MARSHALL & SWIFT
THE BUILDING COST PEOPLE

Thursday, June 09, 2011

The Honorable Shaun Donovan
Secretary of Housing and Urban Development
U.S. Department of Housing and Urban Development
451 7th Street, SW
Washington, DC 20410

The Honorable Ben Bernanke
Chairman
Board of Governors of the Federal Reserve
20th Street and constitution Avenue
Washington, DC 20551

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

John Walsh
Comptroller of the Currency, Acting
250 E Street, SW
Washington, DC 20219

Edward DeMarco
Director, Acting
Federal Housing Finance Agency
1700 G Street, NW
Washington, DC 20552

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Ladies and Gentlemen:

Marshall & Swift[1] appreciates your efforts to implement Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We found the Joint Notice of Proposed Rulemaking issued March 31, 2011, to be thoughtfully executed and comprehensive in scope. Your efforts to establish the terms of a Qualified Residential Mortgage (QRM) will not only increase investor confidence in MBS securities, it allows for the improvement of many long standing practices related to real estate.

To date, the Qualified Residential Mortgage discussion has largely focused on the borrower's financial strength and in identifying default risk predictive indicators that may project performance during periods of inflated real estate values and high unemployment. What has been missing from the discussion has been a clear recognition of how poorly determined property values contributed to the increased numbers of foreclosures, distressed sales and ultimately a depressed real estate market. While accurate property values are important for every real estate transaction, they are foundational to the QRM qualification process. Foundational, because the property value is represented in nearly every other qualifying equation being considered today.

[1] Marshall & Swift is the leading provider of construction and reconstruction cost data and valuation solution in North America. Data and technology solutions are utilized by mortgage servicers, appraisers, assessors, tax consultants, lenders and property insurance professionals worldwide. www.marshallswift.com

The traditional valuation methods (cost approach, sales comparables, and income approach) identified by the Uniform Standards of Professional Appraisal Practice, when singularly applied at appraisal, fail to produce enough assessment data to identify under and overvalued properties and markets. *By simply requiring the use of two or more of these value methods, a system of checks and balances will be introduced that yields more accurate value assessments. This accuracy improvement will ultimately lead to better performing securities and improved investor and tax payer confidence.*

The appraisal industry and the mortgage lending industry it supports have benefited over most of the past 65 years from a strict application of multiple valuation methodologies. For residential valuations in particular, government entities, lenders and appraisal professionals relied on the cost approach to value **combined** with market comparables to ensure that values were logical, measurable and protected against unsustainable market values.

Value method – historical review

Concerned with the possible impact to home pricing that run-away inflation or deflation would have, in 1947 the Federal Housing Authority (FHA) established legislative guidelines that mandated more than one approach to assessing value. With these guidelines, the FHA sought to ensure that reasonable collateral was present for the duration of a mortgage loan. Accepted appraisal theory recognized that while sales price might vary due to differing financing terms, appraised value could not. To help safeguard the integrity of the lending community, the FHA developed a comprehensive valuation methodology for existing properties grounded on three principles:[2]

1. The principle of replacement: The estimated cost of replacement fixes an upper limit of value.
2. The principle of substitution: the cost of acquiring an equivalent substitute [or comparable] property fixes the upper limit of value.
3. The principle of income capitalization: A properly made capitalization of expected income fixes an upper limit of value.

As a result, valuation options included the cost approach (the cost to build new), the market comparable approach and/or the income approach (more often used in commercial lending). Trained appraising professionals defined the synergies and differences between both tangible and intangible variables for residential property, including the cost of construction of the home in its local market (included in the cost approach), the cost of land (also included in the cost approach) and market comparables. Sellers had to adjust the sales price downward if one or more of these methodologies yielded a significantly (>20%) lower value.

Policymakers understood that lenders would need to assure themselves of collateral protections over time and that focusing only on the market comparison approach as the base-line for loan originations and associated collateral valuation would likely become a flawed process. Valuing mortgage portfolios within a reasonable tolerance using at least two valuation approaches would ensure the long term sustainability of the lending process and lenders' continued ability to provide mortgage loans, on reasonable terms, to consumers.

