Testimony of Sara W. Stephens, MAI, CRE

# Mortgage Origination: The Impact of Recent Changes on Homeowners and Businesses

**House Committee on Financial Services**

**Subcommittee on Insurance, Housing and Community Opportunity**


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Madam Chair, members of the Subcommittee, thank you for the opportunity to share our thoughts regarding the appraisal process and residential mortgage origination on behalf of the nearly 25,000 members of the Appraisal Institute, the largest professional association of real estate appraisers in the United States. Despite severe economic and industry challenges, real estate appraisers, everyday, are helping financial institutions, consumers, government agencies and investors understand risks in the real estate market. Collateral risk assessment is one of the cornerstones of mortgage lending, and today's complex markets are presenting unique challenges that professional appraisers can help to clarify.

Despite this work, we believe the work of appraisers is vastly underutilized by mortgage lenders today, and facing severe strain as a result of a conflicted and burdensome regulatory environment. Real estate appraisers are professional analysts of real property markets. They are trained to research and investigate the behaviors of buyers and sellers in the market. An appraisal is a *professional service*. It is not like a flood certification, which can be generated by a click of a button. Credible appraisals require research, analysis, inspection and rigorous training. They require competence, independence, and ethics.

However, many mortgage lenders, and sadly, some government agency officials, fail to recognize this distinction, helping to promote commoditization of appraisals, as if they were all the same or created equally. Rather than analysts, appraisers are at risk of becoming glorified data aggregators and form fillers, thanks partly, to government policies. Rather than conducting rigorous valuations of collateral, many lenders are quickly reinforcing practices that promote "collateral validation," focusing more on the form than on the content or analysis. We believe that such views helped to create the mortgage crisis of recent years, and that a continuation of these practices will place us at great risk in the future.

Last year, Congress passed the most significant legislative update of the appraisal regulatory structure in two decades. In our view, this was only a beginning. Moving forward, Congress must maintain an active role in oversight of appraisal regulators and build on these reforms to address ongoing weaknesses. We can ill afford to allow another twenty years to pass without a thorough audit of appraisal regulations. Consumers, lenders, and taxpayers deserve much better than they have been given to date.

Our testimony is divided into two sections. Part I outlines concerns regarding the substance of appraisal policies; Part II outlines concerns regarding "process" and appraisal regulatory oversight.

## Part 1: Promoting Development of Credible Appraisals and Protecting and Informing Consumers

### A. The Consumer Financial Protection Bureau (CFPB) must correct the Interim Final Rule on appraisal independence and implement the intent of the Dodd-Frank Act

On April 1, one of the first rules resulting from the Dodd-Frank Act took effect. Known as the Interim Final Rule on Truth in Lending, and specifically on appraisal independence, the rule carries over many provisions from the Home Valuation Code of Conduct (HVCC) to apply to all consumer mortgage transactions. It also mandated the requirement of payment of customary and reasonable fees to appraisers. Until enactment of the HVCC, this rule was unneeded. The system operated freely with each appraiser setting fees based on their education, experience and assignment conditions. The HVCC, unfortunately, created an environment more consistent with an oligopoly**;** a handful of middleman management companies which presently control approximately 70% of appraisal orders.

Unfortunately, the Federal Reserve Board issued a rule that fails to implement the plain language and public policy intent of defining reasonable and customary fees as those not involving appraisal management companies – a retail fee, if you will. In our view, the reason Congress included this provision in the Dodd-Frank Act is to help ensure that appraisers receive adequate compensation for the education, experience, and time necessary to prepare credible appraisal reports. While the price of any service will always be a factor, quality and competency and transparency to the consumer should come first. Business models that helped fuel the fundamentally unsound run-up of the past decade placed far too much emphasis on pricing and bundling of services and focused scant attention on appraisal quality. Congress got it right; unfortunately, the Federal Reserve got it wrong.

As implemented, the Interim Final Rule contains "two presumptions of compliance" that have no statutory basis. In sum, the first presumption simply reaffirms the status quo business model that crams down fees on appraisers; the second presumption is relatively consistent with the Dodd-Frank Act, but is made secondary by failing to include a safe harbor.

The origins of the two presumption system are unclear, but the result is simple. The two presumption system enables the oligopolistic-like system to maintain its status quo to the detriment of the safety and soundness of the banking system. Nowhere in the Dodd-Frank Act did Congress imply any presumptions of compliance, and Dodd-Frank certainly did not imply that customary and reasonable fees should involve assignments involving known appraisal management companies. Rather, Dodd-Frank very clearly defines such fees as those <u>absent the involvement of known appraisal management companies</u>.

Specifically, Dodd-Frank states:

> *Lenders and their agents shall compensate fee appraisers at a rate that is customary and reasonable for appraisal services performed in the market area of the property being appraised. Evidence for such fees may be established by objective third-party information, such as government agency fee schedules, academic studies, and independent private sector surveys. <u>Fee studies shall exclude assignments ordered by known appraisal management companies</u>.*

However, the results of the Interim Final Rule are clear. The Rule has perpetuated a two-tiered or bifurcated market, where retail appraisal fees float at one level, and those involving AMCs float at a lower level. According to our research, fees to appraisers paid by AMCs are significantly lower than fees paid directly by lenders or through other objective sources such as by the Veteran's Administration according to their VA Fee Schedule. In October, the Appraisal Institute conducted a survey of appraisers regarding the VA Fee Schedule, and the results demonstrate slight to strong majorities of respondents said VA appraisal and inspection fees are "Reasonable" or "Very reasonable"[1]. Further, this research illustrates VA appraisal fees are on par with fees for similar non-VA appraisal and inspection assignments and that when VA appraisal fees are not on par, the fees apparently tend be below par more often than above par.

