

**GAO**

Testimony

Before the Subcommittee on Insurance,  
Housing and Community Opportunity,  
Committee on Financial Services, House  
of Representatives

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For Release on Delivery  
Expected at 10:00 a.m. EDT  
Thursday, June 28, 2012

# RESIDENTIAL APPRAISALS

## Regulators Should Take Actions to Strengthen Appraisal Oversight

Statement of William B. Shear, Director  
Financial Markets and Community Investment



**G A O**

Accountability \* Integrity \* Reliability

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Highlights of [GAO-12-840T](#), a testimony before the Subcommittee on Insurance, Housing and Community Opportunity, Committee on Financial Services, House of Representatives.

## Why GAO Did This Study

Real estate valuations, which encompass appraisals and other estimation methods, have come under increased scrutiny in the wake of the recent mortgage crisis. The Dodd-Frank Act codified several independence requirements for appraisers and requires federal regulators to set standards for registering AMCs. Additionally, the act expanded the role of ASC, which oversees the appraisal regulatory structure established by Title XI of FIRREA. The act also directed GAO to conduct two studies on real estate appraisals. This testimony discusses information from those studies, including (1) the use of different real estate valuation methods, (2) policies on appraiser conflict-of-interest and selection and views on their impact, and (3) ASC's performance of its Title XI functions. To address these objectives, GAO analyzed government and industry data; reviewed academic and industry literature; examined policies, regulations, and professional standards; and interviewed industry participants and stakeholders.

## What GAO Recommends

GAO previously recommended that federal regulators consider key AMC functions in rulemaking to set minimum standards for registering these firms. The regulators agreed with or said they would consider this recommendation. GAO also recommended that ASC clarify the criteria it uses to assess states' compliance with Title XI and develop specific policies and procedures for monitoring the federal banking regulators and the Appraisal Foundation. ASC is taking steps to implement these recommendations. See [GAO-11-653](#) and [GAO-12-147](#).

View [GAO-12-840T](#) or key components. For more information, contact William B. Shear at (202) 512-8678 or [shearw@gao.gov](mailto:shearw@gao.gov).

June 2012

# RESIDENTIAL APPRAISALS

## Regulators Should Take Actions to Strengthen Appraisal Oversight

### What GAO Found

Data GAO obtained from Fannie Mae and Freddie Mac (the enterprises) and five of the largest mortgage lenders indicate that appraisals—which provide an estimate of market value at a point in time—are the most commonly used valuation method for first-lien residential mortgage originations. Other methods, such as broker price opinions and automated valuation models, are quicker and less costly but are viewed as less reliable. As a result, they generally are not used for most purchase and refinance mortgage originations. Although the enterprises and lenders GAO spoke with did not capture data on the prevalence of approaches used to perform appraisals, the sales comparison approach—in which the value is based on recent sales of similar properties—is required by the enterprises and the Federal Housing Administration. This approach is reportedly used in nearly all appraisals.

Conflict-of-interest policies have changed appraiser selection processes and the appraisal industry more broadly, raising concerns about the oversight of appraisal management companies (AMC), which often manage appraisals for lenders. Recent policies, including provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), reinforce prior requirements and guidance that restrict who can select appraisers and prohibit coercion. In response to market changes and these requirements, some lenders have turned to AMCs. Greater use of AMCs has raised questions about oversight of these firms and their impact on appraisal quality. Federal regulators and the enterprises said they hold lenders responsible for ensuring that AMCs' policies and practices meet their requirements but that they generally do not directly examine AMCs' operations. Some industry participants voiced concerns that some AMCs may prioritize low costs and speed over quality and competence. The Dodd-Frank Act requires state appraiser licensing boards to supervise AMCs and requires the federal banking regulators, the Federal Housing Finance Agency, and the Bureau of Consumer Financial Protection to establish minimum standards for states to apply in registering them. Setting minimum standards that address key functions AMCs perform on behalf of lenders could provide greater assurance of the quality of the appraisals that AMCs provide. As of June 2012, federal regulators had not completed rulemaking to set state standards.

