

**GAO**

Report to the Chairman, Subcommittee  
on Housing and Community Opportunity,  
Committee on Banking and Financial  
Services, House of Representatives

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July 1997

# HOMEOWNERSHIP

## Information on Changes in FHA's New Single-Family Appraisal Process



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**Resources, Community, and  
Economic Development Division**

B-277088

July 25, 1997

The Honorable Rick A. Lazio  
Chairman, Subcommittee on Housing  
and Community Opportunity  
Committee on Banking  
and Financial Services  
House of Representatives

Dear Mr. Chairman:

Since December 1994, private mortgage lenders making single-family mortgage loans insured through the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) have been able to select any licensed or certified appraiser listed on FHA's roster to determine the value of homes. Before December 1994, appraisers (referred to as FHA fee panel appraisers) were assigned to lenders by FHA to appraise such properties.<sup>1</sup> Appraisals have an influence on the amount of the mortgage loan, and if a borrower defaults and the loan is subsequently foreclosed, lenders can recover losses from FHA, including the unpaid principal balance of the loan. According to some former FHA fee panel appraisers, allowing lenders to select appraisers has resulted in exposing FHA to greater financial risks because some of the appraisals now being performed are incomplete, inaccurate, and favorable to the lender.

Because of these concerns, you requested that we obtain information on FHA's appraisal process. Specifically, you asked us to provide information on (1) how appraisals of FHA-insured single-family homes were assigned before December 1994, who assigned appraisal work, and why the appraisal assignment process changed; (2) what the reactions to this change have been from the affected parties—former FHA fee panel appraisers, FHA, and FHA lenders; and (3) what problems have been identified by HUD since the implementation of the new appraisal assignment process. As requested by your office, we spoke with 12 former FHA fee panel appraisers to discuss their concerns about the new process. However, as agreed with your office, we did not attempt to verify any allegations of the former fee panel appraisers.

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<sup>1</sup>After December 1994, the number of appraisers selected by lenders began increasing, and by January 1996, most FHA appraisals were being performed by lender-selected appraisers.

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## Results in Brief

Prior to December 1994, houses that were being appraised for FHA-insured home loans were appraised by FHA fee panel appraisers who were assigned on a rotational basis to lenders, and, in turn, lenders paid the fee panel appraisers for their services.<sup>2</sup> HUD's field offices had approximately 6,000 FHA fee panel appraisers to conduct the appraisals. Legislation was enacted in 1990 that allowed FHA's single-family lenders rather than FHA to choose the appraisers of properties whose loans were to be insured by FHA.<sup>3</sup> HUD implemented the legislation in December 1994. According to its history, this legislation was enacted to (1) improve the efficiency of FHA lenders who would no longer have to rely on HUD's field office staff to assign appraisers and (2) improve the quality and reliability of appraisal services for HUD's mortgage assistance and other housing programs by promoting uniform eligibility standards for those performing federal appraisals. In January 1996, FHA informed its lenders that effective March 1, 1996, they had to select appraisers from FHA's roster of about 31,000 state-licensed or -certified appraisers. HUD also allowed lenders to use their in-house appraisers if they were on the roster and assigned by the lender.

We found opinions in both opposition and support of allowing FHA lenders to select appraisers. Those most directly affected by the change, such as the 12 former FHA fee panel appraisers, were particularly opposed to the change, charging that the appraisals now being performed were inaccurate, incomplete, or favorable to lenders. HUD's Office of the Inspector General is reviewing the information provided by the former FHA fee panel appraisers to determine if an investigation is warranted. FHA's appraisal manager and four FHA lenders cited, among other things, improved timeliness and quality of appraisals and a decrease in the number of HUD field office staff needed to administer the appraisal process as the reasons they support allowing lenders to select appraisers.<sup>4</sup> The appraisal manager also said that factors such as unprofessional conduct by some prior fee panel appraisers, fewer FHA properties needing appraisals, and an increase in the number of appraisers on FHA's roster as the reasons for the decrease in lenders' hiring of former fee panel appraisers.

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<sup>2</sup>FHA's policy at that time also allowed in-house appraisers employed by lenders to conduct appraisals. However, most appraisals made before December 1994 were conducted by fee panel appraisers.

<sup>3</sup>Section 322 of the Cranston-Gonzalez National Affordable Housing Act, 1990, amended section 202(e) of the National Housing Act, allowing lenders to choose the appraisers of property to be insured by FHA.