To illustrate the bifurcated market, we provide a comparison of selected fee schedules for the Veterans Administration and those in the same states of a major AMC.[2] On average, fees through the AMC are roughly $100 less than those paid directly by the VA.[3] One might argue this is the result of volume discounts. However, one must also ask what is being cut from the appraisal process to enable the appraiser to "make up for it in volume." In our view, such an arrangement helps set us up for another crisis in coming years.

We expect representatives of AMCs and banks will try to contend that AMCs are providing services to appraisers in an attempt to justify the forced fee reductions. We firmly disagree. Here, it is worth noting again, that AMCs have a client relationship with lenders, not appraisers. Further, claims that AMCs are providing marketing and invoicing services to appraisers are not accurate. In fact, our members report that some AMCs themselves are among the worst offenders of failing to pay appraisers. Further, appraisers with clientele beyond one AMC still have overhead expenses relating to marketing and accounts payable, so any purported benefit to appraisers is an overstatement, at a minimum.

Also, we expect representatives of AMCs will contend "the market" should be the strongest factor in fee determination. We agree, but here, government policies have stood in the way of appraisers charging market fees. For one, many appraisers lost nearly all of their clientele as the result of the prohibition of orders by mortgage brokers. Prior to 2008, mortgage brokers represented roughly 60 percent of all residential appraisal orders. Today, mortgage brokers are no longer allowed to order appraisals for loans sold on the secondary market. Many banks can manage the appraisal function internally; however, a significant portion of work previously derived from mortgage brokers is now channeled through AMCs.

Further, long standing policies of the Federal Housing Administration (FHA), which were recently corrected but helped to establish the bundled service business model of many AMCs, stood squarely against the notion of allowing the market to run its course. In 1996, FHA approved a policy that effectively capped fees to appraisers. The policy said that if an AMC was used, the consumer could only be charged what was customary and

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[1] Appraiser Opinions on Department of Veterans Affairs Appraisal and Inspection Fees. Appraisal Institute. October 5, 2010. Available at http://www.appraisalinstitute.org/newsadvocacy/downloads/key_documents/AI_VA_AppraisalFeeSurveyOct52010.pdf

[2] http://www.appraisalinstitute.org/resources/MD-NY-CA-VA_FeeSchedules.pdf

[3] http://www.appraisalinstitute.org/resources/MD-NY-CA_AMC_FeeSchedule.pdf

reasonable to appraisers in the market area[4]. The policy mistakenly furthered a myth that appraisal and appraisal management functions are one and the same, when they are clearly different[5]. One (appraisal) is a professional service; the other (appraisal management) is a bank administrative function. In essence, the FHA policy that stood for more than a decade allowed lenders to start with what is normally paid to appraisers and work down to carve out an AMC fee. This was not as significant of an issue when AMCs represented less than 20 percent of the market. With the mortgage broker ban and AMC market share now pushing 70 percent, this business model is unsustainable, and it's one of the main drivers behind the inclusion of the customary and reasonable fee requirement by Congress last year.

*Recommendation*
We urge the CFPB to give appraiser independence and appraisal quality the highest priority by revising the first presumption of compliance to require consideration of direct lender fees to appraisers or fees absent the involvement of AMCs. The CPFB should specify that creditors are required to evaluate appraisal fees that involve non-AMC engagements when undertaking the first presumption, even though the use of a third-party survey is not necessarily required. Such information that segregates appraisal fees paid directly by lenders is readily available in the marketplace – we are aware of at least three private sector sources widely used by lenders that identify fees paid to appraisers absent the involvement of AMCs. The Department of Veterans Affairs fee schedules that are established for various geographic markets are another reliable source. Consideration of this "fee schedule" information, along with other factors such as scope of work and qualifications, would help to alleviate the inconsistencies in the fees that AMCs are allowed to pay under the first presumption and those that are paid under the second presumption.

**B. Consumers should understand all charges assessed, including appraisal management**

Real estate agents have reported that consumers are paying higher appraisal fees in recent years[6], yet according to our members, appraiser fees have declined by as much as 40 percent[7].

How can this be the case? The answer is simple – lenders have passed through appraisal administration expenses onto the backs of consumers through the Appraisal line of the HUD-1.

Current RESPA interpretations allow for, and even promote, "bundled" fees to consumers, whereby appraisal management fees are lumped together with actual appraisal fees. When a lender utilizes an AMC, HUD's current interpretation of RESPA dictates the fee paid to the AMC – not the actual appraiser – be disclosed to the consumer on Truth and Lending disclosures and listed on the HUD-1 settlement statement[8]. As a result, a perverse incentive exists for AMCs to seek reductions in appraisal fees to carve out larger profit margins.

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[4] From FHA Mortgagee Letter 97-46, available at
http://portal.hud.gov/hudportal/documents/huddoc?id=DOC_14644.txt
[5] FHA "correct" ML 97-46 by issuing Mortgagee Letter 09-28, available
http://www.appraisal.state.az.us/userfiles/file/09%2009%20FHA%20Mortgagee%20Letter%202009-28.pdf
[6] From NAR survey, available at http://www.docstoc.com/docs/9041271/NAR-HVCC-appraisal-survey-results
[7] "Impact of AMCs – Member Survey." Appraisal Institute, May 25, 2009.
[8] "**Q:** If an appraisal is ordered through XYZ appraisal vendor management company and the appraisal is subcontracted to ABC Appraisal Company, what name is identified in Line 804 on the HUD-1?

It is also a misrepresentation of our profession.

