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Report to Congressional Committees

July 2011

RESIDENTIAL APPRAISALS

Opportunities to Enhance Oversight of an Evolving Industry

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July 2011

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Highlights

Highlights of GAO-11-653, a report to congressional committees

RESIDENTIAL APPRAISALS

Opportunities to Enhance Oversight of an Evolving Industry

Why GAO Did This Study

Real estate valuations, which encompass appraisals and other estimation methods, have come under increased scrutiny in the wake of the recent mortgage crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) mandated that GAO study the various valuation methods and the options available for selecting appraisers, as well as the Home Valuation Code of Conduct (HVCC), which established appraiser independence requirements for mortgages sold to Fannie Mae and Freddie Mac (the enterprises). GAO examined (1) the use of different valuation methods, (2) factors affecting consumer costs for appraisals and appraisal disclosure requirements, and (3) conflict-of-interest and appraiser selection policies and views on their impact. To address these objectives, GAO analyzed government and industry data; reviewed academic and industry literature; examined federal policies and regulations, professional standards, and internal policies and procedures of lenders and appraisal management companies (AMC); and interviewed a broad range of industry participants and observers.

What GAO Recommends

GAO recommends that federal banking regulators, the Federal Housing Finance Agency (FHFA), and the Bureau of Consumer Financial Protection consider addressing several key areas, including criteria for selecting appraisers, as part of their joint rulemaking under the Act to set minimum standards for states to apply in registering AMCs. The federal banking regulators and FHFA agreed with or indicated they would consider the recommendation.

View GAO-11-653 or key components.
For more information, contact William B.Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

Data GAO obtained from the enterprises and five of the largest mortgage lenders indicate that appraisals—which provide an estimate of market value at a point in time—are the most commonly used valuation method for first-lien residential mortgage originations, reflecting their perceived advantages relative to other methods. Other methods, such as broker price opinions and automated valuation models, are quicker and less costly but are viewed as less reliable and therefore generally are not used for most purchase and refinance mortgage originations. Although the enterprises and lenders GAO spoke with do not capture data on the prevalence of approaches used to perform appraisals, the sales comparison approach—in which the value is based on recent sales of similar properties—is required by the enterprises and the Federal Housing Administration and is reportedly used in nearly all appraisals.

Recent policy changes may affect consumer costs for appraisals, while other policy changes have enhanced disclosures to consumers. Consumer costs for appraisals vary by geographic location, appraisal type, and complexity. However, the impact of recent policy changes on these costs is uncertain. Some appraisers are concerned that the fees they receive from AMCs—firms that manage the appraisal process on behalf of lenders—are too low. A new requirement to pay appraisers a customary and reasonable fee could affect consumer costs and appraisal quality, depending on how new rules are implemented. Other recent policy changes aim to provide lenders with a greater incentive to estimate costs accurately and require lenders to provide consumers with a copy of the valuation report prior to closing.

Conflict-of-interest policies, including HVCC, have changed appraiser selection processes and the appraisal industry more broadly, which has raised concerns among some industry participants about the oversight of AMCs. Recently issued policies that reinforce prior requirements and guidance restrict who can select appraisers and prohibit coercing appraisers. In response to market changes and these requirements, some lenders turned to AMCs to select appraisers. Greater use of AMCs has raised questions about oversight of these firms and their impact on appraisal quality. Federal regulators and the enterprises said they hold lenders responsible for ensuring that AMCs' policies and practices meet their requirements for appraiser selection, appraisal review, and reviewer qualifications but that they generally do not directly examine AMCs' operations. Some industry participants said they are concerned that some AMCs may prioritize low costs and speed over quality and competence. The Act places the supervision of AMCs with state appraiser licensing boards and requires the federal banking regulators, the Federal Housing Finance Agency, and the Bureau of Consumer Financial Protection to establish minimum standards for states to apply in registering AMCs. A number of states began regulating AMCs in 2009, but the regulatory requirements vary. Setting minimum standards that address key functions AMCs perform on behalf of lenders would enhance oversight of appraisal services and provide greater assurance to lenders, the enterprises, and others of the credibility and quality of the appraisals provided by AMCs.

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Abbreviations

AMC	appraisal management company
AVM	automated valuation model
the Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
BPO	broker price opinion
ECOA	Equal Credit Opportunity Act
the enterprises	Fannie Mae and Freddie Mac
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
HARP	Home Affordable Refinance Program
HUD	Department of Housing and Urban Development
HVCC	Home Valuation Code of Conduct
LTV	loan-to-value ratio
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
RESPA	Real Estate Settlement Procedures Act
TILA	Truth in Lending Act
UMDP	Uniform Mortgage Data Program
USDA	Department of Agriculture
USPAP	Uniform Standards of Professional Appraisal Practice
VA	Department of Veterans Affairs

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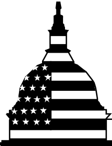

G A O

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United States Government Accountability Office
Washington, DC 20548

July 13, 2011

The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Spencer Bachus
Chairman
The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

Real estate valuations, which encompass appraisals and other value estimation methods, play a critical role in mortgage underwriting by providing evidence that the market value of a property is sufficient to help mitigate losses if the borrower is unable to repay the loan. However, recent turmoil in the mortgage market raised questions about mortgage underwriting practices, including the quality and credibility of some valuations. Some appraisers have reported that, during the mid-2000s, loan officers and mortgage brokers pressured them to overvalue properties to help secure mortgage approvals. In 2007, a lawsuit brought by the New York State Attorney General alleged that a major lender pressured an appraisal management company (AMC) to select appraisers who would inflate property values.[1] The investigation into these allegations led to questions about what the government-sponsored enterprises Fannie Mae and Freddie Mac (the enterprises), which had purchased many of the lender's mortgages, had done to ensure that the

[1]An AMC is defined by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203) as a third party that oversees a network or panel of more than 15 appraisers within a state or 25 or more appraisers nationally in a given year and has been authorized by lenders to recruit, select, and retain appraisers; contract with appraisers to perform appraisal assignments; manage the process of having an appraisal performed; or review and verify the work of appraisers. Dodd-Frank Act § 1473(f)(4) (codified at 12 U.S.C. § 3550(11)).

appraisals for the mortgages met the enterprises' requirements.[2] The outcome of that investigation was an agreement—between the Attorney General, the enterprises, and the Federal Housing Finance Agency (FHFA), which regulates the enterprises—that included the adoption of the Home Valuation Code of Conduct (HVCC). HVCC sets forth certain appraiser independence requirements for loans sold to the enterprises.

Although the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203) (the Act) declared HVCC no longer in effect, it codified several of HVCC's provisions.[3] In addition, the enterprises have incorporated many of the other provisions into their requirements. This report responds to a mandate in the Act that directed us to study the effectiveness and impact of various valuation methods and the options available for selecting appraisers, as well as the impact of HVCC.[4] As required by the mandate, we provided you with a status report on our study in October 2010.[5] Our work focused on valuations of single-family residential properties for first-lien purchase and refinance mortgages. This report discusses (1) the use of different valuation methods and their advantages and disadvantages; (2) policies and other factors that affect consumer costs and requirements for disclosing appraisal costs and valuation reports to consumers; and (3) conflict-of-interest and appraiser selection policies and views on the impact of these policies on industry stakeholders and appraisal quality. We consider the impact of HVCC throughout this report.

[2]The enterprises purchase mortgages that meet specified underwriting criteria from approved lenders. Most of the mortgages are made to prime borrowers with strong credit histories. The enterprises bundle most of the mortgages they purchase into securities and guarantee the timely payment of principal and interest to investors in the securities. On September 6, 2008, the enterprises were placed under federal conservatorship out of concern that their deteriorating financial condition and potential default on $5.4 trillion in outstanding financial obligations threatened the stability of financial markets.

[3]The Act stated that HVCC ceased to be effective as of the date the Board of Governors of the Federal Reserve System (Federal Reserve) issued interim final rules covering appraiser independence. Dodd-Frank Act § 1472(a) (codified at 15 U.S.C. § 1639e(j)). The Federal Reserve issued that rule on October 28, 2010. 75 Fed. Reg. 66554.

[4]Dodd-Frank Act § 1476.

[5]GAO, *Status of Study Concerning Appraisal Methods and the Home Valuation Code of Conduct*, GAO-11-158R (Washington, D.C.: Oct. 19, 2010).

To address these objectives, we analyzed proprietary data we obtained from the enterprises, lenders, AMCs, and FNC, Inc. (a mortgage technology company) on the use of different valuation methods and appraisal approaches. We tested the reliability of the data used in this report by conducting reasonableness checks on data elements to identify any missing, erroneous, or outlying data. We also interviewed enterprise, lender, AMC, and FNC representatives to discuss the interpretation of various data fields. We concluded that the data we used were sufficiently reliable for our purposes. We reviewed academic and industry literature on the advantages and disadvantages of the different valuation methods and appraisal approaches. We examined federal regulations and policies, professional standards published by industry groups, and internal policies and procedures of lenders and AMCs to understand requirements and practices for using different valuation methods, selecting appraisers, ensuring appraiser independence, and disclosing costs and valuation reports to consumers. Finally, we interviewed a broad range of appraisal and mortgage industry participants and observers—including representatives of appraiser groups, lenders, AMCs, and other participants in the valuation process—to obtain their views on the use of different methods and options for selecting appraisers, as well as the impacts of recent policy changes, including HVCC, on industry participants and appraisal quality.[6] We also discussed these issues with officials from the federal banking regulatory agencies—the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)—as well as from the enterprises, FHFA, and the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). Appendix I contains a more detailed description of our objectives, scope, and methodology.

We conducted this performance audit from July 2010 to July 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that

[6]Because our interviews with individual lenders and AMCs focused on larger companies, the views they expressed may not be representative of these industries as a whole.

the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Composition of the Mortgage Market and Lending Channels

The composition of the mortgage market has changed dramatically in recent years. In the early to mid-2000s, the market segment comprising nonprime mortgages (e.g., subprime and Alt-A loans) grew rapidly and peaked in 2006, when it accounted for about 40 percent of the mortgages originated that year.[7] Many of these mortgages had nontraditional or riskier features and were bundled by investment banks into private securities that were bought and sold by investors. The nonprime market contracted sharply in mid-2007, partly in response to increasing default and foreclosure rates for these mortgages, and many nonprime lenders subsequently went out of business.[8] The market segments comprising mortgages backed by the enterprises and FHA had the opposite experience: a sharp decline in market share in the early to mid-2000s, followed by rapid growth beginning in 2007.[9] For example, the enterprises' share of the mortgage market decreased from about one-half in 2003 to about one-third in 2006. By 2009 and 2010, enterprise-backed mortgages had increased to more than 60 percent of the market. Similarly, FHA-insured mortgages grew from about 2 percent of the market in 2006 to about 20 percent in 2009 and 2010.

Lenders originate mortgages through three major channels: mortgage brokers, loan correspondents, and retail lenders. Mortgage brokers are independent contractors who originate mortgages for multiple lenders that underwrite and close the loans. Loan correspondents originate,

[7]The market share figures in this paragraph are in terms of dollar volume and do not include home equity loans.

[8]For additional information about the characteristics and performance of nonprime mortgages, see GAO, *Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources*, GAO-10-805 (Washington, D.C.: Aug. 24, 2010).

[9]FHA insures lenders against losses from borrower defaults on mortgages that meet FHA criteria. FHA historically has served borrowers who would have difficulty obtaining prime mortgages but, in recent years, has increasingly served borrowers with stronger credit histories.