The Appraisal Subcommittee (ASC) has been performing its monitoring role under Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), but several weaknesses have potentially limited its effectiveness. For example, ASC has not clearly defined the criteria it uses to assess states' overall compliance with Title XI. In addition, Title XI charges ASC with monitoring the appraisal requirements of the federal banking regulators, but ASC has not defined the scope of this function—for example, by developing policies and procedures—and its monitoring activities have been limited. ASC also lacks specific policies for determining whether activities of the Appraisal Foundation (a private nonprofit organization that sets criteria for appraisals and appraisers) that are funded by ASC grants are Title XI-related. Not having appropriate policies and procedures is inconsistent with federal internal control standards that are designed to promote the effectiveness and efficiency of federal activities.

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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 and the role of the Appraisal Subcommittee (ASC) of the Federal Financial Institutions Examination Council (FFIEC) in monitoring requirements for real estate appraisals and appraisers.<sup>1</sup> 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, turmoil in the mortgage market 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, that included the Home Valuation Code of Conduct (HVCC).<sup>2</sup> HVCC set forth certain appraiser independence requirements for loans sold to the enterprises and took effect in 2009. Although the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) declared HVCC no longer in effect, it codified several of HVCC's provisions.<sup>3</sup> The Dodd-Frank Act also amended Title XI of the Financial

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<sup>1</sup>FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Bureau of Consumer Financial Protection and to make recommendations to promote uniformity in the supervision of financial institutions.

<sup>2</sup>The enterprises purchase mortgages that meet specified underwriting criteria from approved lenders. The enterprises bundle most of the mortgages they purchase into securities and guarantee the timely payment of principal and interest to investors in the securities. On September 6, 2008, the enterprises were placed under federal conservatorship out of concern that their deteriorating financial condition and potential default on \$5.4 trillion in outstanding financial obligations threatened the stability of financial markets.

<sup>3</sup>Pub. L. No. 111-203. Congress enacted the Dodd-Frank Act in July 2010. The Dodd-Frank Act stated that HVCC ceased to be effective as of the date the Board of Governors of the Federal Reserve System (Federal Reserve) issued interim final rules covering appraiser independence. Dodd-Frank Act § 1472(a) (codified at 15 U.S.C. § 1639e(j)). The Federal Reserve issued these rules on October 28, 2010. 75 Fed. Reg. 66554. The enterprises have incorporated many of the other provisions of HVCC into their requirements.

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Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which made reforms to address the quality of appraisals and appraiser qualifications and created ASC to monitor Title XI's implementation. Among other things, the Dodd-Frank Act gave ASC additional responsibilities and authorities.

The Dodd-Frank Act also directed us to perform two studies concerning real estate appraisals.<sup>4</sup> The first, which we issued in July 2011, included an examination of real estate valuation methods, including appraisals, and conflict-of-interest and appraiser-selection policies.<sup>5</sup> The second, which we issued in January 2012, included an assessment of ASC's monitoring functions and discussed challenges that ASC faces in implementing its new responsibilities and authorities.<sup>6</sup>

My statement today is based on information from those two reports. Specifically, I will discuss (1) the use of different valuation methods for single-family residential mortgages and the advantages and disadvantages of each method, (2) policies on appraiser conflict-of-interest and selection and views on the policies' impact on industry stakeholders and appraisal quality; and (3) ASC's performance of its Title XI functions that existed prior to the Dodd-Frank Act and challenges that it faces in implementing additional responsibilities under the act. 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.<sup>7</sup> We reviewed academic and industry literature on real estate valuation and examined federal regulations and policies, as well as lenders' and appraisal management companies' (AMC) internal policies on and procedures for selecting

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<sup>4</sup>Dodd-Frank Act § 1476.

<sup>5</sup>GAO, *Residential Appraisals: Opportunities to Enhance Oversight of an Evolving Industry*, [GAO-11-653](#) (Washington, D.C.: July 13, 2011).

<sup>6</sup>GAO, *Real Estate Appraisals: Appraisal Subcommittee Needs to Improve Monitoring Procedures*, [GAO-12-147](#) (Washington, D.C.: Jan. 18, 2012).

<sup>7</sup>See [GAO-11-653](#) for more information about the data we obtained for this study.

