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BANK AND THRIFT REGULATION

Observations on Proposed Changes To Appraisal Requirement

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BANKS AND THRIFT REGULATION:
Observations On Proposed Changes to Appraisal Requirements

SUMMARY OF STATEMENT BY HELEN H. HSING, ASSOCIATE DIRECTOR
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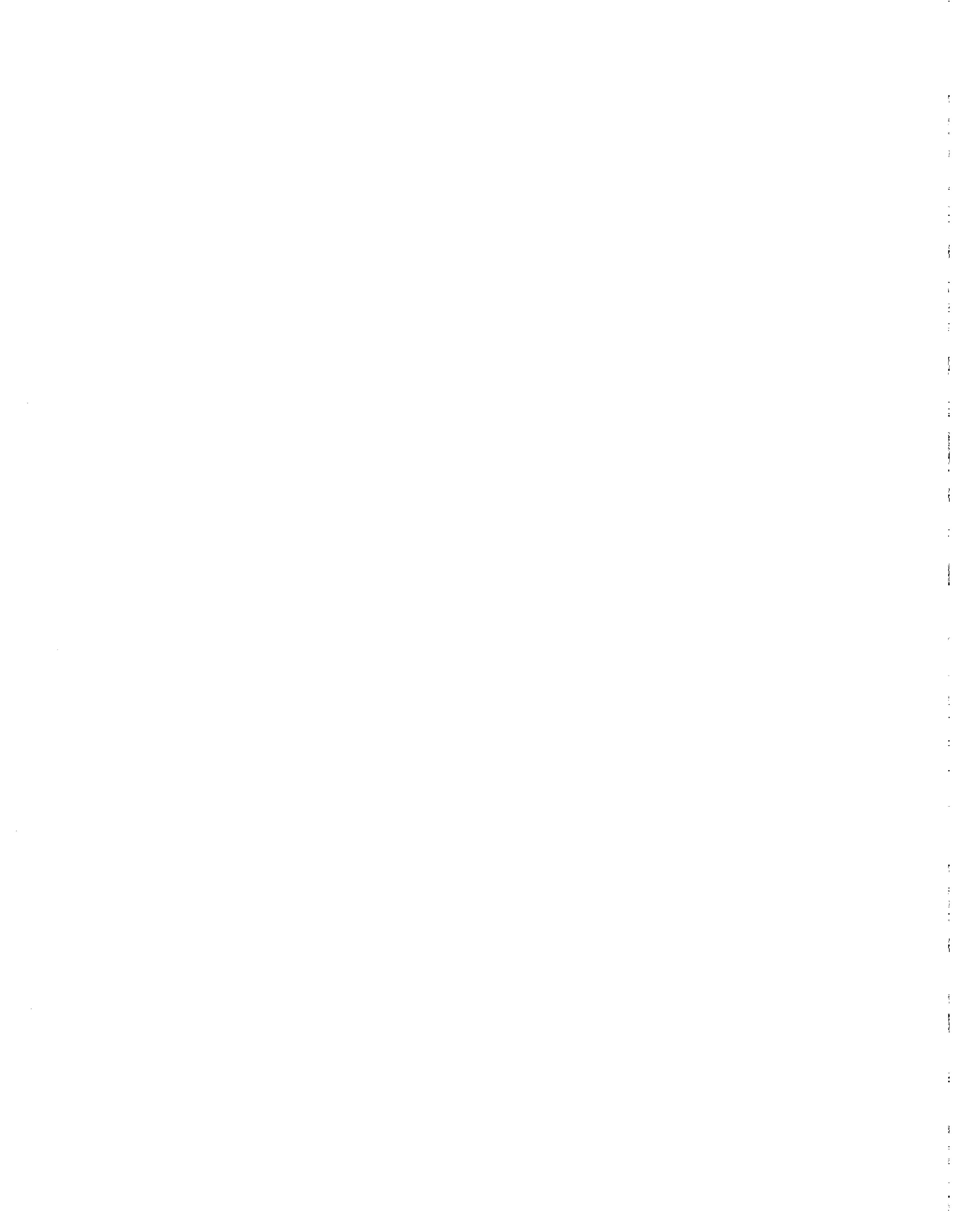
The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) mandated appraisals for many real estate transactions made by federally regulated financial institutions, including banks, thrifts, and credit unions. Specifically, Title XI of the act required appraisals to be written, comply with uniform standards, and be done by individuals who have demonstrated competency and whose professional conduct is subject to effective supervision. Currently, implementing regulations generally require Title XI appraisals for all transactions over a $100,000 threshold.