We believe this policy should be reexamined. Moreover, the CFPB, that will soon have responsibility over these matters, should clearly disclose to consumers how much and which company or individual is being paid for the appraisal. **After all, it is the consumer who pays these fees in nearly all transactions.**

We are not aware of any value to the consumer in a bank using the services of an AMC. The benefit is clearly and solely to the bank, who is passing through a traditional overhead expense on to the backs of consumers. What is particularly troubling to our organizations about the current interpretation of RESPA is that it enables AMCs to operate virtually in the dark. Consumers are led to believe the “Appraisal Fee” being paid to a creditor is for a property appraisal, when in fact it could be for the appraisal as well as appraisal management services. In talking with chief appraisers of banks and financial institutions about this situation, we understand most AMCs actually refuse to disclose the portion of the appraisal fee they have taken for themselves, even upon request by their lender-clients. In essence, the AMCs take from the pockets of appraisers every time an appraisal is completed by an appraiser for an AMC and nobody knows how much. This is not solely the fault of the AMCs but also creditors who seek to outsource their valuation needs to AMCs, but only offer AMC’s the same fee, or something similar, previously paid for appraisal services only.

As such, a requirement that the consumer shall not pay for the services of the AMC would possibly solve the customary and reasonable fee debate in its entirety. Such a policy if enacted by the CFPB would facilitate enhanced competition between the outsourced AMC model and the internal appraisal department model, giving banks the option of choosing between using (and paying for) the services of an AMC or performing similar services internally. We believe an alternative arrangement that recognizes and establishes two markets – one for appraisers, and one from AMCs – would deleverage the AMCs from the fee process and enable each market to act on their own. Further, requiring the creditor to pay each separately would allow AMCs to compete for the management services provided to lenders based on *service*, and not nearly exclusively on *price*, such as the case today. Lastly, we believe this arrangement would be consistent with the spirit of the Federal Housing Administration’s Mortgagee Letter on this subject (ML 09-28) which requires that FHA Roster appraisers be compensated at a rate that is customary and reasonable for appraisal services performed in the market area where the services are being performed. ML 09-28 also requires that AMC fees not exceed what is customary and reasonable for such services provided in the market area of the property being appraised[9].

The CFPB is well positioned to prohibit consumer payment of appraisal management services under the perspectives stated above. We note the CFPB has been granted authority over TILA and RESPA and that the Dodd-Frank Act authorizes separation of appraisal management and appraisal services on the HUD-1 settlement statement. However, we are disappointed to see the CFPB has carried forward the status quo in the first drafts of the revised Good Faith Estimate. All drafts released to date fail to separate the estimated fees to the appraisal and those estimated for appraisal management.

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**A:** XYZ appraisal management company must be identified on Line 804.” From “New RESPA Rule FAQs,” April 2, 2010. Available at http://www.hud.gov/offices/hsg/rmra/res/resparulefaqs422010.pdf

[9] From Mortgagee Letter 09-28, issued September 18, 2009. Available at http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-28ml.pdf

Moving forward, another issue will likely need to be resolved. The Dodd-Frank Act authorizes the separation of AMC and appraisal fees on the HUD-1, however a separate provision (known as the "Merkley amendment") complicates the issue greatly by imposing a 3 percent cap on points and fees relating to the loan. Some banks own AMCs as affiliates. If the fees paid to these entities are separated from the appraisal fee as authorized under Dodd-Frank, it would subject capitively-owned AMC fees to the 3 percent points and fees cap as an affiliate of the bank. This would place such AMCs at a competitive disadvantage in the marketplace.

To address this issue, and to implement the authorization for separation of AMC and appraisal fees, we strongly support separation of AMC and appraisal fees on all consumer mortgage disclosure documents, including the GFE and HUD-1. Further, we believe the CFPB should exempt AMC fees from the points and fees cap, as authorized by the Dodd-Frank Act.

### C. Appraisers should be allowed to analyze all sales in a market, and their judgment and expertise should be respected

In 2011, four bills were introduced in state legislatures (Illinois, Maryland, Missouri, and Nevada), and one bill was introduced in Congress and referred to this Committee, to inappropriately legislate the appraisal process. Each proposal would prohibit the use of distressed sales, such as foreclosure sales or short sales, as comparables in an appraisal of a parcel of real property. While we sympathize with the plight of those in today's real estate market, we strongly oppose such bills, for they will only contribute to an asset bubble and place lenders at great risk.

It seems reasonable to assume that distressed sales should not form the basis for market value opinions. But, in some markets, they are such heavy weights on value that they must be considered along with appropriate adjustments. Distressed sales such as foreclosure sales and short sales are common in a declining market. Depending on the severity of the local market downturn, some, many, or even all sales that occur do so under distressed conditions. Appraisers cannot categorically discount foreclosures and short sales as potential comparable data in the sales comparison approach. However, due to differences between their conditions of sale and the conditions outlined in the market value definition they might not be usable as market information. Foreclosures and short sales usually do not meet the conditions outlined in the definition of market value. A short sale or a sale of a property that occurred prior to a foreclosure might have involved atypical seller motivations (e.g., a highly motivated seller). A sale of a bank-owned property might have involved typical motivations, so the fact that it was a foreclosed property would not render it ineligible as meaningful comparable data that should be considered in developing a credible appraisal. However, if the foreclosed property was sold without a typical marketing program, or if it had become stigmatized as a foreclosure, it might need to be adjusted if used as comparable evidence of value. Further, some foreclosed properties are in inferior condition, so adjustments for physical condition may be needed.

As is always the case in selecting sales to use as comparable market information, appraisers must investigate the circumstances of each transaction, including whether atypical motivations or sales concessions were involved, the property was exposed on the market for a typical amount of time, the marketing program was typical, or whether the property condition was compromised. Adjustments might need to be made for these circumstances. When it is necessary to use a distressed sale as evidence of value, the appraiser must carefully analyze the current local market to determine if an adjustment for conditions of sale is needed. If no adjustment is warranted, the lack of adjustment should be explained.

