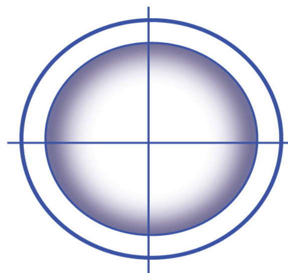

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Appraiser Independence

A Continuing Struggle for Balance

May 2013 by William L. Pittenger, MAI, SRA

No one commissions an appraisal for personal enjoyment, amusement or just mere curiosity. There is always an agenda. Some transaction participants are better served when the value estimate is high and others when it is low. Still others believe they are better served when the appraiser omits adverse information from the appraisal report. Appraisers face these competing agendas every day. This article is the first in a three part series. This issue sets forth a little history. The next issue will describe in more detail Dodd-Frank and Fannie Mae and Freddie Mac Appraiser Independence Requirements (AIR) as well as those set forth by the federal banking agencies in the Interagency Appraisal and Evaluation Guidelines. In the third issue, we will explore a variety of unintended consequences of recent law and regulation that may foster independence at the expense of appraisal reliability.

Appraisers have an ethical responsibility to perform in an independent fashion and not advocate interests other than their own and then only in support of their data, reasoning and conclusions set forth in an appraisal. That standard is not new. In fact, it's always been a hallmark of modern appraisal practice. The public has a right to expect independent analysis and reporting. It was not until 1990 that all of the federal banking agencies codified an appraiser independence standard in the form of regulation. Why then? Like many laws and regulations they are created to cure the crisis just past. In fairness, however, they are usually designed to help ensure that a repeat does not occur.

That crisis was the thrift crisis of the mid and late 1980s when independence broke down and appraisers were pressured to arrive at someone else's pre-determined conclusion. It all came to a head in 1985 and 1986 when former Congressman Doug Barnard of Georgia — a banker by profession — held hearings into *Faulty and Fraudulent Appraisals*. Congressman Barnard and the *Commerce, Consumer and Monetary Affairs Sub-Committee* of the House, which he chaired, heard testimony from all of the federal banking agencies, appraisal and banking organizations, mortgage insurance companies and many others. The committee concluded that there was indeed a problem with many appraisals but the problem was not confined to appraisers but also those who used their services and who frequently needed a certain value estimate to make a deal work. The hearings revealed that pressure on appraisers was enormous and case histories of failed banks and thrifts were replete with evidence of faulty or fraudulent appraisals -- some of which were the result of pressure on appraisers for pre-determined conclusions.

It was not unusual at the time for bank staff appraisers to report to a loan production manager whose compensation was, in part, dependent upon loan production volume. In some cases, pressure was subtle but clear such as *"the bank wants to make this loan and it's now up to you."* In other cases it was subtle but not entirely clear such as comments to the effect that the appraiser is *"not a team player or doesn't have what it takes."* Some were told not to report certain detrimental conditions about the property or its competitive market place in their appraisal report. In the most overt and egregious cases, appraisers were threatened with a poor performance reviews or even termination.

Independent fee appraisers were also pressured. If they didn't come up with a value estimate that would cause the transaction to work, the appraiser risked not being paid. In one particularly egregious example, a loan officer ordered multiple appraisals from different appraisers. The one with the highest value estimate got paid!
Pressure was not limited to that by loan production staff. Near the end of the 1980's as loan problems were finally being recognized and worked out, pressure on appraisers was for *lower* value estimates. "T*he bank needs to sell this property now"* or *"the board won't approve selling it if they know we have a higher appraisal"* were common pleas.

All this contributed to a lack of confidence in appraisal services at best and faulty or fraudulent appraisals at worst. Regardless, many appraisals were defective, incomplete or unclear at a time when the market most needed reliable collateral assessment, much like it does today.