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appraisers.<sup>8</sup> We also reviewed ASC's policies and procedures, including its rules of operation, policy and procedures manual, Title XI policy statements, and compliance review manual. In addition, we reviewed ASC records such as its annual reports to Congress, board-meeting minutes, state compliance review reports, and grant documents. We interviewed a broad range of appraisal and mortgage industry participants and stakeholders, including officials from the enterprises, FHFA, the federal banking regulatory agencies, and ASC. Additionally, prior to this hearing, we interviewed federal regulators to update the status of our recommendations. The work that this statement is based on was performed from July 2010 to June 2012 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.

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## Background

Before originating a residential mortgage loan, a lender assesses its risk through the underwriting process, in which the lender generally examines the borrower's credit history and capacity to repay the mortgage and obtains a valuation of the property that will be the loan's collateral. Lenders need to know the property's market value, or the probable price that the property should bring in a competitive and open market, in order to provide information for assessing their potential loss exposure if the borrower defaults.<sup>9</sup> Real estate can be valued using a number of methods, including appraisals, broker price opinions (BPO), and automated valuation models (AVM). Appraisals are opinions of value based on market research and analysis as of a specific date. Appraisals

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<sup>8</sup>The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203) defines an AMC as a third party that oversees a network or panel of more than 15 appraisers within a state or 25 or more appraisers nationally in a given year and has been authorized by lenders to recruit, select, and retain appraisers; contract with appraisers to perform appraisal assignments; manage the process of having an appraisal performed; or review and verify the work of appraisers. Dodd-Frank Act § 1473(f)(4) (codified at 12 U.S.C. § 3550(11)).

<sup>9</sup>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.

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are performed by state-licensed or -certified appraisers who are required to follow the Uniform Standards of Professional Appraisal Practice (USPAP).<sup>10</sup> A BPO is an estimate of the probable selling price of a particular property prepared by a real estate broker, agent, or salesperson rather than by an appraiser. 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.<sup>11</sup>

In 1986, the House Committee on Government Operations issued a report concluding that problematic appraisals were an important contributor to the losses that the federal government suffered during the savings and loan crisis.<sup>12</sup> The report stated that hundreds of savings and loans chartered or insured by the federal government were severely weakened or declared insolvent because faulty and fraudulent real estate appraisals provided documentation for loans larger than what the collateral's real value justified. In response, Congress incorporated provisions in Title XI of FIRREA that were intended to ensure that appraisals performed for federally related transactions were done (1) in writing, in accordance with uniform professional standards, and (2) by individuals whose competency had been demonstrated and whose professional conduct was subject to effective supervision.<sup>13</sup>

Various private, state, and federal entities have roles in the Title XI regulatory structure:

- *The Appraisal Foundation.* The Appraisal Foundation is a private not-for-profit corporation composed of groups from the real estate industry that works to foster professionalism in appraising. The foundation

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<sup>10</sup>USPAP covers both the principles appraisers must apply in developing appraisals and the information the appraisal report must contain.

<sup>11</sup>A multiple listing service is a database set up by a group of real estate brokers to provide information about properties sold and for sale.

<sup>12</sup>House Committee on Government Operations, *Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investment in the Secondary Market*, 99th Cong., 2nd sess., 1986, H. Rep. 99-891, 4-6.

<sup>13</sup>12 U.S.C. §§ 3331, 3339-3345. Federally related transactions are real estate transactions that require the services of an appraiser and involve financial institutions regulated by the federal government.

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sponsors two independent boards with responsibilities under Title XI. The first of these, the Appraisal Standards Board, sets rules for developing an appraisal and reporting its results through USPAP. The second board, the Appraiser Qualifications Board, establishes the minimum qualification criteria for state certification and licensing of real property appraisers.<sup>14</sup> The foundation is funded primarily by sales of publications but also receives an annual grant from ASC.

- *State-level regulatory entities.* Title XI relies on the states to (1) implement the certification and licensing of all real estate appraisers and (2) monitor and supervise appraisers' compliance with appraisal standards and requirements. To assure the availability of certified and licensed appraisers, all 50 states, the District of Columbia, and four U.S. territories have adopted structures to regulate and supervise the appraisal industry.<sup>15</sup> These structures typically consist of a state regulatory agency and a board or commission that establish requirements for education and experience, consistent with or in excess of Appraiser Qualifications Board criteria; license and certify appraisers; and monitor and enforce appraiser compliance.
- *Federal banking regulators.* Title XI places responsibility for regulating appraisals and "evaluations" performed in conjunction with federally related transactions with the Board of Governors of the Federal Reserve System (Federal Reserve), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA).<sup>16</sup> To meet this responsibility, these financial institution regulators have established requirements for appraisals and evaluations through regulations and have jointly issued Interagency Appraisal and Evaluation Guidelines. The federal regulators have developed procedures for examining the real estate lending activities of regulated institutions that include steps

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<sup>14</sup>Certified appraisers are qualified to appraise properties of greater complexity and value than licensed appraisers and must meet higher requirements for education and experience.

