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RESIDENTIAL APPRAISALS

Opportunities to Enhance Oversight of an Evolving Industry

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Chairman Biggert, Ranking Member Gutierrez, and Members of the Subcommittee:

I am pleased to be here today to discuss our work on residential real estate valuations. 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 has raised questions about mortgage underwriting practices, including the quality and credibility of some valuations. An investigation into industry appraisal practices by the New York State Attorney General led to an agreement in 2008 between the Attorney General; Fannie Mae and Freddie Mac (the enterprises); and the Federal Housing Finance Agency (FHFA), which regulates the enterprises. This agreement included the Home Valuation Code of Conduct (HVCC), which set forth certain appraiser independence requirements for loans sold to the enterprises and took effect in 2009. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203) (the Dodd-Frank Act) 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.[1]

My statement summarizes the report we are releasing today, which responds to the mandate in the Dodd-Frank Act.[2] Our work focused on valuations of single-family residential properties for first-lien purchase and refinance mortgages. The report discusses (1) the use of different valuation methods and their advantages and disadvantages, (2) policies and other factors that affect consumer appraisal costs and requirements for lenders to disclose 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 the report. To do this work, we analyzed proprietary data we obtained from the enterprises, lenders, and a mortgage technology company on the use of different valuation methods and appraisal approaches.[3] We reviewed

[1]Dodd-Frank Act § 1476.

[2]GAO, *Residential Appraisals: Opportunities to Enhance Oversight of an Evolving Industry*, GAO-11-653 (Washington, D.C.: July 13, 2011).

[3]See GAO-11-653 for more information about the data we obtained for this study.

academic and industry literature and examined federal regulations and policies, as well as internal policies and procedures of lenders. Finally, we interviewed a broad range of appraisal and mortgage industry participants and observers and discussed these issues with officials from the enterprises, FHFA, the federal banking regulatory agencies, and other federal agencies. The work that this statement is based on was performed 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.

The Widespread Use of Appraisals for Mortgage Originations Reflects Their Advantages Relative to Other Valuation Methods

Available data and interviews with lenders and other mortgage industry participants indicate that appraisals are the most frequently used valuation method for home purchase and refinance mortgage originations. Appraisals provide an opinion of market value at a point in time and reflect prevailing economic and housing market conditions.[4] Data provided to us by the five largest lenders (measured by dollar volume of mortgage originations in 2010) show that, for the first-lien residential mortgages for which data were available, these lenders obtained appraisals for about 90 percent of the mortgages they made in 2009 and 2010, including 98 percent of home purchase mortgages. The data we obtained from lenders include mortgages sold to the enterprises and mortgages insured by the Federal Housing Administration (FHA), which together accounted for the bulk of the mortgages originated in 2009 and 2010. The enterprises and FHA require appraisals to be performed for a large majority of the mortgages they purchase or insure. 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 (or loan amount in the case of a refinance) against a value generated by an automated valuation model (AVM), in accordance with enterprise policies

[4] The enterprises and federal banking regulators define market value as the most probable price that 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.

that permit this practice for some mortgages with characteristics associated with a lower default risk.[5]

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 for a number of reasons. Most notably, appraisals and appraisers are subject to specific requirements and standards. In particular, the Uniform Standards of Professional Appraisal Practice (USPAP) outlines the steps appraisers must take in developing appraisals and the information appraisal reports must contain.[6] USPAP also requires that appraisers follow standards for ethical conduct and have the competence needed for a particular assignment. Furthermore, state licensing and certification requirements for appraisers include minimum education and experience criteria, and standardized report forms provide a way to report relevant appraisal information in a consistent format.

