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Committee on Financial Services

Housing and Insurance Subcommittee

Hearing on
"Modernizing Appraisals: A Regulatory Review and the Future of the Industry"

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National Association of Consumer Advocates

Chairman and Members of the Committee, on behalf of Mountain State Justice, the National Consumer Law Center, and the National Association of Consumer Advocates, thank you for inviting me to testify today regarding the appraisal industry, the Dodd-Frank Act's impact regarding appraisals, and the future of appraisals.[1] I am the Managing Attorney of Mountain State Justice, a non-profit legal services provider in West Virginia that exclusively represents low-income people at no cost to them. Since the early 2000s, we have served thousands of homeowners in danger of losing their homes as the direct result of appraisal fraud and other predatory lending practices.

I am here today to thank Congress for imposing stricter standards for appraisals under the Dodd Frank Act. As I will explain, these new standards have dramatically reduced fraudulent appraisals, in turn saving tens of thousands of homeowners from foreclosure.

It is common knowledge that lax regulation of the mortgage and appraisal market led directly to the financial collapse of 2008.[2] Prior to that collapse, unscrupulous mortgage brokers and lenders joined forces with a handful of appraisers to fraudulently inflate home values to enable property flipping schemes and other home-secured lending of increasingly large amounts. Many of these loans contained adjustable rate or interest only features that would cause payments to skyrocket after a teaser period. Even before the market collapse in 2008, consumers and their advocates began to see this house of cards topple, as homeowners trapped in these underwater loans were unable to refinance when their adjustable rates spiked.[3] Thousands—and soon millions—of homeowners faced foreclosure.[4]

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[1] More information about **Mountain State Justice** can be found at www.mountainstatejustice.org.

The **National Consumer Law Center** is a nonprofit organization specializing in consumer issues on behalf of low-income people. Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness.

The **National Association of Consumer Advocates** is a non-profit organization whose members are private and public sector attorneys, legal services attorneys, law professors, and law students whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers by maintaining a forum for information sharing among consumer advocates across the country and serving as a voice for its members as well as consumers in the ongoing effort to curb unfair and abusive business practices.

[2] *See, e.g.*, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, available at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/content-detail.html.

[3] Mountain State Justice's Executive Director testified before this Subcommittee in 2005 about these very practices. *See* Daniel F. Hedges, *Testimony before the Subcommittee on Housing and Community Development*, Committee on Financial Services, U.S. House of Representatives (Sept. 29, 2005), available at http://archives.financialservices.house.gov/media/pdf/092905dh.pdf.

[4] The Financial Crisis Inquiry Report: *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States 402*, available at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/content-detail.html.

This bubble in housing prices was not just created by a spike in consumer demand. Rather, in many cases throughout country, it was created as the direct result of intentional fraud and lack of oversight. West Virginia—which saw little increased demand—is a prime example of this. At my organization alone, every week we saw dozens of homeowners facing foreclosure resulting in large part from these fraudulent appraisals.

The Dodd-Frank Act required essential increased regulation of appraisals, building on necessary safety and soundness requirements passed after the savings and loan crisis. These recent changes have been instrumental in ending the practice of fraudulent appraisals, primarily by requiring appraisal independence. Appraisal independence ensures that lenders and brokers cannot intentionally choose appraisers who will deliver implicitly (and sometimes explicitly) requested inflated appraisals. Reforms requiring true, in-person appraisals by qualified appraisers similarly have ensured not only a healthy appraisal industry, but also that lenders and investors can be certain that they have sufficient collateral to protect their risk. These reforms have been an unqualified success. They have worked.

Because the reforms did exactly what they were intended—they stopped appraisal fraud—we urge you to leave these requirements in place. Appraisal oversight does not just help consumers, it also supports honest appraisers and lending institutions, and protects investors and the economy as a whole.

Background

Home appraisals are required to safeguard homeowners, home mortgage investors, and government insurance programs alike. Appraisals protect homeowners who are making the largest investment—and taking on the largest debt—of their lives, by enabling them to make wise and well-informed financial decisions. Appraisals are necessary to ensure that loans do not exceed the values of homes that serve as their collateral. This collateral protects investors and insurers, such as the Federal Housing Authority, against the risk of long-term home lending. Provision of sufficient collateral thus enables and supports lending, which in turn creates a healthy housing market.

Home appraisals are supposed to be conducted by highly trained and skilled professionals with knowledge of the local area. Appraisals, under current standards, require the appraiser to personally view both the interior and exterior of the home, the surrounding area, and comparable homes that have recently sold on the open market, in order to ensure an accurate opinion of value. Appraisers are educated in a classroom and serve as an apprentice under the supervision of an experienced appraiser before they obtain their final certification. All of these requirements ensure that appraisers are qualified and competent to complete their essential work.

Widespread Appraisal Fraud[5]

Without independent and qualified appraisals, home secured lending poses significant risks to consumers, investors, as well as the entire economy. Two main types of appraisal fraud in particular led to the market collapse in the 2000s: property flipping scams and refinance fraud.