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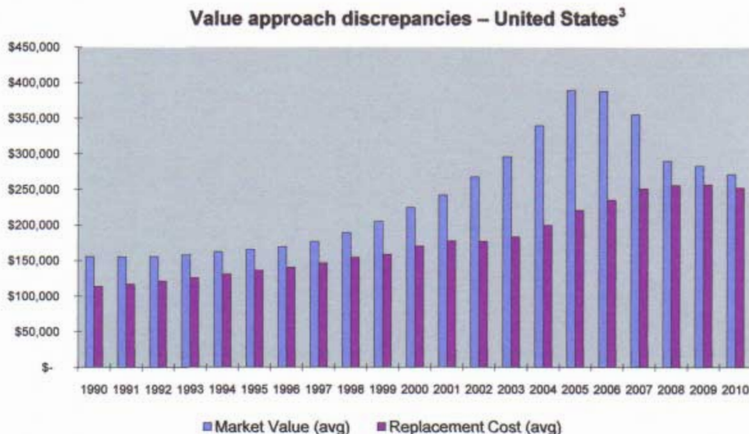
[2] McMichael's Appraising Manual, 4th Edition (1951)

Under mounting pressure from mortgage originators seeking to write larger loans, the principles of replacement and income capitalization came to be relied on less and less, until they were made optional in the 1990's by Fannie Mae. As a result, the Uniform Standards of Professional Appraisal Practice (USPAP), the industry-wide quality control guidelines for appraisal analyses, and the Fannie Mae Uniform Residential Appraisal Report, stopped requiring the use of the cost approach.

Starting in the late 1990's, the widespread use of loans with high loan to values ("LTV's") combined with subprime credit, interest only and low document/no document qualifying drove market prices higher. These prices not only became the comparables used to justify inflated sales prices, but they also became the comparables for appraisals supporting cash out refinancing loans.

Because the cost approach was not affected by the inflationary factors that appeared with the comparison approach, many participants concluded that the cost approach was no longer applicable, and the use of the cost approach to value became no longer required by Fannie Mae and Freddie Mac for residential appraisals. As a result, the gap between market values and the cost approach continued to expand, with the values of the cost approach more accurately reflecting the objective value.

Value approach discrepancies – United States[3]



The graph above illustrates the historical relationship between the market comparison and cost approaches to value. The left side of the graph illustrates a consistent relationship between the two approaches and is indicative of the basic principle that a knowledgeable buyer will not pay appreciably more for an existing house than what it would cost to build. The right side of the graph illustrates the

[3] **Value approach discrepancies - U.S.** created by Marshall & Swift (Data Sources: Market Values calculated using Q4 2010 average sales price data from National Association of Realtors and United States Census Bureau, then trended using S&P/Case-Shiller Home Price Indices; Replacement Cost determined using average cost data by region from U.S. Census Bureau and Marshall & Swift's Construction Cost Indices, including land value allowance)

de-coupling of these methods following the de-emphasis of the cost approach. As history has proven, and the graph clearly illustrates, the de-coupling of these two approaches to value provide a very clear indication of the housing bubble that was supported by relying solely on the use of the more *subjective* market comparison approach to value without regard to the more *objective* cost approach to value.

Construction cost data has a long tradition as a tool for implementing public policy, ranging from its codification in federal statutes to its current use in transforming public housing. This track record spans more than six decades of economic change. This history of reliability supports using a valuation method premised on construction cost data to update the current appraisal methodology for the American residential housing market, and for use in the QRM qualification process.

Cost data as a measure of value

Under the United States Housing Act of 1937[4] ("1937 Act"), the federal government codified the use of construction costs through use of the statutory term development cost[5]. The 1937 Act and development cost are related to housing issues presented in the Native American Housing Assistance and Self Determination Act of 1996 ("NAHASDA")[6]. Specifically, total development cost limits are determined by averaging the current construction costs as listed in two nationally recognized residential construction cost indices: Marshall & Swift/Boeckh, LLC and RS Means.[7] Additionally, construction cost data is part of the total development cost (TDC) limits promulgated by HUD.[8] Here the use of construction cost data modernized public housing through the Hope VI Grant Agreement program.[9] As with NAHASDA, the Hope VI Program also derives construction cost data from averaging construction cost indices from two "nationally recognized residential construction cost indices."[10] The Marshall & Swift/Boeckh construction cost index is used for construction of "good quality." [11]