In June 1993, the Federal regulators, except for the National Credit Union Administration, proposed a rule change that would raise the threshold to $250,000 and thereby reduce the number of transactions requiring appraisals--allowing instead less formal evaluations. The rule change is intended to reduce regulatory burden, improve credit availability, and serve federal financial and public policy interests without threatening the safety and soundness of financial institutions. However, the rule change elicited contentious public reaction. Many commenters charged that elements of the proposal lacked substantial supporting evidence.

In this regard, GAO's preliminary work indicates that (1) qualitative differences between appraisals and evaluations are unknown, (2) the effect on the deposit insurance funds is difficult to determine because of the many variables affecting safety and soundness, (3) the extent of exempted transactions could vary widely by institution, and (4) little is understood about the impact on consumers. GAO expects to soon complete its initial assessment and report its results to date.



Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to discuss the "de minimis" appraisal threshold--the dollar level regulatory agencies have set for exempting real estate transactions of federally insured banks, thrifts, and credit unions from appraisal requirements. The Housing and Community Development Act of 1992 required us to do two studies of appraisals and evaluations[1] for loans under that threshold. While this work is in process, we would like to share with you our preliminary results.

In this testimony, I will discuss: (1) the current appraisal legislation and requirements; (2) the proposed change in the threshold; (3) the arguments for and against the proposal; (4) the regulators' response to public comments; and (5) our preliminary observations on the proposal's effect on valuations of real estate, deposit insurance funds, and consumers.

CURRENT APPRAISAL LEGISLATION AND REQUIREMENTS

In 1986, the House Committee on Government Operations reported that fraudulent real estate appraisals played a crucial role in the gradual weakening and ultimate collapse of major financial institutions in the 1980s.[2] In response, Congress enacted appraisal reform provisions in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Title XI of the act required real estate appraisals for all federally related real estate transactions[3] made by a financial institution regulated by the federal government. The act required appraisals to be written, comply with uniform standards, and be done by individuals who have demonstrated competency and whose professional conduct is subject to effective supervision.

Title XI also required states to develop and implement programs for licensing and certifying appraisers. Generally, a certified appraiser must meet higher qualification standards than a licensed appraiser. In California, for example, both types of

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[1]Evaluations serve the same purpose as appraisals but do not need to meet all the detailed requirements of an appraisal.

[2]Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investment in the Secondary Market (House Report 99-891, Sept. 25, 1986).

[3]Federally related transactions are those real estate transactions entered into by a federal financial institution regulatory agency or a financial institution regulated by the federal government. This includes banks, thrifts, and credit unions. It does not include real estate transactions of mortgage bankers, brokers, pension funds, and insurance companies.

appraisers must have 2,000 hours of real estate experience, but a certified appraiser must have at least 1,000 hours in non-residential appraisal work. Licensed appraisers in California must have at least 75 classroom hours in specific subjects, while certified appraisers must have an additional 90 hours covering more subjects.

Title XI required the financial institution regulators and the Resolution Trust Corporation (RTC)[4] to issue regulations that prescribe (1) the categories of federally related real estate transactions requiring appraisals by a certified appraiser and those by a licensed appraiser and (2) appropriate standards for the performance of appraisals for transactions made by federally regulated financial institutions. Accordingly, each of the regulators and RTC published separate regulations in July and August of 1990. Except for the Federal Reserve Board, all the regulators set the threshold for an appraisal at $50,000 and above. The Federal Reserve Board's threshold was $100,000.

All the regulators concluded that Title XI and safety and soundness banking principles do not require all federally related real estate transactions to have appraisals performed. Each of the regulators also found appraisals unnecessary for loans below their dollar threshold levels because of low loss rates. The regulators required that evaluations, instead of appraisals, be performed for most loans exempted from the appraisal requirement. Later in this testimony, I will discuss in more detail how evaluations differ from appraisals.