Property Flipping

Property flipping scams involve speculators who buy dilapidated residential properties or develop shoddy new construction at low prices and resell them to unsophisticated first time home buyers at huge markups.[6] Homeowners end up saddled debt load that exceeds the market value of the property. These homeowners are unable to resell the home in an arms-length transaction because the mortgage indebtedness exceeds the fair market value of the property. Ultimately, the homeowners may lose their homes due to foreclosure sales[7] because the home's condition is much worse than represented, promised repairs are not performed, and the consumer's mortgage payments may be higher than the consumer can afford.[8] Then the scams can begin again against different homeowners if the wrongdoers or their confederates purchase the homes at the foreclosure sales.

An inflated appraisal, which is necessary to both reassure the homeowner and to secure an inflated loan, is the linchpin of these transactions.[9] While many property flipping schemes rely on steering borrowers to high-cost lenders,[10] other schemes depend on the availability of government insurance.[11] Because Federal Housing Administration (FHA) insurance, unlike regular mortgage insurance, covers 100% of lender's losses, lenders quickly profit from inflated loans they know will foreclose.[12] The loan officer gets a commission; the Department of Housing and Urban

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[5]Significant portions of the following text, especially background on appraisal fraud, the mortgage market, and regulatory overviews are drawn from the National Consumer Law Center's book on mortgage lending, National Consumer Law Center, *Mortgage Lending* (2d ed. 2014).

[6] *See, e.g.,* Synovus Bank v. Karp, 887 F. Supp. 2d 677 (W.D.N.C. 2012); Kaing v. Pulte Homes, Inc., 2010 WL 625365 (N.D. Cal. Feb. 18, 2010), *aff'd*, 464 Fed. Appx. 630 (9th Cir. 2011). *See also* Upton Sinclair, The Jungle 77–78 (1920) (describing a scheme in which a developer repeatedly sold poorly constructed homes, foreclosed on them, and then resold them as "new").

[7] *See, e.g.,* United States v. Geig, 176 Fed. Appx. 638, 639 (6th Cir. 2006) (upholding restitution award and prison term for participant in property flipping scheme that "left buyers with overvalued properties with a high risk of foreclosure"); David Cho, Housing Boom Tied to Sham Mortgages, Lax Lending Aided Real Estate Fraud, Wash. Post., Apr. 10, 2007, at A1 (more than 300 homes go into disrepair and foreclosure in wake of property flipping scheme, surrounding homeowners lose as much as half of the value of their homes).

[8] *See* Edmonds v. Hough, 344 S.W.3d 219 (Mo. Ct. App. 2011).

[9] *See* United States v. Owens, 301 F.3d 521 (6th Cir. 2002) (describing appraiser's key role in a property flipping scheme); Vaughn v. Consumer Home Mortg. Inc., 2003 WL 21241669 (E.D.N.Y. Mar. 23, 2003).

[10] *See, e.g.,* United States v. Sheneman, 2012 WL 1831660 (N.D. Ind. May 18, 2012); Edmonds v. Hough, 344 S.W.3d 219 (Mo. Ct. App. 2011).

[11] *See, e.g.,* Vaughn v. Consumer Home Mortg., Inc., 293 F. Supp. 2d 206 (E.D.N.Y. 2003); Consumer Prot. Div. v. Morgan, 874 A.2d 919 (Md. 2005).

[12] *See* M & T Mortg. Corp. v. White, 2006 WL 47467 (E.D.N.Y. Jan. 9, 2006) (finding predatory lending scheme was caused in part by HUD's issuance of insurance without due diligence); Vaughn v. Consumer Home Mortg., Inc., 293 F. Supp. 2d 206 (E.D.N.Y. 2003) (denying HUD's motion to dismiss declaratory judgment that FHA insurance was issued without due diligence). *See also* LaBoy v. Better Homes Depot, Inc., 2004 WL 6393656, at *8 (E.D.N.Y. July 14, 2004) (recognizing role of FHA insurance in property flipping scheme involving inflated appraisals).

Development (HUD) is left with the costs associated with the bad loan.[13] Some of these scams landed their perpetrators in prison after the market collapse. Others just led to disastrous consequences for homeowners.

Many of Mountain State Justice's clients suffered from these dynamics. For example, the S family is extremely low-income and had never before owned a home, but were desperate to find a safe place for themselves and their five children. In 2007, Mr. and Mrs. S family visited a loan officer at a national lender that had a storefront office in their community, and were preapproved for a loan. Mr. S then located a home and contacted the lender. The loan officer promptly contacted an appraiser from a different region of the state who reliably inflated appraisals, and provided her with the requested target figure. The S family purchased the home for $35,000, based on the resulting appraisal. Little did they know that the home had evident defects that any appraiser should have recognized, including exposed wiring, significant leaks, termites, mold, dryrot, and sewage leaking in the basement. I met the S family when they faced foreclosure because they could not afford to keep up with the loan payments—which had an interest rate over 9% and exceeded their prior rental payment—or make necessary repairs on the home to keep their family safe. They also could not sell the home because the loan far exceeded its value. They never would have purchased the home or entered the loan if the appraisal had noted these facially evident safety hazards.