Physical condition and conditions of sale are two distinctly different factors that must be considered separately. They may be related to some degree in a distressed market, but not necessarily. An appraiser must not assume, for example, that a property was in inferior condition simply because it was a foreclosure. The level of investigation needed to meet the requirement for sufficient diligence is generally more than is needed in non-distressed market situations. Further, supporting such adjustments can be particularly challenging when there are few current transactions to analyze. Competency in performing such investigation and analysis is essential, which is why we believe the best and most productive way to alleviate concerns about appraisals in complex markets is to ensure that highly qualified appraisers– particularly those with advanced training, peer review, and competency exams – are used by lenders and their agents.

Further, under federal and state law, appraisers are required to follow the Uniform Standards of Professional Appraisal Practice (USPAP). USPAP Standards Rule 1-4(a) requires that appraisers "must analyze such comparable sales data as are available." This means all sales, including foreclosures and short sales. In some markets, there are so many distressed sales that they are the market and must be considered. When there is a glut of distress sales in the marketplace, and those properties are truly comparable to the subject, it would be misleading not to use them as part (or in some cases all) of the basis for a value conclusion.

USPAP further states that, "When compliance with USPAP is required by Federal law or regulation, no part of USPAP can be voided by a law or regulation of a state or local jurisdiction."

As such, we urge that this Committee refrain from legislating the appraisal process and refrain from advancing the appraisal provisions of H.R. 1755, as introduced.

### D. We must focus on the *service provider*, not just the *service*

To its credit, one thing the Home Valuation Code of Conduct did well was reduce “value pressure” on appraisers, meaning, pressure to provide predetermined values has decreased substantially according to our members. However, in doing so, the HVCC, and the resulting repurchase risk, has created a host of problems for appraisers and lenders. These include:

a. “Scope creep” by underwriters and lenders, or subtle increases in scope of work as a result of proprietary rules established simply to paper a file, while fees dictated to appraisers prevent additional billing for the additional work. Automated quality control and assurance systems that are mistakenly read to be appraiser performance measures, rather than property or market risk indicators.
b. Further commoditization of the appraisal process, whereby appraiser-to-appraiser conversations are rare, as interactions with lender or AMC staff, many of whom have little or no knowledge of the appraisal process, much less recognized methods and techniques, multiplies.

Arbitrary rules, such as adding additional comparable sales that provide little credibility to the appraisal, are now commonly requested by underwriters and lenders. Such requests are often made well after delivery of the appraisal report and are tied directly to internal or proprietary rules established to provide protection from repurchase risk. Some automated compliance review systems ordered by lenders virtually never clear an appraisal without raising a red flag on one or many issues. If no appraisals are passing such a system, it begs the question of what purpose such systems are actually performing.

What is striking about such systems is the lack of attention paid on the service *provider*. It is our view that if lenders paid as much attention to the credentials of the appraiser (or the individuals performing the appraisal) as they do to critiquing the form or end product, many of their problems would be solved. However, rare is the day in consumer mortgage appraisal engagement when lenders or their agents ask whether the appraiser is professionally designated by a professional appraisal organization, or has both market and geographic competency to conduct the appraisal assignment. Instead, impersonal and/or automated systems that attempt to protect lenders through quantity (and price) rather than quality are the norm.

Unfortunately, these problems may be exacerbated by the Uniform Appraisal Dataset (UAD) planned to be implemented by Fannie Mae and Freddie Mac this fall. This initiative has been characterized by some as an advancement or improvement to appraisal quality. While the UAD will result in a standardization of data collected by Fannie Mae and Freddie Mac, it may not necessarily result in improved appraisal quality. In fact, in may result in further masking the work of less than competent appraisers, who provide “good looking” data that is poor in quality. The reason for this is simple – data standardization does not magically convert poor data and weak analysis into quality data and professional analysis. Form processing software, which can produce an attractive report, is currently available. But, especially as we have seen in recent years, report appearance has been mistaken for professionalism. As our members have reviewed UAD, they have informed us that it has the potential to further mask the poor quality opinions delivered in high quality reporting.

Credible real estate appraisal requires independent appraisers and competent analysis, which in many cases is best provided in a thoughtfully composed *narrative* format. While there may be examples of where the new descriptors may be better at identifying characteristics and issues than merely marking “x” or “average” as we have now, disallowing certain data from the form forces the appraiser to place additional information in the addenda. In some cases, it’s simply unwise to even attempt standardization because it creates potential conflicts with the Uniform Standards of Professional Appraisal Practice (USPAP). In this regard, it is worth noting that the Appraisal Standards Board and state appraiser regulatory agencies have expressed concern regarding the enforcement of UAD appraisals and for consumers and lenders to be misled by UAD reports.

It is also worth noting the original UAD project intended to standardize only a handful of fields with appraisal reports. However, as data systems analysts became involved with the project, UAD morphed into what appears to be a gigantic data mining project. Quite literally, the UAD is now attempting to standardize every significant element and field within commonly used residential appraisal forms. Uniform appraisal standards, state licensing requirements, and the integrity of the appraisal process will require appraisers to add a multitude of addendums to appraisal reports to comply with USPAP and state licensing requirements. This will increase the scope of work for appraisers and increase costs for lenders and consumers. Appraisal costs are directly proportional to the appraisal scope of work and the time expended on the assignment. As such, there is a strong chance that UAD will actually increase the time/effort expended and, as a result, the cost of appraisals

Standardization of data may assist the GSEs in analytics. But it seems reasonable that the GSE’s would desire a higher level of professional analysis to provide this more robust data. If the market will not accept increased appraiser fees, professional appraisers will continue to abandon mortgage lending work in favor of alternate assignments, leaving GSE-related assignments to less capable practitioners.

