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Testimony presented on behalf of the

Appraisal Institute

Before the

House Committee on Financial Services'
Subcommittee on Financial Institutions and Consumer Credit

On

Mortgage Lending Reform: A Comprehensive Review of the American Mortgage System

Presented by

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Chairman Gutierrez, Ranking Member Hensarling and members of the Subcommittee, I am Jim Amorin, MAI, SRA, President of the Appraisal Institute and Vice President of Atrium Real Estate Services in Austin, Texas. Today, I am here on behalf of the Appraisal Institute the largest professional appraisal organization in the United States, representing 25,000 real estate appraisers.

Thank you for the opportunity to testify on "Mortgage Lending Reform: A Comprehensive Review of the American Mortgage System." The professional appraisal community stands ready to assist the Congress, the Administration, consumers and investors in addressing critical issues confronting the real estate market and the economy. Armed with high ethics and advanced methodologies, professional appraisers today provide real-time information on local real estate markets, vital in trying times—as well as in periods of prosperity. This critical link has been missing in the latest crisis, as "collateral" was rarely considered.

Today I will discuss five major issues confronting us, including:

1. Lack of Consistent Oversight and Enforcement
2. Appraiser Coercion and Appraisal Independence
3. Mortgage Fraud
4. Inconsistent Bank Regulation
5. Abandoning Long-Standing Safety and Soundness Policies

First, please allow me to describe the function of appraisers. Independent, competent and qualified professional appraisers provide crucial safeguards in the mortgage process. Our fees are not contingent upon whether loans go through, nor are they based on loan amounts. Our objectivity, experience and ethics help participants in residential and commercial transactions to know property values and to understand the risks inherent in collateral lending.

That is what is supposed to happen. Unfortunately, the mortgage industry has long suffered structural problems. While much of it, including appraisal, is regulated effectively, more or less. Yet, all too often, government regulators have been asleep at the switch on matters of oversight and enforcement. In particular, existing rules have not been enforced adequately, and regulatory loopholes have invited devious participants to skirt basic safety and soundness requirements. Underfunding is the primary cause for inadequate oversight, but structural deficiencies and the unwillingness to act also contribute to their ineffectiveness. Structural reforms for regulatory entities must occur to strengthen enforcement.

We must return to the fundamentals of mortgage lending: capacity to repay, credit history soundness and collateral. Today, even in the midst of our current economic crisis, inadequate attention is paid to the collateral held in support of a loan. This oversight, combined with loose credit policies and a lack of universal and enforceable underwriting guidelines, produced economic disaster. We no longer can continue to ignore these fundamental basics.

Too often, appraisal has been relegated into a formality in mortgage lending, a gimmick to push a deal, rather than a risk-management essential. It is and must continue to be a serious component if we are to promote transparency in the primary and secondary markets, and rebuild our residential mortgage securitization market.

However, we can correct these disorders of the mortgage market if we act decisively. America’s professional appraisers stand ready to support that effort.

Lack of Consistent Oversight and Enforcement

Appraisal and valuation-related issues must be addressed in any efforts to improve the overall mortgage financing system. The lack of effective regulation and enforcement is a central problem that also must be addressed. Real estate appraisers are licensed and certified by state boards, which are reviewed by a federal agency, the Appraisal Subcommittee, for compliance with Title XI of the Financial Institutions Reform Recovery and Enforcement Act (FIRREA). Unfortunately, that oversight is not effective in ensuring an independent appraisal process. Title XI was designed to accomplish three purposes: 1) protect the safety and soundness of collateralized real estate lending; 2) raised the professional qualifications of those providing appraisal services; and 3) provide consumers with independent reliable opinions of the market value of residential properties they are financing. We believe that Title XI has succeeded somewhat in accomplishing those purposes, but on some occasions it has fallen short. State and federal oversight is feeble. State appraisal boards often lack the resources necessary to enforce violations of standards. Few have the authority to intervene effectively against pressure placed on appraisers to produce false reports. That is why we also believe that Title XI can and must be improved by modernizing some of its provisions and by providing additional resources to state appraiser licensing agencies so they can better enforce Title XI's professional appraisal requirements.