<sup>15</sup>The four territories are Guam, Northern Mariana Islands, Puerto Rico, and the Virgin Islands.

<sup>16</sup>Evaluations are estimates of market value that do not have to be performed by a state-licensed or -certified appraiser. The federal banking regulators permit evaluations to be performed (consistent with safe and sound lending practices) in certain circumstances, such as mortgage transactions of \$250,000 or less that are conducted by regulated institutions.

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for assessing the completeness, adequacy, and appropriateness of these institutions' appraisal and evaluation policies and procedures.

- *Appraisal Subcommittee.* ASC has responsibility for monitoring the implementation of Title XI by the private, state, and federal entities noted previously. Among other things, ASC is responsible for (1) monitoring and reviewing the practices, procedures, activities, and organizational structure of the Appraisal Foundation—including making grants to the Foundation in amounts that it deems appropriate to help defray costs associated with its Title XI activities; (2) monitoring the requirements that states and their appraiser regulatory agencies establish for the certification and licensing of appraisers; (3) monitoring the requirements established by the federal banking regulators regarding appraisal standards for federally related transactions and determinations of which federally related transactions will require the services of state-licensed or -certified appraisers; and (4) maintaining a national registry of state-licensed and -certified appraisers who can perform appraisals for federally related transactions. Among other responsibilities and authorities, the Dodd-Frank Act requires ASC to implement a national appraisal complaint hotline and provides ASC with limited rulemaking authority. To carry out these tasks, ASC has 7 board member positions and 10 staff headed by an Executive Director hired by the board. Five of the board members are designated by the federal agencies that are part of FFIEC—the Bureau of Consumer Financial Protection (also known as the Consumer Financial Protection Bureau or CFPB), FDIC, the Federal Reserve, NCUA, and OCC. The other two board members are designated by the U.S. Department of Housing and Urban Development (HUD)—which includes the Federal Housing Administration (FHA)—and FHFA. ASC is funded by appraiser registration fees that totaled \$2.6 million in fiscal year 2011.

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## 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. 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 included mortgages sold to the enterprises and



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mortgages insured by 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 amounts in the case of refinances) against an AVM-generated value, in accordance with enterprise policies that permit this practice for some mortgages that have characteristics associated with a lower default risk.

The enterprises, FHA, and lenders require and obtain appraisals for most mortgages because mortgage industry participants consider appraising 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, USPAP outlines the steps appraisers must take in developing appraisals and the information appraisal reports must contain. It 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 BPOs and AVMs are not permitted for most purchase and refinance mortgage originations. The enterprises do not permit lenders to use BPOs for mortgage originations and permit lenders to use AVMs for only 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 a 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 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

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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 the 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 the most applicable for estimating market value in typical mortgage transactions. Consistent with these policies, our review of valuation data from a mortgage technology company—representing about 20 percent of mortgage originations in 2010—indicated that appraisers used the sales comparison approach for nearly all (more than 99 percent) of the mortgages covered by these data.<sup>17</sup> 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 viewed as a limitation of the sales comparison approach. They told us that relying solely on the sales comparison approach could 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, they 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 might 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—could 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.

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<sup>17</sup>The enterprises and lenders we spoke with did not capture data on the prevalence of approaches used to perform appraisals.

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## 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 the now-defunct HVCC, which took effect in May 2009; the enterprises' new appraiser independence requirements that replaced HVCC in October 2010; provisions in the Dodd-Frank Act; and revised Interagency Appraisal and Evaluation Guidelines from the federal banking regulators that were issued in December 2010. Provisions of these and other policies address (1) prohibitions against the involvement of loan production staff 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, to lenders' more frequent use of AMCs to select appraisers. AMCs are third parties that, among other things, select appraisers for appraisal assignments on behalf of lenders. Some appraisal industry participants said that HVCC, which required 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.<sup>18</sup>

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<sup>18</sup>Although industrywide data on lenders' use of AMCs over time are unavailable, appraisal industry participants told us that between 60 and 80 percent of appraisals were currently ordered through AMCs. They provided varying estimates of AMC use prior to HVCC that ranged from 15 percent to 50 percent of mortgage originations.