All this caused Congressman Barnard to draft legislation to regulate the appraisal industry. It was informally known as *"The Barnard Bill."* The bill never became law in its original form but it did become law. It became Title Eleven of FIRREA, *The Financial Institutions Reform, Recovery and Enforcement Act of 1989.*

Federal Appraisal Regulation
Office of Comptroller of the Currency

Appraiser Independence
Staff Appraisers. If an appraisal is prepared by a staff appraiser, that appraiser must be independent of the lending, investment and collection functions and not involved, except as an appraiser, in the federally related transaction, and have no direct or indirect interest, financial or otherwise, in the property. If the only qualified persons available to perform an appraisal are involved in the lending, investment or collection functions of the regulated institution, the regulated institution shall take appropriate steps to ensure that the appraisers exercise independent judgment. Such steps include, but are not limited to, prohibiting an individual from performing an appraisal in connection with federally related transactions in which the appraiser is otherwise involved and prohibiting directors and officers from participating in any vote or approval involving assets on which they performed an appraisal.
Fee Appraisers. If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the regulated institution or its agent, and have no direct or indirect interest, financial or otherwise , in the property or the transaction.
SOURCE: 12CFR Part 34.45

These same standards were re-stated and expanded in the Interagency Appraisal and Evaluation Guidelines which were released by all of the federal banking agencies in December 2010. These standards are intended to apply to all federally related transactions entered into by banks, thrifts and credit unions regulated by the federal banking agencies.

Fannie Mae and Freddie Mac also published Appraiser Independence Requirements (AIR) in October 2010. The standards apply only to loans sold to Fannie and Freddie but they close a gaping hole by recognizing that many residential loans are sold by other than federally regulated institutions. Indeed, during the mid 2000s housing run up, some 70% of loans were originated by other than federally regulated institutions. The Home Valuation Code of Conduct (HVCC) became effective in May 2009 and was intended to shore up many of the independence problems. Under the Dodd-Frank Act, however, it was required to sunset 90 days after the Dodd-Frank Act was signed into law (which it was in July 2010.) Fannie Mae and Freddie Mac worked with the Federal Housing Finance Agency and other industry participants to develop the Appraiser Independence Requirements to replace the Home Valuation Code of Conduct. Fannie and Freddie were very specific that these new requirements "*maintained the spirit and intent of the HVCC*". In Fannie's Selling Guide Announcement SEL-2010-14, for example, Fannie clearly stated that the new Appraiser Independence Requirements posed no significant change to the core principles of the HVCC.

Among its many provisions, it made appraisers, attorneys, accountants and others *"Institution Affiliated Parties"* and made them subject to removal, prohibition, cease and desist orders and civil money penalties just like a bank's officers and directors. FIRREA also led to state licensing and certification of appraisers, uniform appraisal standards among all of the banking agencies and much more.

Over the years, the regulatory agencies issued "Appraisal and Evaluation Guidelines and additional guidance memoranda dealing with appraiser independence .

Fast forward roughly two decades. In the early and mid 2000s home prices were escalating at double digit rates, new and exotic mortgage products were introduced and the role of mortgage brokers and correspondents was increasing. By early 2006, over 70% of residential mortgage loans were being originated by brokers and correspondent lenders, most of whom were not regulated or were at most loosely regulated by the states. For several years, heavily regulated banks lost significant market share.

Banks which were originating residential loans either at the bank level or through a subsidiary received little or no appraisal scrutiny from the federal banking regulators as a result of the provisions set forth in 12 CFR Part 34.43 (10)(ii). That is an OCC citation but all other agencies had identical provisions. These provisions exempted transactions from an appraisal that complied with the agency appraisal regulation if it complied with Fannie Mae or Freddie Mac standards.

In August 2007, the sub-prime mortgage market collapsed and the effect was felt around the world. Roughly a year later, Fannie Mae and Freddie Mac were technically insolvent and were seized by the federal government. They remain in conservatorship at this writing. The U.S. financial system was near the brink of collapse and total collapse was avoided only with the unprecedented intervention by the federal government at a mind-boggling cost to tax payers. Many things had gone terribly wrong in the chain of originating, processing, rating and securitizing loans for sale in the securities markets both domestically and abroad.

About the same time, but in a matter at most distantly related to the bigger crisis, New York State Attorney General Andrew Cuomo, took action against the former Washington Mutual and its appraisal management subsidiary "eappraiseIT" for alleged faulty appraisals and absence of appraiser independence. That, in turn, led to Cuomo's wider investigations into Fannie and Freddie.