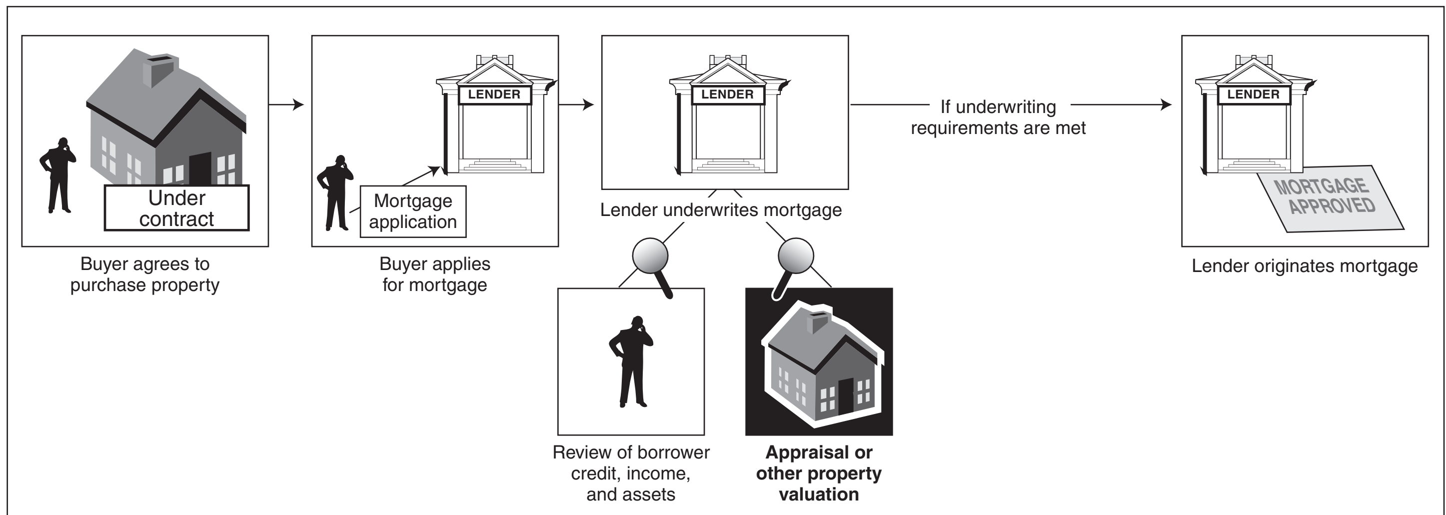
underwrite, and close mortgages for sale or transfer to other financial institutions. Retail lenders originate, underwrite, and close loans without reliance on brokers or loan correspondents. Large mortgage lenders may originate loans through one or more channels.

Appraisals and Other Valuation Methods

Before originating a mortgage loan, a lender assesses the risk of making the loan through a process called underwriting, in which the lender generally examines the borrower's credit history and capacity to pay back the mortgage and obtains a valuation of the property to be used as collateral for the loan. (See fig. 1.) Lenders need to know the property's market value, which refers to the probable price that a property should bring in a competitive and open market, in order to provide information for assessing their potential loss exposure if the borrower defaults.[10] Lenders also need to know the value in order to calculate the loan-to-value (LTV) ratio, which represents the proportion of the property's value being financed by the mortgage and is an indicator of its risk level.

[10]The enterprises and federal banking regulators define market value as the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Market value is distinct from other types of value, such as liquidation value or investment value. Liquidation value refers to the probable price a property will bring in a limited market where the seller is under extreme compulsion to sell. Investment value refers to the price a particular investor would pay for a property in light of the property's perceived value to satisfy his or her investment goals.

Figure 1: Appraisals as Part of the Mortgage Origination Process



Source: GAO; Art Explosion (images).

Real estate can be valued using a number of methods, including appraisals, broker price opinions (BPO), and automated valuation models (AVM).[11] An appraisal is an opinion of value based on market research and analysis as of a specific date. Appraisals are performed by state-licensed or -certified appraisers who are required to follow the Uniform Standards of Professional Appraisal Practice (USPAP).[12] A BPO is an estimate of the probable selling price of a particular property prepared by a real estate broker, agent, or sales person rather than by an appraiser. BPOs can vary in format and scope, and currently there are no national standards that brokers are required to abide by in performing BPOs. An AVM is a computerized model that estimates property values using public record data, such as tax records and information kept by county

[11]While other valuation methods exist, such as tax assessment valuations, we focus on appraisals, BPOs, and AVMs because they are specifically mentioned in the statutory language mandating this study.

[12]The Appraisal Standards Board of the Appraisal Foundation develops, interprets, and amends USPAP. The Appraisal Foundation is a not-for-profit organization established by the appraisal profession in 1987. In addition to the Appraisal Standards Board, the Appraisal Foundation sponsors the Appraisal Qualifications Board, which sets minimum education and experience requirements for states' appraiser licensing and certification programs, and the Appraisal Practices Board, which identifies and issues opinions on recognized valuation methods and techniques.

recorders, multiple listing services, and other real estate records.[13] These models use statistical techniques, such as regression analysis, to estimate the market values of properties. The enterprises and various private companies have developed a range of proprietary AVMs.

Lenders have several options open to them for selecting appraisers. Lenders can select appraisers directly, using either in-house appraisers, independent appraisers, or appraisal firms that employ appraisers, or they can use AMCs that subcontract with independent appraisers. AMCs perform a number of functions for lenders, including identifying qualified appraisers in different geographic areas, assigning appraisal orders to appropriate appraisers, following up on appraisal orders, and reviewing appraisal reports for completeness and quality prior to delivering them to lenders.

Appraisers consider a property's value from three points of view—cost, income, and sales comparison—and provide an opinion of market value based upon one or more of these appraisal approaches. The cost approach is based on an estimate of the value of the land plus what it would cost to replace or reproduce the improvements (e.g., buildings, landscaping) minus physical, functional, and external depreciation.[14] The income approach is an estimate of what a prudent investor would pay based upon the net income the property produces and is of primary importance in ascertaining the value of income-producing properties, such as rental properties. The sales comparison approach compares and contrasts the property under appraisal (subject property) with recent offerings and sales of similar properties.

The scope of work for an appraisal depends on a number of factors, including the property type and the requirements of the mortgage lender

[13]A multiple listing service is a database set up by a group of real estate brokers to provide information about properties for sale.

[14]Physical depreciation is a loss in value caused by deterioration in the physical condition of the improvements. Functional depreciation, also known as functional obsolescence, is a loss in value caused by defects in the design of the structure (such as inadequacies in sizes and types of rooms) or changes in market preferences that result in some aspect of the improvements being considered obsolete by current standards (for example, the location of a bedroom on a level with no bathroom). External depreciation, also referred to as economic obsolescence, is a loss in value caused by negative influences that are outside of the site, such as economic factors or environmental changes (for example, expressways or factories that are adjacent to the subject property).

or investor. For example, the lender may require the appraiser to provide an estimate of value using the income approach in addition to the sales comparison approach for a property that will be rented, or the lender may request that the appraiser provide a specific number of sales of comparable properties and properties currently listed for sale to better understand the subject property's local market. Appraisals vary in type by the property being appraised (for example, a single-family home or condominium unit) and the level of inspection performed (exterior only or both interior and exterior).[15]

Federal Oversight of Appraisals

In response to losses the federal government suffered during the savings and loan crisis of the mid-1980s, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[16] Title XI of this statute contains provisions to ensure that certain real estate-related financial transactions have appraisals that are performed (1) in writing, in accordance with uniform professional standards, and (2) by individuals whose competency has been demonstrated and whose professional conduct is subject to effective supervision.[17] The primary intent of the appraisal reforms contained in Title XI is to protect federal deposit insurance funds and promote safe and sound lending. Title XI also created the Appraisal Subcommittee, which is responsible for monitoring the implementation of Title XI.[18] The subsequent regulations implementing FIRREA exempt transactions that have appraisals conforming to the enterprises' appraisal standards or that are insured or

[15]Appraisers perform limited physical inspections of the property on behalf of lenders to assess the property's condition as it relates to value. The inspection performed by an appraiser is not equivalent to a home inspection performed by a qualified home inspector. Home inspections are performed on behalf of borrowers and provide information on the condition of the physical structure (e.g., roof, foundation) and systems (e.g., electrical, plumbing, heating and cooling) of the house.

[16]Pub. L. No. 101-73, 103 Stat. 183 (1989).

[17]12 U.S.C. §§ 3331, 3339-3345.

[18]Currently the Appraisal Subcommittee board includes officials from the Federal Reserve, FDIC, OCC, OTS, NCUA, HUD, and FHFA. Later in 2011, OTS (which the Act abolishes) will drop off the board, and the Bureau of Consumer Financial Protection created by the Act will be added.

guaranteed by a federal agency, such as FHA, the Department of Veterans Affairs (VA), and the Department of Agriculture (USDA).[19]

The enterprises, whose activities are overseen by FHFA, include appraisal requirements in the guides they have developed for lenders that sell mortgage loans to them. These guides identify the responsibilities of lenders in obtaining appraisals and selecting appraisers, specify the required documentation and forms for different appraisal types (including different levels of inspection), and detail the appraisal review processes lenders must follow. In addition, the enterprises issued appraiser independence requirements in 2010 that replaced HVCC.

FHA uses appraisals to determine a property's eligibility for mortgage insurance. FHA's appraisal requirements are outlined in a handbook on valuations and in periodic letters to approved lenders (called mortgagee letters). FHA requires appraisals to include inspections to assess whether the property complies with FHA's minimum property requirements and standards. Appraisers must be state-certified and must have applied to FHA to be placed on FHA's appraiser roster in order to perform appraisals for FHA-insured loans. Lenders select an appraiser from the FHA roster. VA and USDA have loan guaranty programs, and USDA also has a direct loan program, with their own appraisal requirements and processes.[20] VA's appraisal process is different from those of FHA and USDA in that VA assigns an appraiser from its own panel of approved appraisers and has established a fee schedule that sets a maximum fee that can be charged to the borrower. USDA does not have a roster of appraisers or many requirements beyond that lenders must use properly licensed or certified appraisers.

For mortgages originated by federally regulated institutions but not sold to the enterprises or insured or guaranteed by a federal agency, Title XI of FIRREA places responsibility for regulating appraisals and "evaluations"

[19]OCC: 12 C.F.R. Part 34, subpart C; Federal Reserve: 12 C.F.R. Part 208, subpart E and 12 C.F.R. Part 225, subpart G; FDIC: 12 C.F.R. Part 323; OTS: 12 C.F.R. Part 564; NCUA: 12 C.F.R Part 722.

[20]VA originations represented about 5 percent of the first-lien residential mortgage market in 2010, while USDA originations comprised about 1 percent of the market.

with the federal banking regulatory agencies.[21] Federal banking regulators have responsibility for ensuring the safety and soundness of the institutions they oversee, protecting federal deposit insurance funds, promoting stability in the financial markets, and enforcing compliance with applicable consumer protection laws. To achieve these goals, the regulators conduct on-site examinations to assess the financial condition of the institutions and monitor their compliance with applicable banking laws, regulations, and agency guidance. These agencies are OCC, which oversees federally chartered banks; OTS, which oversees savings associations (including mortgage operating subsidiaries);[22] NCUA, which charters and supervises federal credit unions; the Federal Reserve, which oversees insured state-chartered member banks; and FDIC, which oversees insured state-chartered banks that are not members of the Federal Reserve System. Both the Federal Reserve and FDIC share oversight with the state regulatory authority that chartered the bank. The Federal Reserve also has general authority over lenders that may be owned by federally regulated holding companies but are not federally insured depository institutions.

As required by Title XI, federal banking regulators have established appraisal and evaluation requirements through regulations and have also jointly issued *Interagency Appraisal and Evaluation Guidelines*. These regulations and guidelines address the minimum appraisal and evaluation standards lenders must follow when valuing property and specify the types of policies and procedures lenders should have in place to help ensure independence and credibility in the valuation process. Among other things, lenders are required to have risk-focused processes for determining the level of review for appraisals and evaluations, reporting lines for collateral valuation staff that are independent from the loan

[21]An evaluation provides an estimate of the property's market value but does not have to be performed by a state-licensed or -certified appraiser. The federal banking regulators permit evaluations to be performed in certain circumstances, such as mortgage transactions below $250,000 that are conducted by regulated institutions. According to the federal banking regulators' guidance, an evaluation should identify the location of the property and provide a description of it and its current and projected use; describe the methods used to confirm its physical condition and the extent to which an inspection was performed; indicate all sources of information used in the analysis; and include information on the preparer of the evaluation.

[22]12 U.S.C. § 1813(q). In July 2011, OCC will assume oversight responsibility of federal savings associations from OTS, while FDIC will assume OTS' oversight responsibility for state savings associations.

production function, and internal controls to monitor any third-party valuation providers. The federal banking regulators have procedures for examining the real estate lending activities of regulated institutions that include steps for assessing the completeness, adequacy, and appropriateness of these institutions' appraisal and evaluation policies and procedures.