## Part II: Public Accountability and Regulatory Oversight of Appraisal Functions

### A. Appraiser regulators must be held accountable and observe their Congressional authorizations.

We are deeply concerned about recent actions taken by the Appraisal Subcommittee (ASC) that raise serious questions about its oversight capabilities. Evidence suggests the ASC has asserted inappropriate influence, or direction, to The Appraisal Foundation (TAF), beyond its authorization from Congress. Instead of monitoring and reviewing TAF, the ASC appears to have made TAF an arm of the ASC and is in effect directing some of its activities.

Specifically, the ASC, as a significant financial underwriter of TAF activities, appears to have directed TAF to establish an "Appraisal Practices Board" with the intent to deliver federal funding prior to authorization by Congress. Such actions would far exceed the ASC's statutory mandate and would have the intended effect of usurping Congress' role in establishing law and policy.

We urge Congress not to let these actions go unchallenged. In fact, we believe it may be incumbent upon Congress to establish legislative protocols relative to the relationship between the ASC and TAF. Last, as the mission and role of TAF changes, so too should its Congressional authorization, as it is wholly appropriate for Congress to establish boundaries and parameters to entities receiving public funds.

For background, TAF is a not-for-profit organization recognized by Congress[10] to perform certain limited functions relating to appraisal standards and appraiser qualifications. TAF was mandated with promulgating the Uniform Standards of Professional Appraisal Practice (USPAP) for federally related transactions, as well as issuing the minimum qualification criteria for appraiser certification and licensure. Both the Appraisal Standards Board (ASB) and Appraiser Qualifications Board (AQB) are designed to be independent of TAF's Board of Trustees in carrying out their duties.

Section 1103(b) of Title XI of FIRREA authorizes the ASC, along with monitoring state licensing agencies, to "monitor and review the practices, procedures, activities, and organizational structure of TAF.[11]" on behalf of the federal financial regulatory agencies. The ASC is charged with reporting to Congress on these activities each year. While the ASC attends or observes meetings of TAF, and reviews and approves funding requests relating to appraisal standards and appraiser qualifications, it *does not* have the ability to "direct or overrule specific actions" of TAF. According to a September 11, 2002 letter from the ASC:

[10] 12 U.S.C. 3331-3351, available at https://www.asc.gov/Documents/TitleXI/TitleXI.pdf
[11] 12 U.S.C. 3332, available at https://www.asc.gov/Documents/TitleXI/TitleXI.pdf

> *Title XI does mandate that the ASC 'monitor and review the practices, procedures, activities, and organizational structure of the Appraisal Foundation' and the AQB, Congress did not provide the ASC with the authority or the power to direct or overrule the operations or structure of these private entities."*[12]

Currently, the ASC is authorized to provide grants to TAF in support of Title XI responsibilities related to appraiser qualifications and appraisal standards. No direct Congressional authorization exists to provide grant funding in the area of "best practices," or recognized methods and techniques. "Standards" are guiding principles, and they are "standard," meaning their application does not change much, if at all, with the situation. "Best practices" are fluid; what they are and how they are applied is highly dependent on the specific circumstances.

*ASC/TAF Efforts to Codify Best Practices*

Despite these limitations, for approximately the past two and one-half years, the ASC or its influential member(s) presided over a campaign to establish a new TAF board, known as the "Appraisal Practices Board" or APB. The ASC first expressed its aspiration to expand TAF's mission beyond standards and qualifications in the December 2008 monthly meeting of the ASC[13]. At this meeting, two ASC members, one of whom was the chair, expressed a desire for TAF to address appraisal methodology or practice issues.

It is unfortunate that members of the ASC committed to advance such an endeavor, knowing that Title XI limited TAF to the areas of standards and qualifications, and despite TAF's acknowledgement that such an endeavor would be "encroaching" on other organizations"[14]. The body of knowledge and education on methods and procedures has been long reserved to academia and the professional appraisal organizations.

It should be noted that during this period of time, the ASC was without an executive director for nearly two years, so greater responsibilities and authorities were placed in the hands of the members of the ASC, particularly the chair. This was also a period in which the ASC faced sharp public criticism over its effectiveness in handling appraisal oversight[15].

To address what the ASC and TAF perceived as a shortcoming in appraisal practices, both organizations jointly advanced an amendment in the House Financial Services Committee in May 2009 to a prior version of H.R. 4173. Specifically, the amendment would have required all appraisals of federally related transactions to be prepared in accordance with "best practices" or "recognized methods and techniques" developed or recognized by the

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[12] From Appraisal Subcommittee correspondence with George R. Harrison, Ph.D., September 11, 2002, available at https://www.asc.gov/documents/othercorrespondence/ltr%20harrison%20request%2009.11.02.pdf

[13] From the ASC Meeting Minutes, December 2008, https://www.asc.gov/Documents/MeetingMinutes/ASC%20Bd%20Mtg%20Minutes%2012.11.2008.pdf

[15] Weiss, M. (2008) October 28. "Appraisal agency's new chief quits after first day." *Associated Press*. Available at http://www.blueridgenow.com/article/20081028/NEWS/810280277/1170

[16] From Appraisal Foundation Letter to the Subcommittee on Capital Markets. April 22, 2009. Available at http://www.appraisalinstitute.org/newsadvocacy/downloads/TAFbestpracticesproposal.pdf

[15] Weiss, M. (2008) October 28. "Appraisal agency's new chief quits after first day." *Associated Press*. Available at http://www.blueridgenow.com/article/20081028/NEWS/810280277/1170

[16] From Appraisal Foundation Letter to the Subcommittee on Capital Markets. April 22, 2009. Available at http://www.appraisalinstitute.org/newsadvocacy/downloads/TAFbestpracticesproposal.pdf

Appraisal Foundation.[16] This amendment would have authorized federal funding to TAF in the area of appraisal practice, methodology and, potentially, appraisal instruction, without further clarification.