Bogus Refinances

In addition to being the linchpins of property flipping schemes,[14] inflated appraisals are also the key to predatory mortgage refinances that directly led to the 2008 market collapse.[15] For instance, loan churning, which involves repeated refinancing with additional fees and costs rolled into the new principal balance, often depends on inflated appraisals to justify higher loan amounts.[16] Without the inflated appraisal, these loans would be denied for insufficient equity.[17]

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[13] *E.g.*, Saucier v. Countrywide Home Loans, 64 A.3d 428 (D.C. 2013); Hoffman v. Stamper, 867 A.2d 276 (Md. 2005).

[14] *See* United States v. Curtis, 635 F.3d 704, 709 (5th Cir. Mar. 11, 2011) ("Obtaining inflated appraisal reports was a critical leg of the conspiracy."); United States v. Owens, 301 F.3d 521, 528 (6th Cir. 2002) (describing appraiser's key role in a property flipping scheme); Vaughn v. Consumer Home Mortg., Inc., 2003 WL 21241669 (E.D.N.Y. Mar. 23, 2003).

[15] *Cf.* Wallace v. Midwest Fin. & Mortg. Services, Inc., 714 F.3d 414, 422 (6th Cir. 2013) (reversing summary judgment for broker and lender on civil racketeering claims based on an inflated appraisal of borrower's home; noting, "Though the decision to obtain a mortgage is no doubt complicated, the appraisal of the home used to secure it is a fundamental part of the calculus.").

[16] *See, e.g.,* Hill v. Meritech Mortg. Services, Inc. (In re Hill), 2002 WL 34560882 (Bankr. E.D. Pa. Sept. 27, 2002).

[17] *See, e.g.,* Wallace v. Midwest Fin. & Mortg. Services, Inc., 714 F.3d 414, 417 (6th Cir. 2013) (inflated appraisal "factored significantly into" the underwriting of the loan; discussing importance of inflated appraisal to conspiracy to sell borrower a high-interest rate loan with high fees); United States v. Rivera, 2004 WL 3153171 (D. Conn. Aug. 5, 2004); Chavarria v. Fleetwood Retail Corp. of N.M., 115 P.3d 799 (N.M. Ct. App. 2005) (affirming judgment against manufactured home seller based on fraudulent conduct of two employees in inflating trade-in value of borrower's previous manufactured home and including fictitious home improvements in the loan amount; reducing duplicative damages and reversing award of punitive damages), aff'd in part, rev'd in part, 143 P.3d 717 (N.M. 2006) (affirming judgment against seller but reversing compensatory and punitive damages award); Office of the New York State Att'y Gen., Press Release, N.Y. Attorney General Sues First American and Its Subsidiary for Conspiring with Washington Mutual to Inflate Real Estate Appraisals (Nov. 1, 2007), available at www.ag.ny.gov (alleging that large national lender demanded that appraisers inflate property values).

My office, like others across the country, has worked with countless homeowners facing foreclosure as the result of these schemes. One of my first clients were an elderly couple from Parkersburg, West Virginia. Mr. F., a glass glazer, built their home himself in the evenings after work in the 1980s. In 2002, the Fs had a fixed rate mortgage, which a loan officer began aggressively soliciting them by phone for a refinance. After multiple calls and promises, the Fs broke down and applied for the loan. The lender then directly contacted an appraiser who it regularly secured inflated valuations from. Although the Fs' home was actually only worth $50,000, the appraiser provided a value of nearly $100,000. Even though they did not ask for it, the loan was increased to the full appraised value. Instead of what they'd been promised, the Fs' payments increased, their interest rate increased, their home secured debt obligation increased, and they were switched from a fixed to an adjustable rate mortgage. I met the Fs after their payments skyrocketed and they had no way to refinance the loan or save the home they had built. I have countless examples like these of lenders who knew exactly which appraisers to contact to provide inflated loans that led inexorably to foreclosure.

Another client was Mrs. R, a single, middle-aged woman. Mrs. R was repeatedly solicited to refinance her loan in the early 2000s. After purchasing her home for $15,000 in the mid-1990s, Mrs. R fell prey to a mortgage broker-appraiser team, who soon had her in a loan exceeding $70,000. Scared of losing her home and looking for lower payments, Mrs. R entered her information into a website that advertised that it could lower her bills. Soon an out-of-state lender contacted her and promised lower payments. This lender did not bother with an appraisal from a licensed appraiser; instead, it utilized an automated valuation model (AVM) of her home which provided a wholly inaccurate and inflated valuation of her home based on faulty market data. Although her home was actually only worth $34,000, the lender told her that her home was worth $84,000 based on the AVM. The lender pressured her to borrow additional funds up to the "value" of her home to pay other debts. I met Mrs. R. when the interest only feature of her loan expired and she was faced with impossibly high payments. Mrs. R. tried to refinance, but she was rejected because the loan so far exceeded the value of her home. Now she faced foreclosure.

Mrs. R's situation highlights the need for appraisals conducted by properly educated and regulated appraisers, rather than alternative methods. The automated valuation used by her lender was based on aggregate data from unverified public records that is often inaccurate, incomplete, or outdated. Moreover, programs like these cannot adequately consider neighborhood, condition of the property, location appeal, or altered building characteristics. Each of these factors is essential in understanding the true value of a home.