<sup>4</sup>The four FHA lenders we contacted are among the largest FHA loan originators in California, Colorado, Virginia, and Maryland.

HUD has identified two problems—the lack of reviews for completed appraisals by staff in some HUD field offices and the decline in the number of women and minority appraisers selected by lenders—since the implementation of the new appraiser selection process. The lack of appraisal review surfaced when a private accounting firm hired by HUD to conduct a financial audit of the agency reviewed HUD’s Los Angeles field office’s appraisal process as part of that audit. We also reported on similar problems with reviews of completed appraisals by HUD’s Los Angeles field office in February 1991.<sup>5</sup> The accounting firm found that the Los Angeles field office had not performed any required field reviews of completed appraisals in fiscal year 1996. The purpose of appraisal reviews is to, among other things, verify the accuracy and reasonableness of the appraisers’ property valuations; rate appraisers; and ensure that appraisals comply with administrative, statutory, and regulatory requirements. FHA’s appraisal manager agreed with the finding and cited a lack of staff to perform the reviews as the cause of the problem. In December 1996, the manager indicated to the accounting firm that FHA was looking into the possibility of contracting out the review function. In addition, FHA’s records show that 6 other HUD field offices among its 81 offices had conducted few or no field reviews of completed appraisals from October 1, 1996, to June 20, 1997. In June 1997, FHA officials told us that while agency instructions require field offices to conduct some field and desk reviews of completed appraisals, the agency no longer requires that a specific percentage of the appraisals be reviewed by field offices.

The other problem identified by HUD since the implementation of the new appraisal process is that women and minority appraisers are not being selected to perform a proportionate number of FHA appraisals. In response to this problem, HUD’s Assistant Secretary for Housing-Federal Housing Commissioner in a July 1996 letter to FHA lenders requested that they review their appraiser assignment process to ensure that women and minority appraisers receive a fair share of the appraisal assignments commensurate with their representation on the appraisers’ roster. HUD is currently reviewing various strategies aimed at resolving this problem.

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## Background

The National Housing Act (12 U.S.C. 1709) authorizes FHA to insure mortgage loans made by private lending institutions to buyers of single-family homes. The amount that FHA can insure is based, in part, on the appraised value of the home. The maximum loan amount permitted

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<sup>5</sup>Federal Housing Administration: Monitoring of Single-Family Mortgages Need Improvement (GAO/RCED-91-11, Feb. 7, 1991).

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under FHA's program for single-family homes in the highest-cost areas of the continental United States is currently set at \$160,950. If a borrower with an FHA-insured mortgage loan defaults, the lender may foreclose on the loan and collect nearly all of the losses from FHA.<sup>6</sup> Losses generally include the unpaid principal balance of the loan, delinquent interest due on the loan, and legal expenses incurred during foreclosure.

In 1983, FHA implemented the Direct Endorsement Program, which authorized FHA-approved lenders to underwrite loans without FHA's prior approval. HUD authorizes a direct endorsement lender to execute all phases of an FHA mortgage. Almost all of FHA's single-family mortgages today are provided by direct endorsement lenders. Underwriting usually includes determining the borrower's ability to repay the loan and performing appraisals, which establish the value of the property to be mortgaged.

Prior to December 1994, FHA did not require fee panel appraisers to be licensed by states. However, to perform FHA appraisals, fee panel appraisers had to meet certain requirements established by FHA concerning their general and specialized experience and attend FHA training courses. In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was enacted, which, among other things, required appraisals performed for federally related real estate transactions to be done by individuals licensed or certified by the state in which they work. This law was in response to a concern in the Congress that poorly conducted or fraudulent appraisals by unlicensed appraisers played a major role in the weakening and collapse of some financial institutions in the 1980s. In addition, the Department of Housing and Urban Development Reform Act of 1989 required that the appraisal of all properties securing an FHA-insured mortgage be performed in accordance with generally accepted appraisal standards and be prepared by a licensed or certified appraiser. Since the states implementation of licensing and certification procedures took until 1994 to complete, FHA did not mandate that appraisers be licensed or certified until December 1994.

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<sup>6</sup>FHA does not allow lenders to recover one-third of their administrative costs and 2 months' delinquent interest.