In contrast, other valuation methods, such as broker price opinions (BPO) and AVMs, are not permitted for most purchase and refinance mortgage originations.[7] The enterprises do not permit lenders to use BPOs for mortgage originations and only permit lenders to use AVMs for a modest percentage of mortgages they purchase. Additionally, the federal banking regulators' guidelines state that BPOs and AVMs cannot be used as the primary basis for determining property values for mortgages originated by regulated institutions. However, the enterprises and lenders use BPOs and AVMs in a number of circumstances other than purchase and refinance mortgage originations because these methods can provide quicker, less expensive means of valuing properties in active markets.

When performing appraisals, appraisers can use one or more of three approaches to value—sales comparison, cost, and income. The sales comparison approach compares and contrasts the property under

[5]An AVM is a computerized model that estimates property values using public record data, such as tax records and information kept by county recorders, multiple listing services, and other real estate records.

[6]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.

[7]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.

appraisal with recent offerings and sales of similar properties. 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 minus depreciation. The income approach is an estimate of what a prudent investor would pay based upon the net income the property produces. USPAP requires appraisers to consider which approaches to value are applicable and necessary to perform a credible appraisal and provide an opinion of the market value 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, 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. Consistent with these policies, our review of valuation data that we obtained from a mortgage technology company—representing about 20 percent of mortgage originations in 2010—indicates that appraisers used the sales comparison approach for nearly all (more than 99 percent) of the mortgages covered by these data. The cost approach, which was generally used in conjunction with the sales comparison approach, was used somewhat less often—in approximately two-thirds of the transactions in 2009 and 2010, according to these data. The income approach was rarely used. Some mortgage industry stakeholders have argued that wider use of the cost approach in particular 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 market values rising to unsustainable levels 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, these stakeholders pointed to a growing gap between average market values and average replacement costs of properties as the housing bubble developed in the early to mid-2000s. However, other mortgage industry participants noted that a rigorous application of the cost approach may not generate values much different from those 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. The data we obtained did not allow us to analyze the differences between the values appraisers generated using the different approaches.

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

Factors such as the location and complexity of the property affect consumer costs for appraisals. For example, a property may have unique characteristics that are more difficult to value, such as being much larger than nearby properties or being an oceanfront property, which may require the appraiser to take more time to gather and analyze data to produce a credible appraisal. 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 engages an appraiser directly or uses an appraisal management company (AMC)—which manages the appraisal process on lenders' behalf—to select an appraiser.[8] They said that AMCs typically charge lenders about the same amount that independent fee appraisers would charge lenders directly, and lenders generally pass on these charges to consumers. In general, lenders, AMC officials, appraisers, and other industry participants noted that consumer costs for appraisals have remained relatively stable in the past several years. However, appraisers have reported receiving lower fees when working with AMCs compared with working directly with lenders because AMCs keep a portion of the total fee.

A provision in the Dodd-Frank Act that requires lenders to pay appraisers a customary and reasonable fee could affect consumer costs and appraisal quality, depending on interpretation and implementation of federal rules.[9] The effect of this change on consumer costs may depend on the approach lenders and AMCs take in order to demonstrate compliance. For example, some lenders and industry groups are having fee studies done to determine what constitutes customary and reasonable fees. According to the Dodd-Frank Act, these studies cannot include the fees AMCs pay to appraisers. As a result, some industry participants, including some AMC officials, expect these studies 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, which in turn could increase appraisal costs for consumers. However, some lenders are evaluating the possibility of no longer using AMCs and engaging appraisers directly, which would eliminate the AMC administration fee from the appraisal fee that consumers pay.

[8]AMCs perform a number of specific functions for lenders, including recruiting, selecting, and contracting with appraisers.

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

Other recent policy changes that took effect in 2010 aim to provide lenders with a greater incentive to estimate costs accurately when providing consumers with an estimated price for third-party settlement services, including appraisals. If actual costs exceed estimated costs by more than 10 percent, the lender is responsible for making up the difference. The Dodd-Frank Act permits, but does not require, lenders to separately disclose to consumers the fee paid to the appraiser by an AMC and the administration fee charged by the AMC.[10] Another policy change enhances disclosures by requiring lenders to provide consumers with a copy of the valuation report prior to closing.