In March and April of 1992, the FDIC, OCC, and OTS amended their appraisal regulations, raising the threshold level to $100,000; RTC later did the same. NCUA maintained its threshold at $50,000. The regulators also indicated which loans require services of a certified appraiser and which of a licensed appraiser. In general, certified appraisers are required for appraisals of commercial and complex[5] residential real estate loans for amounts of $250,000 or greater. All other loans not exempted from the appraisal requirement could be performed by either a licensed or certified appraiser. Table 1 of appendix I

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[4]The federal financial institutions regulatory agencies identified in Title XI included the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA). In addition, RTC as the conservator or receiver of failed thrift institutions was covered by Title XI.

[5]Complex residential appraisals are those where the property, form of ownership, or market conditions are atypical.

contains more detail on current appraisal requirements by type and size of loan.

In August 1992, the Office of Management and Budget (OMB), in response to a statutory mandate, issued a report on increasing the threshold beyond $100,000 for commercial real estate.[6] The OMB report concluded that an increase in the de minimis level for commercial real estate is not appropriate until the appraisal reform provisions of FIRREA can be evaluated after full implementation of the act and more reliable data.

The appraisal industry had challenged the regulators' authority to establish and implement appraisal thresholds, asserting that Congress intended that appraisals be part of all real estate related transactions. In October 1992, Congress affirmed the regulators' authority to establish a threshold provision in the Housing and Community Development Act of 1992. The act allowed the regulators to establish thresholds provided they determine in writing that such thresholds do not threaten the safety and soundness of financial institutions. In the fall of 1992, the regulators issued revised guidelines to financial institutions on evaluations.

PROPOSED APPRAISAL REQUIREMENT CHANGES ARE CONTROVERSIAL

In June 1993, the regulators proposed a change in their regulations that would further reduce the number of transactions requiring appraisals. Among other things, the proposed rule change would (1) increase the de minimis threshold to $250,000, (2) expand and clarify existing exemptions to the appraisal requirements, and (3) identify additional circumstances under which appraisals would not be required. The regulators contend that the proposed change would: reduce regulatory burden on banks resulting from Title XI appraisal requirements; improve credit availability; and serve federal financial and public policy interests without threatening the safety and soundness of financial institutions. Table 2 of appendix I contains information on how the proposed change would affect appraisal requirements by loan size and type.

The regulators based their decision to raise the threshold on the 1992 OMB report and their experience with loan defaults. The OMB report referred to a survey conducted by the American Bankers Association of a small sample of lending institutions (246 banks). The survey indicated that losses on commercial real estate loans did not significantly increase until the loan size exceeded $500,000. The regulators also reported having

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[6] De Minimis Levels for Commercial Real Estate Appraisals, Office of Management and Budget, August 1992.

experienced relatively low losses with the $100,000 threshold because most loans under $100,000 were secured by residential real estate. They contended this would also be the case for most loans under the proposed $250,000 threshold.

The proposed change elicited contentious public reaction. Increasing the threshold from $100,000 to $250,000 was the most controversial element of this proposal. Many commenters charged that elements of the proposal lacked substantial supporting evidence. The first comment period, which closed in July 1993, resulted in thousands of comment letters. To address public concerns, the agencies submitted supplemental information for the public record and re-opened the comment period in November 1993.

ARGUMENTS FOR AND AGAINST THE PROPOSAL

Most letters in opposition to the proposed change were from individual appraisers; other opposing comment letters were from state appraisal boards, the Consumer Federation of America, the Mortgage Insurance Companies of America, the National Association of Realtors, the Appraisal Institute, the Appraisal Foundation, and the Appraisal Standards Board. The following were key concerns expressed.

- Safety and soundness problems would result from the threshold increase because of the sheer volume of loans that would be exempted from the appraisal requirement.
- In permitting evaluations, regulators expose financial institutions to risk from inadequate appraisals which had a significant role in financial institution failures.
- Small business lending, or the "credit crunch", is not materially affected by appraisal cost or appraiser availability.
- Any problems in obtaining appraisals have been mitigated by increased numbers of appraisers and stabilized appraisal fees.
- Loan applicants would be affected negatively if valuations of property were not done by individuals with demonstrated competency.

Supporting the threshold increase were banks, state banking associations, the American Bankers Association, and the Independent Bankers Association of America. The following were key points raised in support of increasing the threshold.

-- Raising the threshold would not result in more risk to deposit insurance funds because the loss rate associated with loans under $250,000 is low.

-- Inadequate appraisals had not been shown to be a significant factor in bank failures or losses, and sound business judgment leads banks to obtain appraisals whenever needed.