## Recent Change to FHA's Appraiser Selection Process and the Reasons for the Change

Before December 1994, appraisals for FHA-insured homes were conducted almost exclusively by approximately 6,000 fee panel appraisers. Each of a lender's loans was assigned on a rotational basis to an appraiser from the fee panel maintained by HUD's field office staff. Collectively, the fee panel appraisers conducted about 500,000 to 750,000 FHA appraisals each year, usually at a cost commensurate with the market rate for private appraisals in the area. FHA did not pay the fee panel appraisers; rather, lenders paid the appraisers and charged the cost to the borrowers.

After completing an appraisal, the fee panel appraiser then submitted the results to the lender and the appropriate HUD field office. HUD's field offices were required to review 10 percent of all completed appraisals, including 5 percent of each appraiser's work for mathematical accuracy, reasonableness, logical conclusions, and the adequacy of any adjustments made in determining the appraised value. The results of those reviews were to be used to rate the appraiser's work and identify appraisers who were not adhering to FHA's appraisal guidelines. If an appraiser received at least three "poor" ratings in a 12-month period from the field office for poor-quality work, FHA could remove the appraiser from the panel. According to an FHA official, the cumbersome and time-consuming administrative requirements needed to remove appraisers from performing FHA appraisals resulted in few being removed.

In 1990, legislation was enacted allowing FHA single-family direct endorsement lenders rather than FHA to choose state-licensed or -certified appraisers of properties secured by FHA-insured mortgages. HUD drafted regulations calling for lenders' selection of appraisers while waiting for all 50 states to complete licensing and certification standards for appraisers, as required by FIRREA. In its draft regulations issued on September 16, 1993, HUD specifically requested opinions from the public on this issue. In the final regulations published on October 3, 1994, HUD noted that the law precluded the agency from denying FHA lenders the right to choose appraisers and that responses to the lenders' selection of appraisers were fairly well balanced between support and opposition to the practice. In addition, the regulations continued to allow direct endorsement lenders the right to use in-house appraisers for FHA appraisals. HUD's final regulations were effective December 2, 1994.

FHA established a roster of appraisers from which FHA lenders could select. Between December 1994 and January 1996, FHA approved about 37,000 state-licensed or -certified appraisers nationwide for the roster, including many former FHA fee panel appraisers. During that time, FHA lenders used

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fee panel appraisers and appraisers selected or employed by lenders to perform FHA appraisals. In January 1996, the FHA Commissioner, noting that the vast majority of appraisals were being performed by lender-selected appraisers, directed all FHA lenders that effective March 1, 1996, FHA appraisals had to be performed by appraisers selected from the new roster. In addition, FHA allowed lenders to continue to use appraisers who worked exclusively for them if they were listed on the roster and chosen by the lenders for each case.

There were various reasons why the change to lenders' selection of appraisers was made. The conference report on the legislation proposing FHA lenders' selection of appraisers states that the conferees believed the legislation would improve the efficiency of FHA lenders because they would no longer have to rely on HUD's field office staff to assign appraisers. The conferees believe it would also improve the quality and reliability of appraisal services for HUD mortgage assistance and other housing programs by promoting uniform eligibility standards for those performing federal appraisals.

In addition, according to FHA's appraisal manager, other reasons contributed to the change in the method used to select FHA appraisers. First, the number of staff in HUD's field offices had been reduced and the remaining staff had difficulty assigning, maintaining, and monitoring the fee panel appraisers. FHA believed that devolving this responsibility to lenders freed its field office staff to perform other duties. Second, FHA wanted to privatize some of its functions, and since lenders were already adept at selecting appraisers for their conventional home loans, transferring the responsibility of selecting FHA appraisers to them seemed reasonable. Third, according to FHA's appraisal manager, some lenders complained to HUD and Members of Congress about the personal and professional conduct of some fee panel appraisers assigned by FHA's field offices. The appraisal manager told us that FHA and its lenders believed that some fee panel appraisers acted unprofessionally because once approved as FHA appraisers, they were guaranteed work from FHA and did not have to market themselves to lenders or compete with other fee panel appraisers for work.



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## Views of Former Fee Panel Appraisers on Lenders' Selection Differs From Those of FHA and Its Lenders

The 12 former FHA fee panel appraisers that we spoke with were strongly opposed to allowing FHA lenders to select appraisers because they believe that some of the appraisals now being performed are incomplete, inaccurate, and favorable to lenders. However, FHA and the four lending officials we contacted believe that lenders' selection has been beneficial to them by improving the timeliness and overall quality of FHA appraisals and by eliminating a burdensome administrative task from HUD's field office staff.