This Committee is aware that various federal agencies regulating the nation's financial institutions have responsibility for real estate appraisal standards in certain federally related financial transactions. FIRREA requires these agencies to adhere to appraisal standards, yet numerous loopholes have emerged, allowing financial institutions to avoid getting appraisals.

I could cite numerous good laws crippled by insidious amendments or by ineffective application. For instance, the recently enacted "SAFE Act" requiring the licensing of mortgage originators was a good step, although it was taken 10 years after it should have been. And, in one state (Alabama), the appraisal independence provisions were recently struck from the implementing legislation.

Oversight of Licensed Appraisers

The savings and loan crisis of the 1980s inspired FIRREA. Its Title XI established the current appraisal regulatory structure. While created with the best of intentions, binding federal and state regulators to the private sector to oversee appraisers in the U.S has left us, 18 years later, with a configuration that is, without question, extremely convoluted and possibly a contributing factor in the current crisis.

Title XI created the *federal* Appraisal Subcommittee to oversee the activities of the *state* appraisal boards and commissions. Yet, the Subcommittee's only real power over state boards is the authority to "decertify" a state found to be out of conformance with Title XI. This penalty is nicknamed the "atomic hammer," because if invoked, it would stop virtually all mortgage-related lending in that state. Because of its severity, the Appraisal Subcommittee has never used this power, and it likely never will. This is why we support the concept contained in H.R. 3915, *The Mortgage Reform and Anti-Predatory Lending Act*, which would grant the Appraisal Subcommittee the authority to impose interim sanctions and suspensions on State appraiser certifying and licensing agencies. Such powers include the necessary ability to write rules and regulations.

State Appraisal Board Underfunding Allows Abuses

Many state appraisal boards have acute difficulties maintaining effective regulatory systems. According to the 2006 Annual Report of the Appraisal Subcommittee, 60 percent of the state appraisal regulatory agencies failed to uphold their enforcement responsibilities. Most states try to keep up with the demanding workload, but they simply don't have the resources to perform effectively.

This lack of resources allows unscrupulous and unqualified appraisers to continue practicing with virtual impunity. Some bad appraisers have been linked to mortgage fraud schemes throughout the country. For example, a notorious real estate appraiser in New York was convicted of a felony for grossly inflating appraisals. His state license was revoked and he served a year in prison. Upon his release, he challenged the state appellate court to reinstate his license. The court did so, reasoning that he had served his time and he must return to becoming a "beneficial member of society." Amazingly, this fraudulent appraiser charged with participating in numerous land-scam schemes is now a practicing, sanctioned appraiser in New York.

Here's another example. In June 2003, a Maryland appraiser pleading guilty to fraud admitted that the government lost between $500,000 and $800,000 due to his actions. In the fall of 2003, he applied to renew his license. On the online application, he answered "no" to whether or not he had ever been convicted of a felony. His attorney argued that he answered the question honestly because in the federal system, one is not convicted until sentenced, and the appraiser was not sentenced until February 2004. Thus, the Maryland Commission of Real Estate Appraisers and Home Inspectors renewed his license last October for another three years. A spokesperson for the Maryland Commission told the *Baltimore Sun*, "All we have to go by is the honesty of the licensee. We are not required to perform background checks; moreover, the financial and personnel resources are not available at this time."

The Government Accountability Office conducted a lengthy investigation on the appraiser regulatory structure, and determined that underfunding of state appraisal board activities was a major hindrance to enforcement. A GAO survey of state boards identified resource limitations as the primary impediment in doing their jobs. Of the 54 states and territories responding, 26 (48 percent) reported that the current number of investigators was insufficient for meeting their regulatory responsibilities, 37 (69 percent) cited a need for increasing investigative staff , and 22 (41 percent) cited a need for more resources to support litigation.

