The exterior hybrid appraisal form, used by the two banks referenced in this white paper, *looks like, feels like and acts like a 2055 exterior appraisal form*. There is one main exception: A local real estate agent, not the appraiser, conducts the exterior inspection. The form has the same comparable sales grid as the 2055, including line item adjustments and photos of the comparable sales and is completed by a licensed, local appraiser. The appraiser's value opinion is provided without AVMs or suggested comparable sales. The real estate agent has no say on value and the appraiser can override or reject elements of the inspection and/or even reject the assignment based on the inspection or complexity of the assignment. The form used in these cases also contains appropriate USPAP disclosures and limiting conditions, including the fact that the appraiser is relying upon a third party for the inspection results.

Not all hybrid exterior appraisals meet these criteria. Some do not provide a full grid of comparable sales with adjustments. Some do not provide photos of comparable sales. In many cases, some of these hybrids are completed by appraisers licensed in the subject property state; but it turns out the AMC companies rely exclusively on staff appraisers to complete them or do not require appraisers to be located within a reasonable distance from the subject property. These are all significant concerns and lenders should be careful when considering hybrids, but these issues do not apply to the hybrid approaches used in the case studies presented here.

Note, the hybrid appraisals used by the lenders in our case studies were audited for appraiser' geographic competency and appraisal defect rate. The audits produced similar results when compared to audits performed on 2055's.

Finally, appraisal hybrids or other lower--cost alternatives perform best when they are not forced into being a one-size-fits-all solution for all applications or for all properties. Higher-end properties (over $1 million), unique properties (log homes, domes, etc.) or agricultural properties (farmhouses with acreage and/or many outbuildings) may require lenders to conduct a traditional interior appraisal. *What made the lender experiences successful in the case studies presented is that the lenders used their own or an AMC's up-front, pre-assignment screening tool to limit how and when the hybrids or alternatives could be used*.

Case Study 1- Home Equity Lender Replaces 2055s with Exterior Appraisal Hybrids



Case Summary
Background:

Like many large home equity lenders, the bank had been facing the federal regulatory elimination of lower--cost AVMs for lending purposes. Without AVMs, the bank had been faced with increases in per-unit valuation costs from $15 for an AVM to about $300 for an exterior appraisal. Turn times for collateral decisions would also increase, from an immediate decision with an AVM to almost a week waiting for a 2055 traditional appraisal! As a result, the bank began exploring the use of exterior appraisal hybrid products to gradually replace the use of 2055 exterior appraisals.

The Goal:

How to find alternatives to the traditional 2055 appraisal that would *lower costs and turn times* but still meet regulatory and appraisal industry requirements for *compliance* and *quality*.

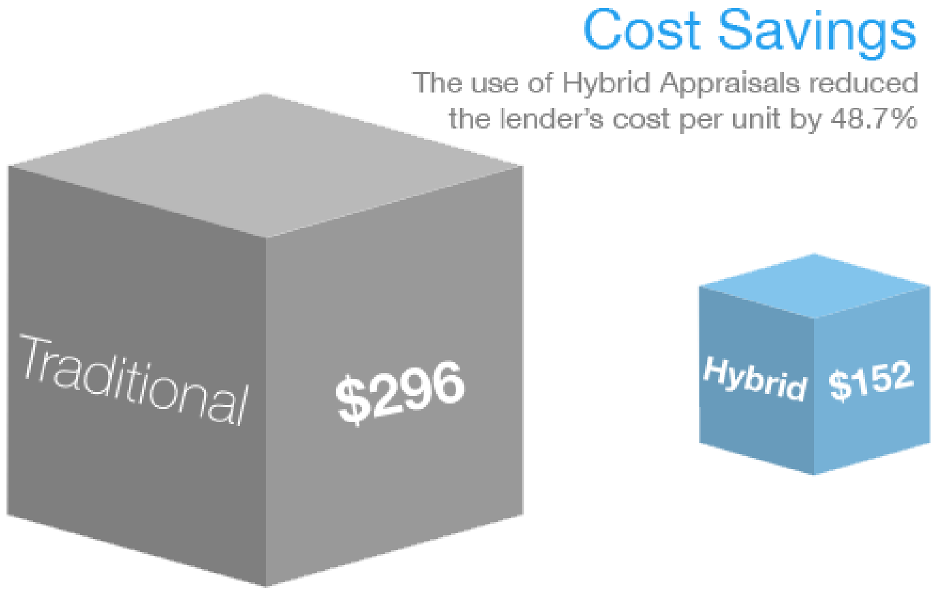
What Happened?