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## Former FHA Fee Panel Appraisers Allege That FHA Lenders Are Selecting Appraisers Who Provide Inaccurate or Incorrect Valuations

The 12 former FHA fee panel appraisers from Ohio, New Jersey, Michigan, Texas, and the District of Columbia that we spoke with allege that some FHA lenders are selecting appraisers who are not accurately reporting the value and physical condition of the homes they assess. According to the former fee panel appraisers, they and their colleagues were told by FHA lenders that as a condition of employment, they will have to provide property valuations specified by the lenders or ignore defective conditions in the properties. The former fee panel appraisers believe that if left uncorrected this situation will result in increased financial risk to FHA if borrowers default on their mortgage loans. They also believe that with inaccurate reporting on the physical condition of homes, borrowers will not know the extent and cost of needed home repairs. The former fee panel appraisers wrote to HUD and Members of Congress with their concerns in 1996 and 1997, and, in response, HUD requested that they provide the information on wrongdoing between FHA lenders and appraisers to the agency. HUD's Office of the Inspector General is reviewing the information provided by the former FHA fee panel appraisers to determine if an investigation is warranted.

The former fee panel appraisers also noted that some of the new appraisers on FHA's roster are providing incorrect or inaccurate property valuations because they are not familiar with FHA's minimum standards for appraising properties. The former fee panel appraisers told us that prior to the lenders' selection of appraisers, fee panel appraisers were required to attend at least four FHA-sponsored training sessions a year. However, new applicants for the roster are required only to read FHA's procedures on appraisals and sign a document stipulating they have read the information before being listed on the roster. The former FHA fee panel appraisers told us they want the Congress to repeal the 1990 law, which allows FHA lenders to select appraisers and return to a system in which FHA would rotationally select a limited number of appraisers.

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In addition, the former fee panel appraisers, many of whom also perform appraisals for home loans guaranteed by the Department of Veterans Affairs (VA), expressed concern that legislation will be changed to allow VA lenders the right to choose appraisers and that this change will lead to the same abuses and problems they claim to have observed in FHA's appraiser selection process. Currently, legislation requires VA's appraisers to be rotationally assigned to lenders by VA's field office staff. (See app. I for a discussion of VA's appraisal process.)

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## FHA Supports Lenders' Selection of Appraisers

FHA's appraisal manager stated that FHA supports allowing lenders to select appraisers for homes purchased with FHA-insured loans, reiterating the reasons he provided on why the legislative change was made. Namely, he believes that lenders' selection has simplified and quickened FHA appraisals because lenders no longer have to contact a HUD field office to obtain an appraiser each time an appraisal is needed. According to the appraisal manager, consumers benefit from the new appraiser selection process by having appraisals performed faster, which will allow closing to occur sooner. Also, lenders' selection has eliminated the need for understaffed field offices to manage the fee panel appraisers, allowed FHA to privatize one of its processes, and resolved the problem of some fee appraisers' behavior.

The appraisal manager said that he is not surprised that some former FHA fee panel appraisers are not receiving the volume of appraisals they once did, but he doubted the reason was wrongdoing by lenders and appraisers, as claimed by the former fee appraisers. Rather, the manager attributed the decrease in appraisal work to a general decline in lenders' need for their services and the large group of appraisers from which lenders can now select. For instance, the official said that the number of home loans being insured by FHA that required appraisals decreased from about 765,000 in 1994 to approximately 577,000 in 1995, while the number of appraisers eligible to perform FHA appraisals increased from about 6,000 to about 31,000. In addition, the appraiser manager said that FHA always informs buyers that the appraisal is not an inspection. In fact, FHA mandates that borrowers be given notice of "Importance of Home Inspections," which must be signed by borrowers on or before the date of the sales contract.

In commenting on this report, the FHA Commissioner stated that although some former fee panel appraisers have alleged that some appraisers have performed poorly, either by design or due to a lack of skills and

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understanding of HUD's procedures, no statistical or other basis exists for concluding that the appraisal system is flawed.

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### FHA Lenders Like Being Able to Select Appraisers

The officials we contacted at four of the largest (in terms of lending activity) FHA lenders in California, Colorado, Virginia, and Maryland indicated that being able to select appraisers reduces the amount of time it takes to obtain an appraisal because they no longer have to wait until an appraiser is assigned to them by HUD's field offices. In addition, the lenders told us that the quality of the appraisal work performed by the former fee panel appraisers varied and that being able to select appraisers for FHA cases generally ensures more professional results than if appraisers are assigned to them.