Consumer Protection Statutes Relating to Appraisals

Other laws that apply to appraisals for residential mortgages include consumer protection statutes, such as the Truth in Lending Act (TILA), which addresses disclosure requirements for consumer credit transactions and regulates certain lending practices; the Equal Credit Opportunity Act (ECOA), which addresses non-discrimination in lending; and the Real Estate Settlement Procedures Act of 1974 (RESPA), which requires transparency in mortgage closing documents.[23] Regulations implementing TILA and ECOA are issued by the Federal Reserve and enforced by the federal banking regulators. RESPA regulations are issued by HUD and enforced by HUD and the federal banking regulators. Under the Dodd-Frank Act, most rulemaking authority and some implementation and enforcement responsibilities for these laws will be transferred to the Bureau of Consumer Financial Protection to be established in the Federal Reserve System.[24]

[23]Truth in Lending Act, 15 U.S.C. §§ 1601-1667f; Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691f; Real Estate Settlement Procedures Act of 1974, 12 U.S.C. §§ 2601-2617.

[24]Dodd-Frank Act §§ 1011(a), 1021, 1061(b), and 1062. The Secretary of the Treasury has designated July 21, 2011, as the transfer date. 75 Fed. Reg. 57252 (Sept. 20, 2010).

The Widespread Use of Appraisals and the Sales Comparison Approach Reflect Their Relative Advantages for Valuations in Mortgage Originations

Available Data Indicate That Appraisals Are the Most Commonly Used Valuation Method for Mortgage Originations

Available data, lenders, and mortgage industry participants we spoke with indicate that appraisals are the most frequently used valuation method for home purchase and refinance mortgages. To determine the use of valuation methods in mortgage originations, we requested data from the enterprises and the five lenders with the largest dollar volume of mortgage originations in 2010.[25] The enterprises provided us with data on the minimum valuation method and, when applicable, the level of appraisal inspection they required for the mortgages they purchased from 2006 through 2010 that were underwritten using their automated underwriting systems.[26] (Because these are minimum requirements, lenders can and sometimes do exceed them.) The lenders provided us with data on the actual valuation method and appraisal inspection level for mortgages they made during the same period, although they did not always have information for the earlier years or for mortgages originated through their broker and correspondent lending channels. Because the enterprise and lender data were more complete for recent years, the

[25]These five lenders accounted for about 64 percent of first-lien mortgage originations in 2009 and 66 percent in 2010, according to industry data.

[26]The mortgages included in these data represent from 24 percent to 59 percent of the loans the enterprises purchased each year from 2006 through 2010. We focus on valuation requirements for mortgages processed through the enterprises' automated underwriting systems because this was the segment of their business for which comparable data were readily available for both enterprises. The enterprises also purchase mortgages from lenders that were not underwritten using their automated underwriting systems. Some lenders have their own automated underwriting systems that they can use instead of the enterprises' systems. The enterprises also purchase mortgages that have been manually underwritten, and they purchase mortgages in bulk through an investor channel.

following discussion provides more detail on 2009 and 2010, a period in which mortgages backed by the enterprises (along with FHA) dominated the market.[27]

Data for the two enterprises combined show that, for first-lien residential mortgages, the enterprises required appraisals for

- 94 percent of mortgages they bought in 2009, including 92 percent of purchase mortgages and 94 percent of refinance mortgages; and
- 85 percent of mortgages they bought in 2010, including 86 percent of purchase mortgages and 84 percent of refinance mortgages.

For the remaining mortgages processed through their automated underwriting systems, the enterprises did not require an appraisal because their underwriting analysis indicated that the default risk of the mortgages was sufficiently low to instead require validation of the sales prices (or loan amounts in the case of refinances) by an AVM-generated estimate of value.[28] In both 2009 and 2010, the enterprises required interior and exterior inspections for roughly 85 percent of the appraisals for purchase mortgages and roughly 92 percent of the appraisals for refinance mortgages. The remaining appraisals required exterior inspections only. Available enterprise data for the preceding 3 years showed that appraisals were required for almost 90 percent of mortgages (purchase and refinance transactions combined), and the percentage of appraisals requiring both interior and exterior inspections increased from approximately 80 percent to 86 percent, although the data covered a smaller proportion of the enterprises' total mortgage purchases.

[27]See appendix I for additional information on the completeness of these data. In 2009 and 2010, the enterprises and several lenders we contacted participated in the Home Affordable Refinance Program (HARP), which was part of the Making Home Affordable program started in 2009 to stabilize the housing market. The purpose of HARP was to provide a refinancing vehicle for homeowners that had (1) mortgages held or guaranteed by Fannie Mae or Freddie Mac, (2) interest rates above the prevailing market rates, and (3) LTV ratios between 80 and 125. HARP transactions are excluded from the data discussed here.

[28]When the enterprises waive the appraisal, they may also waive the inspection, or they may require an exterior-only inspection completed by a state-licensed or -certified appraiser.

We also aggregated data from five lenders, which include not only mortgages sold to the enterprises, but also mortgages insured by FHA, guaranteed by VA or USDA, held in the lenders' portfolios, or placed in private securitizations.[29] These data show that, for the first-lien residential mortgages for which data were available, these lenders obtained appraisals for

- 88 percent of the mortgages they made in 2009, including 98 percent of purchase mortgages and 84 percent of refinance mortgages; and
- 91 percent of the mortgages they made in 2010, including 98 percent of purchase mortgages and 88 percent of refinance mortgages.

For mortgages for which an appraisal was not done, the lenders we spoke with reported that they generally relied on validation of the sales price against an AVM-generated value, in accordance with enterprise policies that permit this practice for some mortgages with characteristics associated with a lower default risk.

For both 2009 and 2010, the lenders reported that interior and exterior inspections of the subject property were conducted for over 99 percent of the appraisals for purchase mortgages and about 97 percent of the appraisals for refinance mortgages. The remainder involved exterior inspections only. Although data for the preceding 3 years were less complete, they showed roughly similar percentages to those for mortgages made in 2009 and 2010. The higher percentages reported by the lenders compared with those from the enterprises in 2010 may partly reflect lender valuation policies that exceed enterprise requirements in some situations. For example, officials from some lenders told us their own risk-management policies may require them to obtain an appraisal even when the enterprises do not, or they may obtain an appraisal to better ensure that the mortgage complies with requirements for sale to either of the enterprises. Additionally, FHA requires appraisals with interior and exterior inspections for all of the purchase mortgages and most of the refinance mortgages it insures, and most of the lenders we contacted make substantial numbers of these mortgages.

[29]Private securitizations are securities issued by investment banks or other private entities rather than the enterprises.

The enterprises have efforts under way to collect more complete proprietary data on the use of different valuation methods. In order to obtain consistent appraisal and loan data for all mortgages they purchase from lenders, the enterprises are currently undertaking a joint effort, under the direction of FHFA, called the Uniform Mortgage Data Program (UMDP). UMDP has two components related to appraisals. The first component is scheduled to begin September 2011, when appraisers will be required to use new standardized response options in completing appraisal report forms. The second component will be a Web-based portal that will facilitate the delivery of standardized appraisal data to the enterprises, and the enterprises are planning to fully implement UMDP by March 2012. According to officials from the enterprises, UMDP will produce a proprietary dataset that will allow the enterprises to work with lenders to resolve any concerns regarding appraisal quality prior to purchasing mortgages. Additionally, officials told us that the dataset would also allow them to assess the impact of their valuation policies on appraisal quality and mortgage risk.[30] However, some appraisal industry stakeholders have expressed concerns that in some circumstances the standardized response options may be too limited to clearly and accurately communicate information that is material to the appraisal.

Valuation Policies and Practices Generally Reflect the Advantages and Disadvantages of Different Methods

The enterprises, FHA, and lenders require and obtain appraisals for most mortgages because appraising is considered by mortgage industry participants to be the most credible and reliable valuation method. According to mortgage industry participants, appraisals have certain advantages that set them apart from other valuation methods. Most notably, appraisals and appraisers are subject to specific requirements and standards. The minimum standards for appraisals included in USPAP cover both the steps appraisers must take in developing appraisals and the information the appraisal report must contain. USPAP also requires that appraisers follow standards for ethical conduct and have the competence needed for a particular assignment. For example, the appraiser must be familiar with the specific type of property, the local market, and geographic area. Furthermore, state licensing and

[30]In addition to the enterprises, FHA plans to adopt the standardized appraisal data fields of UMDP for two appraisal forms (the Uniform Residential Appraisal Report and the Individual Condominium Unit Appraisal Report), but an FHA official told us that they will not have access to the Web-based portal and therefore will not be able to collect and analyze appraisal data on FHA-insured mortgages using this system.

certification requirements for appraisers include minimum education and experience criteria and call for successfully completing a state-administered examination. Also, standardized report forms, including those developed by the enterprises, provide a way to report relevant appraisal information in a consistent format. However, some of these potential advantages depend on effective oversight, and we have previously reported on weaknesses in oversight of the appraisal industry. For example, in a 2003 report we noted that many state appraiser regulatory agencies cited resource limitations as an impediment to carrying out their oversight responsibilities.[31] In addition, as previously discussed, some appraisal industry participants have reported that some lenders and mortgage brokers have pressured appraisers to inflate property values in violation of appraiser independence standards. Even in the absence of overt pressure, biased appraisal values may result from the conflict of interest that arises where the appraiser is selected, retained, or compensated by a person with an interest in the outcome or dollar amount of the loan transaction.

In contrast with appraisals, BPOs do not have standard requirements and are generally not considered a credible valuation method for mortgage originations. According to some mortgage industry participants, a key disadvantage of BPOs is that real estate brokers and agents who perform them are not required to obtain training or professional credentials in property valuation, and the BPO industry lacks uniform standards. At least one industry group has developed standards of practice for BPOs, which are reportedly used by some BPO providers, but adherence to these standards is voluntary. Similarly, the industry has not adopted standardized BPO forms, resulting in differences in the content and quality of BPO reports, according to some mortgage industry participants. Additionally, BPOs provide somewhat different information than appraisals—a sales price or listing price rather than the property's market value. The enterprises do not permit lenders to use BPOs for mortgage originations, and guidelines from federal banking regulators state that BPOs do not meet the standards for an evaluation and cannot be used as

[31]GAO, *Regulatory Programs: Opportunities to Enhance Oversight of Real Estate Appraisal Industry*, GAO-03-404 (Washington, D.C.: May 14, 2003).

the primary basis for determining property values for mortgages originated by regulated institutions.[32]

Lenders and other mortgage industry participants we spoke with identified advantages to BPOs that make them useful for property valuations in situations other than first-lien purchase or refinance mortgage transactions, such as monitoring the collateral in their existing loan portfolios and developing loss-mitigation strategies for distressed properties. In these circumstances, some mortgage industry participants told us that leveraging real estate brokers' knowledge of local sales and listings is an advantage because it helps them determine probable selling prices. BPOs can be also performed cheaper and faster than appraisals, which allows lenders to obtain more of them and make decisions more quickly, particularly when dealing with distressed properties. Lenders and AMCs we spoke with estimated that BPOs cost from $65 to $125 and are generally completed in 3 to 5 days, while appraisals can cost more than twice as much and take several days longer to complete.

AVMs are generally not used as the primary source of information on property value for first-lien mortgage originations, due in part to potential limitations with the quality and completeness of the data AVMs use. Data sources for AVMs include public records, such as tax records and information kept by county recorders, and multiple listing services. Assessed values for property tax purposes are not always current and are themselves often generated from statistical models. Information on property sales kept by county recorders is not necessarily complete or consistent because disclosure and data collection methods can vary by county.[33] Similarly, data from multiple listing services can be fragmented and inconsistent, in part because real estate professionals enter the data themselves, which may result in incomplete or inaccurate data. Incomplete data for a particular geographic area will prevent an AVM from

[32]Some mortgage industry participants raised concerns about conflicts of interest that can arise when brokers prepare BPOs for properties they hope to be able to list for sale. In those situations, brokers may have an incentive to recommend an artificially low listing price—below what the market value of the property would be—in order to sell the property and earn the sales commission as quickly as possible. Alternatively, if they believe the market will bear a higher price, they may have an incentive to recommend a very high listing price in order to maximize their sales commission.

[33]Information at the county level is not available for properties that are located in "nondisclosure states"— states in which the price and terms of real estate transactions, such as the amount paid for the property, are not subject to public disclosure.

producing reliable values for properties in those areas. Lenders have to regularly monitor the accuracy and coverage of multiple AVMs to determine which ones should be used for properties in various locations. Some mortgage industry participants also told us that AVMs tend to be less reliable in areas where properties are not homogeneous—for example, a neighborhood with houses built at very different times and on different sized lots (in contrast with a suburban subdivision, which may have houses built at the same time and in the same style). In addition, AVMs may not include information on property conditions; rather, they may assume that all properties are in average condition. While the enterprises permit lenders to use AVMs for some mortgage originations (as discussed earlier), guidelines from federal banking regulators state that AVMs generally do not meet the standards for an evaluation and cannot be used as the sole basis for determining property values for mortgages originated by regulated institutions.