-- An increase in the threshold would help bank customers get credit by reducing their lending costs and also by expediting loan closing, since the scarcity of appraisers delayed the lending process.

-- Regardless of thresholds, banks would get appraisals for most residential loans because the secondary mortgage market requires them.

The few thrifts that submitted comment letters in response to the regulators' request for comments were divided in their support for the $250,000 threshold. The Savings and Community Bankers of America, a trade group for the thrift industry, commented that the $250,000 threshold will have little effect on its members as they would continue their practice of obtaining appraisals on loans above $100,000.

REGULATORY RESPONSE TO PUBLIC COMMENTS

In response to concerns about insubstantial evidence, the regulators provided supplemental information on November 10, 1993, related to the proposed $250,000 threshold and invited further public comment. This information included: (1) results of the agencies' surveys of senior bank examiners on the potential effects of the proposed threshold increase; (2) various statistical data on the distribution of loans above and below the current and proposed threshold levels; and (3) data on loans sold in the secondary market. The regulators told us they are reviewing and analyzing the public comments received thus far.

PRELIMINARY OBSERVATIONS ON THE THRESHOLD PROPOSAL

The regulators' proposed increase in the appraisal threshold has the potential to reduce costs to consumers and reduce regulatory burden. While the regulators contend these benefits outweigh the risks, it is uncertain whether this is in fact the case. Based on our preliminary work, we found little available information on: (1) the qualitative difference between appraisals versus evaluations; (2) the risk to the deposit insurance funds as a result of proposed changes; and (3) the effect on the consumer.

Qualitative Difference Between Appraisals and Evaluations Unknown

Both appraisals and evaluations are intended to validate real estate values. However, appraisals differ from evaluations in terms of standards and requirements. Our work to date suggests that the regulators' guidance on evaluations is being interpreted inconsistently by financial institutions. We have been unable to determine, however, to what extent appraisals differ from evaluations in terms of quality.

The Appraisal Standards Board of the Appraisal Foundation has issued standards governing appraisals termed the Uniform Standards of Professional Appraisal Practice (USPAP). Federal regulations require that appraisals conform to these standards; however, they do not apply to evaluations. In comparing USPAP's guidance with the regulators' guidance on evaluations we found several areas covered by USPAP standards which were not addressed in the regulators' evaluation guidance.

USPAP requires appraisers to: (1) consider three approaches to value (cost, sales, income) and reconcile the applicability of each approach; (2) consider and analyze any prior comparable sales of property within 1 year for one-to-four family residential units or 3 years for all other property types; (3) identify whether or not the property is in a flood zone, or an environmental hazard area; and (4) consider the effect on use and value of the following factors: existing land use regulations, reasonably probable modifications of such land use regulations, economic demand, the physical adaptability of the real estate, neighborhood trends, and the highest and best use of the property.

Regulators' guidance on evaluations provides financial institutions broad latitude. Individuals performing evaluations do not have to meet specific requirements for education, training, or testing. Instead, the regulators' evaluation guidelines require that the individual performing evaluations must be capable of rendering an unbiased estimate of value and must have training or experience relevant to the type of property being valued. The guidance requires the evaluation reports to be written, include the preparer's name and address, describe the property and its location and use, and contain sufficient information to understand the analysis including the calculations and assumptions used in determining the property's value. In general, the scope of an evaluation is expected to correlate to the complexity of the transaction and type of real estate collateral.

Our visits to 14 banks and thrifts suggest there is no standard interpretation of what an evaluation is. One bank we visited interpreted regulators' guidance on evaluations as requiring an assessment similar to an appraisal. However, others viewed the

guidance as permitting an assessment far different. For example, one bank we visited had evaluations that resembled an appraisal; however, the evaluation was not prepared by a licensed or certified appraiser. Another bank we visited conducted an evaluation that consisted of the loan officer preparing an assessment based solely on the exterior of the property.

Effect on the Deposit Insurance Funds Difficult to Determine

The risk that the proposed threshold poses to the deposit insurance funds is unknown and perhaps not quantifiable. In an earlier report, we found that information to assess the safety and soundness implication of raising the threshold (then to $100,000) was lacking.[7] Our current work to date confirms this is still the case. Regulators do not have comprehensive data on loss rates by size of loan for both residential and commercial real estate. Even with such data, however, the effect of raising the appraisal threshold on the deposit insurance funds may be extremely difficult to determine and the data needed to make the determination may not be feasible to gather.