The survey continued, saying that the average state appraisal board had approximately three staff members responsible for overseeing almost 2,000 appraisers. Many agencies had to share resources—administrative staff, office space, investigators or all three—with other state agencies. Most states sharing resources also shared investigators, often with no real estate appraisal experience. The survey results indicated that investigations of complaints about problem appraisers suffered most from these shortages. GAO recommended that the Appraisal Subcommittee explore options for funding or otherwise assisting states in carrying out their Title XI activities, particularly investigating complaints against appraisers. While the Subcommittee has helped to develop state investigator training programs, funding mechanisms for enforcement have not been established.

The Appraisal Subcommittee is funded exclusively by license fees on individual state certified and licensed appraisers, which are collected by state appraisal boards. Individual appraisers are assessed an annual fee that is passed through to the Appraisal Subcommittee, which has resulted in a sizable reserve fund held by the Appraisal Subcommittee with no identified purpose. The Appraisal Subcommittee claims to lack legal authority to use these funds for grants to state appraisal boards.

We disagree and suggest a few options that are available to Congress in this area:

1. Grant the Appraisal Subcommittee authority to establish and manage a grant program to state appraisal boards to support enforcement activities.
2. Require state appraiser licensing fees to be used for state appraiser licensing and enforcement. Commonly, these fees are diverted into a state's general fund, forcing the appraisal board to compete with other state programs for funding. Self-funded Boards have significantly more enforcement capability.

Require the Appraisal Subcommittee to add “funding” as one criterion considered in monitoring a state program. We encourage this Committee to explore these options to help with the current state appraisal board funding crisis.

Problem appraisals are being allowed by a regulatory structure that is underfunded and allows lax enforcement and ineffective oversight. H.R. 3915 provided the Appraisal Subcommittee with a more robust oversight system, including a full range of supervisory sanctioning powers over state regulators. This modification, if implemented fairly and through an open and public process by the Appraisal Subcommittee, will encourage state appraisal boards to act against unethical and fraudulent appraisers.

Promoting Professionalism

The best advice Americans may obtain for the biggest financial transaction in their lives is an accurate real estate appraisal. Computer-generated analyses cannot approach the worth of appraisals prepared locally, by hands-on appraisers who are experts in their communities. In appraisal, all wisdom is local.

The use of knowledgeable appraisers is thwarted by misinterpretation of the ironically titled “Anti-Discrimination” clause (Section 1122 (d)) of FIRREA, which discriminates against highly trained and credentialed appraisers in favor of those with the most minimal qualifications. Intended to prevent the arbitrary exclusion of minimally licensed appraisers, it has been warped to favor them over more accomplished colleagues. Congress should fix this.

In a recent Appraisal Institute poll of significant users of appraisal services, 50 percent responded that the quality of appraisal services and appraisal reporting has declined, whereas only 28 percent said appraisal services and reporting have improved. Yet many of these users perceive the possession of a license to be the only necessary qualification on which to base whether or not an appraiser is “qualified” to perform an assignment, not fully considering the issue of competency for a particular appraisal.

While minimum qualifications are a good place to start, limiting clients to only those who are minimally qualified makes no sense. Currently, a third of the approximately 100,000 licensed and certified appraisers in the United States belong to professional appraisal organizations, evidence that greater professionalism is still valued, but not as strongly pursued as it should be. H.R. 3915 made certain that professional designations can be considered by clients to help determine an appraiser's proficiency. This would not exclude anyone without a designation from receiving an assignment, but rather promote professionalism and place an emphasis back on quality.

Any legislation curbing predatory lending and mortgage fraud must address current weaknesses in the appraiser regulatory structure. H.R. 3915 addressed these concerns by prohibiting inappropriate pressure of appraisers, providing greater accountability of federal and state appraiser regulators, and promoting professionalism among appraisers.