Despite these disadvantages, AVMs provide a fast, inexpensive means of indicating the value of properties in active markets, and the enterprises and lenders make use of AVMs for a number of purposes. In addition to their use in a small percentage of mortgage originations, representatives from the enterprises and some lenders and AMCs told us they use values generated by AVMs as part of their quality control processes. They said that when the appraised value varies significantly from the value generated by an AVM, they conduct additional analysis to examine the quality of the appraisal. Similar to BPOs, AVMs may also be used to monitor collateral values in lenders' existing loan portfolios. Furthermore, in circumstances where AVMs are appropriate, they offer a number of advantages over appraisals. AVMs are generally much quicker and cheaper than appraisals, requiring only a few seconds to generate an estimate and costing between $5 and $25, according to mortgage industry participants we spoke with. Also, proponents of AVMs argue that this technology delivers more objective and consistent appraisal values than human appraisers, who may value properties differently and may be subject to conflicts of interest or pressure from lenders to assess a property at a specific value, as discussed later in this report.

The Sales Comparison Approach Is Required in Nearly All Appraisals Because It Is Considered Reliable in Most Situations

USPAP requires appraisers to consider which approaches to value—such as sales comparison, cost, and income—are applicable and necessary to perform a credible appraisal of a particular property. Appraisers must then reconcile values produced by the different approaches they use to reach a value conclusion. The enterprises and FHA require that appraisals provide an estimate of market value at a point in time and reflect

prevailing economic and housing market conditions. They require that, at a minimum, appraisers use the sales comparison approach for all appraisals because it is considered most applicable for estimating market value in typical mortgage transactions.[34] They also require appraisers to use the cost approach for manufactured homes but do not require the income approach for one-unit properties unless the appraiser deems it necessary.[35] Consistent with these policies, valuation data we obtained from FNC suggest that appraisers use the sales comparison approach in a large majority of mortgage transactions, while the cost approach is used less often—generally in conjunction with the sales comparison approach—and the income approach is rarely used.[36] FNC captures data on appraisals conducted for a number of major lenders; FNC's data represent approximately 20 percent of mortgage originations in 2010.[37] FNC's data for both purchase and refinance transactions show the following:

- Nearly 100 percent of appraisals from 2010 used the sales comparison approach. The percentage was the same for 2009 appraisals.
- Sixty-six percent of appraisals from 2010 used the cost approach, generally in combination with the sales comparison approach, similar to 65 percent for 2009 appraisals.

[34]Similarly, VA requires the sales comparison approach for all appraisals, except in unusual circumstances involving inadequate or nonexistent comparable sales or an extremely unique property. Other approaches that are applicable may be used in combination with the sales comparison approach. USDA regulations for guaranteed loan programs require all residential appraisals to be completed using the sales comparison approach. The cost approach must also be used when appraising properties that are less than 1 year old (7 C.F.R. § 1980.334(b)).

[35]FHA and the enterprises require the income approach for two- to four-unit properties.

[36]These data reflect how frequently the appraiser entered an estimate of value for each of the approaches on the appraisal report form. They do not include information about how the appraiser reconciled the estimated values from the different approaches.

[37]These data may not be representative of the mortgage market as a whole. See appendix I for additional information about these data.

- Five percent of appraisals from 2010 used the income approach, virtually always in combination with one or both of the other approaches. The corresponding percentage for 2009 appraisals was 4 percent.

These percentages were roughly similar for purchase and refinance mortgages. In addition, although FNC's data for the preceding 3 years covered a smaller proportion of total mortgages, the percentages for purchase and refinance transactions combined were generally comparable to those described above.

Because the sales comparison approach involves an analysis of recent sales of similar properties, it is generally viewed as the most appropriate way to estimate market value in active residential markets, according to industry guidance and research literature. When appraisers use the sales comparison approach, they find recent sales of comparable properties and make adjustments to the selling prices of those properties based on any differences between them and the subject property to estimate market value. In selecting comparable properties, appraisers often consider locational attributes (including, but not limited to, distance from the subject property), which may be critical to a property's value. Properties used for comparison should also have been sold relatively recently to reflect the current market. However, one criticism of the sales comparison approach is that it may perpetuate price trends in overheated (or depressed) markets. For example, the use of comparable sales with inflated sales prices (driven up by factors that increase consumer demand, such as expanded credit availability) can lead to progressively higher market valuations for other properties, which in turn become comparables for future sales transactions. Also, in markets where there are few recent sales of comparable properties, there may be insufficient information to support a credible estimate of value.

The second approach to value—the cost approach—is mostly used in addition to the sales comparison approach, and in specific circumstances, such as valuing newly constructed properties or manufactured homes, according to federal officials and appraisal industry participants. To implement the cost approach, appraisers must estimate how much it would cost to build a new or substitute property in place of the subject property. In addition, they must value other site improvements and the land and consider accrued depreciation. According to some appraisal industry participants, some circumstances in which the cost approach can be particularly useful exist more often in rural areas. These circumstances include properties with unusual features, such as additional structures or

larger (or smaller) lots than those of otherwise comparable properties. Using the cost approach can provide additional information to appraisers to account for these unusual features. Further, the cost approach can be important in estimating the value of newly constructed homes because cost and market value are usually more closely related when properties are new (unless there are economic or functional factors that impact value). However, the cost approach also has a number of disadvantages. As a property ages, estimating the appropriate amount of depreciation becomes more difficult and adds uncertainty to the estimate of value. Additionally, while a common way to estimate land values is to review recent sales of vacant lots close to the subject property, such sales may be rare in many mature residential areas. The cost approach also may not be appropriate for appraising certain types of properties, such as high-rise condominium units, which are not built individually but rather as part of a larger complex, and historic properties, which have value not fully captured by the cost approach.

The third approach to value used in appraisals is the income approach, which is an estimate of what a prudent investor would pay based upon a property's expected net income (such as from rent). For residential properties, the income approach is considered most useful when there is an active rental market for comparable properties. However, in some residential areas, rental properties are relatively rare, resulting in limited data on which to base an estimate using the income approach. Even when data on rents are available, they may not be equivalent. For example, some rent amounts may include the cost of utilities or other amenities, while others may not. In addition, some lenders told us that the income approach is often not applicable when the intended use of the subject property is as an owner-occupied home rather than as an income-producing property.

Some mortgage industry stakeholders have argued that wider use of other approaches—particularly the cost approach—could help mitigate what they view as a limitation of the sales comparison approach. They told us that reliance on the sales comparison approach alone can lead to unsustainable market values and that using the cost approach as a check on the sales comparison approach could help lenders and appraisers identify when this is happening. For example, they pointed to a growing gap between the average market values and average replacement costs of properties as the housing bubble developed in the early to mid-2000s. However, the industry data discussed previously suggest that the cost approach was used in a substantial proportion of mortgage originations in recent years. In addition, other mortgage industry participants noted that

a rigorous application of the cost approach may not generate values much different from values generated using the sales comparison approach. They indicated, for example, that components of the cost approach—such as land value or profit margins of real estate developers—can grow rapidly in housing markets where sales prices are increasing.

Additional information would be needed to assess any differences between the values appraisers generated using the different approaches. Although the available data on appraisal approaches did not include this information, enterprise officials told us that the UMDP initiative will capture data on appraisal approaches and values generated by these approaches, which may help them perform more in-depth analysis of appraisals for the mortgages they purchase. However, given uncertainty regarding the future role of the enterprises in the mortgage market and the proprietary nature of the effort, the degree to which data from the UMDP initiative will benefit the broader market is unclear. FHFA officials told us that UMDP could be a potentially important risk management tool for the enterprises and that they have not made decisions about whether they will make any of the data collected through the program available for wider use.

Recent Policy Changes May Affect Consumer Costs for Appraisals, while Other Policy Changes Have Enhanced Disclosures to Consumers

Consumer Costs for Appraisals Vary by Geographic Location, Appraisal Type, and Property Complexity

Lenders generally require consumers to pay for costs associated with obtaining appraisals, which can include fees paid to appraisers and appraisal firms for providing the appraisal and fees charged by AMCs that lenders often use to administer the appraisal process. Mortgage and appraisal industry participants we spoke with estimated that, for a conventional mortgage, consumers pay an average of $300 to $450 for a typical appraisal with an interior and exterior inspection, depending on

where the property is located.[38] Appraisals for properties in high cost-of-living areas and rural areas tend to be more expensive than in low cost-of-living areas and urban areas, according to mortgage industry participants and available documentation. Some of these differences are evident—for example, in the VA's appraiser fee schedule, which shows variation in fees by state ranging from a low of $325 in Kentucky to a high of $625 in Alaska. Industry fee information published in February 2010 by a real estate technology company shows similar state-level variation, with median fees ranging from $300 to $600.[39] According to this company's data, appraisal fees also vary substantially within states, sometimes by more than $200.

Other factors that affect appraisal costs include the type of appraisal product (e.g., level of inspection, scope of work) and the size and complexity of the property, according to appraisers, lenders, and AMCs we spoke with. For example, one lender said an appraisal with an exterior-only inspection for a conventional mortgage may cost $100 to $150 less than an appraisal that also has an interior inspection. Others told us that an appraisal for an FHA-insured mortgage, which has additional inspection requirements, might cost $75 more than an appraisal for a conventional mortgage.[40] Complex properties may require specialized experience or training on the part of the appraiser and may require the appraiser to take more time to gather and analyze data to produce a credible appraisal. A complex property may have unique characteristics that are more difficult to value, such as being much larger than nearby properties or being a lakefront or oceanfront property, because there are likely few properties with comparable features that have recently been sold. As a result, appraisal costs are often higher for these properties and would be passed on to the consumer. In addition, the extent to which data on comparable sales are readily available and the number of comparables required by the lender may affect appraisal costs.

[38]Conventional mortgages are loans that are not insured or guaranteed by federal agencies, such as FHA, VA, or USDA.

[39]Mercury Network, *Appraisal Fee Reference: Median Observed Appraisal Fees by County, State, and Region*, February 2010.

[40]FHA uses the appraisal to determine the property's eligibility for mortgage insurance based in part on the property's condition. The appraiser inspects the property to be able to report on whether the property meets FHA's minimum requirements and, if not, the repairs required to correct any deficiencies.

Appraisers, lenders, and AMCs we spoke with told us that, in general, neither the number of appraisal approaches (i.e., sales comparison, cost, and income) used by an appraiser nor a lender's use of an AMC affect consumer costs for an appraisal. USPAP requires appraisers to use as many of the three approaches as are applicable for each property. While using multiple approaches requires additional time and effort on the part of the appraiser, appraisers typically do not adjust their fees on this basis, according to appraisers we spoke with. Instead, to the extent they are able to set their fees, they will do so at a level that will cover their total time and effort across all their assignments, including those requiring multiple approaches. Similarly, mortgage industry participants we spoke with told us that the amount a consumer pays for an appraisal is generally not affected by whether the lender uses an AMC or engages an appraiser directly. Rather, they said that AMCs typically charge lenders about the same amount that independent fee appraisers would charge lenders when working with them directly, and lenders generally pass on the entire cost to consumers. Appraisers have reported receiving lower fees when working with AMCs compared to when working directly with lenders because AMCs keep a portion of the total fee. Appraisal industry participants told us that the AMC portion is at least 30 percent of the fee the consumer pays for an appraisal. For example, one AMC official told us that, for a $375 appraisal, the appraiser would receive approximately $250, and the AMC would keep $125, $100 of which would cover its costs and $25 of which would be pretax profit.[41]

According to lenders and AMCs we spoke with, consumer costs for appraisals increased slightly in 2009, as a result of the enterprises requiring appraisers to complete an additional form, called the market conditions addendum. This form prompts appraisers to report on market conditions and trends in the subject property's neighborhood, including housing supply, sales price and listing price trends, seller concessions, and foreclosure sales. Lenders and AMCs we spoke with estimated that having appraisers complete the market conditions addendum added

[41]Some mortgage industry participants we spoke with said that, like AMCs, appraisal firms that employ appraisers also keep a portion of the total appraisal fee—estimates ranged from 30 percent to 50 percent—to cover expenses. Unlike AMCs, these firms would typically provide health insurance and other benefits to the appraisers they employ, according to those we spoke with. A number of appraisal industry participants also said that some AMCs include appraisers employed by appraisal firms on their appraiser panels, which may result in even lower fees paid to those appraisers because both the AMC and the appraisal firm are keeping a portion of the total appraisal fee.

between $15 and $45 to the cost of an appraisal. VA also adopted this form and added $50 to the fees on its fee schedule.