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### Problems Identified by HUD Since the Implementation of the New Appraiser Selection Process

HUD has identified two problems since the implementation of the new appraiser selection process. A review of FHA's appraisal operations by a private firm hired by HUD found that a HUD field office was not implementing required internal control procedures over the quality of appraisals made in its jurisdiction. In addition, FHA's internal review of information received from FHA lenders showed that women and minority appraisers are not obtaining work assignments from lenders under the new selection process in the same proportion they did when FHA assigned appraisers.

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### Problems With Field Reviews of Appraisals in Some HUD Field Offices

A 1996 audit of HUD's Los Angeles field office by the firm of KMPG Peat Marwick under a contract with HUD found that the office had not conducted any field reviews of completed appraisals during fiscal year 1996. HUD usually requires an on-site review of its processes and procedures at least at 1 of its 81 field offices as part of the annual financial audit of the agency. Field office reviews of completed appraisals are essential to ensure that appraisals comply with statutory, regulatory, and administrative requirements. The results of such reviews are used by FHA to rate appraisers and identify FHA lenders with deficient appraisal practices that warrant close monitoring. In response to the audit finding, field office management cited insufficient staff to perform the reviews and monitor lenders. FHA's appraisal manager indicated in December 1996 that the FHA field office might contract out for the appraisal review function. In addition, FHA's records showed that six other HUD field offices conducted few or no field reviews of completed appraisals during the period October

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1, 1996, to June 20, 1997 (four offices reviewed 1 percent or fewer of the completed appraisals, and two offices performed no reviews).

However, in June 1997, FHA officials told us that while agency instructions require field offices to conduct some field and desk reviews of completed appraisals, the agency no longer requires that a fixed percentage of the appraisals made be reviewed by field offices. In addition, according to the appraisal manager, few HUD field offices require a percentage of completed appraisals to be reviewed, but the majority of field offices do review some percentage of the appraisals made. Although field reviews of completed appraisals were not conducted by all HUD's field offices, FHA's records showed that all of the field offices conducted desk reviews of some completed appraisals.<sup>7</sup> It should be noted that this problem is not a result of lenders' selection of appraisers.

In the past, we reported a similar problem involving HUD's review of completed appraisals in its Los Angeles field office. In our February 1991 report on the agency's monitoring of single-family mortgages, we reported that HUD's Los Angeles field office lacked documentation of supervisory desk reviews of appraisals for either FHA-processed loans or direct endorsement loans. In response to our audit findings, HUD acknowledged that the failure of field offices to document their actions limits the agency's ability to track performance or evaluate program monitoring, and indicated that it was committed to more effective documentation of monitoring compliance. HUD indicated that the Los Angeles field office would develop logs to document and track the results of future reviews, and the office has done so.

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## Women and Minority Appraisers Are Not Being Proportionately Selected by FHA Lenders

Comments received by HUD on its draft regulations on FHA lender selection of appraisers included concerns that women and minority appraisers would obtain significantly fewer appraisal assignments from FHA lenders than they did when FHA selected appraisers. HUD responded to this concern in a November 1994 letter to all FHA lenders, which stated that the agency expected that lenders would affirmatively select appraisers from these two groups for a fair share of appraisals.

HUD uses a specially designed computer system called Computer Homes Underwriting Mortgage System (CHUMS) to collect descriptive data of FHA-approved appraisers, such as their state license or certification

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<sup>7</sup>Desk reviews are performed by HUD staff who check that appraisals submitted to the field office are properly performed and accurately reflect the value of the house.

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number, sex, and racial background to monitor lenders' selections. In mid-1996, HUD conducted an analysis of the lender and appraiser information in CHUMS after receiving complaints that women and minority appraisers were not being selected by some lenders. HUD's analysis showed that the shares of FHA's appraisal work going to women and minorities were not in proportion with their representation on FHA's roster of appraisers since lenders' selection was mandated by HUD. In response, the FHA Commissioner, in a July 1996 letter to all FHA lenders, requested that they review their appraiser assignment process to ensure that women and minority appraisers be given a fair share of appraisal assignments commensurate with their representation on FHA's roster. The Commissioner also offered to assist FHA lenders in identifying women and minority appraisers on the roster who can be selected for appraisal work and indicated that HUD will continue to use CHUMS to monitor lenders' choice of appraisers and the sex and race of appraisers who are chosen.