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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 that these standards are met when lenders outsource appraisal functions to third parties, such as AMCs. Officials from the federal banking regulators told us that they reviewed lenders' policies and controls for overseeing AMCs, including the due diligence performed when selecting AMCs. However, they told us that they generally did not review an AMC's operations directly unless they had serious concerns about it that the lender was unable to address. 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 selected appraisers based on who would accept the lowest fee and complete the appraisal report the fastest rather than on who was the most qualified, had the appropriate experience, and was familiar with the relevant neighborhood. AMC officials we spoke with said that they had processes that addressed these areas of concern—for example, using an automated system that identified the most qualified appraiser based on the requirements for the assignment, proximity to the subject property, and performance metrics such as timeliness and appraisal quality.

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 requiring state appraiser regulatory boards to supervise AMCs. The Dodd-Frank Act requires the federal banking regulators, CFPB, and FHFA to establish minimum standards for states to apply in registering AMCs, including requirements that

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appraisals coordinated by an AMC comply with USPAP and be conducted independently and free from inappropriate influence and coercion.<sup>19</sup> 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, we recommended in our July 2011 report that the heads of the federal banking regulators, CFPB, and FHFA—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.<sup>20</sup> The federal banking regulators and FHFA agreed with or indicated that they would consider our recommendation but as of June 2012 had not issued a rule setting minimum standards for state registration of AMCs.<sup>21</sup>

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## Several Weaknesses Have Potentially Limited ASC's Effectiveness in Performing Its Title XI Functions

ASC has been performing its monitoring role under Title XI, but several weaknesses have potentially limited its effectiveness. In particular, ASC has not fully developed appropriate policies and procedures for monitoring state appraiser regulatory agencies, the federal banking regulators, and the Appraisal Foundation. In addition, ASC faces potential challenges in implementing some Dodd-Frank Act provisions.

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## Monitoring States' Compliance with Title XI

ASC has detailed policies and procedures for monitoring state appraiser regulatory programs and has issued 10 policy statements covering different aspects of states' implementation of Title XI requirements. The policy statements cover topics including submission of data to the

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<sup>19</sup>Dodd-Frank Act § 1473(f)(2) (codified at 12 U.S.C. § 3353(a)).

<sup>20</sup>[GAO-11-653](#).

<sup>21</sup>CFPB did not receive a draft of our July 2011 report in time to comment on our recommendation.

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national registry of appraisers, license reciprocity (which enables an appraiser certified or licensed in one state to perform appraisals in other states), and programs for enforcing appraiser qualifications and standards. ASC primarily uses on-site reviews conducted by ASC staff to monitor states' compliance with the policy statements. ASC's routine compliance reviews examine each state every 2 years or annually if ASC determines that a state needs closer monitoring. These reviews are designed to encourage adherence to Title XI requirements by identifying any instances of noncompliance or "areas of concern" and recommending corrective actions.<sup>22</sup> ASC conveys its findings and recommendations to states through written reports. In 2010, ASC reported 34 findings of noncompliance, the majority of which concerned weaknesses in state enforcement efforts, such as a lack of timeliness in resolving complaints about appraiser misconduct or wrongdoing. At the completion of each review, ASC executive staff and board members deliberate on the findings and place the state into one of three broad compliance categories: "in substantial compliance," "not in substantial compliance," and "not in compliance." According to ASC, in substantial compliance applies when there are no issues of noncompliance or no violations of Title XI; not in substantial compliance applies when there are one or more issues of noncompliance or violations of Title XI that do not rise to the level of not in compliance; and not in compliance applies when "the number, seriousness, and/or repetitiveness of the Title XI violations warrant this finding."<sup>23</sup>

We found that ASC had been using the three compliance categories in its reports to states and annual reports to Congress (which provide aggregate statistics on the number of states in each category). However, it had not included the definitions of the categories in these reports or in its compliance review manual or policy and procedures manual, and its definition of "not in compliance" was not clear or specific.<sup>24</sup> As previously

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<sup>22</sup>ASC defines an area of concern as one in which the state is in compliance but could improve.