Incentives for Appraisal Fraud

Without the strict requirements imposed by the Dodd Frank Act, the financial incentives of those involved in the mortgage loan process work against honest appraisals.[18] Origination fees

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[18] *See* Wallace v. Midwest Fin. & Mortg. Services, Inc., 714 F.3d 414, 422 (6th Cir. 2013) (reversing summary judgment in favor of creditor on civil racketeering claim; noting that lender not dissuaded by facially unreasonable appraisal); Fed. Hous. Fin. Auth. v. JPMorgan Chase & Co., 902 F. Supp. 2d 476 (S.D.N.Y. 2012) (quoting amended complaint, "WaMu falsely overstated appraisals in order to secure low LTV ratios for mortgages, thereby making the loans more attractive to prospective purchasers of certificates"); David Callahan, Home Insecurity: How Widespread Appraisal Fraud Puts Homeowners at Risk (Mar. 2005), available at www.demos.org.

for lenders and loan brokers are commonly based on the amount of the mortgage loan.[19] This can make lenders and brokers complicit in, or simply indifferent to, appraisal fraud because higher loan volume and higher loan amounts lead to greater profits.[20] Some lenders may deliberately seek inflated appraisals in order to trap borrowers in abusive loans and prevent them from refinancing.[21] Lenders' indifference to appraisal fraud may be traceable, at least in part, to securitization, which allows them to pass on the risk of loss while retaining minimal liability in the event of default by the borrower.[22] Lenders also rely on mortgage insurance to insulate them either partially (or fully, in the case of the government-backed FHA insurance), from the risk of loss after foreclosure. Secondary market participants, those who buy loans from lax lenders, can also purchase their own

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[19] *Cf.* 15 U.S.C. § 1639b(c)(1) (explicitly permitting compensation for loan originators to be based on loan amount).

[20] *See* Fed. Hous. Fin. Auth. v. JPMorgan Chase & Co., 902 F. Supp. 2d 476 (S.D.N.Y. 2012) (quoting amended complaint, "WaMu falsely overstated appraisals in order to secure low LTV ratios for mortgages, thereby making the loans more attractive to prospective purchasers of certificates"); In re Bear Stearns Mortg. Pass-Through Certificates Litig., 851 F. Supp. 2d 746 (S.D.N.Y. 2012) ("[L]oan officers applied 'intense' pressure on underwriters to approve risky loans and rewarded 'high producers.'"); Cedeno v. IndyMac Bancorp, Inc., 2008 WL 3992304 (S.D.N.Y. Aug. 26, 2008) (alleging that lender selected appraisers, who provided inflated appraisals, in order to complete more transactions and earn greater profits; granting lender's motion to dismiss RESPA and TILA claims). *Cf.* United States v. Grintjes, 237 F.3d 876 (7th Cir. 2001) (discussing evidence that tended to show that mortgage broker had knowledge of clients' property flipping scheme); Am. Mortg. Network v. Shelton, 2006 WL 909415 (W.D.N.C. Apr. 6, 2006) (discussing how a buyer arranged for and helped prepare a fraudulent appraisal), aff'd, 486 F.3d 815 (4th Cir. 2007).

[21] *See, e.g.,* Tocco v. Argent Mortg. Co., 2007 WL 170855 (E.D. Mich. Jan. 18, 2007) (describing a borrower's inability to refinance an Argent loan when the appraisal for the refinancing came in $300,000 lower than the appraisal, performed less than a year previously, on which the original loan had been based); Office of the New York State Att'y Gen., Press Release, N.Y. Attorney General Sues First American and Its Subsidiary for Conspiring with Washington Mutual to Inflate Real Estate Appraisals (Nov. 1, 2007), available at www.ag.ny.gov (alleging that large national lender demanded that appraisers inflate property values).

[22] *See, e.g.,* Wallace v. Midwest Fin. & Mortg. Services, Inc., 714 F.3d 414, 422 (6th Cir. 2013); Homeward Residential, Inc. v. Sand Canyon Corp., 2014 WL 2510809, at *9–10 (S.D.N.Y. May 28, 2014) (refusing to dismiss trust's breach of warranty claims against Option One based upon appraisal fraud); Prudential Ins. Co. v. Credit Suisse Sec. (USA) L.L.C., 2013 WL 5467093 (D.N.J. Sept. 30, 2013) (investor suit against parties to a securitization of New Century and Option One loans; fraud claim based on pattern of false appraisals survived motion to dismiss); Fed. Hous. Fin. Auth. v. JPMorgan Chase & Co., 902 F. Supp. 2d 476 (S.D.N.Y. 2012); Fed. Hous. Fin. Agency v. UBS Americas, Inc., 858 F. Supp. 2d 306, 320 (S.D.N.Y. 2012), aff'd, 712 F.3d 136 (2d Cir. 2013); HSH Nordbank AG v. Barclays Bank PLC, 986 N.Y.S.2d 866, 2014 WL 841289, at *15, 18 (Sup. Ct. 2014) (table) (refusing to dismiss investor claims of fraud against seller and depositor in deal involving Fremont Inv. & Loan and New Century Mortg. Co. loans based on appraisal fraud; data showed approximately 24.5%–51.6% of the loans had combined loan-to-value ratios of over 100%, which contradicted the offering documents). *See also* Settlement Agreement, Annex 1, Statement of Facts at 4–5, U.S. Dep't of Justice & JPMorgan Chase & Co. (Nov. 19, 2013), available at www.justice.gov (describing JPMorgan's purchase and pooling into securities of loans it knew were missing appraisals, its tolerance for appraisals of 15% below loan amount, even when the loan-to-value ratio was 100%, and its inclusion in securitizations of loans that exceeded even that tolerance).