Before any hybrid appraisals went into live production, side-by-side tests were conducted in all footprint states comparing the hybrid value estimate to the 2055. The lender tests determined that there was no material difference in the value conclusions between the traditional and hybrid products.

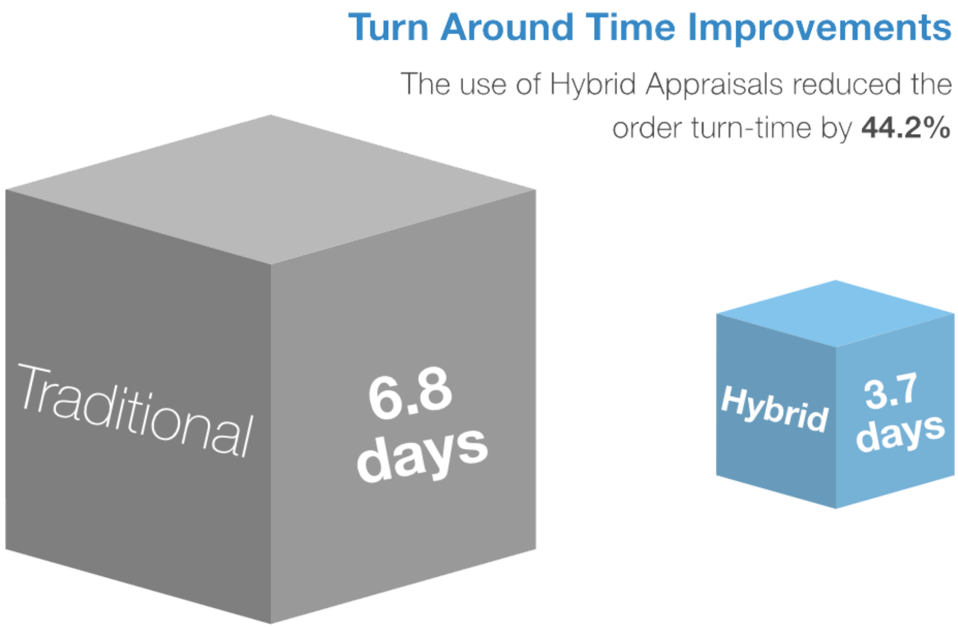
When the pilot went to live production, the bank selected the risk, property and loan criteria under which a hybrid could be used. *Orders for hybrid appraisals were subject to an up-front screening process to make sure the lender's criteria were met before an inspection was ordered and before an appraiser was assigned to complete the desktop appraisal.* If the order failed the up--front screening, it was either cancelled or upgraded to a full interior. The results that follow are based on this lender's experiences over the course of 2014 and 2015.

The Results?

Cost Savings:



Turn Around Time Improvements:



Quality Differences

Lower costs and improved turn times would matter little if the use of hybrid appraisals created quality issues for the lender or somehow impacted the borrower experience. During the two--year period, the lender did not experience any significant impact in the use of hybrid appraisals over traditional exterior appraisals as measured by the following:

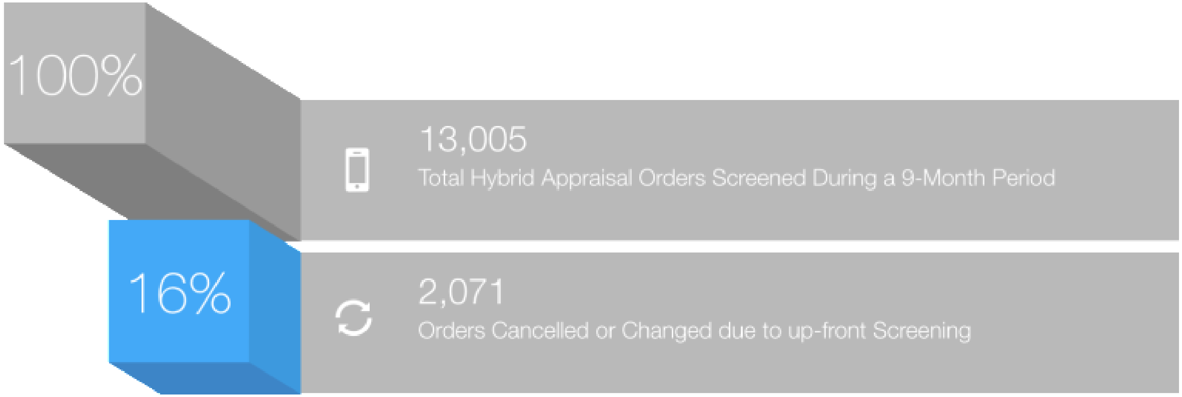
Process Efficiencies/Acceptance

Inserting an alternative product into a valuation cascade can present challenges when it comes to process efficiencies. If hybrid appraisals ended up increasing the number of upgrades to full appraisals, for example, then the lender's costs go up and borrowers have to wait longer to get approvals since the lender would have to wait for two appraisals. What's more, in the appraisal industry, the introduction of new solutions is often met with skepticism, if not downright resistance from appraisers. Regulators also have to get comfortable to make sure that new appraisal products are USPAP compliant and meet industry guidelines.

The lender found that the best way to confront these challenges was to make sure that hybrid appraisals were treated not just as a new product, but were integrated into the bank's entire collateral risk and valuation process. As mentioned above, the use of up-front screening of orders slated for hybrid appraisals had a huge impact; namely, it reduced the probability of upgrades to full appraisals and helped ensure that the AMC being used to conduct the hybrid appraisals did not force local appraisers to complete assignments better suited for interior appraisals.

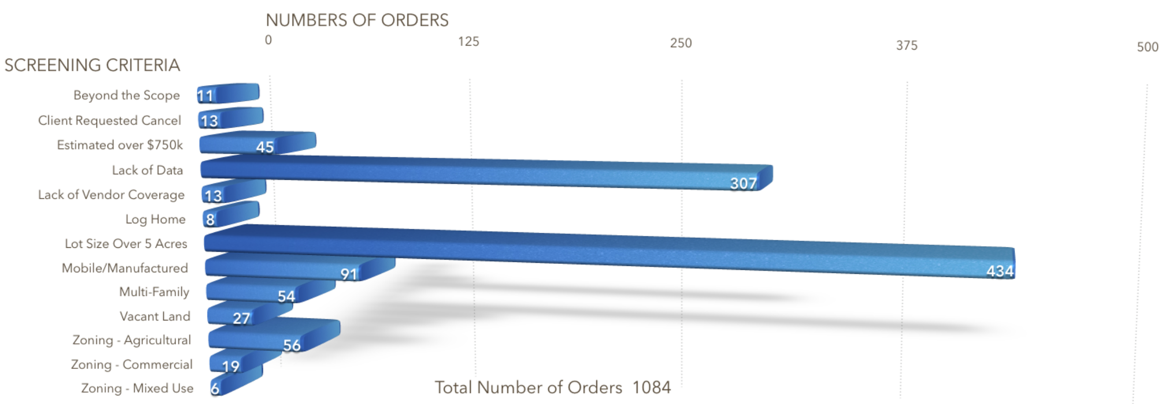
During a nine-month period in 2015, the following analysis was done on this up-front screening process used by the lender and the AMC. In essence, the up-front screening compared the lender's stated home equity loan and collateral risk policies against the borrower's actual subject property characteristics. This screening included both automated and manual review and took usually no longer than a few hours. If it could be determined during the screening that the subject property characteristics were outside the lender's criteria for using a hybrid appraisal, or the lender determined the borrower failed to qualify for home equity loan, the process was halted. The hybrid appraisal order was then put on hold, cancelled or immediately upgraded to an interior appraisal, depending on what happened with the screening.