In the 110th Congress, this Committee issued, and the House passed, H.R. 3915, *The Mortgage Reform and Anti-Predatory Lending Act*, which contained provisions to protect consumers and financial institutions from mortgage fraud by addressing shortcomings in the appraisal regulatory structure. These provisions originally were found in H.R. 3837, the Escrow, Appraisal, and Mortgage Servicing Bill, co-authored by Representatives Paul Kanjorski, Barney Frank, Paul Hodes and Charlie Wilson. We appreciate the work of the bill sponsors because mortgage fraud still demands the attention of Congress. It requires a holistic solution, since it involves many aspects of the real estate and mortgage finance industry, including real estate appraisals. It specifically addressed appraisal-related concerns by modifying *Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA),* which created the current state appraiser regulatory structure with federal oversight. We continue to support these provisions, and we urge that they be enacted immediately.

Appraiser Coercion and Appraisal Independence

In recent years, many financial institutions have lost touch with fundamental risk management practices, including the separation between loan production and risk management. Unfortunately, parties with a vested interest in a transaction are often the same people managing the appraisal process within many financial institutions: a flagrant conflict of interest. Appraisers are ordered to doctor their reports or else never receive work from those parties again. This was evident in a recent case involving nearly all state Attorneys General against Ameriquest, which resulted in an out-of-court settlement imposing new standards to prevent unfair and deceptive practices. Specifically, Ameriquest had to overhaul its appraisal practices by removing branch offices and sales personnel from the appraiser selection process through the following means: instituting an automated system to select appraisers from panels created in each state; limiting the company's ability to get second opinions on appraisals; and, prohibiting its employees from influencing appraisals.

Acts of appraiser coercion may be blatant or subtle. Subtle tactics may fall short of outright coercion, but the implication is the same. It is common for clients to ask appraisers to remove details about the material condition of property, in order to avoid problems in qualifying certain types of mortgage. However, this omission amounts to a violation of appraiser ethical requirements. Such direct threats typically occur informally over the phone making it very difficult to document such pressure.

Another coercion tactic is the threat of being placed on a "blacklist" (aka "exclusionary appraiser list"), commonly used to blackball appraisers. It is one thing to maintain a list of reputable businesses to work with, or to maintain a list of firms to avoid as a result of poor performance. However, is another to place an appraiser on a blacklist for refusal to hit a predetermined value. Worse, we have heard reports of these blacklists circulating secretly among lenders, where the blacklisted appraiser has no notice of being on such lists, nor any chance to defend his or her reputation.

That such tactics fly in the face of regulation makes no difference where enforcement is feeble. Where rules prohibiting coercion exist, they are not always well enforced. Only a few diligent regulators and observant legislators have fought for appraisal independence. Appraisers themselves have made some gains lately in the states. Specifically, our organization has fought for amendments to the Truth in Lending Act (Regulation Z) to prohibit the coercion of appraisers by mortgage lenders and mortgage brokers, while advancing state appraiser independence requirements now enacted in some 16 states.

The recent agreement between the Attorney General of New York, Fannie Mae, Freddie Mac and the Federal Housing Finance Agency also highlights the issue of appraiser independence. Lenders selling loans to Fannie Mae and Freddie Mac must abide by a "Home Valuation Code of Conduct" starting May 1, 2009, which requires separation between loan production and risk/appraisal management. Further, it prohibits mortgage brokers from ordering appraisals on loans sold to Fannie Mae and Freddie Mac.

The intentions of the Home Valuation Code of Conduct are consistent with our support for promoting appraiser independence. However, the insertion of third party "appraisal management companies (AMCs)" into the mortgage financing process may lead to actual declines in appraisal quality. With many AMCs taking as much as 60 percent of the fee as their "management" cost, many highly qualified appraisers are reluctant to perform mortgage appraisals for such entities. This flight of highly qualified appraisers is the last thing an already ailing mortgage market needs. Further, our members report that AMCs are just as likely to pressure appraisers into providing predetermined values. We note that AMCs are unregulated. As such we are concerned that the appraiser independence problem simply may be diverted from one formerly unregulated entity (mortgage brokers) to a new one (AMCs).

To address this concern, our organization has developed a model state bill to register appraisal management companies with state appraisal boards. The model bill is under review in several states at this time.