Secondary market purchasers may not be vigilant in policing lenders because they underestimate the risk of inflated appraisals or because they may be insured against this kind of fraud. See, e.g., Mass. Mut. Life Ins. Co. v. Residential Funding Co., 843 F. Supp. 2d 191 (D. Mass. 2012) (securities disclosures insufficient to put secondary market purchaser on notice that appraisers were systematically abandoning the represented appraisal procedures). In these cases, the insurer bears the risk of loss instead of the trust or other secondary market purchaser.

Some of the notorious FAMCO loan trusts were insured by mortgage guaranty policies issued by MBIA Insurance Corp. Stipulation of Settlement, Fed. Trade Comm'n v. First Alliance Mortg. Co. (In re First Alliance Mortg. Co.), No. SA CV 00-964 (C.D. Cal. Feb. 25, 2002), available at www.ftc.gov.

insurance against failure and so have reduced incentives to police the pool,[23] even if the disclosures are enough to put them on notice of the inflated appraisals.[24]

In some cases, appraisers received direct benefits for their participation in the fraud, through the promise of repeat business or more overt kickbacks or payment schemes.[25] Other times, lenders and brokers pressure appraisers to hit or exceed a predetermined value.[26] Failure to do so could lead the lender or broker to withhold business from the appraiser, to refuse to pay the appraiser, or to blacklist the appraiser.[27]

Appraisers themselves advocated for tighter regulation to protect their industry. In 2007, a petition with 11,000 appraiser signatures was delivered to Washington explaining that "Lenders . . . as a normal course of business, apply pressure on appraisers to hit or exceed a predetermined value. . . . We believe that this practice has adverse effects on our local and national economies and that the potential for great financial loss exists. We also believe that many individuals have been adversely affected by the purchase of homes which have been over-valued."[28] The appraisers went on to request that the government appropriately regulate the market to protect appraisers from "pressur[e] . . . to do dishonest appraisals."[29] Given the potential incentives for lenders and appraisers to inflate appraisal amounts, the need for focused oversight and effective supervision of both appraisers and appraisal practices has long been recognized.[30]

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[23] *See, e.g.*, Stipulation of Settlement, Fed. Trade Comm'n v. First Alliance Mortg. Co. (In re First Alliance Mortg. Co.), No. SA CV 00-964 (C.D. Cal. Feb. 25, 2002), available at www.ftc.gov (noting insurance of some of the notorious FAMCO loan trusts by mortgage guaranty policies issued by MBIA Insurance Corp.).

[24] *See, e.g.*, Mass. Mut. Life Ins. Co. v. Residential Funding Co., 843 F. Supp. 2d 191 (D. Mass. 2012) (securities disclosures insufficient to put secondary market purchaser on notice that appraisers were systematically abandoning the represented appraisal procedures).

[25] *See* First Magnus Fin. Corp. v. Star Equity Funding, L.L.C., 2007 WL 414272 (D. Kan. Feb. 2, 2007) (discussing scheme between mortgage brokers and appraisers).

[26] *See, e.g.*, Wallace v. Midwest Fin. & Mortg. Services, Inc., 714 F.3d 414, 417 (6th Cir. 2013) (describing scheme whereby broker requested appraisal value needed from the appraiser); Davis v. Wells Fargo Bank, 976 F. Supp. 2d 870, 876 (S.D. Tex. 2013) (describing pressure brought to bear on appraisers to produce low values at foreclosure sales of property, allegedly in order to maximize paper losses for tax purposes), dismissed on other grounds, 2014 WL 585403 (S.D. Tex. Feb. 14, 2014); Office of the New York State Att'y Gen., Press Release, N.Y. Attorney General Sues First American and Its Subsidiary for Conspiring with Washington Mutual to Inflate Real Estate Appraisals (Nov. 1, 2007), available at www.ag.ny.gov (detailing scheme in which a large national lender demanded that appraisers inflate property values).