<sup>23</sup>Because a state only has to have one noncompliance finding to be "not in substantial compliance," this category can encompass a fairly wide range of performance. For example, in 2009, states in this category had from one to seven findings of noncompliance.

<sup>24</sup>In June 2012, ASC officials told us they had begun incorporating the definitions in ASC reports and policies.

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noted, the definition states only that the category is to be used “when the number, seriousness, and/or repetitiveness of the violations warrant this finding” and does not elaborate on how these factors are weighed or provide examples of situations that would meet this definition. These shortcomings are inconsistent with our internal control standards, which state that federal agencies should have appropriate policies and procedures for each of their activities.<sup>25</sup> Without clear, disclosed definitions, ASC limits the transparency of the state compliance review process and the usefulness of information Congress receives to assess states’ implementation of Title XI. Further, by not incorporating the definitions into its compliance review and policy and procedures manuals, ASC increases the risk that board members and staff may not interpret and apply the compliance categories in a consistent manner. To address these shortcomings, we recommended in our January 2012 report that ASC clarify the definitions it uses to categorize states’ overall compliance with Title XI and include these definitions in ASC’s compliance review and policy and procedures manuals, compliance review reports to states, and annual reports to Congress.<sup>26</sup> In June 2012, ASC officials told us that they had developed a revised system for rating states that included five compliance categories (ranging from excellent to poor), each with specific criteria. They said that they would soon be publishing the compliance categories in the *Federal Register* to obtain public comments and would include the final categories in appropriate manuals and reports.

In addition to this procedural weakness, ASC has functioned without regulations and enforcement tools that could be useful in promoting state compliance with Title XI. Prior to the Dodd-Frank Act, Title XI did not give ASC rulemaking authority and provided it with only one enforcement option—“derecognition” of a state’s appraiser regulatory program. This action would prohibit all licensed or certified appraisers from that state from performing appraisals in conjunction with federally related transactions. ASC has never derecognized a state, and ASC officials told us that using this sanction would have a devastating effect on the real estate markets and financial institutions within the state. The Dodd-Frank Act provides ASC with limited rulemaking authority and authorizes ASC to

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<sup>25</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999) and *Internal Control Management and Evaluation Tool*, [GAO-01-1008G](#) (Washington, D.C.: August 2001).

<sup>26</sup>[GAO-12-147](#).

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impose (unspecified) interim actions and suspensions against a state agency as an alternative to, or in advance of, the derecognition of the agency.<sup>27</sup> As of June 2012, ASC had not implemented this new enforcement authority. ASC officials said that determining the interim actions and suspensions they would take against state agencies would be done through future rulemaking.

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## Monitoring the Appraisal Requirements of the Federal Banking Regulators

Although Title XI charges ASC with monitoring the appraisal requirements of the federal banking regulators, ASC has not developed policies and procedures for carrying out this responsibility. While ASC's policy manual provides detailed guidance on monitoring state appraiser regulatory programs, it does not mention any activities associated with monitoring the appraisal requirements of the federal banking regulators. Further, ASC officials acknowledged the absence of a formal monitoring process. The absence of policies and procedures specifying monitoring tasks and responsibilities limits accountability for this function and is inconsistent with federal internal control standards designed to help ensure effectiveness and efficiency in agency operations.

According to ASC officials, ASC performs this monitoring function through informal means, primarily through its board members who are employed by the federal banking regulators. However, minutes from ASC's monthly board meetings and ASC's annual reports to Congress indicate that the monitoring activities of ASC as a whole have been limited. For example, our review of board-meeting minutes from 2003 through 2010 found no instances of the board discussing the appraisal requirements of the federal financial regulators.<sup>28</sup> Additionally, evidence of this monitoring function in ASC's annual reports is limited to a summary of any new appraisal requirements issued by the federal financial regulators and HUD during the preceding year.

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<sup>27</sup>The act also gives ASC the authority to remove a state-licensed or -certified appraiser or a registered AMC from the national registry on an interim basis, not to exceed 90 days, pending state agency action on licensing, certification, registration, and disciplinary proceedings. In June 2012, ASC officials told us that they had developed policies to implement this authority and planned to publish the policies in the *Federal Register* to obtain public comment.