In commenting on a draft of this report, the FHA Commissioner stated that in addition to the actions already taken to eliminate this problem, FHA is working to develop additional means by which to remedy the problem. In addition to increasing lenders' awareness and sensitivity to the matter, HUD plans to refine its computer tracking system to provide data on a local rather than national basis. This action will allow HUD to focus its attention on specific problem areas, even if the problem is not apparent on the national level.

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## Conclusions

While current procedures that require state licensing and certification of appraisers and lender quality assurance programs may help reduce financial risks to FHA, verification of appraisers' valuations of properties would help to protect against fraud, waste, and mismanagement. Although FHA requires field offices to perform field and desk reviews, a key control over the quality of appraisals made on properties it insures—requiring a stated percentage of field and desk reviews of some completed appraisals—was eliminated because of staffing reductions. As a result, while most HUD field offices have conducted some field reviews of completed appraisals, others have conducted few or no reviews. In the absence of an agency mandate to review a specific percentage of completed appraisals, there is no assurance that appraisals comply with statutory, regulatory, and administrative requirements. Also, no assurance exists that FHA can monitor the quality of appraisers and identify FHA lenders with deficient appraisal practices.

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## Recommendations to the Secretary of HUD

To reduce the financial risks assumed by FHA, we recommend that the Secretary of HUD reestablish a requirement that each HUD field office responsible for overseeing appraisals randomly select a specific percentage of completed FHA appraisals for field and desk review by either HUD staff or a licensed or certified appraiser who is not a member of FHA's roster of appraisers for lenders' selection. In addition, we recommend that the Secretary of HUD establish a process to ensure that such field offices meet this appraisal review requirement.

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## Agency Comments

We provided HUD and VA with a draft of this report for their review and comment. We received written comments on the draft report from HUD. (See app. II.) In addition, VA's Assistant Director for Construction and Valuation provided us with changes that clarified information contained in the report, which we incorporated.

HUD concurred with our recommendation that each HUD field office responsible for overseeing appraisals randomly select a specific percentage of field appraisals for field and desk review. HUD stated that in fiscal year 1998, its field offices will be required to perform field and desk reviews on no less than 10 percent of the mortgage loans underwritten within their jurisdictions. With regard to field reviews, HUD noted that they may be conducted by HUD staff or by qualified appraisers working for FHA on a contractual basis and that appraisers under contract with HUD are ineligible to perform appraisals for FHA lenders. HUD did not comment on our recommendation that it establish a process to ensure that each field office meet the appraisal review requirement.

HUD pointed out that its latest report shows that during the period October 1, 1996, to June 20, 1997, 7.8 percent of all appraisals made were field reviewed, and all such reviews were made within 45 days of the completion of the appraisals. HUD also pointed out that during the same period, all HUD field offices had performed some desk reviews of completed appraisals. In total, 9.3 percent of all appraisals performed were desk reviewed, and on a rating system of 1 to 5, appraisers received an overall performance rating of 4.59.

On the basis of the scope and extent of the above field office activities and the overall performance ratings achieved by lenders, to date, HUD stated it was satisfied that no significant problems exist with the appraisal process. Also, the experience of its Los Angeles field office is clearly the exception and not the norm, according to HUD. HUD stated that nevertheless, FHA has

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decided to enhance its current appraisal review process in fiscal year 1998 in line with our recommendation that its field offices randomly select a specific percentage of field appraisals to be field and desk reviewed.

Regarding HUD's comment that the experience of its Los Angeles field office is clearly the exception and not the norm, it should be noted that other HUD field offices performed few or no field reviews of completed appraisals. As discussed in our report, two other HUD field offices in addition to the Los Angeles office had not performed any field reviews of completed appraisals in fiscal year 1997 as of June 20, 1997, and four other offices reviewed 1 percent or fewer of the completed appraisals.

HUD also stated that under the current appraisal system, lenders, in making their own selections, have not selected women and minority appraisers in sufficient numbers. In addition to the corrective actions outlined in our report, HUD pointed out that it was developing additional means by which to remedy the problem. The additional actions being taken by HUD have been incorporated in the report.

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## Scope and Methodology

To describe FHA's appraisal process and the reasons why it was changed, we reviewed legislation, including the National Housing Act; the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and the Cranston-Gonzalez National Affordable Housing Act. We also reviewed FHA's appraisal-related policies, procedures, and memorandums on agency requirements; reviewed the goals and guidelines for FHA lenders, appraisers, and appraisals; and interviewed HUD and VA officials who are responsible for each agency's appraisal policies.