[27] *See* Davis v. Wells Fargo Bank, 976 F. Supp. 2d 870, 876 (S.D. Tex. 2013) (appraiser who did not meet target values was blacklisted), dismissed on other grounds, 2014 WL 585403 (S.D. Tex. Feb. 14, 2014); Fed. Hous. Fin. Auth. v. JPMorgan Chase & Co., 902 F. Supp. 2d 476 (S.D.N.Y. 2012) (quoting amended complaint; "WaMu selected individual appraisers who were willing to produce false, inflated appraisals and refused to hire appraisers who maintained their independence."); Gaudie v. Potestivo Appraisal Services, 837 F. Supp. 2d 799 (N.D. Ill. 2011) (discussing appraiser's possible motivation in inflating appraisal, noting that the appraiser was dependent on lender for employment and "had to give [it] the the appraised values [it] desired if [he] wanted to work in that field"); Office of Pol'y Dev. & Research, U.S. Dep't of Hous. & Urb. Dev., Report to Congress on the Root Causes of the Foreclosure Crisis 40–41 (2010), available at www.huduser.org (arguing that appraisal fraud depends on lack of underwriting control of the broker and appraiser). See also People v. First Am. Corp., 878 N.Y.S.2d 860 (Sup. Ct. 2009) (recounting complaint's allegations of lender control of appraisers, in violation of state law and Uniform Standards of Professional Appraisal Practice), aff'd, 902 N.Y.S.2d 521 (App. Div. 2010).

[28] Appraisers Petition, available at http://appraiserspetition.com.

[29] *Id.*

[30] Office of Pol'y Dev. & Research, U.S. Dep't of Hous. & Urb. Dev., Report to Congress on the Root Causes of the Foreclosure Crisis 40–41 (2010), available at www.huduser.org (arguing that appraisal fraud depends on lack of

Consequences of Appraisal Fraud

The consequences of appraisal fraud are far reaching.[31] When a borrower becomes bound to a mortgage that exceeds the value of his home at origination, he is immediately prohibited from refinancing to obtain better loan terms, such as a fixed interest rate or lower interest rate. Unlike with other types of loans, this is of significant import because the borrower's home is placed at risk. Moreover, predatory lenders often pair overvalue mortgages with other exploitative terms that make a borrower's need to refinance even more pressing.[32] In addition, the borrower cannot sell his home to relocate, even if he needs to do so to find work.[33] And when the borrower finds himself in this dire situation, the last resort protections provided by the bankruptcy code provide him with little assistance. Even if he chooses to declare bankruptcy, the homeowner must pay the full balance of the mortgage or forfeit his home; he cannot avail himself of the relief available for unsecured debts or debts secured by personal property, which can be discharged or reduced to the value of the collateral.[34] The homeowner becomes trapped with no way out of the loan except foreclosure. Finally, unlike with other loans, realizing on the security interest for a home-secured loan can result in homelessness, a far greater impact than loss of personal goods or loss of credit, and has negative spillover onto the surrounding community.[35]

Indeed, for many of these reasons, placing a borrower underwater significantly increases the risk of foreclosure.[36] Empirical data demonstrates that higher loan to value ratios lead to an increased risk of foreclosure. For example, securities ratings agencies have determined that loans with LTV ratios between 95% and 100% are 4.5 times more likely to enter foreclosure than loans with ratios below 80%. Loans that exceed 100% of the market value of the collateral are even more likely to enter foreclosure.[37] As a HUD-Treasury Report during the Bush Administration explained,

> Many of the borrowers who are victims of this [fraudulent appraisal] scheme cannot afford to repay or refinance the mortgage based on the inflated price, and these loans may go into default and foreclosure quickly. Appraisers and others engaging

underwriting control of the broker and appraiser). *See, e.g.*, Fed. Reserve Bank of Atlanta, Appraisal Reviews Are Important to Safe Banking, Fin. Update, 4th Quarter, 2004, available at www.frbatlanta.org.

[31] As the Sixth Circuit noted, "a borrower has much to lose from entering into a too-big loan." Wallace v. Midwest Fin. & Mortg. Services, Inc., 714 F.3d 414, 422 (6th Cir. 2013).

[32] *See, e.g.*, *id*. at 421 (noting key role of inflated appraisal in inducing borrower to take out overpriced payment-option ARM, with high fees and "unreasonable" terms, resulting ultimately in borrower's loss of home and bankruptcy).

[33] The public policy against such transactions tracks the longstanding public policy against restraints on landowners that limit their ability to transfer or otherwise control their real property. *See, e.g.*, *McCreery v. Johnston*, 110 S.E. 464, 466 (W. Va. 1922).

[34] *See* 11 U.S.C. §§ 521(a)(2)(A), 1322(b)(2).

[35] *See* Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 Yale J. on Reg. 1, 69 (2011); David Callahan, *Home Insecurity: How Widespread Appraisal Fraud Puts Homeowners at Risk* (Mar. 2005), *available at* www.demos.org/sites/default/files/publications/home_insecurity_v3.pdf.

[36] Laurie S. Goodman et al., *Negative Equity Trumps Unemployment in Predicting Defaults*, 19 J. Fixed Income 67 (2010).

[37] See Federal Housing Finance Agency v. Nomure Holding America, Inc., 104 F.Supp.3d 441, 465 (S.D.N.Y. 2015).

> in this fraudulent practice are helping to send first-time home buyers and whole communities into economic ruin.[38]

While homeowners feel the direct impact of these foreclosures, investors, insurers, neighboring homeowners, and ultimately taxpayers incur significant losses from foreclosures caused by appraisal fraud.