<sup>28</sup>The minutes indicated that on at least two occasions, the HUD representative to the ASC board provided updates on appraisal policies for mortgages insured by FHA.



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Stakeholder views differ as to how to interpret the Title XI requirement that ASC monitor the requirements established by the federal banking regulators with respect to appraisal standards.<sup>29</sup> Specifically, some ASC board members told us that they understand their monitoring role as maintaining an awareness of the federal financial regulators' appraisal requirements. Further, one ASC board member told us that ASC's monitoring of the federal financial regulators was more limited than its monitoring of states because (1) board members from the federal financial regulatory agencies are knowledgeable of the appraisal requirements of their agencies, (2) the federal regulators' interagency process for developing appraisal guidelines (in place since 1994) has reduced the need for monitoring the consistency of guidelines across agencies, and (3) monitoring the states' appraiser requirements requires in-depth review of state processes for licensing, certification, and enforcement.

In contrast, some appraisal industry stakeholders and observers have proposed a larger ASC role in monitoring the appraisal requirements of the federal banking regulators. An ASC board member who conducted a review of ASC's operations in 2007 recommended a more structured and active monitoring role for ASC. The board member's report—which the board never officially adopted—suggested that ASC staff could be assigned to keep abreast of federal financial regulators' requirements and guidelines; the staff could then assess the impact of the requirements on ASC's operations and policies. Under this proposed recommendation, which ASC did not implement, ASC staff would annually report the results of this work to the ASC board members.<sup>30</sup> A former General Counsel of ASC told us that ASC's monitoring role should include critically assessing the adequacy of the federal financial regulators' appraisal requirements and evaluating how well the requirements are being implemented. He indicated that such assessment might have helped federal financial regulators and policymakers address issues such as appraiser independence, establishing dollar-based exemptions from appraisal requirements, and referral of Title XI violations to state agencies. A representative of an appraisal industry group expressed a similar view

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<sup>29</sup>12 U.S.C. § 3332(a)(2).

<sup>30</sup>ASC adopted some of the report's recommendations, such as creating a Deputy Executive Director position and allowing states to respond to preliminary compliance review findings prior to the issuance of final reports.

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and noted that ASC's annual reports did not provide substantive analysis or critique of federal appraisal requirements.

However, appraisal industry stakeholders also noted that implementing a more expansive interpretation of ASC's monitoring role would pose challenges. For example, existing ASC staff may not have the capacity to take on additional monitoring responsibilities. Even if ASC staff were able to independently analyze the federal regulators' appraisal requirements, the analysis would be subject to review by the ASC board, which, because of its composition, is not independent from the agencies that ASC is charged with monitoring.

To better define the scope of its monitoring role and improve the transparency of its activities, we recommended in our January 2012 report that ASC develop specific policies and procedures for monitoring the appraisal requirements of the federal banking regulators.<sup>31</sup> In June 2012, ASC officials told us that they recognized the need for ASC to perform this monitoring function, were deliberating on ways to carry it out, and expected to have policies and procedures in place later in the year.

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## Monitoring the Appraisal Foundation's Grant Activities

As previously noted, the Appraisal Foundation is a private not-for-profit corporation that sponsors independent boards that set standards for appraisals and minimum qualification criteria for appraisers. ASC approves an annual grant proposal and provides monthly grant reimbursements to the Appraisal Foundation to support the Title XI-related activities of the foundation and its Appraisal Standards Board and Appraiser Qualifications Board. The reimbursements cover the foundation's incurred costs for activities under the grant. From fiscal years 2000 through 2010, ASC provided the foundation over \$11 million in grant reimbursements, or about 40 percent of ASC's expenditures over that period.

Although ASC monitors the foundation in several ways, ASC lacks specific policies and procedures for determining whether grant activities are related to Title XI. ASC's policies and procedures manual does not address how ASC monitors the Appraisal Foundation. Instead, ASC uses monitoring procedures contained in a memorandum prepared by a former

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<sup>31</sup>[GAO-12-147](#).