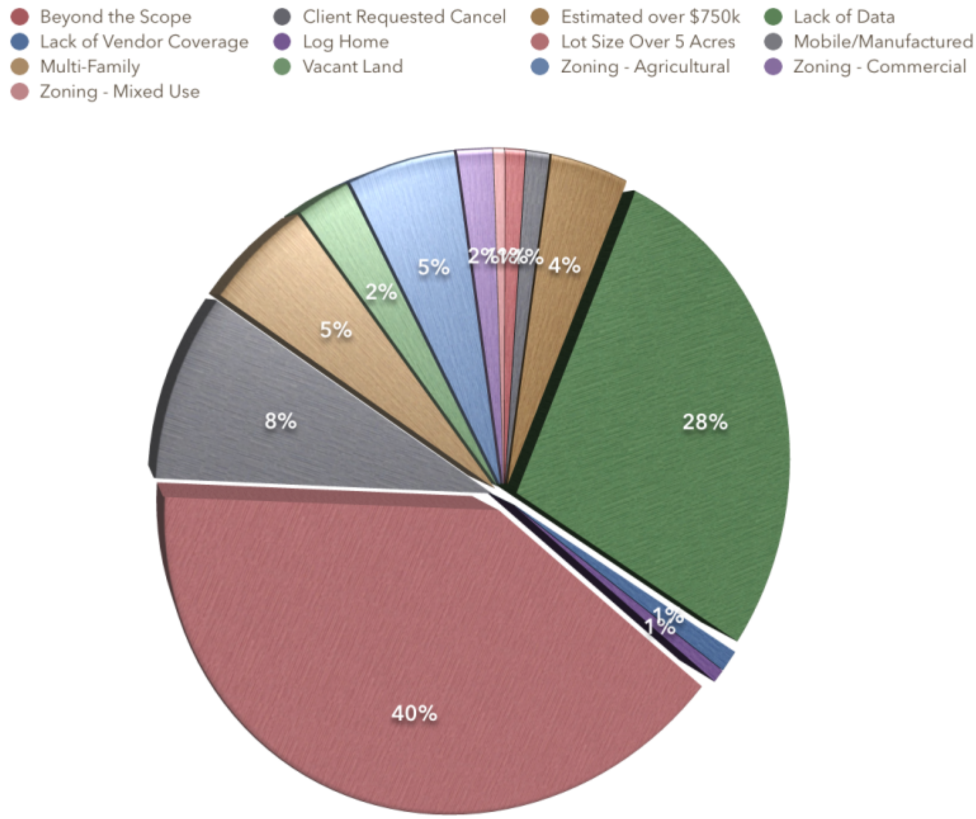
During a nine-month period in 2015, 16% of all orders screened up-front during that period resulted in some type of order change or cancellation that helped streamline the client process:



Some of the screened orders were cancelled immediately because they were duplicates or the borrower requested cancellation, however, the up-front screening process identified over 1,000 instances in which the lender found out that the hybrid appraisal could not be used for the loan application and in these cases the hybrid appraisal was cancelled or upgraded to an interior appraisal right away.

Instances requiring upgrades included identification of subject property characteristics that violated bank home equity lending policy (e.g. the subject property was a farm with over 5 acres) or where there was a known lack of online assessor data (needed to complete the hybrid appraisal or 2055.) Again, we point out the bank set lending criteria for the subject property, and the criteria was under the control of the bank only.