The reach of construction cost data is also present in the federal government's recommendation and advocacy of the construction cost approach to residential property valuation. For example, for properties that seek Federal Housing Authority (FHA) Insurance, FHA recommends and requires specific valuation methods. The valuation analysis for one to four bedroom dwellings is guided by a specific handbook, commonly referred to as 4150.2 (the "Handbook"). Appendix D to the Handbook specifically *recommends* the cost approach to value for new construction residential housing and requires the cost approach for a property with specialized improvements and a property that is manufactured housing. FHA *requires* use of the square foot approach and recommends use of the "Marshall & Swift Form 1007". More likely than not, FHA's use of the cost approach to value is preferred due to the absence of reliable supporting data to corroborate other valuation methods. This likely preference is suggested by

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[4] 42 U.S.C. 1437, *et seq.*
[5] Section 3(c)(1) of the 1937 Act, 42 U.S.C. 1437a(c)(1).
[6] 25 U.S.C. 4101, *et seq.*
[7] US Department of Housing and Urban Development Office of Public and Indian Housing Notice PIH 2009-27 (Issued: August 10, 2009 and Expired: August 31, 2010).
[8] Section 6(b) of 1937 Act; 24 CFR 941.306.
[9] US Department of Housing and Urban Development Office of Public and Indian Housing Notice PIH 2008-47 (Issued: December 22, 2008 and Expired: December 31, 2009).
[10] Id.
[11] Id.

Federal tax policy that recommends the cost approach for real property valuations where supporting data is not available.[12]

The evolving use of the cost approach to the valuation of residential property secured by a mortgage is a logical progression of the history of construction cost and the cost approach to value that has been implemented in federal statutes and regulations and has furthered federal public policy

NPR requests for comment

#122. Should other valuation approaches be considered in determining the value of the real property pledge on the mortgage transaction?

- Mortgages qualifying for QRM status must be required to include a market value assessment based on BOTH the cost approach and market comparable value methods. It is only when both methods are used together that the critical beneficial checks and balances occur that lead to more accurate value assessments. Failing to require both methods will result in the industries continued reliance on the subjective market comparable approach, which was shown to be ineffective during the recent real estate boom and bust markets.

#110. The Agencies seek comment on all aspects of the proposed definition of a QRM, including the specific terms and conditions discussed in the following section.

- Current QRM discussions fail to address the fundamental problem of poor valuation processes that undervalues properties during real estate contractions and overvalues properties during market expansions. Moderating the exaggerated swings in property values by implementing a system of checks and balances based on multiple value methods would result in greater stability in the real estate market and stronger performance of Mortgage Backed Securities. These checks and balances will not impede free market forces, but provide additional value data points for consideration during the value determination process, and support the long term health and vitality of the U.S. real estate market.

- The historical relationship between the market comparable and cost approach value methods is clearly seen on the left side of the page (3) illustration. Equally observable, is the market value bubble that developed after the industry shifted from a multiple value approach to one that favored the market comparable only approach. The spread between these two methods warrants consideration as a potential indicator of transactional soundness and market stability that should be considered in the QRM definition. If QRM qualifying mortgages were required to be valued with an appraisal that utilized both value methods, the data needed to calculate the gap would be readily available for QRM compliance assessment.

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[12] Internal Revenue Manual 4.48.6.

#120. The Agencies seek comment on the appropriateness of the proposed LTV and combined LTV ratios for the different types of mortgage transactions.

- The results of the proposed LTV and combined LTV ratios would be suspect given the concerns of property value accuracy raised here. As previously demonstrated, value determinations based on single method appraisals can be dramatically inaccurate, tending to exaggerate value during boom and bust real estate markets. Both the LTV and combined LTV ratios may be dramatically impacted by a poorly determined property value. For a buyer who has a fixed amount of capital available for a down payment, every dollar the property is under or overvalued will directly impact the LTV calculation. In some instances the impact will be helpful; while in other instances it will be detrimental. Either way, mortgages will be improperly assessed. Meaningful LTV assessments SHOULD NOT be made without a multi value method appraisal being completed.

Marshall & Swift would like to thank the agencies for allowing us the opportunity to share our expertise by participating in the NPR process. We welcome the opportunity to discuss any of our comments and responses at your convenience.

Very Sincerely,

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