To assess the risk of loss to the deposit insurance funds, information is needed on a number of factors including: (1) the extent to which evaluations would be used rather than appraisals for loans between $100,000 and $250,000; (2) the qualitative difference between appraisals and evaluations; and (3) the extent to which appraisals affect real estate loan defaults. Further complicating this determination is the fact that there are many variables which affect the safety and soundness of a financial institution, such as the borrower's equity in the property supporting the loan.

We found the regulators did not have information on loss rates by loan size for both commercial and residential real estate. Instead their data showed residential real estate loans as a group had the lowest loss rate. The regulators had no comprehensive data on the loss rate of loans secured by commercial real estate by loan amount. Regulators acknowledged they lacked comprehensive data on loss rates by size of loans because collecting such data would have been excessively burdensome to the industry.

In supporting their proposal, regulators surveyed their senior examiners. Most senior bank examiners the regulators surveyed believed the $250,000 threshold would not pose a serious risk to bank safety and soundness or deposit insurance funds. For example, senior examiners from one regulator explained that the level of losses from residential real estate loans was low, and

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[7]Appraisal Reform: Implementation Status and Unresolved Issues (GAO/GGD-93-19, Oct. 30, 1992).

that such loans comprised most of those under $250,000. However, some examiners the regulators surveyed believed that inadequate appraisal practices for loans under $250,000 contributed to the failure of financial institutions. For example, three OTS regional directors indicated inadequate appraisals for loans less then $250,000 contributed to significant financial losses to thrifts.

Secondary Market Appraisal Requirements Limit Exemptions

Regulators believe changing the threshold would pose little risk to the deposit insurance funds because many residential loans are sold to the secondary market which requires appraisals. Their data showed over 60 percent of loans originated from 1990 through 1992 were sold to federal credit agencies and federally sponsored mortgage pools that required appraisals on all loans purchased.[8] Thus, a higher threshold would not eliminate appraisals for those loans.

While it is true that many loans are sold in the secondary market, problems may exist in relying on the secondary market. For example, the two largest purchasers of mortgage loans on the secondary market, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association, currently limit their purchases of single family residential loans to a maximum amount of about $203,000. Therefore, the appraisal requirements of the secondary market would not affect these loans between $203,000 and the proposed $250,000 threshold. The volume of such loans falling between these two amounts is not known.

Extent of Exempted Transactions Could Vary Widely

To determine the possible effects of the threshold change, the regulators estimated the distribution of residential real estate loans based on the sales price of the real estate. They estimated that over 90 percent of the homes sold in the first half of 1993 had mortgage loans of $250,000 or less. About half of the homes sold during this period were estimated to have mortgages of $100,000 or less.

Our discussions with bankers suggest that the effect of the $250,000 threshold could vary widely depending on the composition of the institution's loan portfolio. Specifically, the $250,000

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[8]Federal credit agencies include the Government National Mortgage Association, Farmers Home Administration, Federal Housing Administration, Veterans Administration, Federal National Mortgage Association, Federal Land Banks, and Federal Home Loan Mortgage Corporation. Federally sponsored mortgage pools include the Government National Mortgage Association, Federal National Mortgage Association, and Federal Home Loan Mortgage Corporation.

threshold could exempt virtually all small or rural banks and thrifts from needing an appraisal for their real estate related loans. For example, one rural bank we spoke with had about 87 percent of its entire real estate portfolio falling under the proposed $250,000 threshold. At a multi-billion dollar financial institution, we were told that about two-thirds of its entire real estate loan portfolio consisted of loans for amounts of $250,000 or less.

Effect On Consumers Uncertain

The proposed threshold, to the extent it increases the number of loans subject to an evaluation, may result in lower costs to the consumer and speedier loan processing. However, limited information exists on whether consumers may be adversely affected by having an evaluation done and whether they have legal recourse for evaluations performed incompetently.

Little quantitative information is available on the cost of appraisals versus evaluations. Our interviews of financial institution officials yielded some insight into costs. Appraisal fees at 11 of the 14 institutions we visited as of February 1994, ranged from $350 to $7,500 for commercial real estate and from $150 to $450 for residential real estate. In contrast, the fees being charged for evaluations were lower than the appraisal fees (in the case of commercial real estate significantly lower) and the range not as extreme. The average cost of evaluations varied from zero to $175 for residential and commercial real estate. This cost information suggests that consumers may realize savings if lenders use evaluations rather than appraisals in making loan decisions and pass directly to consumers the lower cost of evaluations.