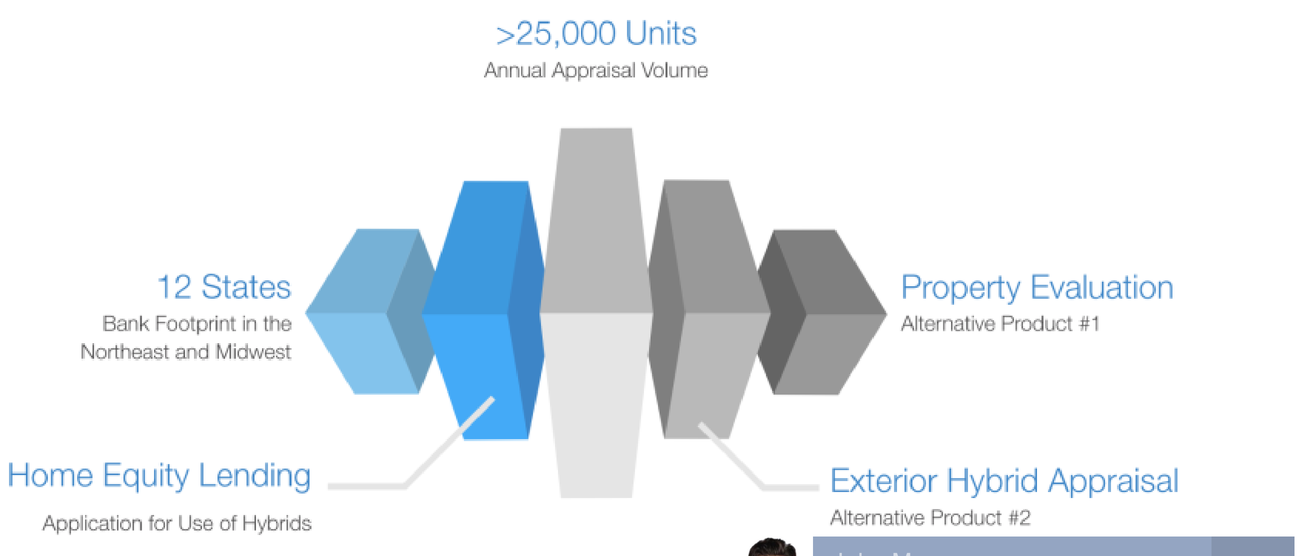




Because this screening was completed over 90% of the time within the same day as the order, several benefits to different parties occurred at the same time:

- **The lender avoided paying twice for appraisals** – once for a hybrid appraisal that would not have worked and once for the upgraded interior appraisal. In the event up-front screening determines the property does not meet the lender criteria, the order is cancelled without charge to the lender.
- **The borrower did not have to wait the extra time** for two appraisals because the hybrid was upgraded to an interior right away.
- Appraisers were not forced to complete hybrid appraisals on high-end or unique properties that should have been subject to interior appraisals.

Case Study 2 - Home Equity Lender Integrates Two Alternatives into Valuation Process



Case Summary
Background:

This lender had already replaced traditional exterior appraisals with hybrid appraisals prior to 2014. This put the bank ahead of the curve compared to other lenders. But the introduction of hybrid appraisals had also inadvertently created a process problem. For low-risk, low value loans, the lender was using an internal collateral review process “evaluation,” that involved the use of an AVM, an exterior property inspection and a review by bank staff. The next step in the process was to upgrade to a hybrid exterior appraisal. If that didn’t work, then the lender would upgrade to a full appraisal.

The issue occurred because the lender was using different AMC vendors to complete the different product sets. This meant that the lender might wait for the “evaluation” product, which would sometimes fail, then wait for the hybrid appraisal, which may have also failed, only to end up having to upgrade to a full appraisal.

This created wasted cycle time and increased costs. As a result, the lender began exploring the use of a more streamlined evaluation/appraisal process that was designed to eliminate these inefficiencies.

The Issue:

How to replace the current evaluation/appraisal process with a more streamlined approach but still meet regulatory and appraisal industry requirements for compliance and quality.

What Happened?

In order to streamline its collateral valuation process, the bank took three steps:

1. The lender revamped its “evaluation” product and strengthened it by making it a more robust reconciliation of an AVM and an inspection. Using the definition of an “evaluation” as defined by federal regulators, the lender also tightened some of the rules as to when the evaluation could be used. It was reserved for only the lowest risk, lower loan amount loans. If it failed, it would be upgraded to an exterior hybrid appraisal.
2. Instead of completing the evaluation in house, the lender selected a vendor who would perform not only the evaluation, but also the hybrid exterior appraisal if the evaluation “failed.” By doing this, the exterior inspection the outside vendor used for evaluation product could then be leveraged as the inspection used for the hybrid appraisal at no cost to the lender and with no further delay.
3. The lender implemented a pre--screening order process similar to the one used in the first case study. If it could be determined during the screening process that the subject property characteristics violated (a) the lender’s criteria for using either the evaluation of the hybrid appraisal or (b) the granting of the home equity loan in the first place, the order was put on hold, cancelled or immediately upgraded to the next product in the process path, ending with an interior appraisal.

The results that follow are based on this national lender’s experiences with this new streamlined process during the course of 2015.

