

(Still) Seeking Appraisal Independence

By Dena G. Patel

Twenty years ago, borrowers could engage an appraisal on a property they hoped to purchase or refinance and forward it to their lender together with their application to obtain credit. That practice often led to overinflated values and artificially low LTVs (loan-to-value ratios) that were largely responsible for the collapse of the real estate markets and resulting financial institutions failures of the late 1980s. In an effort to avoid future real estate crises, Congress intervened and passed the Financial Institutions Reform and Recovery Act (FIRREA) of 1989 that mandated that the federal banking regulatory agencies adopt regulations that preserve independence in the appraisal process.

Nearly a generation later, history has repeated itself. Ironically, despite regulations that were intended to extract not only borrowers but also loan production staff from the appraisal selection and engagement process, appraisals engaged by financial institutions or their agents have continued to be inflated. Once again, financial institutions have underwritten to artificially low LTVs and those practices have contributed to the mortgage crisis and economic woes of today.

Volume Appetite Leads to Appraiser Pressure

During the protracted boom years, it seemed unnecessary if not impossible to look beyond the horizon to project less favorable conditions. While property values were skyrocketing year after year, the only risk perceived by some lenders seemed to be the opportunity cost of lending less than the maximum allowable by the lender's underwriting policies or those imposed by regulatory guidelines.

Lenders' insatiable appetite to book business, and consumer willingness to assume more and more debt, combined with lush market liquidity to create a uniquely competitive environment. Financial institutions of various types all subject to differing, if any, standards and regulation placed pressure on appraisers to maximize market values in an effort to get deals done.

Does that mean that appraisers were forced to lie or commit fraud? Not necessarily, but many appraisers have expressed frustration with the conundrum of consequences, including

withholding payment for services or blacklisting by the lender if they don't hit expected values necessary to underwrite loans.¹

Uneven Regulatory Oversight

Collectively, five government agencies² oversee the universe of federally regulated financial institutions. These agencies formulate and publish joint interagency regulations and guidelines in an effort to create a level playing field for the majority of financial institutions. However, even among financial institutions subject to federal oversight, differences in supervisory processes and interpretation of interagency policy guidelines can and do result in a variety of lending and collateral valuation practices. Regulatory heavy-handedness can seem unnecessary when financial institutions' asset quality and profits are strong even if internal appraisal review processes or internal audit functions are weak. However, in a lending environment characterized by ever-increasing market values, the most liberal of lending practices tend to set a low bar for market competitors to follow thereby initiating a race to the bottom.

Exacerbating the competitive issue even further is the role that non-regulated financial institutions play in the competitive marketplace. Many of these entities adhere to liberal lending practices in part because they are not subject to similar standards of regulation. However, these entities can and do play active roles as correspondents and/or brokers in federally related transactions. In fact, federal regulations explicitly allow sharing of appraisals between regulated and non-regulated institutions. Intended to foster portability of appraisals, reducing cost to borrowers and burden to financial institutions, the provision has often resulted in promoting the use of inflated appraisals in which independence in the engagement process has been compromised.

Ineffective State Licensing Framework:

The framework developed by Congress for the oversight of appraiser qualifications and credentialing of appraisers, as well as the standards provided in the Uniform Standards of Professional Appraisal Practice (USPAP) is imperfect. Appraisers are licensed in the states in which they do business so ideally the states' programs should have the necessary infrastructure to investigate claims of unethical practices and issue appropriate sanctions. Unfortunately, lack of resources in many states results in a delayed or nonexistent practice of complaint investigation which, in turn, results in lack of enforcement.

¹ A 2007 Chief Appraiser Survey published by Allterra Consulting Group, LLC indicated that 95% of survey responders believe that an appraisal independence problem exists in the industry today.

² Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration.

To make matters worse, federal oversight over state appraiser programs envisioned by FIRREA allows for only a single supervisory response. The Appraisal Subcommittee, a federal agency, regularly examines the effectiveness of states' appraisal programs, but is empowered with but one enforcement option to inspire effectiveness in a weak state program. Should it ever be used, non-recognition of a state's program is a draconian measure that would likely result in devastating consequences for consumers, lenders, credentialed appraisers and regional economies.

Reform

A steady stream of proposals detailing appraisal reform has been advocated by various industry stakeholders over the years, but few effective changes have resulted. Most recently, an agreement among each of the two mortgage finance giants (Fannie Mae and Freddie Mac), their regulator, the Office of Federal Housing Enterprise Oversight and the New York Attorney General's Office referenced a Home Valuation Code of Conduct that promotes stricter independence standards for lending institutions. The Home Valuation Code of Conduct, if adopted as proposed during a recent public comment period, would alter practices for appraisal engagements on properties supporting transactions delivered for sale to either Fannie Mae or Freddie Mac.

The proposed Home Valuation Code of Conduct is the latest attempt to promote independence in the appraisal process by conditioning secondary market acceptance on stricter standards that have existed or been enforced in the past. Should the catalyst for reform have been the responsibility of one state attorney general? Probably not, but recognition of a flawed system and heightened attention may be the first of many steps needed for reform. Twenty years or so from now when real estate markets exhibit another inevitable down cycle, let's hope this lesson will have been learned.

Ms. Patel serves AVMetrics, LLC as Regulatory Compliance Director. She is also a principal of Valuation Guidance, LLC, a provider of advisory and consulting services to the financial services industry concerning real estate collateral valuation. She is a former examiner and credit risk specialist with the Office of the Comptroller of the Currency (OCC) in Washington, DC. During her tenure with the OCC, she formulated and implemented policies in the area of real estate lending and collateral valuation that promoted safe and sound banking practices for national banks.