Representatives of both organizations lobbied leaders of the Appraisal Institute in a private meeting to support the amendment. Ultimately, the amendment was never considered by the Committee and was not included in the final version of H.R. 4173 due to concerns about its merits and enforceability.

However, failure to secure Congressional authorization to expand TAF's authority to the area of appraisal practices did not impede the ASC and TAF from advancing the project. A special "Best Practices Task Force" had been convened by TAF to examine the issues of appraisal methodology and best practices. The formation of the Task Force occurred concurrently with the development of the legislative amendment advanced by the ASC and TAF, although the existence of the amendment was apparently never disclosed to Task Force participants, and the bulk of the Task Force's work occurred after the amendment was rejected by the House Financial Services Committee.

Our organization was, and remains, deeply concerned about the functions and operations of this Task Force, especially after the ASC's and TAF's overtures on appraisal methodologies and techniques were rebuffed by Congress. Members of the ASC were originally a part of this Task Force and may have instrumental in its creation. However, legal counsel from the respective federal financial institution regulatory agencies apparently removed the ASC members shortly after the Task Force convened because of concerns about conflicts of interest.

The Final Report of the Task Force on Best Practices does not appear to be consistent with the Task Force's actual deliberations[17]. For instance, we understand from participants of Task Force meetings that leaders of TAF spoke openly about developing appraisal education and future revenue opportunities as a result of the creation of a panel or committee relating to appraisal methodology and instruction. Concerns were expressed by several members of the Task Force about the mission creep of TAF, the scope and enforceability of the project, and the potential conflicts of interest. Yet, the Report includes only a scant mention about potential conflicts, and it relates more to potential overlap with other TAF boards. It omits any concerns expressed by Task Force members about education development. This leaves us to speculate that the recommendations of the Task Force may have been predetermined by the ASC and TAF, and that creation of the Task Force was only to give the illusion of objectivity and openness. Further, it appears that federal funds provided by the ASC were used by TAF to reimburse expenses relating to the Best Practices Task Force, a questionable reimbursement given Title XI's limitations.[18]

Despite repeated concerns and reservations expressed by our organization and others, representatives of TAF proceeded to present a funding request to the ASC in September 2009 for monies to support funding a panel – called the Recognized Methods and Techniques Panel (RMAT) - recommended in the Report of the Task Force

[16] From Appraisal Foundation Letter to the Subcommittee on Capital Markets. April 22, 2009. Available at http://www.appraisalinstitute.org/newsadvocacy/downloads/TAFbestpracticesproposal.pdf

[17] From the Task Force Report to the Board of Trustees, September 11, 2009, available at http://www.appraisalinstitute.org/newsadvocacy/downloads/TaskForceMemo_BOT_091109.pdf

[18] From the ASC Meeting Minutes, September 23, 2009. Available at https://www.asc.gov/Documents/MeetingMinutes/ASC%20Bd%20Mtg%20Minutes%2009.23.2009.pdf

on Best Practices.[19]. This funding request was subsequently withdrawn in November, 2009[20]. The reason for this withdrawal is not entirely clear, but during this period of time the scope of the RMAT project was substantially expanded by the TAF Board of Trustees. While the Task Force recommended creation of a panel, the leadership of TAF disregarded this recommendation and established a third board (the APB) instead.[21]

When leaders of our organization in the fall of 2009 asked TAF leadership why the third board had been created, TAF leadership confirmed they were "told to do it" by representatives of the ASC. The chair of TAF, in a recent interview, confirmed that TAF was "asked by the Appraisal Subcommittee to do this, not informally….[22]" If this position of the ASC is in fact true, it would certainly be well beyond its authorization by Congress, albeit consistent with past actions that would suggest TAF is under direction by the ASC, or at least certain members of the ASC.

The only public accountability requirement of the ASC is to issue an annual report to Congress, which includes a review of the TAF's activities. Remarkably, neither the 2009 or 2010 Annual Reports issued by the ASC divulge any of these activities, reporting only that TAF established the APB and summarizing its intentions, but advising nothing about the apparent influence, involvement and direction advanced by members of the ASC.[23] These reports also fail to mention the expression of concern by the Appraisal Institute regarding this unauthorized mission creep, which ultimately led to AI withdrawing as a TAF sponsor.

*Potential Explanations*

The original intent behind establishing a third board appears to be to position TAF to receive additional federal funding from the ASC. TAF revenues have declined substantially in recent years, so new funding streams have been sought to help offset recent losses. We see two possibilities for this to occur: 1) direct funding/ reimbursement for its operations, and 2) recognizing future work products of the APB – so-called "monographs" – within ASC regulations and regulations of the federal bank regulatory agencies. TAF leadership openly has expressed their desire to seek federal funding for the APB, having originally sought ASC funding in September 2009. TAF leadership has also implied that federal funding of the APB may follow a similar course as that of the ASB and AQB, which were created prior to Congressional authorization in Title XI[24].

[19] From the ASC Meeting Minutes, September 23, 2009. Available at https://www.asc.gov/Documents/MeetingMinutes/ASC%20Bd%20Mtg%20Minutes%2009.23.2009.pdf

[20] From the ASC Meeting Minutes, November 18, 2009. Available at https://www.asc.gov/Documents/MeetingMinutes/ASC%20Bd%20Mtg%20Minutes%2011.18.2009.pdf

[21] From the June 3, 2009 Memo from the TAF Board of Trustees entitled, "Proposed Legislative Amendment/Best Practices."