The Results?

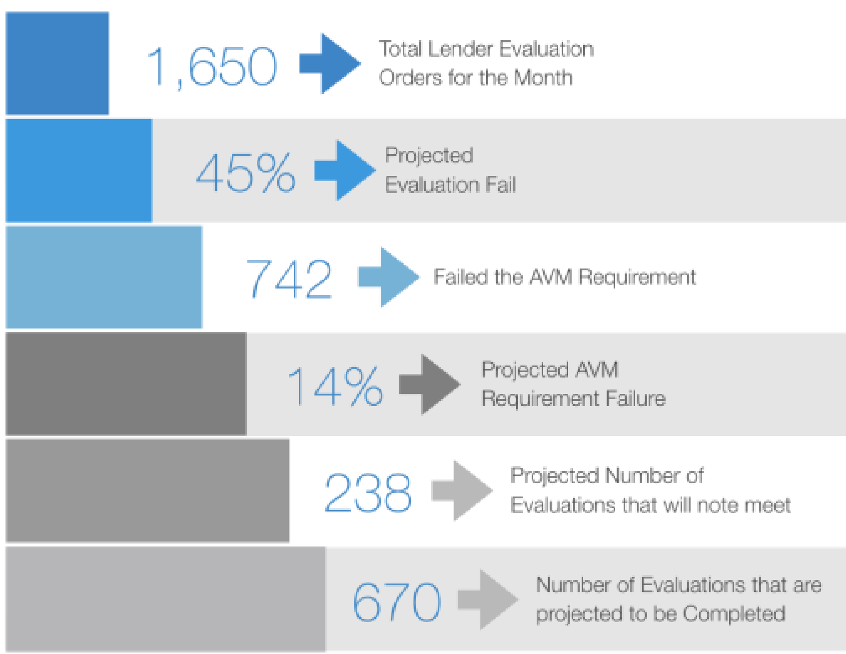
Cost Savings:

Because the lender had previously eliminated the use of 2055 exterior appraisals in favor of either an evaluation or a hybrid appraisal, the cost savings for using hybrids were not as dramatic for this lender. But there were still significant savings during the last six months of 2015 due to the more streamlined order process that was implemented.

Savings on “Hybrid Appraisals”

Hybrid Cost Savings - Due to Cancellation/Screening						
Cancelled Orders per Month	**% of Cancelled Orders**	**Reason of Cancellation**	**Savings: Having Eliminated paying twice for Hybrid**	**Savings: $50 Trip Fee Eliminated**	**Total Monthly Cost Savings (Inspection + Trip Fee)**	**Projected Annual Savings**
43	17.05%	Beyond Scope of Product	$5,778.84		$5,778.84	$69,346.08
35	13.95%	Client Cancelled	$4,728.14		$4,728.14	$56,737.68
39	15.50%	Client Criteria (No Hit)	$5,253.49		$5,253.49	$63,041.88
8	3.10%	Commercial or Mixed Use			$0.00	$0.00
1	39.00%	Condo	$131.34		$131.34	$1,576.08
7	2.71%	Manufactured or Mobile Home			$0.00	$0.00
4	1.55%	Multi-Family			$0.00	$0.00
71	28.29%	No Coverage		$3,550.97	$3,550.97	$42,611.64
22	8.91%	No Data Available		$1,118.80	$1,118.80	$13,425.60
2	78.00%	No Data Available - New Construction			$0.00	$0.00
15	5.81%	Over 10 Acres	$1,907.06		$1,907.06	$22,884.72
5	1.94%	Vacant Land			$0.00	$0.00
252	**100.00%**		**$17,798.87**	**$4,669.77**		
				Total Monthly Savings	**$22,468.64**	
				Total Annual Savings		**$269,623.68**

Savings on “Evaluations”



Sample Evaluation / Inspection Cost Savings			
Calculated Savings at $50 per Inspection	**Additional Calculated Savings at $15 per AVM**	**Total Monthly Cost Savings (Inspection and AVM)**	**Projected Annual Savings**
$11,880	$3,564	$15,444	$185,328
	Total Monthly Savings	**$15,444**	
	Total Annual Savings		**$185,328**

Turn Around Time/ Efficiency Improvements:

Due to the streamlined evaluation/appraisal ordering process, there were significant savings in overall turn-around time for the lender.