In general, however, lenders, AMC officials, appraisers, and other industry participants noted that consumer costs for appraisals have remained relatively stable in the past several years and pointed to several factors that could explain this stability. First, a number of those we spoke with said that increased use of technology and greater availability of data electronically has allowed appraisers to complete some of their required tasks more quickly. Second, the supply of appraisers relative to the demand for their services has helped to hold consumer costs steady. Some lender and AMC officials said that there is an oversupply of appraisers in some markets where fewer mortgage loans are being originated, which has put downward pressure on appraisers' fees. Third, AMCs compete with each other for lenders' business, which keeps costs relatively stable.

How the New Requirement That Appraisers Be Paid Customary and Reasonable Fees Will Affect Consumer Costs Is Unknown

A provision in the Act that requires lenders to pay appraisers a "customary and reasonable fee" may affect consumer costs for appraisals, depending on interpretation and implementation of federal rules.[42] The Federal Reserve issued rules in October 2010 outlining two "presumptions of compliance" for lenders and their agents, such as AMCs, to demonstrate they are meeting the Act's requirements.[43] Compliance with these rules became mandatory on April 1, 2011. Under the rules, lenders and AMCs are presumed to be in compliance with customary and reasonable fee requirements if they pay appraisers an amount reasonably related to recent rates of compensation for comparable appraisal services performed in a given geographical market and make adjustments for the specific circumstances of each assignment (including the type of property, scope of work, and appraiser qualifications).[44] Alternatively, lenders and AMCs are presumed to comply

[42]Dodd-Frank Act § 1472(a) (codified at 15 U.S.C. § 1639e(i)).

[43]75 Fed. Reg. 66554 (Oct. 28, 2010). If lenders and AMCs do not rely on information that meets the conditions outlined in the rules, their compliance is determined based on all of the facts and circumstances without a presumption of either compliance or violation.

[44]Under the first presumption of compliance, lenders and AMCs are also prohibited from engaging in anticompetitive acts that would affect appraisers' compensation, such as price-fixing or restricting others from entering the market.

with these rules if they set fees by relying on objective third-party information, such as fee schedules, studies, and surveys prepared by independent third parties, including government agencies, academic institutions, and private research firms. According to the Act, these third-party studies cannot include fees paid to appraisers by AMCs.[45] However, a person may rebut either presumption with evidence that the fee for a given transaction is not customary and reasonable based on other information.

The effect of this change on consumer costs may depend on the approach lenders and AMCs take in complying. Some lenders and AMCs told us that, under the first presumption of compliance, they believe they can continue to compensate appraisers at the rates they have been paying them for recent assignments, relying in part on internal data from the previous 12 months as evidence that those fees are customary and reasonable.[46] Assuming they were able to meet the conditions for this presumption of compliance, consumer costs likely would not change, according to representatives of these companies. However, other lenders are taking steps to meet the requirement under the second presumption of compliance. Some mortgage industry participants told us that some lenders, including smaller ones, may set appraiser fees at the level outlined in the VA appraiser fee schedule, which uses information from periodic surveys of lenders to set maximum fees that borrowers can be charged in each state. Other lenders and industry groups are having fee studies done in order to comply. Because these studies cannot include the fees AMCs pay to appraisers, some industry participants, including some AMC officials, expect them to demonstrate that appraiser fees should be higher than what AMCs are currently paying. If that is the case, these lenders would require AMCs to increase the fees they pay to appraisers to a rate consistent with the findings of those studies. The expected result would be an increase in appraisal costs for consumers, as well as potential improvements in appraisal quality.[47] However, some lenders are evaluating the possibility of no longer using AMCs and managing their own panels of appraisers, which would eliminate the AMC

[45]Dodd-Frank Act § 1472(a) (codified at 15 U.S.C. § 1639e(i)(1)).

[46]The rules also require lenders and AMCs to demonstrate that these rates consider factors such as the type of property and scope of work.

[47]Several appraisal industry groups told us that higher fees for appraisers would improve appraisal quality by retaining and attracting better qualified appraisers to the profession.

administration fee from the appraisal fee that consumers pay. Some regulatory officials and lenders told us that lenders can still recover the cost of managing the appraisal process from the consumer in other ways—for example, through higher application fees, origination fees, or interest rates.

FHA instituted a policy requiring lenders to pay reasonable and customary fees to appraisers in 1997. Initially, this policy required that lenders charge consumers only the actual amount paid to the appraiser but was changed several months later to allow lenders to have consumers pay costs associated with services provided by AMCs, as well as the fee paid to the appraiser. FHA limited the total costs to consumers to the amount that was customary and reasonable for an appraisal in the market area in which the appraisal was performed. In 2009, FHA released additional guidance on fee requirements, stating that appraisers must be compensated at a rate that is customary and reasonable for an appraisal performed in the market area of the property and that AMC fees must not exceed what is customary and reasonable for the appraisal management services they provide. FHA's guidance places responsibility with the lender for knowing what is customary and reasonable in the areas in which they lend and advises appraisers not to accept assignments for which they believe the fees are not reasonable. FHA officials told us they did not know whether or how this change had affected consumer costs.

Policy Changes Limit Costs to Consumers Relative to Disclosed Cost Estimates and Require That the Valuation Report Be Disclosed to Consumers Prior to Closing

RESPA requires that lenders disclose estimated appraisal costs to the consumer along with estimates of other services that are required in order to close the mortgage loan.[48] These estimates, which are included on a standard good faith estimate form, must be provided within 3 days of receiving the consumer's application for a mortgage loan, unless the lender turns down the application or the consumer withdraws the application. Appraisals typically fall in the category of third-party settlement services required and selected by the lender. In the estimate provided to the consumer, the lender must identify each third-party settlement service required, along with the estimated price to be paid by the consumer to the provider of each service. Subsequently, at loan

[48] 12 U.S.C. § 2604(c), 24 C.F.R. § 3500.7.

closing, the lender must disclose the actual costs for these services on the HUD-1 settlement form.[49]

Changes to RESPA that took effect in 2010 require that actual costs paid by consumers for third-party settlement services not exceed estimated costs by more than 10 percent. If actual costs are higher than this threshold, the lender is responsible for making up the difference, providing lenders with a greater incentive to estimate costs accurately. For each service, the lender is to disclose the name of the third-party service provider and the amount they were paid. For example, according to HUD guidance, when a lender uses an AMC to engage an appraiser, the lender is required to disclose the name of the AMC and the total amount paid to the AMC (but not how much the AMC paid the appraiser). When a lender engages an appraiser directly, the lender must disclose the name of the appraiser and how much the appraiser was paid. The Act permits, but does not require, lenders to disclose to the consumer separately the fee paid to the appraiser by an AMC and the administration fee charged by the AMC at closing.[50] Some appraisers and federal and state regulatory officials said requiring separate disclosures of AMC fees and appraiser fees would benefit consumers by providing greater transparency. However, other federal officials and lenders questioned the value of separate disclosures for various reasons: the information could be confusing to consumers, would come too late to inform consumer decision making if provided at closing, and involves a small part of total closing costs.

Regulations implementing ECOA require lenders to notify consumers of their right to receive the valuation report associated with a mortgage transaction and to provide it upon request. Alternatively, lenders can routinely provide consumers with a copy of the report during the mortgage origination process.[51] The Act amended ECOA to require lenders to provide consumers with a copy of the valuation report no later than 3 days prior to loan closing for first-lien mortgages secured by the consumer’s principal dwelling and for all types of valuations, including

[49]The HUD-1 settlement form is a standard form that itemizes the charges imposed upon both the consumer (borrower) and the seller by the lender in relation to the settlement, as required by 24 C.F.R. § 3500.8 and Appendix A to 24 C.F.R. Part 3500.

[50]Dodd-Frank Act § 1475 (codified at 12 U.S.C. § 2603).

[51]12 C.F.R. § 202.14.

appraisals, BPOs, and AVMs.[52] In 2009, the enterprises had adopted a similar requirement as part of HVCC for appraisal reports associated with mortgages to be sold to the enterprises. These policy changes enhance disclosures to consumers by guaranteeing they receive information about the value of the property prior to completing their mortgage transaction.

Conflict-of-Interest Policies Have Changed Appraiser Selection Processes, with Implications for Appraisal Oversight

Recent Policies Address Conflicts of Interest by Enhancing Appraiser Independence Requirements

Recently issued policies reinforce long-standing requirements and guidance addressing conflicts of interest that may arise when parties have an incentive to unduly influence or pressure appraisers to provide biased values. Conflicts of interest arise when direct or indirect personal interests bias appraisers from exercising their independent professional judgment. These conflicts can arise in several ways. Loan production staff and mortgage brokers are often compensated on a commission based upon mortgage originations, which may give them an incentive to pressure appraisers to provide values that will allow loans to close. When lenders order appraisals from an AMC they own or are affiliated with, the lender's loan production staff may be able to influence AMC staff to pressure appraisers, according to some mortgage industry stakeholders. Companies that provide both valuation services and title services for the same transaction may also have a potential conflict of interest because the company stands to profit if the mortgage is approved and the borrower subsequently purchases the company's title insurance at closing. Real estate agents earn commissions based on a property's sales price, which may give agents an incentive to influence an appraiser's opinion of value. Borrowers may also want to influence appraisers to provide a value that will allow their loans to be approved. Some appraisers may acquiesce to these different sources of pressure

[52]Dodd-Frank Act § 1474 (codified at 15 U.S.C. § 1691(e)).

because they want to satisfy their clients, receive future assignments, or do not want to be responsible for stopping the property transaction from going through.

In order to keep appraisers independent and prevent them from being pressured, the federal banking regulators, enterprises, FHA, and other agencies have regulations and policies governing the selection of, communications with, and coercion of appraisers. Examples of recently issued policies that address appraiser independence include HVCC, which took effect in May 2009; the enterprises' new appraiser independence requirements that replaced HVCC in October 2010; and revised Interagency Appraisal and Evaluation Guidelines from the federal banking regulators, which were issued in December 2010 and apply to federally regulated financial institutions. Additionally, the Act broadly prohibits conflicts of interest in the valuation process for all consumer credit transactions secured by a consumer's principal dwelling. Provisions of these and other policies address some or all of the following issues:

- *Prohibitions against loan production staff involvement in appraiser selection and supervision.* Loan production staff are prohibited from selecting, retaining, recommending, or influencing the selection of an appraiser for a specific assignment. The reporting structure for appraisers must also be independent of the loan production function.[53] A version of these requirements has been included in the federal banking regulators' appraisal regulations since 1990 and in FHA guidance since 1994. Similar prohibitions were included in HVCC for loans sold to the enterprises and remain in effect in the enterprises' current appraiser independence requirements. For VA-guaranteed loans, VA assigns appraisers on a rotational basis on behalf of lenders, removing loan production staff and mortgage brokers from the process altogether.

- *Prohibitions against third parties selecting appraisers.* Appraisers should be selected by the lender or its agent rather than by a third party with an interest in the mortgage transaction. The federal banking

[53]The policies provide guidance for small institutions with limited staff about how to comply. In such cases where absolute lines of independence in the reporting structure cannot be achieved, lenders are to take steps to help ensure that officials involved in selecting an appraiser for a particular loan are not involved in approving the loan. New consumer regulations implementing the Act's prohibition on conflicts of interest in the valuation process include similar provisions.

regulators include this requirement in their appraisal regulations. In addition, the enterprises expressly prohibit borrowers from selecting and retaining appraisers. The enterprises and FHA also prohibit real estate agents and mortgage brokers from selecting appraisers.