As requested by your office, we contacted 12 former FHA fee panel appraisers who raised complaints to obtain their reactions to FHA lenders' selection of appraisers. We also contacted FHA headquarters officials; four FHA lenders—three of whom are among the largest FHA lenders in their states and the other who is the largest FHA lender nationwide; and a headquarter's official with the Department of Veterans Affairs. In addition, we examined trade association literature and other industry documents related to this issue. We did not attempt to verify the claims made by the former fee panel appraisers.

Our information on the problems identified by HUD since the implementation of the new appraiser selection process was obtained through interviews with FHA officials in charge of the process and the

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manager of HUD's financial audit and by reviewing KMPG Peat Marwick's report of audit findings for HUD's Los Angeles field office and prior reports of our office. We performed our work from December 1996 through June 1997 in accordance with generally accepted government auditing standards.

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Please call me at (202) 512-7631, if you or your staff have any questions. Major contributors to this report were Robert S. Procaccini and Phillis Riley.

Sincerely yours,

A handwritten signature in cursive script that reads "Judy A. England-Joseph".

Judy A. England-Joseph  
Director, Housing and Community  
Development Issues



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# The Department of Veterans Affairs' Appraisal Process

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The Department of Veterans Affairs (VA) provides assistance to qualified veterans, their families, and certain active duty military personnel by partially guaranteeing mortgage lenders against financial loss if a loan is foreclosed. VA is required by law (38 U.S.C. section 3731) to rotationally select and assign an appraiser from a list of VA-approved appraisers to perform an appraisal of a property for a lender whose borrower is seeking a VA loan. Prior to December 1994, both FHA and VA assigned fee appraisers to lenders and, under a reciprocity agreement, accepted each other's valuation of the same property to reduce paperwork, simplify the appraisal process, and avoid duplication of effort. When FHA implemented regulations that terminated FHA's assignment of fee appraisers, VA could no longer legally use appraisals prepared by FHA lender-selected appraisers.

According to a VA official in charge of appraisals, some lenders and other program participants have complained to the agency and Members of the Congress about the loss in reciprocity of value determinations and the expense and time it takes to have both a VA and FHA appraisal performed on the same property. Also, VA lenders want the Congress to repeal VA's legislation to remove the rotational assignment constraint, which would then allow VA to give lenders the same choice now permitted to FHA lenders. The official also said that some VA appraisers do not want the law changed to allow lenders' selection because they believe the problems alleged by former FHA appraisers with FHA's new appraisal process will occur for VA home loans. The VA official pointed out that legislation to change VA's appraiser selection process has not been introduced and that VA did not have an official position on this issue as of June 1997.

# Comments From the Department of Housing and Urban Development



U. S. Department of Housing and Urban Development  
Washington, D.C. 20410-8000

JUN 30 1997

OFFICE OF THE ASSISTANT SECRETARY  
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Ms. Judy England-Joseph  
Director  
Housing and Community  
Development Issues  
General Accounting Office  
441 G Street, NW - Room 2056  
Washington, DC 20548

Dear Ms. England-Joseph:

Thank you for the opportunity to meet and to comment on the draft audit report concerning the Single Family Appraisal Process. Enclosed are the Office of Housing's written responses to the draft. Jim Schoenberger or Eliot Horowitz are available to assist you or your staff, should you require additional information.

Sincerely,

A handwritten signature in black ink, appearing to read "Nicolas P. Retsinas".

Nicolas P. Retsinas  
Assistant Secretary for Housing-Federal  
Housing Commissioner

Enclosure

**GAO REPORT:**

**Homeownership: Information on Changes in FHA's New Single-Family Appraisal Process**

In its review of the FHA Single-Family Appraisal process, GAO concluded that while current appraisal procedures help to reduce financial risks to FHA, "verification of appraisers valuations of property would help to protect against fraud, waste, and mismanagement." GAO recommended that HUD establish enhanced requirements for Field Office reviews of lenders' appraisals.

Also, although not the subject of a recommendation, GAO's report also noted that, under the current system, women and minority appraisers are not being proportionately selected by FHA lenders.

This response addresses these two issues in turn.