Regulation

FIRREA

In 1989, Congress, in response to the savings and loan crisis of the 1980s, enacted the Financial Institutions, Recovery, Reform, and Enforcement Act of 1989 (FIRREA).[39] Under FIRREA, Congress mandated appraisal standards, review of appraisals and supervision of appraisers by lenders, and appraiser independence. FIRREA has the express purposes of ensuring that:

> Federal financial and public policy interests in real estate related transactions will be protected by requiring that real estate appraisals utilized in connection with federally related transactions are performed . . . by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision.[40]

Guidelines promulgated by the federal banking agencies under FIRREA require covered institutions to establish an effective real estate and evaluation program that, among other things, ensures appraiser independence, provides for adequate review of appraisals, and monitors appraisers and reviewers. Institutions are also directed to establish policies and procedures for resolving any inaccuracies or weaknesses in an appraisal prior to the credit decision.[41]

As part of FIRREA,[42] in order to ensure that appraisals were conducted according to "uniform standards,"[43] Congress required that each federal banking regulator adopt rules governing appraisal standards, including the promulgation of appraisal standards and appraisal reviews for compliance with the Uniform Standards of Professional Appraisal Practice (USPAP).[44] Among other things, the rules of conduct state that an appraiser may not accept a fee for an assignment that is contingent upon the reporting of a predetermined result or of a particular amount of the value opinion.[45]

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[38] *See* HUD-Treasury National Predatory Lending Task Force, Joint Report: Curbing Predatory Home Mortgage Lending (2000), *available at* http://archives.hud.gov/reports/treasrpt.pdf.
[39] Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183; H. Rep. No. 101-54(I), at 311, reprinted in 1989 U.S.C.C.A.N. 86 (discussing role of faulty appraisals in the crisis).
[40] 12 U.S.C. § 3331.
[41] 75 Fed. Reg. 77,450, 77,463 (Dec. 10, 2010).
[42] Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183.
[43] 12 U.S.C. § 3331.
[44] Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, tit. XI, § 1110, 103 Stat. 183 (as codified at 12 U.S.C. § 3339).
[45] 2016-2017 USPAP at 8-9, available at www.appraisalfoundation.org.

Truth in Lending Act

Regulations issued under the Truth in Lending Act set some additional requirements for appraisals done in connection with higher-priced mortgage loans,[46] including that the appraisal be completed by a licensed appraiser who conducts a physical inspection of the interior of the home.[47] If the loan is a purchase-money loan, the property was purchased by the seller within the previous six months, and the new purchase price exceeds the old by certain amounts, the lender is responsible for getting two written appraisals.[48]

Dodd-Frank Act

Additionally, regulations promulgated in the Truth in Lending Act, pursuant to the Dodd-Frank Act, regulate the supervision of appraisers.[49] Lenders are prohibited from extending credit when they know that an appraisal materially misrepresents the value of the consumer's principal dwelling. Creditors may only escape liability if they exercised "reasonable diligence."[50] Creditors and settlement service providers are required to report any material failure to follow USPAP by an appraiser.[51]

Appraiser Independence

Standards for appraisals and review of appraisals are not, by themselves, enough to prevent coercion of appraisers by lenders and brokers anxious to make the deal. Independence is a key component of protecting the market from the widespread overvaluation that triggered the savings and loan crisis in the 1980s and the subprime collapse in the 2000s. Since 1989, federal law has attempted to protect appraisers by forbidding lenders from offering anything of value in exchange for an appraisal performed by other than a certified or licensed appraiser.[52] In 2008, the Federal Reserve Board used its authority to prohibit unfair or deceptive acts and practices to prohibit creditors, mortgage brokers, and their affiliates from exercising inappropriate influence over the amount at which a consumer's home is appraised.[53] Fannie Mae and Freddie Mac have both issued

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[46] *See* National Consumer Law Center, Truth in Lending §§ 9.5.2, 9.5.4 (9th ed. 2015), updated at www.nclc.org/library (discussing the definition of higher-priced mortgage loans for purposes of the appraisal rules).
[47] National Consumer Law Center, Truth in Lending § 9.5.4.6 (9th ed. 2015), updated at www.nclc.org/library (discussing the appraisal regulations for higher-priced mortgage loans).
[48] 12 C.F.R. § 1026.35(c)(4) (eff. Jan. 18, 2014). See generally National Consumer Law Center, Truth in Lending § 9.5.4.6 (9th ed. 2015), updated at www.nclc.org/library (discussing the appraisal regulations for higher-priced mortgage loans).
[49] *See generally* National Consumer Law Center, Truth in Lending §§ 9.4.2 (discussing the appraisal regulations issued under Truth in Lending Act), 9.4.4 (reviewing Truth in Lending Act remedies for violations of these regulations) (9th ed. 2015), updated at www.nclc.org/library.
[50] 12 C.F.R. § 1026.42(e).
[51] 12 C.F.R. § 1026.42(g)(1). *See generally* National Consumer Law Center, Truth in Lending §§ 9.4.2 (discussing the appraisal regulations issued under Truth in Lending Act), 9.4.4 (reviewing Truth in Lending Act remedies for violations of these regulations) (9th ed. 2015), updated at www.nclc.org/library.
[52] 12 U.S.C. § 3349(a)(1).
[53] 12 C.F.R. § 1026.42.