All that led to creation of the "Home Valuation Code of Conduct" (HVCC) in a negotiated settlement between the New York Attorney General, Fannie Mae, Freddie Mac and their regulator at the time, the Office of Federal Housing Enterprise Oversight (OFHEO) which later became the Federal Housing Finance Agency (FHFA) after the crisis. The FHFA was given dramatically enhanced powers.

The HVCC went a long way to at least theoretically force appraiser independence. Nevertheless it met with enormous resistance and political pressure. Even former Comptroller of the Currency, John Dugan, wrote that its provisions were "draconian" even though the agency he headed (OCC) had promulgated similar guidance dealing with appraiser independence.

The matter of the HVCC today, however, is moot. It was allowed to "sunset" following enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Fannie Mae and Freddie Mac have now included in their seller servicer guides *Appraiser Independence Requirements* (AIR) which became effective on October 15, 2010.

Among the many provisions in the 2,000+ pages and 16 titles of the Dodd-Frank Act is creation of a strong consumer protection watchdog known as the *Consumer Financial Protection Bureau* CFPB). Congress laid out a very broad and often non-specific mandate and left it to the regulatory agencies to put flesh on the legislative bones. In fact, Dodd-Frank contains some 200 requirements for rulemakings (new regulations); 1,000 key provisions and 70 instances where agencies are required to conduct studies and decide how to proceed. From this we should anticipate dozens if not hundreds of new or amended regulations and renewed or more aggressive enforcement of regulations already on the books. In addition, there will likely be countless unintended or unanticipated consequences.

Today, effective appraiser independence is still a struggle. Some things just never change despite Herculean effort by the appraisal industry and regulators to change them.

Before we describe a few anecdotes, let's remember four things. First, there is always an "agenda" behind an appraisal. No one commissions an appraisal for enjoyment, personal amusement or mere curiosity. In fact, most appraisals are commissioned by third parties such as banks, attorneys, government agencies and others. Second, most appraisers are small businesses or solo practitioners. They don't have the clout most banks have and they struggle to satisfy their customers just like banks strive to satisfy theirs. Sometimes the quest for client satisfaction becomes problematic when the appraiser does not wish to offend the client and obscures or fails to report complete information. There is an expression among appraisers that says, *"you're only as good as your last appraisal."* The implication is if the client doesn't like your conclusions, you may not be retained again." Fourth. It <u>is</u> acceptable to question or even challenge an appraiser but it must be done with fact and logic. It must never be couched in terms such as *"if you don't make the changes I want, you won't get paid or won't get hired again."*

Let's look at a few recent illustrations of subtle but inappropriate activity.

In recent years many banks have wrestled with loan losses that threatened their survival. Nearly 500 institutions lost the battle and failed since 2007. The quest for survival has brought out the animal instincts in some bank managers. Some have gone to significant lengths avoid write downs. A South Florida bank, for example, requires its chief financial officer to approve any proposed write down or charge off. While that, in itself, is not troublesome, it becomes a problem when the CFO, who has no appraisal training, background or experience and who has a substantial portion of his compensation riding on bank profitability and is at risk legally if earnings are mis-stated must also approve the appraisal that led to the adverse action. In this case, he has never concurred and has pressured staff to pressure appraisers to amend their value conclusion or obtain another appraisal that indicates a higher value estimate.

In another bank, a highly qualified and experienced fee appraiser estimated the value of land where there were no current or reliable comparable sales. He based his estimate on a series of case studies and discounted the results to their estimated present worth. The chief financial officer stepped in and stated that financial accounting standards require the use of "comparables — a clear mis-understanding or mis-representation of the applicable accounting pronouncement. The bank's internal appraisal review officer concurred with the fee appraiser's findings. Nevertheless, the CFO directed a production officer to find "comps." He did, but they were three to five years old and came from a time when market conditions were active. The bank relied on the outdated comparables and decided the land value was $3.0 million higher than the appraiser's estimate and there was no loss.

Another bank who has had three chief appraisers in four years told the incumbent that he was not helping the bank by concurring with "low ball" value estimates. This same bank has ordered as many as three appraisals of the same property in order to find one that didn't suggest a loss.

Some things just never change. Look for more anecdotes in future *Real Estate and Economic Commentaries*.