

FEDERAL RESERVE SYSTEM
12 CFR Part 225
[Regulation Y; Docket No. R-0990]

Real Estate Appraisals

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System is soliciting comments on a proposed amendment to Subpart G of the Board's Regulation Y, Appraisal Standards for Federally Related Transactions, to exempt any transaction involving the underwriting or dealing of mortgage-backed securities from the Board's appraisal requirements. This amendment would permit a bank holding company or a nonbank subsidiary of a bank holding company engaged in underwriting and dealing in securities (a so-called section 20 subsidiary) to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements.

The Board is proposing this amendment to address concerns raised by bank holding companies regarding the inability of section 20 subsidiaries to actively participate in the commercial mortgage-backed securities (CMBS) market due to the appraisal restrictions of Subpart G.

DATES: Comments must be received on or before January 8, 1998.

ADDRESSES: Comments should refer to Docket No. R-0990 and may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C., 20551. Comments addressed to Mr. Wiles may also be delivered to the Board's mail room between 8:45am and 5:15pm, and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments may be inspected in Room MP-500 between 9:00am and 5:00pm weekdays, except as provided in § 261.8 of the Board of Governors' Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Norah M. Barger, Assistant Director (202/452-2402), or Virginia M. Gibbs, Senior Supervisory Financial Analyst, (202/452-2521), Division of Banking Supervision and Regulation; or Deneen L. Donnley-Evans, Staff Attorney (202/736-5567), Legal Division; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. 3331 et seq., directed the federal banking agencies (the agencies) to publish appraisal rules for federally related transactions within the jurisdiction of each agency. The stated purpose of the legislation is to provide 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 in writing, in accordance with uniform standards, and by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision.^{1/}

Section 1121(4) of FIRREA, 12 U.S.C. 3350(4), defines a federally related transaction as a real estate-related financial transaction that is regulated or engaged in by a federal financial institutions regulatory agency and requires the services of an appraiser. Section 1121(5), in turn, defines a real estate-related financial transaction as any transaction that involves: (1) the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof; (2) the refinancing of real property or interests in real property; and (3) the use of real property or interests in real property as security for a loan or investment, including mortgage-backed securities (emphasis added).^{2/} In enacting Title XI, Congress envisioned that competent appraisals in these transactions would reduce the risk of loss to the deposit insurance funds, regulated institutions, and the secondary markets, arising from a financial institution's lending activities where real estate is taken as collateral.

In 1990, in accordance with the mandates of Title XI, the agencies adopted appraisal regulations for federally related transactions within their jurisdiction, and exempted certain real estate-related transactions from the appraisal requirements of Title XI. In June 1994, several existing exemptions to the appraisal regulation were modified and new exemptions were added. At that time, the agencies clarified that a regulated institution investing in a mortgage-backed security or similar instrument need not obtain new Title XI appraisals for the underlying loans so long as the loans met regulatory appraisal requirements for the institution at the time the real estate-secured loan was originated.^{3/} This requirement also applies to the activity of underwriting and dealing in mortgage-backed securities.

In adopting this requirement, the agencies did not foresee that requiring evidence that the loans underlying mortgage-backed securities had appraisals would be a difficult task. The mortgage securities market consisted of securitized 1-to-4 family residential loans, most of which were generated in accordance with the agencies' appraisal requirements. The appraisal regulation appears not to have hindered the secondary market in 1-to-4 family mortgages, for two reasons. First, the Federal National Mortgage Association (Fannie Mae) and the Federal National Mortgage Corporation (Freddie Mac) dominate the market for the underwriting and dealing of residential

^{1/} See Title XI's Statement of Purpose. 12 U.S.C. 3331.

^{2/} See 12 U.S.C. 3350(5).

^{3/} See 59 FR 29482 (1994).

mortgage-backed securities, and neither bank holding companies nor their investment banking competitors have large stakes in this market. Second, banks and bank holding companies have not been prevented from investing in such securities, even though the underlying mortgages may not have conforming appraisals, because the interagency appraisal regulations contain an exemption for any transaction that qualifies for sale to, or involves a residential real estate transaction in which the appraisal conforms to the appraisal standards of, a United States government or government-sponsored agency, including Fannie Mae and Freddie Mac. However, recent developments in the emerging CMBS market, including the recovery of the commercial real estate market, the wider acceptance of collateralized securities, the significant expansion of the CMBS market, and the operation of the agencies' appraisal regulations, have worked to bar banking organizations from actively participating in the CMBS market's growth.

Proposed Amendment

The Board proposes to amend its real estate appraisal regulation to permit bank holding companies and their nonbank subsidiaries to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements. However, in practice, the proposed amendment would only apply to the section 20 subsidiaries because, to date, section 20 subsidiaries are the only regulated-institution affiliates permitted to underwrite or deal, to a limited extent, in corporate debt and equity securities.^{4/}

The CMBS Securities Market

The CMBS market has been in existence since the mid-1980s, with banking organizations, investment banks, and insurance companies serving as the primary underwriters of CMBS. Recently, there has been significant growth in new CMBS issues. In 1996, \$30 billion of new CMBS were issued, a 50 percent increase over the \$20 billion issued in 1994, and new issuances of \$25 billion to \$35 billion are expected in 1997.^{5/} Approximately 90 percent of the tranches of new CMBS issues are rated investment grade.