[22] "*The Appraisal Practices Board is a good example…*we were asked by the Appraisal Subcommittee to do this, not informally [sic], but its members expressed an interest in the Foundation doing this at least." From *"The Housing Helix" podcast with Jonathan Miller, September 15, 2010.* Available at http://matrix.millersamuel.com/?p=9541

[23] From the 2009 Annual Report of the Appraisal Subcommittee. Available at https://www.asc.gov/Documents/AnnualReports/2009%20ASC%20Annual%20Report.pdf

[24] Presentation by David Bunton, President of the Appraisal Foundation before the Association of Appraiser Regulatory Officials, May 1, 2010.

Our organization is troubled by the possibility of the appraisal profession's exclusive standards and qualifications setter being at the mercy of federal bank regulators. On this point, we strongly believe that the public is best served by an appraisal profession that is independent of government control and influence. This important separation of functions was recognized and established by Title XI when it mandated that there be requirements for certification and licensing for real estate appraisers, as well as adherence to USPAP, and reserved the promulgation and issuance of appraisal standards and appraiser qualifications to TAF. This was done with an explicit understanding that the "body of knowledge" of the profession is separate and distinct from standards and qualifications and requires greater flexibility given the diversity of property types and the continuous evolution of valuation theory. It is for this reason that areas of appraisal practice have been reserved to academia, as well as the appraisal practitioners collectively and professional appraisal organizations that have a nearly 80-year history in development of the body of valuation knowledge.

Any directive by the ASC and its members to establish a new board – without Congressional authorization – would go far beyond the ASC's legal mandate to monitor and review activities of TAF related to standards and qualifications as authorized under Title XI. Our organization is not aware of the ASC advising Congress of any concerns regarding areas of appraisal practice and recognized methods and techniques, as well as any perceived disconnect between appraisal standards and appraisal practice. Expression of such concerns in the ASC's Annual Report or in other forms of correspondence would have been an appropriate expression of the ASC's monitoring and review authorization, and yet none can be found in any public Report to Congress[25].

Further, this abrogation of the ASC's oversight responsibility comes amidst growing concerns over the independence of the TAF boards. Specifically, we have heard concerns from several former members of the Appraisal Standards Board (ASB) regarding the independence of the ASB which may have been compromised by TAF's Board of Trustees in recent years. According to TAF By-Laws, the ASB is to operate independent from the TAF's Board of Trustees with regard to the terms and content of USPAP.[26] Former members of the ASB report that members of TAF's Board of Trustees interfered with the ASB's duties and obligations, directing it to take certain actions or avoid taking others. It is this type of activity that Congress trusted the ASC with monitoring; yet, it appears that this oversight function may have been ignored in lieu of the ASC providing direction to TAF.

We also have concerns about the TAF board appointment process and recommend an examination into whether the appointment process to the ASB and AQB is impartial and not subject to personal interests or favors. Specifically, in this regard, the TAF President apparently has considerable influence, and in several cases, we do not believe the better-qualified candidates have been selected. At a minimum, TAF's selection process and criteria should be examined, as should the question of whether or not they have been adhered to. This is an oversight task that the ASC should have performed, but apparently has not.

[25] ASC Annual Reports are available at https://www.asc.gov/About-the-ASC/AnnualReports.aspx

[26] "*Except as otherwise provided in these Bylaws or by resolution of the Board of Trustees, the Standards Board shall have and exercise all authority and power and perform all functions of the Foundation and the Board of Trustees in respect to establishing improving and promulgating the terms and content of the Uniform Standards of Professional Appraisal Practice." Available at https://appraisalfoundation.sharefile.com/d-scb075c284704f3c8*

*Recommendations*

These issues speak to broader concerns that our organization has regarding the overall oversight process outlined by Title XI of FIRREA. The Dodd-Frank Act represents the first significant legislative review by Congress of the ASC in nearly twenty years. While our organization has expressed concerns about the effectiveness of the ASC in monitoring standards and qualifications for many years, the current "review every 20 years approach" is not conducive to active and effective oversight by Congress. We hope Congress will examine this issue and instill much-needed accountability for the betterment of our profession and the protection of the public.

To this end, we question whether the current structure of the ASC includes appropriate oversight and public-accountability measures to protect the public and whether comprehensive reorganization is necessary to accomplish this goal. More specifically, the concerns outlined above illustrate several of the problems with the underlying ASC structure, which appears to allow individual appraisal policy managers in federal bank regulatory agencies to wear two "hats" in the realm of appraisal regulation. Traditionally, the same individuals that write appraisal related policy and guidance for federally regulated financial institutions have been assigned as members of the ASC. These are two entirely different functions, requiring separate and distinct knowledge sets. For instance, it is possible that the directive from members of the ASC to create the APB was based on their experiences as appraisal policy managers at their respective agencies. The appraisal policy managers may have identified problems found in appraisals during bank examinations, and then carried those perspectives to meetings of the ASC. However, the ASC, as illustrated above, is limited by law to monitoring and reviewing the activities of TAF and is prohibited from providing directives. Yet, it may not be clear which hat is being worn – the member of the ASC, or the policy manager of the federal bank regulatory agency.

In addition, as Congress reviews legislative recommendations, we urge its authorizations to TAF be reflective of any change in its mission statement. For instance, we do not believe it would be appropriate for Congress to continue federal funding to TAF if it moves to become a membership organization. We do not believe it is appropriate to continue federal funding if TAF moves to provide education, either directly or indirectly, to appraisers. We see enormous conflicts of interest with exclusive standards-setting bodies also providing education, especially, when that organization *approves* education[27]. Most, if not all, standards-setters that we are familiar with go to great lengths to safeguard their independence by explicitly *restricting or limiting* their involvement in education. In our view, this actually strengthens a standards-body position as an authoritative voice on standards issues by protecting it from any perception of ulterior motives.

