The New Frontier of AVMs
With AVMs, originators and lenders must keep in mind their benefits and their limitations

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In the past few years, automated valuation models (AVMs) have been adopted across the mortgage industry, from origination to the secondary market. They are used to estimate risk exposure, to analyze various business strategies and to estimate fair values of financial instruments and acquisitions.

Although AVMs have benefits, they also have limitations. To make best use of these tools, it is important for mortgage originators and lenders to understand AVMs’ plusses and minuses, as well as to know what regulations are on the horizon.

The rise of AVMs
Before AVMs, originating loans was slower and more expensive. There was less of an ability to validate other types of valuation services. Secondary-market transactions were also slower and more expensive to complete.

AVMs have become invaluable in the mortgage business for many reasons. First, they are the fastest valuation service available. Loan originators can have an answer on a valuation within seconds, rather than having to wait for hours or even days.

Second, AVMs are an inexpensive way to decrease loan-cycle times. Third, they are unbiased because the human touch is removed. Finally, they are a strong measurement of portfolio risk and capital allocations.

In some cases, AVMs actually substitute for appraisals, but they also have many other uses. AVMs offer an unbiased mechanism to layer on top of an appraisal to validate what is being examined. They also have the potential to be a sole valuation service for low-credit-risk loans (e.g., home-equity lines of credit, home-equity loans and low-risk firsts).

AVMs also are efficient post-funding tools. The secondary market was an early adopter of AVMs for collateral due diligence of pool transactions. Quick and convenient, these tools let participants in this market decrease their sample sizes and identify what loan exceptions will require further scrutiny. They can also be used for portfolio valuation for capital-reserve calculations.

New guidelines
In recent bulletins, the U.S. Office of the Comptroller of the Currency (OCC) has been looking at risk modeling and model valuation. Specifically, it has been reviewing how the models are put together and the limitations of the results.

According to the OCC, using unvalidated models to manage risk is a “potentially unsafe and unsound practice.” The office has issued guidelines concerning how users should conduct testing and validation and how to determine model risk.

One OCC bulletin (OCC 2000-16) outlines expectations regarding model validation. Some expectations include ensuring that the process is clearly defined and using benchmarks (i.e., the most recent sales price of the property) to validate the values returned.

The proper use of AVMs in the mortgage marketplace can create some real efficiencies, but not all AVMs perform equally well. Some have high hit rates but low accuracy. Some have high accuracy but low hit rates.

Blending AVMs in a cascade enhances performance. Cascading AVMs provide access to more than one AVM through a single interface, which helps to determine an average valuation. An AVM cascade can be designed to outperform any single AVM, and it can leverage the ability to choose the best AVM for the location, loan type and price level. A cascade can get a higher hit rate for the same level of accuracy as a single AVM.

When testing cascades for regulatory compliance, cascades can be treated as blended AVMs. Model risk lies in the performance of the blended result, not in the underlying AVMs.

There are two methods for validating a cascading AVM. Theoretical model validation requires users to investigate the model’s method and cascade-design technique for logical and conceptual soundness. In empirical model validation, users compare cascade results to observed benchmark prices. The model must predict the stated goal with enough certainty. Using both methods will keep users compliant with OCC guidelines.

AVMs and values
The OCC is also concerned with “value shopping.” Value shopping allows a cascade to return multiple answers by running the property through the cascade multiple times. This lets users choose the value that suits their needs (usually the highest).

This procedure minimizes the loan-to-value ratio and exposes the financial institution to undue severe-loss risk. It is a sure regulatory failure. Cascades should only return one result that represents the most accurate automated estimate of the subject property’s value. In short, a cascade should be built to return the best valuation.

While recognizing that AVMs have certain limitations, one leading ratings agency has recently revised its criteria for rating residential mortgage-backed securities that are backed by properties valued solely with AVMs. Previously, for lender processes it reviewed, the agency discounted AVM-appraisal values by 10 percent to 15 percent for properties it considered soft or weak.

Its new methodology will no longer discount the value based on location. Instead, the agency will apply guidelines to evaluate each originator’s program and process for using AVMs as a sole valuation tool for newly originated mortgages.

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It will discount values by 5 percent or more if, based on its evaluation, the lender’s usage process and controls do not adequately mitigate overvaluation risk or if the lender does not disclose its policies.

The agency believes that the benefits of AVMs outweigh the risks. It has thus developed these guidelines to ensure that each lender’s usage procedures mitigate these risks. The guidelines consider the AVM-selection process, business rules and testing procedures.

It will also review the lenders’ policies for addressing risk layering and will look to the lenders’ program restrictions to ensure that AVM usage is applied selectively. A lender that provides the agency with a solid understanding of the analyses and procedures for its AVM usage will help it determine the program’s adequacy. The discount could thus ultimately be reduced or eliminated.

There is no mandate to follow the regulatory guidelines. Financial institutions are only penalized from an audit perspective. But it is important to be aware of regulatory prohibitions and to be compliant if your objective is a favorable rating.