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

Recently issued policies reinforce long-standing requirements and guidance designed to address conflicts of interest that may arise when direct or indirect personal interests bias appraisers from exercising their independent professional judgment. In order to prevent appraisers from being pressured, the federal banking regulators, the 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. Provisions of these and other policies address (1) prohibitions against loan production staff involvement in appraiser selection and supervision; (2) prohibitions against third parties with an interest in the mortgage transaction, such as real estate agents or mortgage brokers, selecting appraisers; (3) limits on communications with appraisers; and (4) prohibitions against coercive behaviors.

According to mortgage industry participants, HVCC and other factors have contributed to changes in appraiser selection processes—in particular, lenders' more frequent use of AMCs to select appraisers.[11] Some appraisal industry participants said that HVCC, which required

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

[11]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. They provided varying estimates of AMC use prior to HVCC, ranging from 15 percent to 50 percent of mortgage originations.

additional layers of separation between loan production staff and appraisers for mortgages sold to the enterprises, led some lenders to outsource appraisal functions to AMCs because they thought using AMCs would allow them to easily demonstrate compliance with these requirements. In addition, lenders and other mortgage industry participants told us that market conditions, including an increase in the number of mortgages originated during the mid-2000s, and lenders' geographic expansion over the years, put pressure on lenders' capacity to manage appraisers and led to their reliance on AMCs.

Greater use of AMCs has raised questions about oversight of these firms and their impact on appraisal quality. 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. 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. 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. In addition, a number of states began regulating AMCs in 2009, but the regulatory requirements vary and provide somewhat differing levels of oversight, according to officials from several state appraiser regulatory boards.

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. 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 guidelines for lenders' appraisal functions—may have led to a decline in appraisal quality. For example, 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. AMC officials we spoke with said that they have processes that address these areas of concern—for example, using an automated system that identifies the most qualified appraiser based on the requirements for the assignment, the appraiser's proximity to the subject property, and performance metrics such as the timeliness and quality of the appraiser's work.

While the impact of the increased use of AMCs on appraisal quality is unclear, Congress recognized the importance of additional AMC oversight in enacting the Dodd-Frank Act by placing the supervision of AMCs with state appraiser regulatory boards. The Dodd-Frank Act requires the federal banking regulators, FHFA, and the Bureau of Consumer Financial Protection to establish minimum standards for states to apply in registering AMCs, including requirements that appraisals coordinated by an AMC comply with USPAP and be conducted independently and free from inappropriate influence and coercion.[12] This rulemaking 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. Such reinforcement could help to provide greater assurance to lenders, the enterprises, and federal agencies of the quality of the appraisals provided by AMCs.

To help ensure more consistent and effective oversight of the appraisal industry, the report we are issuing today recommends that the heads of the federal banking regulators (FDIC, the Federal Reserve, NCUA, and OCC), FHFA, and the Bureau of Consumer Financial Protection—as part of their joint rulemaking required under the Dodd-Frank Act—consider including criteria for the selection of appraisers for appraisal orders, review of completed appraisals, and qualifications for appraisal reviewers when developing minimum standards for state registration of AMCs. In written comments on a draft of our report, the federal banking regulators and FHFA agreed with or indicated they will consider this recommendation. The Bureau of Consumer Financial Protection did not receive the draft report in time to provide comments.

Chairman Biggert, Ranking Member Gutierrez, and Members of the Subcommittee, this concludes my prepared statement. I am happy to respond to any questions you may have at this time.

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

GAO Contact and Staff Acknowledgments

For further information on this testimony, 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 statement. Key contributors to this testimony include Steve Westley, Assistant Director; Don Brown; Marquita Campbell; Anar Ladhani; John McGrail; Erika Navarro; Jennifer Schwartz; and Andrew Stavisky.

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