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The Appraisal Racket Why the housing bubble's burst failed to align the home-appraisal business with reality. By Bethany McLean Posted Tuesday, Nov. 16, 2010, at 5:09 PM ET Is this house worth what an appraiser might say it is worth? At the height of the housing bubble, 90 percent of residential real estate appraisers—the people who decide whether the house you made the winning bid on is really worth what you're about to pay—reported feeling pressured, frequently by mortgage brokers, to increase their estimate of the property's true value so that the deal could go through. The value of your house serves as the collateral for your mortgage; it's the only thing the bank has left if you don't pay up. Given this reality, you might think that the crash of the housing market would make it easier for appraisers to do their jobs without interference. But while there have been some big changes in the appraisal business, many appraisers say privately that things have gotten worse, not better.

And while the Dodd-Frank financial reform bill, which President Barack Obama signed into law this past summer, made a well-intentioned effort to fix the problem, there's reason to fear that it won't. Appraisers have long been the mopes of the U.S. home loan industry. In other countries, such as Mexico, you have to be an architect or an engineer to make home appraisals; here, you just have to get a license, the requirements for which are not at all onerous. One appraiser says that in international forums, he's seen the Chinese laugh as the U.S. requirements are translated. Appraisers enjoy little status in the U.S. housing industry because they are the "no" people, the ones who stop the deals. No one—not mortgage brokers, lending executives, nor even consumers—likes "no" people. Appraisers get paid far less than loan sales representatives, and get beat up far more. "In 95 percent of fraud cases, the appraiser isn't even getting a piece of the action," one appraiser tells me. "They're just getting their small fee and the opportunity to commit more fraud down the road." The first attempt to reform the home-appraisal business came more than 20 years ago, in the wake of the savings and loan crisis. Because flawed

appraisals played such a major role in that debacle (sound familiar?), new regulations came to be written requiring that the appraisal process be isolated from the loan production side. That way, it was reasoned, mortgage brokers and others with a financial interest in making the loan couldn't beat up on the appraisers. And new regulations were put in place that were supposed to help police appraisal fraud. It didn't work. The states were supposed to bear some of the new responsibility to regulate. But appraisers' licensing fees, which the states were supposed to use to fund regulatory oversight of home appraisals, instead often got swept into state general funds, leaving little money for enforcement. At the federal level, the Appraisal Subcommittee, created in 1989 to oversee state regulation of home appraisals, had only one penalty it could impose: Disapprove a state, thereby blocking any federally insured lender from using the work done by an appraiser in that state. Because that was such a drastic threat, states understood it was also an idle threat. It was hard to track bad appraisers, and there were cases where an appraiser who had a license revoked in one state simply moved on to another state. And since there was no system for tracking bad appraisals, a mortgage broker could shop a loan with a flawed appraisal, have it turned down by one lender, and keep shopping the same appraisal until some other lender bit. As for keeping appraisers separated from loan production people, well, federal regulators simply didn't enforce the rules. (Does that sound familiar too?) "Appraisers were not supposed to know" the size of the loan, says an appraiser named John Ferguson, who worked as both an independent appraiser and for Bank United, which was taken over by the FDIC. But the loan salesmen "would tell you what the number was," Ferguson explains. "They would shove it in your face. 'If you do this one for me, I'll give you a whole bunch of work.' And you knew if you didn't, you would never get work again." Another former appraiser at a major lender says that federal regulators never once spoke to him, or to any appraiser he knows, about their independence from the sales staff. He also says that despite repeated warnings about the pressure appraisers were being subjected to by mortgage brokers, the federal regulators simply reiterated the guidance on independence but refused to say that mortgage brokers couldn't be the ones to order the appraisals. "The regulators would have had to have been hit over the head with a Mack truck before they took issue," he says. In the spring of 2008, New York Attorney General (now Gov.-elect) Andrew Cuomo who had taken a big interest in appraisals while he was secretary of Housing and Urban Development, announced a major change in the industry. Among other things, Fannie Mae and Freddie Mac, the government-sponsored mortgage securitizers, agreed that they wouldn't purchase any loans in which mortgage brokers played a role in selecting the appraisers. In addition, in order to ensure appraiser independence, lenders weren't supposed to use appraisal companies that they owned. (Big lenders like Countrywide had their own in-house appraisal units.) And an independent institute would monitor all of this. Although Cuomo's rule applied only to loans that were bought by Fannie and Freddie, in the wake of the crisis, Fannie and Freddie became the entire market, and so Cuomo's rule de facto became the industry rule. Cuomo's rule sounded good-at first. After fierce lobbying from the financial industry, the provision forbidding lenders to use their own in-house appraisal businesses was dropped (although firewalls that prevent conflicts were supposed to be put in place). The institute was never established. And the rule against mortgage brokers had a consequence that may or may not have been intended. Instead of a mortgage broker hiring an independent appraiser, lenders began to contract with appraisal management companies (known colloquially as AMCs), which would in turn contract with the appraisers. One appraiser tells me that AMCs' market share has roughly doubled since Cuomo's law went into effect. The obvious benefit to AMCs raised eyebrows: At the time, Cuomo sat on the board of an AMC called Amco. While

AMCs can provide a valuable service, the knock on them is that they mostly care about getting the appraisal done quickly and cheaply, not necessarily well. And they take a good chunk of the appraiser's fee—often more than half—with the result that appraisers say they can no longer make a living; competent people are fleeing the profession. Ferguson tells me that 15 years ago he charged \$350 to do a straightforward appraisal of a single family home. That would be a high fee today. And some appraisers say that they are still pressured by lenders, albeit in a less direct form. After all, if an AMC is getting most of its business from a big lender, and that lender complains that the appraisals are coming in too low, what is the response going to be? (Both lenders and AMCs defend AMCs as offering better, more independent appraisals.) Will Dodd-Frank, which will replace Cuomo's rule, make things better? Even skeptical appraisers were initially hopeful. Although the law does nothing to discourage the proliferation of AMCs, it does require more state enforcement of appraisal standards, and it requires AMCs to pay "customary and reasonable" fees to appraisers. It also says that federal regulators are supposed to delineate "with specificity acts or practices that violate appraisal independence." But as is the case with much of Dodd-Frank, crucial details are left to the federal regulators to decide. So far, the signs aren't auspicious. In mid-October, the Federal Reserve issued an "interim final rule." But Joan Trice, a long-time appraiser who founded an industry forum called the Collateral Risk Network, says that in the face of fierce lobbying from lenders and AMCs, the regulators watered down the "customary and reasonable" provision to the point where she thinks it actually contradicts the law. The Fed's rule does prohibit anyone from attempting or causing "the value assigned to the consumer's principal dwelling to be based on a factor other than the independent judgment" of the person doing the appraisal. All the language sounds really good. But if appraisal independence wasn't enforced the last time around, why should we believe it will be enforced this time? Some skepticism is warranted given that when Cuomo was proposing his law, the federal regulators wrote a letter in which they claimed that, with changes they were considering making to prohibit mortgage brokers or creditors from coercing the appraiser, "issues regarding appraiser independence and protection from coercion are already adequately addressed." There are more details to come, like the role of federal regulators in overseeing state enforcement efforts. If lenders and appraisers could anticipate certain punishment for bad appraisals, that would be the most effective deterrent of all. "We'll see what kind of stomach they have," says one appraiser about the federal regulations to come. "[They] have kowtowed to the big banks before. I am hopeful, but I'm not optimistic."