^{4/} Consistent with the Board's policy of imposing operating restrictions according to risk, the Board also proposes to permit section 20 subsidiaries to underwrite and deal in both residential and commercial mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements. In this regard, the Board notes that residential mortgage-backed securities are considered far less risky than CMBS as 1-to-4 family residential mortgages have one of the lowest historical loss rates of any credit-related asset class. The Board expects this exemption to affect a relatively small number of transactions because, as previously noted, the vast majority of loans underlying residential mortgage-backed securities meet the appraisal standards of Fannie Mae or Freddie Mac, and thus qualify for an exemption under the agencies' appraisal regulations. See e.g. 12 CFR 225.63(a)(10).

^{5/} Between 1992 and 1996, approximately \$100 billion of CMBS were issued, all of which are still outstanding.

In recent years, the majority of new CMBS issuances have involved loans originated by nonbank financial companies that are not subject to the agencies' appraisal requirements.^{6/} While the Board has not studied whether these companies generally obtain appraisals conforming to Title XI requirements upon origination of the underlying loans, anecdotal evidence suggests that many of the underlying loans originated by these institutions do not have Title XI conforming appraisals. In addition, although commercial bank participation as lenders and investors in this market is expected to increase as larger national and regional banking organizations reenter the real estate lending business, banking organizations and their affiliates currently are precluded from actively participating in this market because the majority of the loans underlying CMBS issuances do not have Title XI conforming appraisals.

Policy Considerations

As noted above, Title XI's purpose and intent was to protect "federal financial and public policy interest" in real estate-related transactions.^{7/} Those "federal interests" were described in predecessor legislation and accompanying Congressional reports as encompassing the federal government's role as: (1) regulator and insurer of financial institutions; (2) guarantor or lender on mortgage loans; (3) as a direct party itself in real estate-related transactions; and (4) as the overseer of financial markets and real estate-related investments therein.^{8/}

The Board believes that permitting section 20 subsidiaries to underwrite and deal in mortgage-backed securities without obtaining appraisals that meet the Board's appraisal requirements will not lead to substantial losses for bank holding companies or pose a systemic risk to the banking system. The Board notes that section 20 subsidiaries have the expertise necessary to evaluate the credit risks involved in underwriting and dealing mortgage-backed securities. In this regard, the Board notes that, section 20 subsidiaries are subject to an operational and managerial infrastructure inspection prior to being permitted to engage in corporate underwriting. Periodic inspections verify that proper underwriting and risk management procedures are in place.

When a section 20 subsidiary serves as lead underwriter, it is responsible for performing adequate due diligence. In other instances, such as the dealing of an outstanding debt security, a section 20 subsidiary may rely on the due diligence performed by independent rating agencies. These due diligence efforts often include analyses of factors such as payment history, mortgage and security structure, borrower's income or property cash flow, credit enhancements, and seasoning. In most CMBS transactions, the underlying loans have demonstrated their ability to perform over some period of time. As the underlying commercial real estate loans in the CMBS season, the Board believes that appraisals obtained at origination become increasingly less relevant to

^{6/} For example, of the \$30 billion of new CMBS issued in 1996, only \$2.4 billion involved the collateralization of loans underwritten by commercial banks.

^{7/} See Title XI's Statement of Purpose. 12 U.S.C. 3331.

^{8/} See Real Estate Appraisal Reform Act of 1988, H.R.Rep. No. 100-101, 100th Cong., 2d Sess., pt. 1 at 19 (1988); 135 CONG. REC. H10, 709 (daily ed. November 20, 1987) (statement of Rep. Barnard).

the CMBS investment decision because the market assumptions upon which the appraisals were based become obsolete. Further, the public rating or due diligence that must be obtained for CMBS provides information that is at least as sufficient for assessing risks as requiring new appraisals if appraisals were not obtained at loan origination. For residential mortgage-backed securities, the market is well established with very clear standards for loan documentation and underwriting. In light of the foregoing, the Board concludes that permitting section 20 subsidiaries to underwrite and deal in CMBS without demonstrating that the loans underlying the CMBS are supported by appraisals that meet the Board's appraisal requirements would not adversely affect financial markets and real estate investments therein.

Regulatory Flexibility Act Analysis

This proposal is not expected to have a significant economic impact on a substantial number of small business entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) because, if adopted, the proposal would not impose additional burdens on bank holding companies or their section 20 subsidiaries.

Paperwork Reduction Act

No collection of information pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.) is contained in this proposal.

List of Subjects in 12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, the Board proposes to amend 12 CFR part 225 as set forth below:

PART 225 -- BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828o, 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 331-3351, 3907, and 3909.

2. In subpart G, § 225.63 is amended by removing the word “or” at the end of paragraph (a)(11), and by redesignating paragraph (a)(12) as paragraph (a)(13) and by adding a new paragraph (a)(12) to read as follows:

§ 225.63 Appraisals required; transactions requiring a State certified or licensed appraiser.

(a) * * *

(12) The transaction involves underwriting or dealing in mortgage-backed securities;

or

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By order of the Board of Governors of the Federal Reserve System,
December 3, 1997.

(Signed) William W. Wiles

William W. Wiles
Secretary of the Board.