Mortgage Fraud

For years, appraisers have been warning Congress about perennial schemes perpetrated on consumers and the financial markets by real-estate rogues, including some mortgage brokers, mortgage lenders, realty agents and investors set on "flipping" properties for a quick buck. Professional appraisers help fight such scams. Through educational and ethical initiatives, the profession works to ensure that appraisers are both competent and accountable. We have been leading the fight to protect the public and shield our members from the intense pressure they receive from participants who only get paid if the deal goes forward. Such coercion to rubberstamp a predetermined value undermines the integrity of the process. Appraisers with integrity have found themselves frozen out of the market, while new or inexperienced appraisers become the minions of some lenders.

Mortgage fraud contributed heavily to our current situation. Fraud continues to cost consumers, lenders and taxpayers more than $1 billion annually and suspicious activity reports have increased by an astounding 1,411 percent since 1997, according to the FBI and Department of the Treasury, respectively.

We are angry and disgusted that mortgage fraud can be perpetrated because of faulty appraisals. Law enforcement agencies must be given additional resources for enforcement. Furthermore, there must be coordination between law enforcement and licensing agencies in order to thwart such activity while it is being perpetrated.

Inconsistent Bank Regulation

The present crisis grew from several factors, many long simmering beneath the surface, including the following:

- Imprudent mortgage lending,
- Inconsistent and lax regulation,
- A housing bubble,
- Global imbalances,
- Breakdowns in the securitization model,
- Lack of transparency and accountability,
- Risky banking and financial activity,
- Failure of risk management systems, and
- Excessive leveraging[1].

Inconsistent bank examinations have been highlighted as a significant factor in the housing crisis. The Treasury Department's Office of the Inspector General recently shed light on this issue, claiming the Office of Thrift Supervision was too slow to react to the high-risk lending practices of IndyMac Bank and did not take aggressive enough actions to stop such practices from continuing to proliferate. The report presented a review of the failure of IndyMac Bank and the supervision of the institution by the Office of Thrift Supervision (OTS).

According to the audit report's findings, the OTS viewed growth and profitability as evidence that IndyMac management was capable of success, while failing to recognize the unsafe and unsound manner in which the thrift was operated.

In addition, included in the Inspector General's report were the findings that IndyMac relied too heavily on appraisals that were often supported by weak underlying collateral. According to the audit report, the Inspector General identified several instances in which a borrower's qualifications were not properly reviewed; where IndyMac officials accepted appraisals that were not in compliance with USPAP; and where the borrower was allowed to select the appraiser.

The Inspector General's material loss review of IndyMac is the second such review the Treasury Department has performed of an OTS-regulated financial institution during the current financial crisis. In its first material loss review – of NetBank – the Treasury Department was critical of the Office of Thrift Supervision for not taking stronger action when problems noted by examiners remained uncorrected through several examination cycles. There also were several problems noted by examiners with regard to the business practices of IndyMac, however, these too went mostly uncorrected.

Wall Street and the secondary markets also played by its own set of rules, absent sufficient oversight from government regulators. Investment banks operated under different regulations than federally regulated institutions. Further, loan pools were not subject to consistent securitization due diligence standards, which would have facilitated a critical assessment of the value of the underlying assets making up the loan pool. Moving forward, greater transparency in the securitization market -- including greater awareness and understanding of the underlying assets that make up the loan pools -- is essential to help restore investor confidence. Specifically, Wall Street investors must understand that valuation services have varying degrees of risk. While appraisals prepared by licensed or certified appraisers are widely considered to be the "gold standard" in the industry, lesser services such as automated valuation models and broker price opinions are often used as a cost-cutting method in these situations. Investors deserve greater due diligence.

Abandoning Long-Standing Safety and Soundness Policies

Last week, the Obama Administration released guidelines outlining policies for the Home Affordable Modification program, which intends to help between three and four million at-risk homeowners avoid foreclosure by reducing monthly mortgage payments.

[1] Jickling, M. (2009, January 29). *Causes of the Financial Crisis*. Congressional Research Service.