- *Limits on communications with appraisers.* While certain communications between loan production staff and appraisers are necessary, other communications that may unduly influence appraisers are inappropriate. For example, according to the federal banking regulators' guidelines, this includes communicating a predetermined, expected, or qualifying estimate of value or a loan amount, or a target LTV ratio, to an appraiser. Similarly, the enterprises and FHA prohibit loan production staff from communicating with appraisers or AMCs about anything that relates to or impacts valuation. All of these requirements and guidelines permit lenders to request that an appraiser (1) consider additional property information, including additional comparable properties; (2) provide further detail, substantiation, or explanation of the value conclusion; or (3) correct errors in the appraisal report. VA permits lenders' staff to communicate with appraisers about the timeliness of an appraisal report, but only VA-approved appraisal reviewers may discuss valuation matters with the appraiser.

- *Prohibitions against coercive behaviors.* Coercive behavior is intended to influence appraisers to base property value on factors other than the person's independent judgment. The federal banking regulators' guidelines state that no lender or person acting on a lender's behalf should engage in coercive actions, and the enterprises and FHA expressly prohibit such actions. Examples of coercive actions include withholding timely payment or partial payment for an appraisal report; expressly or implicitly promising future business, promotions, or increased compensation to an appraiser; and implying to an appraiser that his or her current or future retention depends on the valuation estimate.

A Number of Factors, Including HVCC, Increased the Use of Appraisal Management Companies and Changed How Other Industry Participants Operate

Although industry-wide data on lenders' use of AMCs over time are unavailable, appraisal industry participants told us that between 60 and 80 percent of appraisals are currently ordered through AMCs, compared with less than half before HVCC went into effect in 2009.[54] According to these participants, this increased demand for AMCs' services has resulted in a proliferation of new AMCs across the country. Lenders and other mortgage industry participants identified several factors that have contributed to a greater use of AMCs. First, market conditions, including an increase in the number of mortgages originated during the mid-2000s, put pressure on lenders' capacity to manage appraiser panels. Second, as lenders expanded the areas in which they originated mortgages, they found identifying appraisers with the appropriate experience and familiarity with the various locations to be increasingly burdensome. They also said it would be difficult to predict where across the country they would need appraisers at any given time. AMCs provided a practical solution to these two issues. According to a number of lenders we spoke with, AMCs can manage the valuation process and costs more efficiently than their internal valuation departments. In particular, they told us that AMCs are better equipped to handle the administrative effort of managing appraiser panels, such as checking licenses, maintaining contact information, placing and following up on appraisal orders, performing initial quality control, and providing national geographic coverage. In several of these cases, the lenders had already switched to using AMCs years before HVCC went into effect. The third factor that affected some lenders' use of AMCs was that HVCC required additional layers of separation between loan production staff and appraisers. According to some appraisal industry participants, some lenders may have outsourced appraisal functions to AMCs because they thought using AMCs allowed them to easily demonstrate compliance with the appraiser selection provisions in HVCC. Several appraisal industry participants told us that some lenders incorrectly believed they were required to use AMCs in order to be in compliance with HVCC.

Some appraisers, mortgage brokers, and lenders told us that the increased use of AMCs and the policy changes that banned mortgage brokers from selecting appraisers disrupted the business relationships they relied on and changed the ways they operate. Some of these

[54] Appraisal industry participants we spoke with provided varying estimates of AMC use prior to HVCC, ranging from 15 percent to 50 percent of mortgage originations.

industry participants told us small appraisal firms went out of business as lenders increased their reliance on AMCs. Having lost their lender and mortgage broker clients, some appraisers said they joined AMC panels to be able to make a living as appraisers but found they were asked to perform the same amount of work for less money than they had been making previously. Some appraisers also indicated that some AMCs pressure appraisers to complete appraisal reports within unreasonable time frames or try to guide the appraiser's value conclusion—for example, by recommending the use of certain comparable sales. Other appraisal industry participants told us that some experienced appraisers decided to perform nonresidential appraisals or left the appraiser profession altogether instead of working for lower fees. In addition, several lenders told us they required mortgage brokers to use only designated AMCs—a change that eliminated the brokers' ability to communicate with appraisers. Some mortgage industry participants, including mortgage brokers, also said that the lack of communication with appraisers caused delays in receiving appraisals because the brokers had to go through AMCs to correct reports or have questions answered. In addition, mortgage brokers we spoke with told us that it may be difficult to transfer appraisals to another lender if a deal falls through because lenders often do not accept appraisals that were not from their designated AMCs. In these instances, a second appraisal would need to be ordered, but at the borrower's or mortgage broker's expense.

Greater Use of Appraisal Management Companies Highlights Potential Shortcomings in Existing Oversight and Has Raised Questions about Appraisal Quality

Although reliance on AMCs has increased, direct federal oversight of AMCs is limited. Federal banking regulators' guidelines for lenders' own appraisal functions list standards for appraiser selection, appraisal review, and reviewer qualifications. For example, a lender's criteria for selecting appraisers should identify appraisers who possess the requisite education, expertise, and experience to competently complete the assignment. In addition, a lender's appraisal review policies and procedures should, among other things, establish a process for resolving deficiencies in appraisals and set forth documentation standards for the review. Similarly, the guidelines state that a lender should establish qualification criteria for appraisal reviewers that take into consideration education, experience, and competence. The guidelines also require lenders to establish processes to help ensure these standards are met when lenders outsource appraisal functions to third parties, such as AMCs. Officials from the federal banking regulators told us they review lenders' policies and controls for overseeing AMCs, including the due diligence they perform when selecting AMCs, performance expectations outlined in contracts, and processes for assessing appraisal quality.

However, they told us they generally do not review an AMC's operations directly unless they have serious concerns about the AMC, and the lender is unable to address those concerns. Similarly, the enterprises review lenders' policies and controls but not those of AMCs because lenders are responsible for ensuring that AMCs meet the enterprises' requirements. Officials from the enterprises said they do not review AMCs directly because they do not have business relationships with AMCs.

In light of the growing use of AMCs, a number of states enacted laws beginning in 2009 to register and regulate AMCs operating within their jurisdictions, according to officials from several state appraiser regulatory boards. These officials told us that these laws typically contained several common elements, including requiring AMCs to have processes in place for adding appraisers to their panels, reviewing appraisers' work, and keeping records of appraisal orders and activities. However, they said that some states have not adopted such laws, and existing state laws provide differing levels of oversight. For example, while a number of states require AMCs to certify that they have the above processes in place, Utah also requires AMCs to provide a written explanation of those processes as a condition of registering. Similarly, while some state laws do not specify requirements for AMC appraisal reviewers, Vermont requires reviews that address technical aspects of the appraisal to be performed by appraisers with credentials equal to or greater than the minimum required to perform the original appraisal assignment.[55]

Some appraiser groups and other appraisal industry participants have expressed concern that existing oversight may not provide adequate assurance that AMCs are complying with industry standards and their own policies and procedures, with negative impacts on appraisal quality. Although they did not provide us with data to demonstrate a change in quality, these participants suggested that the practices of some AMCs for selecting appraisers, reviewing appraisal reports, and establishing qualifications for appraisal reviewers—key areas addressed in federal

[55]Some appraisal reviews are administrative in nature—for example, focusing on whether all fields in the appraisal report were filled in—and can be performed by a variety of individuals. Other appraisal reviews examine the technical aspects of the appraisal report—for example, the reasonableness of the properties selected as comparable sales and the adjustments made to them—and require a certain level of knowledge and expertise in appraising.

guidelines for lenders' appraisal functions—may have led to a decline in appraisal quality:

- *Selecting appraisers.* Appraiser groups said that some AMCs select appraisers based on who will accept the lowest fee and complete the appraisal report the fastest rather than on who is the most qualified, has the appropriate experience, and is familiar with the relevant neighborhood. They said that, with many experienced appraisers departing from the industry, less experienced appraisers, who are often willing to accept lower fees, are left to perform most of the work.

- *Reviewing appraisal reports.* According to some appraisal industry groups, some AMCs' appraisal reviews overemphasize how close the appraiser's value conclusion is to an expected value generated by an AVM, at the expense of other important elements of the appraisal, such as the appropriateness of the comparable sales. One group noted instances in which AMCs told appraisers which comparable sales to use when the appraisers' original value conclusions were not consistent with AVM-generated values.

- *Establishing qualifications for appraisal reviewers.* Representatives of an appraisal industry group told us that some AMC reviewers may lack the expertise necessary to identify problems with quality. They noted that in some states appraiser licensing and certification requirements do not address qualifications for appraisal reviewers.

AMC officials we spoke with said that they have processes and standards that address these areas of concern. Several AMC officials told us they have vetting processes to select appraisers for their panels, including minimum requirements for years of appraising experience and education. When selecting appraisers for a specific assignment, these AMCs indicated that they use an automated system that identifies the most qualified appraiser based on criteria such as the requirements for the assignment, the appraiser's geographic proximity to the subject property, and performance metrics such as timeliness and the quality of appraisers' work. The AMC officials we spoke with said they allow appraisers to specify how much they will charge for different types of appraisal assignments and, in some cases, provide appraisers with the range of fees their peers on the appraiser panel charge. These officials said they compare fees only when two appraisers are equally qualified for an assignment, in which case they might default to the appraiser with the lower fee. Further, these officials said that when performing quality reviews on appraisals, they run automated checks to identify any

problems with completeness and internal consistency. These reviews may also involve comparing the appraiser's estimated value to a value generated by an AVM. Appraisals flagged for potential problems, such as risk of overvaluation, are manually reviewed by staff reviewers, who often have backgrounds in underwriting or appraising. One AMC official told us that their reviewers also provide coaching for less experienced appraisers to help them improve the quality of their appraisal reports.

The enterprises and some lenders we spoke with told us that appraisal quality had improved after HVCC was adopted, although they could not specifically tie the quality improvements they observed to the use of AMCs. Some industry participants noted that other market changes that were occurring at the same time HVCC was implemented could have contributed to an improvement in appraisal quality, such as the enterprises' requirement in 2009 that appraisers also complete the market conditions addendum form (as previously discussed in connection with its impact on appraisal costs). Nevertheless, the enterprises told us that variances between the values in the appraisal reports and values produced by their proprietary AVMs decreased after HVCC went into effect—in particular, for mortgages from third-party originators, including mortgage brokers. In addition, officials from one lender said that once HVCC went into effect, they required appraisals for mortgages in their broker channel to be ordered through AMCs and, on the basis of similar internal metrics that compare AVM-generated values to appraised values, observed improvements in appraisal quality. Officials from the enterprises told us that once they have obtained data through UMDP and evaluated its quality, they may be able to use the data to assess the appraisal quality of individual AMCs and appraisers.

While views on the impact of AMCs on appraisal quality differ, Congress recognized the importance of additional AMC oversight in enacting the Act by requiring each state to register and regulate AMCs and placing the supervision of AMCs with state appraiser regulatory boards.[56] In addition, the Act requires the federal banking regulators, along with FHFA and the Bureau of Consumer Financial Protection, to establish minimum standards for states to apply when registering AMCs, including requirements that appraisals coordinated by an AMC comply with USPAP and be conducted independently and free from inappropriate influence

[56]Dodd-Frank Act § 1473(f)(2) (codified at 12 U.S.C. § 3353(a)).

and coercion.[57] This rulemaking also provides a potential avenue for reinforcing existing federal requirements for key functions that may impact appraisal quality, such as selecting appraisers, reviewing appraisals, and establishing qualifications for appraisal reviewers. Federal guidelines for lenders address these functions and require that lenders take steps to ensure that AMCs comply with the guidelines when lenders rely on AMCs to perform these functions. However, federal regulators do not directly monitor AMCs' compliance with the guidelines; direct oversight of AMCs will be instead performed by state regulators, with the Appraisal Subcommittee monitoring state AMC oversight. If state standards do not also address these functions, state oversight of AMCs may not provide adequate assurance that these functions are being properly carried out.

Conclusions

Because appraisals provide an estimate of market value at a particular point in time, they are affected by changes in the housing and mortgage markets. In recent years, turmoil in these markets has heightened attention on residential property valuations, and appraisals in particular. The prominent role of appraisals in the mortgage market underscores the importance of efforts to better ensure appraisal quality. HVCC, the Act, and federal banking regulator guidance have sought to address some of the factors that can affect appraisal quality, including appraiser independence and compensation. In addition, the enterprises are undertaking an initiative to collect detailed and standardized appraisal data that could provide them with greater insight into appraisal practices for the mortgages they purchase.