TAF was never envisioned by Congress or its sponsors to function like a professional organization and compete with professional organizations. Yet this clearly appears to be part of the intention of the ASC with its directives and TAF with its actions.[28]

This is particularly important in light of the new APB, for which, as recent history has shown, the ASC and TAF will continue to advance and potentially propose again to Congress once it is fully operational. On this point, we do not believe Congress should recognize the APB without establishing appropriate limitations on TAF, including

[27] TAF's Course Approval Program is recognized by state appraiser regulatory agencies and is now recognized in the Dodd-Frank Act. Available at https://appraisalfoundation.sharefile.com/d-s29a914a06494fcc8

[28] A the October 2010 AARO-TAF-ASC meeting in Washington, DC, the President of TAF announced the development of education for real estate appraisers in the area of financial reporting.

restrictions in offering education where there are apparent conflicts of interest. Similar standards-setting bodies and those with authorizations from Congress, such as the Conference of State Bank Supervisors who are authorized by Congress with approving education, are strictly prohibited by Congress from offering education to licensees.[29] We believe such limitations are appropriate for TAF given its role as an exclusive standards-setter, where independence is crucial to protecting the public.

### B. Risk management functions must be enhanced with competent and independent appraisers and appraisal reviewers

One of the biggest challenges facing real estate appraisal is the marginalization of risk management processes within many financial institutions. As several recent investigations into the financial crisis have confirmed, bank regulators have failed to properly oversee financial institutions. In some cases, virtually no oversight existed, and it should come as no surprise that many of those institutions are no longer in existence.

In March, 2011, the Federal Deposit Insurance Corporation filed a civil complaint against executives of Washington Mutual (WaMu), illustrating how risk management was marginalized. According to the complaint[30], senior bank executives knew that strong risk analysis and management was critical to managing this type of higher risk loan portfolio. Nevertheless, just at the point when risk management was most critical, the executives allegedly marginalized the risk management function in WaMu's Home Loans Division. Repeated warnings about the risks associated with the bank's aggressive lending practices – even those as stark as senior risk managers declaring that WaMu was "putting borrowers into homes that they simply cannot afford" – went unheeded. As the Bank's chief risk officer told the chief executive just weeks before WaMu went into receivership, the bank's "DNA" was missing "the risk chromosome."

Also in March, the Senate Government Affairs Permanent Investigations Subcommittee issued a report on the failure of WaMu, citing a slew of factors involved. Passive oversight of bank appraisal functions was one of many indictments identified in the report. During the five-year period from 2004 through 2008 reviewed by the Subcommittee, Office of Thrift Supervision (OTS) examiners identified over 500 serious deficiencies in Washington Mutual's lending, risk management, and appraisal practices. With regard to appraisal oversight, the report found the OTS failed to take appropriate enforcement action involves WaMu's appraisal practices. OTS failed to act even after other government entities accused WaMu of systematically inflating property values to justify larger and more risky home loans. Specifically, WaMu's decision to outsource the appraisal function received minimal attention from OTS. Problems began almost immediately after WaMu outsourced the appraisal function.

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[29] The SAFE Act limits the National Mortgage Licensing System established by the CSBS from directly or indirectly offering education for qualifying or continuing education for mortgage originators. See 12 U.S.C. 5104(c)(3) http://www.law.cornell.edu/uscode/html/uscode12/usc_sec_12_00005104----000-.html. For this reason, the CSBS is not found amongst the list of approved education providers found http://mortgage.nationwidelicensingsystem.org/courseprovider/Documents/NMLS%20Approved%20Course%20Providers.pdf

[30] Available at http://graphics8.nytimes.com/packages/pdf/business/conformedcomplaint.pdf

Similar findings can be found in recent Material Loss Reports, which are conducted by offices of inspectors general following a bank failure. This includes the IndyMac Bank failure, where appraisal citations were found, but not acted on, by bank regulators for many years all the way up until failure. We recently conducted a review of Material Loss Reports and found that 64 percent of Material Loss Reports contained previous citations by bank regulators relating to appraisal management deficiencies in 2009. This percentage increased to 75 percent in Material Loss Reports published in 2010, where failed banks were previously cited for appraisal management deficiencies.

All of these reports indicate the federal bank regulators must become more proficient in appraisal matters. Following the Savings and Loan Crisis of the 1980s, the Office of Thrift Supervision and the Federal Deposit Insurance Incorporation had large appraisal divisions that assisted with bank oversight and supervision. Over time, these divisions were downsized out of existence. At one point in the past decade, there were no appraisers on staff at any bank regulatory headquarters agency.  Regulators relied on the expertise from non-appraisers to assist with appraisal oversight and examination issues. Sadly, the results were disastrous.

Today, we are aware of four designated members of the Appraisal Institute who work for bank regulatory agencies, three of whom were hired in the last three years. The Federal Reserve and National Credit Union Administration still do not have any appraisal staff. We understand the Consumer Financial Protection Bureau may assign one staff position for an appraiser, which will be important to oversight of non-bank mortgage lender appraisal and risk management operations. We hope this hiring trend continues, but in a bolder way" or "more robust manner" in order to use the wealth of appraisal knowledge and experience that is available.

Concluding Remarks

If we have learned anything during this crisis it is that we need a return to the basics. We need to reinsert ethics, competency and accountability into the real estate sector. We also need to ensure regulators are doing their job. To this end, it is critical that Congress remain engaged on these matters, as continuing threats continue to loom large over the financial recovery.

United States House of Representatives
# Committee on Financial Services

## "TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

| **1. Name:** | **2. Organization or organizations you are representing:** |
|---|---|
| Sara Stephens, MAI | Appraisal Institute |
| **3. Business Address and telephone number:** | |
| [redacted] | |
| **4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** | **5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** |
| ☐ Yes ☑ No | ☐ Yes ☑ No |
| **6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.** | |
| | |
| **7. Signature:** | |
| Sara W. Stephens | |

*Please attach a copy of this form to your written testimony.*