Participating lenders will be required to consider refinancing through FHA's Hope for Homeowners program and then conduct a standard "waterfall" test with regard to the loan modification. Part of this process involves a cost-benefit analysis on whether to foreclose or modify the loan. As part of this test, the current property value is a factor, and because no new monies are being conveyed, the agencies are apparently applying an exemption to Title XI of FIRREA that allows for the use of evaluations or appraisals to establish value.

According to the Guidelines, the servicer may use, at its discretion, either one of the government-sponsored enterprises automated valuation models (AVMs) – provided that the AVM renders a reliable confidence score – or a broker price opinion. As an alternative, the servicer may rely on the AVM it uses internally provided that (i) the servicer is subject to supervision by a federal regulatory agency, (ii) the servicer's primary federal regulatory agency has reviewed the model and/or its validation, and (iii) the AVM renders a reliable confidence score.

If the GSE or servicer AVM is unable to render a value with a reliable confidence score, the servicer must obtain an assessment of the property value utilizing a property valuation method acceptable to the servicer's federal regulatory agency.

Our organization is concerned by the Administration's decision to rely heavily on unregulated valuation services in the loan modification program, when streamlined appraisal services are readily available in the marketplace. The Interagency Appraisal and Evaluation Guidelines have consistently encouraged lenders to obtain appraisals where there have been material changes in market conditions, even in cases of loan modifications when no new monies have been conveyed. The Administration's plan rolls the dice on every homeowner's equity as it retreats from meaningful bank regulations in favor of unregulated and exotic valuation services.

Professional real estate appraisers deliver a diverse menu of valuation services, with many specifically designed to address distressed properties and others that may be used for most non-complex transactions. Examples of the types of services that appraisers can deliver for loan modification or distressed asset purchases include:

- Appraisal updates and reviews, or updates to existing appraisals.
- Drive-by appraisals, or appraisals of the exterior-of-the-property desktop appraisals.

- Appraisals performed from the appraiser's desktop without any exterior or interior inspection.

Today's technology and current methodology allow real estate appraisers to deliver necessary services quickly and securely. Given the advances in technology, these services are very cost-effective and affordable with delivery from the thousands of designated, certified and licensed appraisers in every community in the country.

Treasury should do everything in its power to encourage the use of services prepared by regulated individuals, in accordance with industry standards, that have the force of law, particularly where there have been material changes in market conditions, as we see in many parts of the country today.

Recommendations

Our organization recommends that a series of steps be taken to address the weaknesses and problems identified above, as follows:

1. Introduce and pass mortgage reform legislation similar to H.R. 3915, addressing the inappropriate pressure of appraisers, providing greater accountability of federal and state appraiser regulators, and promoting professionalism among appraisers. In addition to the appraisal provisions found in H.R. 3915, we offer the following improvements:
    - Require the regulation of Appraisal Management Companies within 24 months of enactment;
    - Require secondary market due diligence requirements/standards for appraisals;
    - Include a consumer protection mechanism, such as encouraging the formation of state "recovery funds" funded by real estate practitioners/licenses in the states. This, as opposed to requiring a surety bond for appraisers (which unnecessarily raises costs for borrowers) would be a preferred approach;
    - Require review of all exemptions to the use of appraisers for federally regulated transactions;

- Elevate the oversight and structure of the Appraisal Subcommittee board to a position reporting directly to the Secretary of the Department of the Treasury.

2. Establish a high-level position for collateral valuation review. As Congress moves forward with broader reform of the financial regulatory industry, the appraisal and valuation issues need to be addressed. We support a departmental level “Chief Appraiser” who oversees all appraisals and valuation issues across the financial spectrum, including the mortgage and secondary markets and all financial, mortgage and real estate-related financial instruments.
3. Conduct an immediate review of the new loan modification guidelines (Home Affordable Modification) released by Treasury last week, in order to ensure that consumers and neighborhoods are being protected and proper valuation is being utilized, including questioning the allowances of Broker Price Opinions being used in lieu of appraisals.

We are eager to work with Congress, consumer groups and banking interests to ensure that these provisions are included in any mortgage reform legislation in the 111^{th} Congress.

Thank you for giving me this opportunity to address you today.