**(1) An enhanced review process:** Under the current appraisal process, lenders are free to select qualified appraisers, i.e., appraisers that are duly licensed or certified by states. Although some former fee appraisers have alleged that some appraisers have performed poorly, either by design or due to a lack of skills and understanding of HUD procedures, no statistical or other basis exists for concluding that the appraisal system is flawed. Nonetheless, HUD agrees that a review process is necessary to ensure the integrity of the process. Notably, HUD has never stopped the HUD appraisal review process. In past years, Headquarters identified this function as one that Field staff must treat as among the highest priorities (i.e., a function identified in the Office's Management Plan Goal). The function is not currently a Management Plan Goal. Nonetheless, Field Offices are still required to conduct appraisal reviews and, as discussed below, they are doing so. While HUD's current review process has proven adequate, HUD plans to enhance the review process in Fiscal Year 1998.

FHA Field Offices are currently required to routinely conduct reviews of lenders' appraisals (reviewing a sampling of appraisals performed within the local jurisdictions). The nature of these reviews falls into two categories. The first is a "desk review", the second, a "field review".

**(a) Desk Reviews:** Under the desk review process, a lender's paperwork is assessed by HUD staff to assure that quality underwriting, including appraisals, is achieved. Between October 1, 1996 and June 20, 1997 (FHA's latest cumulative reporting period), every FHA Field Office performed desk reviews. During this period, 9.3 percent of all appraisals performed were desk reviewed. On a rating system of one to five, appraisers received an overall appraiser performance rating of 4.59.

A desk review, standing alone, (i.e., in the absence of a field review), is often sufficient to alert a HUD reviewer to the quality of an appraisal. For example, the reviewer can determine whether the appraiser has used appropriate comparables (i.e., housing of similar ilk), and whether the

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**Appendix II  
Comments From the Department of Housing  
and Urban Development**

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comparables reflect recently sold homes. While a desk review isn't likely to uncover a fraudulent appraisal, it is a meaningful tool for assessing the quality of an appraisal and the competence of an appraiser.

**(b) Field Reviews:** A field review is an on-site review of the property that has been appraised. When an appraisal is selected for a field review, the review is routinely conducted within 45 days of the time the lender's appraisal was performed. FHA's latest Field Review report (October, 1996 through June 20, 1997), reveals that 7.8 percent of all appraisals performed were field reviewed. Moreover, these reviews were all conducted within the prescribed 45 day period.

**(c) Enhanced Review Procedures:** Based upon the scope and extent of the above Field Office activities, and the overall performance ratings achieved by lenders, to date, HUD is satisfied that no significant problem exists with the appraisal process. Also, the experience of the Los Angeles Field Office, cited by GAO, is clearly the exception and not the norm. All of this notwithstanding, FHA has decided to enhance its current appraisal review process in Fiscal Year 1998.

In Fiscal Year 1998, Field Offices will be required to perform desk reviews, including appraisal reviews, on no less than 10 percent of the mortgage loans underwritten within their jurisdictions. Secondly, this requirement shall be made a component of the Single-Family Housing Office's "Management Plan Goal". Management Plan goals are those that the Office of Housing identifies as its highest priority workload items in each fiscal year. Office managers are not relieved of their other, numerous responsibilities, but they must focus their efforts on achieving the goals in the management plan. Thus, elevation of the desk review process to a management goal, coupled with the new, 10 percent review threshold, should further assure that the appraisal process is working efficiently.

Although the conduct of field reviews shall not be elevated to Management Goal status, Field Offices will be required to perform field reviews on no less than 10 percent of the appraisals conducted within their jurisdictions. These reviews may be conducted by HUD staff or by qualified appraisers working for FHA on a contractual basis. (Appraisers under contract with HUD are ineligible to perform appraisals for FHA lenders).

**(2) Selection of minority and women appraisers:** Under the system that preceded the current appraisal system, HUD-approved appraisers were assigned to lenders on a rotational basis. Consequently, there was no issue concerning whether minority and women appraisers were selected in sufficient, "proportionate", numbers. Under the current system, lenders, in making their own selections, have not selected women and minority appraisers in sufficient numbers. As noted by GAO, HUD has already taken actions designed to eliminate this problem. At this time, FHA is working with HUD's Office of Fair Housing and Equal Opportunity to develop additional means by which to remedy the problem. In addition to increasing lender awareness and sensitivity to the matter, HUD plans to refine its computer tracking system to provide data on a local rather than national basis. This action will allow HUD to focus its attention on specific problem areas, even if the problem is not apparent on the national level.

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