A. AVM/Inspection/Review Cycle Time Savings:

Previous Lender Process

Previous Lender Process			
Order →	**Inspection →**	**Review →**	**Complete**
Day 1	Day 2	Day 2.5	Day 3
	Lender Average for Previous Process	**3 Days**	

Previous Process

- Lender ordered the inspection for AVM/Inspection/Internal Review from one vendor and ordered the desktop from a different vendor
- If the Lender AVM/Inspection/Internal Review failed or had to be upgraded to a desktop, the inspection for a desktop had to be ordered again with new vendor
- Using YTD volume, we estimate this occurred 25% of the time and, for these fles, resulted in 2 days' cycle time "wasted" while waiting for the second inspection to be used in the desktop

Assumptions for Previous Process Cycle Time for Lender Hybrids:

- Hybrids took 3.5 days
- 1200 at 3.5 days
- 400 at 3.5 days + 2 days (to wait for new inspection) = 5.5 days on 25% of files
- Average Cycle Time Calculation: 400 at 5.5 days + 1200 at 3.5 days = 4 days average previous cycle time for hybrids

*The Previous "Wasted" Cycle Time was eliminated because the inspections used for the Evaluations that failed or were upgraded were now leveraged in the upgraded hybrid appraisal. (The hybrid was ordered immediately instead of waiting two days for a new vendor hybrid inspection)

B. Hybrid Appraisal Cycle Time Savings: New Lender Evaluation Process

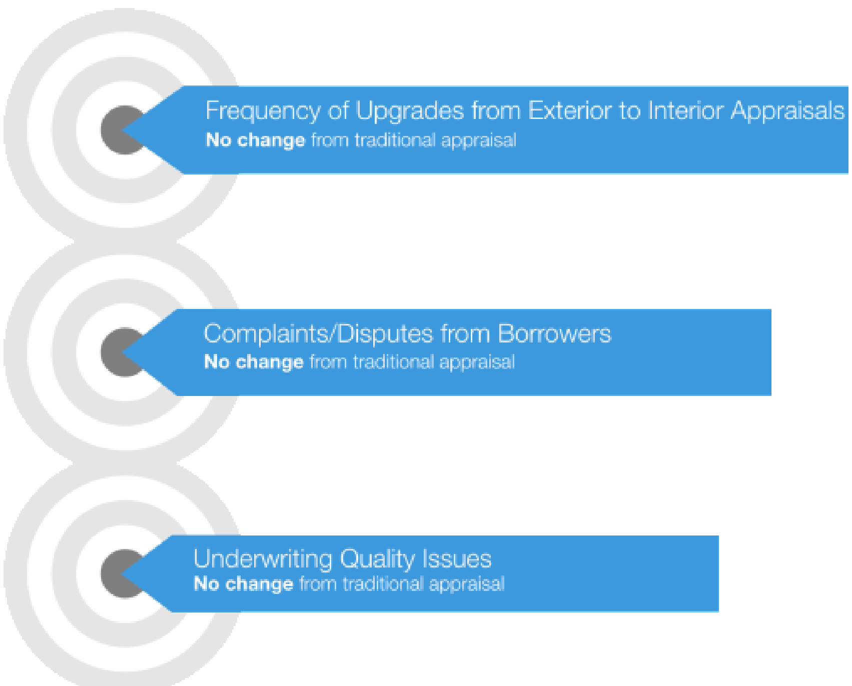
New Lender Evaluation Process Cycle			
Order * →	**Inspection →**	**Review →**	**Complete**
Day 1	Day 1.5	Day 1.5	Day 1.9
	Lender Average for Previous Process	**1.9 Days**	

*Includes Pre-Screening Time

Order * →	**Inspection →**	**Actual Cycle Days Saved Per File:**
Evaluation Cycle Time Saving YTD		1.1 Cycle Days
		Percent Reduction in Per File Cycle Time: 37%

Quality Differences

The hybrid appraisals used by this lender were subject to an audit for appraiser' geographic competency and appraisal defect rate. The audits and the experiences of the lender showed the following:



About the Author

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