Partly in reaction to appraiser independence requirements, lenders have increasingly relied upon AMCs to perform certain functions. Despite the increased use of AMCs, direct federal oversight of AMCs is limited because the focus of regulators is primarily on lenders, and state-level requirements for AMCs are uneven, ranging from no laws to laws with specific standards for registering with the state. Some appraisal industry participants have raised concerns that the management practices of some AMCs may be negatively affecting appraisal quality. Among the areas of concern are AMCs' practices for key functions, including selecting appraisers for assignments, reviewing completed appraisal

[57] Officials from the federal banking regulators said they expect this process to begin in August or September 2011.

reports, and establishing qualifications for appraisal reviewers. The federal banking regulators have emphasized the importance of these functions in guidelines that apply to lenders' appraisal functions. The Act requires the federal banking regulators and other federal agencies to set minimum state standards for registering AMCs, which provides an opportunity for the regulators to address these areas of concern and promote more consistent oversight of these functions, whether performed by lenders or AMCs. Doing so could help to provide greater assurance to lenders, the enterprises, and federal agencies of the quality of the appraisals provided by AMCs.

Recommendation for Executive Action

To help ensure more consistent and effective oversight of the appraisal industry, we recommend that the heads of FDIC, the Federal Reserve, FHFA, NCUA, OCC, and the Bureau of Consumer Financial Protection—as part of their joint rulemaking required under the Act—consider including the following areas when developing minimum standards for state registration of AMCs: criteria for selecting appraisers for appraisal orders, review of completed appraisals, and qualifications for appraisal reviewers.

Agency Comments and Our Evaluation

We provided a draft of this report to FDIC, the Federal Reserve, NCUA, OCC, and OTS, as well as FHFA, HUD, USDA, and VA, for their review and comment. We received written comments from the Director of Risk Management Supervision, FDIC; the Directors of the Divisions of Banking Supervision and Regulation and Consumer and Community Affairs, Federal Reserve; the Executive Director of NCUA; the Acting Comptroller of the Currency; and the Acting Director of FHFA that are reprinted in appendixes II through VI. We also received technical comments from FDIC, the Federal Reserve, FHFA, HUD, and OCC, which we incorporated where appropriate. OTS, USDA, and VA did not provide comments on the draft report. The Bureau of Consumer Financial Protection did not receive the draft report in time to provide comments.

In their written comments, the federal banking regulators (FDIC, the Federal Reserve, NCUA, and OCC) and FHFA agreed with or indicated they will consider our recommendation to address specific areas as part of joint rulemaking to develop minimum standards for state registration of AMCs. In its written response, the Federal Reserve said that it would consider our recommendation in developing rules to establish minimum standards. It also cited various regulations and guidance it and other agencies have issued related to appraiser independence since the 1990s.

While agreeing with our recommendation, OCC noted in its written comments that improved oversight of AMCs by states does not diminish federally regulated institutions' responsibility to ensure that services performed on their behalf by AMCs comply with applicable laws, regulations, and guidelines. Finally, FHFA in its written response agreed that the joint rulemaking process should consider the areas we mention in our recommendation. While it also noted that the data in the report did not capture differences between the enterprises' practices, it noted that the report discusses that lenders may and do require appraisals beyond what is required by the enterprises.

We are sending copies of this report to the appropriate congressional committees, the Chairman of FDIC, the Chairman of the Federal Reserve, the Acting Director of FHFA, the Secretary of Housing and Urban Development, the Chairman of NCUA, the Acting Comptroller of the Currency, the Acting Director of OTS, the Secretary of Agriculture, the Secretary of Veterans Affairs, the Bureau of Consumer Financial Protection, and other interested parties. In addition, the report is available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff members have any questions about this report, please contact me at (202) 512-8678 or shearw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix VII.

William B. Shear
Director, Financial Markets
and Community Investment

Appendix I: Objectives, Scope, and Methodology

This report focuses on valuations of single-family residential properties for first-lien purchase and refinance mortgages. We examine (1) the use of different valuation methods and their advantages and disadvantages; (2) factors that affect consumer costs and requirements for disclosing appraisal costs and valuation reports to consumers; and (3) conflict-of-interest and appraiser selection policies, and views on the impact of these policies on industry stakeholders and appraisal quality. We also consider the impact of the Home Valuation Code of Conduct (HVCC) throughout the report.

To describe how often different valuation methods are used, we analyzed valuation data from various sources for mortgages originated in calendar years 2006 through 2010. We requested aggregated data on valuations for mortgages originated in these years from Fannie Mae and Freddie Mac (the enterprises), the five largest lenders (as determined by the dollar volume of total mortgage originations in 2010), six of the largest appraisal management companies (AMC) (as identified by industry trade associations), and three private vendors of mortgage and valuation technology. In response to our request, we obtained proprietary data from the enterprises, five lenders (Ally Financial, Inc.; Bank of America, NA; J.P. Morgan Chase Bank, NA; CitiMortgage, Inc.; and Wells Fargo Bank, NA), four AMCs (CoreLogic, Landsafe, LSI, and PCV/Murcor), and one private vendor (FNC, Inc.). Data from each group of entities provide a partial picture of the valuation methods used in purchase and refinance mortgage originations and overlap with each other to a certain degree. The datasets we assembled are unique and therefore difficult to cross-check with other known sources to check their reliability. However, we were able to corroborate some data elements through interviews, and we used each of the datasets we assembled and other proprietary data we obtained to corroborate the other datasets. As a result, we believe that these data are sufficiently reliable for the purpose of this report, keeping in mind the following limitations. Because some of the entities compiled the requested information differently or were reporting information that is not a part of their normal data collection and retention apparatus, our datasets contain various degrees of inconsistency, missing data, and other issues. The data from the enterprises presented in this report only include mortgages originated using their own automated underwriting system. As a result, the data do not reflect mortgages that (1) lenders originated using manual underwriting; (2) lenders originated using their own, enterprise-approved automated underwriting systems; or (3) were originated using the automated underwriting system of one enterprise but purchased by the other enterprise. Data from the lenders often did not include information on mortgages originated through their broker or

correspondent channels. In addition, data from the early part of the 5-year period we examined were limited, in part because (according to officials from some of the lenders) mergers with other financial institutions and data system changes prevented them from accessing these data. For these reasons, we have characterized our results in a manner that minimizes the reliability concerns (e.g., by focusing on 2009 and 2010) and emphasizes the points on which the data are corroborated. Our interviews with federal agencies, lenders, AMCs, appraisers, and other industry stakeholders provided clarification of data elements and additional perspectives on the use of different valuation methods in mortgage transactions. Given these and other steps we have taken, we believe the data are sufficiently reliable for the purposes used in this study.

The enterprises provided us with data on the minimum valuation method they required for mortgages they purchased. Table 1 shows the percentage of total mortgage originations (by dollar volume) that enterprise purchases accounted for in each of the years we examined.

Table 1: Enterprise Share of Total Mortgage Originations Excluding Home Equity Loans (by Dollar Volume), 2006-2010

	2006	2007	2008	2009	2010
Fannie Mae	19%	29%	39%	45%	39%
Freddie Mac	14%	21%	26%	27%	25%

Source: GAO analysis of data from Inside Mortgage Finance.

As previously noted, the data from the enterprises used in this report cover mortgages that were originated using their automated underwriting systems and therefore represent only a portion of the total mortgages they purchased. Table 2 shows the percentage of the enterprises' mortgage purchases each year that were originated using their automated underwriting systems, excluding certain refinance mortgages originated under the Home Affordable Refinance Program.

Table 2: Percentage of Each Enterprise's First-Lien Mortgage Purchases Originated Using Their Automated Underwriting Systems, 2006-2010

	2006	2007	2008	2009	2010
Fannie Mae	49%	52%	54%	58%	59%
Freddie Mac	27%	24%	26%	34%	28%

Source: GAO analysis of data from the enterprises.

Note: These data exclude certain refinance mortgages originated under the Home Affordable Refinance Program.

The five lenders cited previously provided us with data on the valuations they obtained for mortgages they made. These lenders accounted for about 64 percent of mortgage originations in 2009 (excluding home equity loans) and 66 percent in 2010. As discussed earlier, the lender data did not cover all of their mortgage originations. Table 3 shows the percentage of each lender’s mortgages for which they provided valuation data.

Table 3: Percentage of Each Lender’s First-Lien Mortgage Originations for Which They Provided Valuation Data, 2006-2010

	2006	2007	2008	2009	2010
Wells Fargo	85%	97%	98%	99%	99%
Citi	66%	84%	91%	99%	98%
Bank of America	0%	0%	37%	35%	44%
Chase	0%	0%	14%	30%	24%
Ally	0%	0%	0%	11%	7%

Source: GAO analysis of lender data.

Note: Bank of America, Chase, and Ally officials told us they could not access data from earlier years due to mergers with other financial institutions or data system changes.

The four AMCs cited previously provided us with data on the valuations they provided to lenders. For many appraisals, some AMCs were unable to identify whether the appraisals were for mortgage originations (as opposed to other purposes, such as servicing and portfolio management or removal of mortgage insurance) and, if they were, whether they were for home purchases or refinancing existing mortgages. In addition, two of the six AMCs we spoke with did not provide us with data. As a result, the AMC data we obtained represented a small but undetermined portion of the mortgage market and were of limited use for purposes other than corroborating other datasets.

FNC, Inc. is a mortgage technology company that, among other things, provides software platforms for lenders, appraisers, and other participants in the mortgage origination process. It captures appraisal data electronically that pass through its systems and uses the information to build analytical tools for its clients, which include several national lenders, as well as various regional and community lenders. The share of the mortgage market for which FNC captures data has increased over time, reaching about 20 percent in 2010. We interviewed knowledgeable FNC officials about their processes and data controls to assess data reliability.

In general, FNC was able to provide us with valuation data for approximately 80 percent of the appraisals it identified as being for purchase or refinance mortgages. These data provide some insight into how often different appraisal approaches are used, though they may not be representative of the mortgage market as a whole.

To identify the potential advantages and disadvantages of the different valuation methods, we reviewed relevant research studies and articles that examine the strengths and limitations of the different valuation methods and the potential effects on the reliability of appraisals. We also interviewed representatives from the federal banking regulatory agencies (the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the National Credit Union Administration), federal agencies with mortgage insurance or guarantee programs (the Department of Housing and Urban Development's Federal Housing Administration, the Department of Veterans Affairs, and the Department of Agriculture), the enterprises, appraisal industry groups, AMCs, mortgage lenders (including the five cited previously), mortgage industry associations (including those representing smaller and rural lenders), as well as other individual industry stakeholders and researchers.

To examine the factors that affect appraisal costs, we reviewed federal and lender policies on fees, including fee schedules. We interviewed the aforementioned lenders and AMCs and representatives from mortgage and appraisal industry associations to identify the factors that may affect valuation costs, including any that may have caused changes in consumer costs over time. Because our interviews with individual lenders and AMCs focused on larger companies, the views they expressed may not be representative of these industries as a whole. To examine disclosures to consumers, we (1) reviewed and summarized statutes and policies, such as the Real Estate Settlement Procedures Act, that govern the disclosure of costs and valuation documentation to consumers and (2) interviewed federal officials and lenders to ensure our understanding of these requirements. To assess how HVCC affected appraisal costs and disclosures, we reviewed the relevant provisions in HVCC; analyzed information we obtained to identify any changes in costs that may be attributable to HVCC; and interviewed lenders and appraisers, among other industry stakeholders.

To determine how federal policies, including HVCC, have addressed potential conflicts of interest and affected appraiser selection policies, we

reviewed statutes, regulations, guidance, and federal banking regulators' examination procedures covering appraiser independence requirements. We interviewed federal banking regulators, lenders, appraisers, AMCs, state regulatory officials, and other mortgage industry participants to discuss changes in policies and their impact on the appraisal process, industry participants, and appraisal quality. In addition, we interviewed the enterprises, lenders, and AMCs about the policies and procedures they have in place to assess and help ensure appraisal quality.

We conducted this performance audit from July 2010 to July 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Board of Governors of the Federal Reserve System

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

July 6, 2011

Mr. William B. Shear
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
Washington, D.C. 20548

Dear Mr. Shear:

Thank you for the opportunity to comment on the Government Accountability Office (GAO) draft report entitled *Real Estate Appraisals: Opportunities to Enhance Oversight of an Evolving Industry*. The report provides an overview of the valuation methods, including appraisals, used by lenders for first-lien residential mortgage originations. In conducting the study, GAO recognized that the recent mortgage crisis resulted in increased scrutiny of lenders' appraisal practices and that recent policy changes have addressed many of the concerns with these practices. The report contains one recommendation to the Federal Reserve, the other federal banking regulators, the Federal Housing Finance Agency (FHFA), and the Bureau of Consumer Financial Protection (Bureau), concerning the establishment of minimum standards for appraisal management companies (AMCs).