To what extent this sizeable differential would affect small business commercial real estate lending is unknown. Some bank officials have told us that costly appraisal requirements could deter small business commercial real estate lending. Other bank officials we interviewed, told us that the cost of an appraisal is not a major factor in the borrower's decision to obtain a loan.

Another effect of an increased appraisal threshold might be to speed loan processing through use of evaluations rather than appraisals. In October 1992, we reported that some banks, particularly in rural areas, were experiencing a shortage of licensed or certified appraisers. Our ongoing work suggests that appraiser availability may still be an issue for rural banks and thrifts. Small rural banks told us that appraiser availability is still a problem for their institutions. For example, one bank official told us that the nearest licensed or certified appraiser was located 40 miles away from the bank. This official said that obtaining a commercial real estate loan takes an average of 2

months, in part, due to problems in scheduling an appraiser. The banks and thrifts located in metropolitan areas told us that the average times for a commercial real estate appraisal ranged from 2 to 4 weeks.

Although there may be cost savings accruing to the consumer as a result of having an evaluation performed, it is not clear what the consumer may lose in terms of consumer confidence and access to information. Consumers, in having an appraisal performed, gain some measure of confidence that the biggest single purchase they are making is supported by market value. Regardless of the threshold, consumers still can obtain an appraisal if they are willing to pay for it.

The proposed increase in the appraisal threshold, which would likely result in greater numbers of real estate lenders using evaluations instead of appraisals, may also result in a lessening of consumers' access to information. Current federal laws and regulations give loan applicants the specific right to obtain copies of the written appraisal reports used in connection with their application for a loan that is or would have been secured by residential property. However, the loan applicant's right to the written evaluation report may need to be clarified. While at least one regulator believes that current laws and regulations give borrowers access to evaluations, two of the institutions we visited told us it was their policy not to provide borrowers with copies of the evaluation report. One explained that since they did not charge the borrower for the in-house evaluation, they did not have to provide it.

In addition, loan applicants can complain to the state appraisal licensing and certification organization if they feel that the appraiser has acted unprofessionally or negligently. No such mechanism exists for evaluations that are performed by someone other than a licensed or certified appraiser.

CONCLUSIONS

Regulators plan to issue a final rule in the near future that would, among other things, increase the appraisal threshold to $250,000, exempting more real estate loans from the appraisal requirement. The rule change is intended to reduce regulatory burden, improve credit availability, and serve federal financial and public policy interests without threatening the safety and soundness of financial institutions. However, the rule change elicited contentious public reaction. Many commenters charged that elements of the proposal lacked substantial supporting evidence. In this regard, our preliminary work indicates that (1) qualitative differences between appraisals and evaluations are unknown, (2) the effect on the deposit insurance funds is difficult to determine because of the many variables affecting safety and soundness, (3) the extent of exempted transactions

could vary widely by institution, and (4) little is understood about the impact on consumers. We expect to soon complete our initial assessment and report our results to date.

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Mr. Chairman, this concludes my prepared statement. I will be happy to answer any questions that you or the Subcommittee may have.

Table I.1: Appraiser Requirements For Banks and Thrifts as of March 1, 1994, by Loan Amount

Dollar amount of loan	Residential Real Estate Loans	Commercial Real Estate Loans
$100,000 or less	None required	None required
Over $100,000 but less than $250,000	Licensed or certified	Licensed or certified
$250,000 to less than $1 million	Licensed or certified[a]	Certified
$1 million or more	Certified	Certified

Note: These requirements do not apply to NCUA.

[a] Regulations require certified appraisers to perform appraisals of complex residential appraisals.

Source: Code of Federal Regulations.

Table I.2: Revised Appraiser Requirements For Banks and Thrifts Based on the June 4, 1993, Proposal

Dollar amount of loan	Residential Real Estate Loans	Commercial Real Estate Loans
Less than $250,000	None required	None required
$250,000 to less than $1 million	Licensed or certified[a]	Certified
$1 million or more	Certified	Certified

Note: These requirements do not apply to NCUA.

[a] Regulations require certified appraisers to perform appraisals of complex residential appraisals.

Source: Code of Federal Regulations and June 4, 1993, Federal Register.

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