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Executive Director. The memorandum describes how the Executive Director reviewed the foundation's grant activities but does not provide criteria for deciding what is Title XI-related. When we asked current ASC officials for the criteria they used, they indicated only that ASC staff "review submissions from the Foundation and supporting cost spreadsheets to determine that activities proposed in the annual grant request or the monthly reimbursement processes meet the requirements of Title XI." They said that once staff determine whether or not a submission falls within these parameters, they make a recommendation to the ASC board. However, determinations about what activities are Title XI-related are not always clear-cut. For example, in 2003, the Executive Director at the time recommended that the foundation be reimbursed for certain legal expenses in connection with a complaint filed with the foundation's ethics committee. However, the ASC board rejected the reimbursement request because the expenses "were not sufficiently Title XI-related." ASC's records do not indicate what criteria either the Executive Director or the ASC board used as a basis for their decisions or why they disagreed. Similarly, our review of ASC documents for more recent grants found no supporting explanations for decisions about whether grant activities were Title XI-related. One ASC board member said the board had a common understanding of what activities were eligible for grants but acknowledged that the basis for funding decisions could be better documented. As previously noted, our internal control standards state that federal agencies should have appropriate policies for each of their activities. Without policies that contain specific criteria, ASC increases the risk that its grant decisions will be inconsistent, limits the transparency of its decisions, and lacks assurance that it is complying with federal internal control standards. To address this limitation, we recommended that ASC develop specific criteria for assessing whether the grant activities of the Appraisal Foundation were related to Title XI and include these criteria in ASC's policy and procedures manual.<sup>32</sup> In June 2012, ASC officials told us that they had been developing these criteria and planned to finalize them by August 2012.

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## Implementing Dodd-Frank Act Provisions

The Dodd-Frank Act contains 14 provisions that give ASC a number of new responsibilities and authorities. Some of the tasks associated with these provisions are complex and challenging, especially for a small

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<sup>32</sup>[GAO-12-147](#).

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agency with limited resources. One of the more complex tasks for ASC is to establish a national appraisal complaint hotline and refer hotline complaints to appropriate governmental bodies for further action.<sup>33</sup> Appraisal industry stakeholders we spoke with noted that creating and maintaining a hotline could be costly because it will likely require investments in staff and information technology to fully ensure that calls are properly received, screened, tracked, and referred. Stakeholders indicated that screening calls would be a critical and challenging job because frivolous complaints could overwhelm the system and identifying valid complaints would require knowledge of USPAP.

Another complex task for ASC is providing grants to state appraiser regulatory agencies to support these agencies' compliance with Title XI. Appraisal industry stakeholders cited challenges that ASC could face in designing the grant program and the decisions it will need to make. Some noted the challenge of designing grant eligibility and award criteria that (1) do not reward states that have weak appraiser regulatory programs because they use appraisal-related fee revenues (from state appraiser licensing and examination fees, for example) for purposes other than appraiser oversight and (2) will not create incentives for states to use less of their own resources for regulation of appraisers. In addition, ASC officials said they were unsure whether a January 2012 increase in the national registry fee—from \$25 to \$40 per appraiser credential—would be adequate to fund the grants and oversee them, especially in light of recent declines in the number of appraisers.<sup>34</sup>

As of June 2012, ASC had not implemented either the national hotline or the state grant program but had completed some initial steps. For example, ASC officials told us that they had developed initial protocols for handling hotline complaints and had begun work on a complaint form, website, and call center. In addition, ASC is in the process of hiring a grants manager.

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<sup>33</sup>The Dodd-Frank Act first required ASC to determine whether a national hotline existed that received complaints of noncompliance with appraisal independence standards and USPAP. ASC completed this task in January 2011, within the statutory deadline, and reported that no such hotline existed. The Dodd-Frank Act requires ASC to establish and operate such a hotline upon making that determination.

<sup>34</sup>Although the Dodd-Frank Act also authorizes ASC to collect registry fees from AMCs, revenues from this source may not be available for several years because regulations for AMC registration must be developed and implemented first.

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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.

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## Contacts and Staff Acknowledgments

For further information on this testimony, please contact me at (202) 512-8678 or [shearw@gao.gov](mailto: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, Emily Chalmers, Anar Ladhani, Yola Lewis, Alexandra Martin-Arseneau, John McGrail, Erika Navarro, Carl Ramirez, Kelly Rubin, Jerry Sandau, Jennifer Schwartz, Andrew Stavisky, and Jocelyn Yin.

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