guidance specifically addressed to the question of appraiser independence.[54] Bolstering the independence of appraisers and sheltering them from lender coercion has been at the heart of actions taken by the New York attorney general (in negotiating the settlement of an appraisal fraud investigation)[55] and regulations issued under the Dodd-Frank Act.[56]

Regulations promulgated under the Dodd-Frank Act's amendments to the Truth in Lending Act have prohibited the falsification or alteration of an appraisal and a number of coercive practices that might influence an appraiser's valuation.[57] In addition, the regulations limit conflicts of interest and require reasonable compensation of appraisers.[58] The Dodd-Frank Act also included provisions regarding licensure of appraisers and appraisal management companies.[59]

<u>Impact of Regulation & Discussion Topics</u>

These reforms have worked. Unethical lenders, brokers, and appraisers can no longer join forces to defraud homeowners, communities, investors, and insurers. Appraisal independence is the cornerstone of this regime. These requirements build upon earlier steps taken under FIRREA to ensure minimum standards for appraisals and appropriate training. The requirement of a complete appraisal by a licensed and educated appraiser further protects the market.

The home buying and refinancing process is not currently complicated or difficult, and minimum regulatory requirements are necessary to protect homeowners and the economy at large. Any appraiser shortage would be appropriately addressed through market forces: increased demand would lead to increased customary rates, which would accordingly lead to a greater supply of appraisers entering the marketplace. Moreover, any shortage is likely to be temporary and to disappear as interest rates increase and the demand for mortgage refinances decreases. Lowering standards and qualifications, including permitting lenders to rely on alternative valuation products and broker price opinions, will further increase any such shortage, rather than remedy the need for qualified appraisers. Such reliance would further enable lenders to return to obtaining unreliable reports which, in turn, create instability in the market. In short, the regulatory regime is a floor that is essential to avoid both unintentional errors as well as fraud.

Indeed, lowering the *de minimis* appraisal threshold for Federally Related Transactions would assist in addressing any appraiser shortage. More importantly, lowering this threshold—which currently only requires an appraisal for loans over $250,000 or for Higher Priced Mortgage Loans over $25,000—would protect homeowners and communities. The majority of homes

[54] Fannie Mae, Appraiser Independence Requirements (Nov. 10, 2010), available at www.efanniemae.com; Freddie Mac, Oct. 15 Guide Bulletin 2010-23, available at www.freddiemac.com.
[55] Office of the New York State Att'y Gen., Press Release, New York Attorney General Cuomo Announces Agreement with Fannie Mae, Freddie Mac, and OFHEO (Mar. 3, 2008), available at www.ag.ny.gov.
[56] Pub. L. No. 111-203, §§ 1472, 1473, 124 Stat. 1376 (2010); 75 Fed. Reg. 66,554 (Oct. 28, 2010). See 12 C.F.R. § 1026.42; National Consumer Law Center, Truth in Lending § 9.4.2.1 (9th ed. 2015), updated at www.nclc.org/library) (replacement of Federal Reserve Board's 2008 appraisal rules and effective dates).
[57] *See* 12 C.F.R. § 1026.42; National Consumer Law Center, Truth in Lending § 9.4.2.1 (9th ed. 2015), updated at www.nclc.org/library (replacement of Federal Reserve Board's 2008 appraisal rules and effective dates).
[58] *See* National Consumer Law Center, Truth in Lending §§ 9.4.2.3–9.4.2.5 (9th ed. 2015), updated at www.nclc.org/library (substantive prohibition of appraisal regulation).
[59] Pub. L. No. 111-203, § 1473, 124 Stat. 1376 (2010).

throughout the country are worth less than $250,000.[60] Low- and moderate-income homeowners—and the government entities that insure or invest in their loans—deserve the same protections as higher income homebuyers.

A floor of overarching federal regulatory standards for lending and appraisals is necessary to ensure that both consumers and others impacted by the mortgage market are uniformly protected from fraud nationwide. National standards are appropriate for a national market in mortgage lending, investment, and insurance; and to enable appraisers to more easily act with reciprocity in jurisdictions and across state lines, where appropriate. Without this uniform baseline, the marketplace would become more costly and complicated for participants. Both the savings and loan crisis of the 1980s and the mortgage industry collapse in the 2000s demonstrate the clear and pressing need for this federal regulatory framework to establish a floor for acceptable appraisal conduct. Eliminating these protections and relying solely on the states would open the door to more economic crises that devastate homeowners and financial institutions alike. Of course, these federal protections are, appropriately, a floor and not a ceiling on appraisal safeguards. States have always been and continue to be able to create additional, state appropriate protections. This interplay between basic protections on a federal level with *additional* localized regulation is necessary and positive for the market and consumers.

Conclusion

In sum, it is essential that a national regulatory floor be retained and built upon to protect the American dream of homeownership into the future. Without these protections, the market will become more costly in the short term, and lead to new financial crises in the future, even while we have barely recovered from the last one. The appraisal protections were wisely adopted by Congress in response to real, demonstrated need in the very recent past. I urge you to keep these essential protections in place.

[60] *See* S&P Dow Jones Indices LLC, S&P/Case-Shiller 20-City Composite Home Price Index© [SPCS20RSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SPCS20RSA, November 13, 2016.