As the draft report acknowledges, appraisals provide important information on a property's market value that assists consumers in making informed borrowing decisions. Further, the report recognizes that independent and credible real estate valuations, including appraisals, are critical to prudent residential mortgage lending.

Board regulations and supervisory guidance that address the independence of appraisers in credit transactions involving federally-regulated financial institutions have been in place since the 1990s. To strengthen the appraisal process more broadly, in July 2008 the Federal Reserve Board issued final rules that applied to all creditors, mortgage brokers, and their affiliates. The Board's rules expressly prohibited these parties from coercing, influencing, or otherwise encouraging appraisers to misstate or misrepresent the value of a consumer's principal dwelling. The July 2008 final rules also prohibited a creditor from extending credit when the creditor has reason to believe that the appraiser was encouraged to misstate or misrepresent the value of the dwelling, unless the creditor determines that the appraisal was accurate or bases its credit decision on a separate appraisal that was not subject to the prohibited practices.

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Subsequently, the Board issued interim final rules in October 2010 to implement the appraisal independence provisions in section 1472 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The October 2010 interim final rules include several provisions that protect the integrity of the appraisal process and seek to ensure that real estate appraisers are free to use their independent professional judgment in assigning home values without influence or pressure from those with interests in the transactions. For example, the interim rules prohibit a party from withholding or threatening to withhold timely payment from the person preparing the valuation because the person did not value the consumer's principal dwelling at or above a certain amount.

The October 2010 rules also prohibit appraisers and appraisal management companies from having a financial or other interest in the credit transaction or property that is the subject of the appraisal. To facilitate compliance, the interim final rules provide a "safe harbor" for creditors that observe certain restrictions on the selection, supervision and compensation of appraisers. Under the rules, a creditor or settlement service provider that has information about appraiser misconduct must file a report with the appropriate state licensing authorities. To protect the quality of appraisals, the rules also require that independent appraisers receive customary and reasonable compensation for their services. Compliance with the October 2010 interim rules became mandatory on April 1, 2011.

Going forward, the Board and the other federal banking agencies, the FHFA and the Bureau will share responsibility for jointly issuing permanent rules on appraisal independence. In developing permanent rules, we will consider the public comments received on the Board's October 2010 interim final rules, including the views and issues discussed in the GAO's draft report. We will also consider the experience gained through the examination process and the handling of any complaints that the agencies have received since the interim rules became effective.

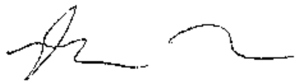
The federal banking regulators have long stressed to federally regulated financial institutions the importance of a quality and independent appraisal process. The federal banking regulators adopted appraisal regulations in 1990 and have reminded institutions of the importance of the appraisal process over the years in several supervisory guidance issuances, including the *Interagency Appraisal and Evaluation Guidelines* (December 2010). These guidelines address the federal banking regulators' expectations for a regulated institution's appraisal process and reflect recent changes in lending and appraisal practices, including the greater use of a third party (such as an AMC) by institutions to perform their residential appraisal management function. In the guidelines, the federal banking regulators remind institutions that, even if a third party performs all or a part of their appraisal function, institutions remain responsible for ensuring that the third party complies with all applicable laws and regulations.

Page 2 of 3

The Dodd-Frank Act recognizes the increasing role of AMCs in residential mortgage lending. The Act mandates that the federal banking regulators, the FHFA, and the Bureau issue rules establishing minimum requirements for states to apply in the registration of AMCs. We expect the agencies to start work on these rules once the Bureau is fully operational. The GAO recommends that these rules address requirements for the selection of appraisers, review of appraisals, and qualifications of appraisal reviewers. In developing rules to establish minimum standards for AMCs, we will consider the GAO's recommendation.

Thank you for the opportunity to review the draft report.

Sincerely,



Patrick M. Parkinson
Director, Division of Banking Supervision
and Regulation

Sandra F. Braunstein
Director, Division of Consumer
and Community Affairs

Page 3 of 3

Appendix III: Comments from the Federal Deposit Insurance Corporation

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Risk Management Supervision

July 6, 2011

William B. Shear
Director, Financial Markets & Community Investment
United States Government Accountability Office
Washington, D.C. 20548

Dear Mr. Shear:

The Federal Deposit Insurance Corporation (FDIC) reviewed the GAO report *Real Estate Appraisals: Opportunities To Enhance Oversight Of An Evolving Industry* (Report) (GAO-11-653).

The Dodd-Frank Wall Street Reform and Consumer Protection Act mandated a GAO study on the effectiveness and impact of various real estate valuation methods, the options available for selecting appraisers and the impact of the Home Valuation Code of Conduct which established certain appraiser independence requirements for loans sold to Fannie Mae and Freddie Mac. The study focused on valuations of single-family residential properties for first lien purchase and refinance mortgages. To conduct the study the GAO (a) examined the most common valuation methods; (b) reviewed the factors affecting consumer costs and disclosure requirements; and (c) evaluated conflict-of-interest and appraisal selection policies and their impact.

A copy of the GAO draft report was provided to the Federal banking regulators for comment prior to the report being issued in final form. FDIC staff discussed the draft report findings and recommendations with GAO representatives. Several areas were identified where clarification or additional supporting facts would augment report findings or expand on one or more important points.

The report recommends that the Federal banking regulators consider developing minimum standards for registering appraisal management companies (AMCs) that include criteria for: selecting appraisers, reviewing completed appraisals, and qualifications for appraisal reviewers. The FDIC along with other Federal banking agencies and the Bureau of Consumer Financial Protection will meet in September 2011 to begin developing standards for registering AMCs.

We appreciated the opportunity to review and comment on the draft audit report and we hope these efforts will further improve the appraisal process.

Sincerely,

Sandra L. Thompson
Director

Appendix IV: Comments from the Office of the Comptroller of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

July 6, 2011

Mr. William B. Shear
Director, Financial Markets and Community Investment
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Shear:

We have received and reviewed your draft report titled "Real Estate Appraisals: Opportunities to Enhance Oversight of an Evolving Industry." Your report responds to a mandate in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) for a study of the effectiveness and impact of various valuation methods and the options available for selecting appraisers, as well as the impact of the Home Valuation Code of Conduct.

You found that: (1) the widespread use of appraisals and the sales comparison approach reflect their relative advantages for valuations in mortgage originations; (2) recent policy changes may affect consumer costs for appraisals, while other policy changes have enhanced disclosures to consumers; and (3) conflict-of-interest policies have changed appraiser selection processes, with implications for appraisal oversight. You note that lenders have increasingly relied upon appraisal management companies (AMC) to perform certain functions and that direct federal oversight of AMCs is limited.

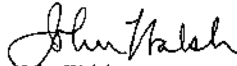
To help ensure more consistent and effective oversight of the appraisal industry, you recommend that we, along with the Federal Deposit Insurance Corporation, Federal Reserve, Federal Housing Finance Agency, National Credit Union Administration, and the Consumer Financial Protection Bureau, as part of the joint rulemaking required under the Act, consider including the following areas when developing minimum standards for state registration of AMCs: criteria for selecting appraisers for appraisal orders, review of completed appraisals, and qualifications for appraisal reviewers.

We agree with your recommendation. The OCC's and the other federal banking agencies' appraisal regulations and related supervisory guidance contain longstanding standards that include: (1) criteria for selecting appraisers for appraisal orders; (2) minimum standards for pre- and post-funding real estate appraisal and evaluation reviews; and (3) qualifications for review appraisers. In short, your recommendation for addressing future standards for state regulation of AMCs is consistent with the agencies' current standards for the performance of real estate appraisals in connection with federally related transactions.

It is important to note, however, that improved oversight by the states does not diminish the federally regulated institutions' responsibility to ensure that any services performed on their behalf by an AMC or other third party comply with applicable laws, regulations, and supervisory guidance.

We appreciate the opportunity to comment on the draft report.

Sincerely,



John Walsh
Acting Comptroller of the Currency

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Appendix V: Comments from the National Credit Union Administration

VIA E-MAIL

National Credit Union Administration

June 23, 2011

Mr. William B. Shear
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548
shearw@gao.gov

Dear Mr. Shear:

We have received and reviewed your draft report "Real Estate Appraisals Opportunities to Enhance Oversight of an Evolving Industry". The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) mandated that GAO study the various valuation methods and the options available for selecting appraisers, as well as the home Valuation Code of Conduct (HVCC) which established appraiser independence requirements for mortgages sold to Fannie Mae and Freddie Mac.

GAO recommends in the draft report: "To help ensure more consistent and effective oversight of the appraisal industry, we recommend that the heads of FDIC, Federal Reserve, FHFA, OCC, NCUA, and the Bureau of Consumer Financial Protection—as part of their joint rulemaking required under the Act—consider including the following areas when developing minimum standards for state registration of Appraisal Management Companies (AMCs): criteria for selecting appraisers for appraisal order, review of completed appraisals, and qualification for appraisal reviewers."

NCUA agrees with GAO's recommendation in the draft report. We will work with the agencies identified above to address GAO's recommendation in the joint rulemaking process required under the Act.

Sincerely,

David M. Marquis
Executive Director

1775 Duke Street - Alexandria, VA 22314-3428 - 703-518-6300

Appendix VI: Comments from the Federal Housing Finance Agency

FEDERAL HOUSING FINANCE AGENCY
Office of the Director

June 30, 2011

Mr. William B. Shear
Director
Financial Markets and Community Investment
Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Shear:

Thank you for the opportunity to review and comment on the Government Accountability Office (GAO) Report, *Real Estate Appraisals: Opportunities to Enhance Oversight of an Evolving Industry*. We appreciate the careful review of valuation practices and requirements over the last two decades and agree with the conclusions and recommendations.

The Report highlights the importance of unbiased appraisal valuations free from undue influence or pressure from parties to the mortgage or real estate transaction. The Report notes that appraisal independence requirements -- separation of appraisal and loan production functions -- have been included in the banking agency appraisal regulations since 1990. It cites the problem of inflated appraisals caused by undue pressure and conflicts of interest, which led to the adoption of the Home Valuation Code of Conduct (HVCC) by Fannie Mae and Freddie Mac (Enterprises). The Report reviews the Dodd-Frank Act requirement that the Federal Reserve Board publish appraisal independence rules to safeguard against coercion and conflicts of interest in the appraisal valuation process for mortgages.

While the Report confirms that appraisals are the most commonly used valuation method for first lien residential mortgage originations, the combined data for the Enterprise (page 12) does not reflect differences between the organizations. However, as noted in the Report, lenders may and do require appraisals for their loans beyond the Enterprise automated underwriting system recommendations. Lenders frequently choose to require appraisals to maximize the secondary market choices for their loans.

The Report suggests that use of appraisal management companies (AMCs) by lenders increased in response to higher loan volumes during the mid-2000s, lender expansion into new geographic areas, and appraisal independence requirements. We appreciate that the Report alludes to the fact that neither the HVCC nor the Enterprises' current Appraisal Independence Requirements mandates use of AMCs or any particular means of meeting the independence requirements.

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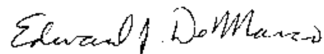
Given increased use of AMCs by lenders and concerns expressed by appraisal industry participants regarding the quality of appraisals produced by AMCs, FHFA understands GAO's recommendation for the agencies identified under the Dodd-Frank Act to consider including certain criteria when developing minimum standards for state registration of AMCs as part of their joint rulemaking. These criteria would include standards for selecting appraisers for appraisal orders, review of completed appraisals and qualifications for appraisal reviewers. FHFA agrees with the GAO's recommendation that the joint rulemaking process with the banking agencies should consider the areas cited by the GAO.

Thank you again for the opportunity to comment on this study. If you have any additional questions, please contact me or Alfred Pollard at (202) 414-3788.

Sincerely,



Edward J. DeMarco
Acting Director

Appendix VII: GAO Contact and Staff Acknowledgments

GAO Contact

William B. Shear, (202) 512-8678 or shearw@gao.gov

Staff Acknowledgments

In addition to the individual named above, Steve Westley (Assistant Director), Don Brown, Marquita Campbell, Anar Ladhani, John McGrail, Marc Molino, Erika Navarro, Jennifer Schwartz, and Andrew Stavisky made key contributions to this report.

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