Federal Housing Finance Agency
1700 G Street, N.W., Washington, D.C. 20552-0003
Telephone: (202) 414-3800
Facsimile: (202) 414-3823
www.fhfa.gov

December 27, 2010

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Interim Final Regulation on Appraisal Independence amending Regulation Z (Truth in Lending Act), Dkt No. R-1394, RIN No. AD-7100-56

Dear Ms. Johnson:

The Federal Housing Finance Agency (FHFA), in its capacity as regulator and conservator for Fannie Mae and Freddie Mac, appreciates the opportunity to provide comments on the above-referenced Interim Final Regulation published at 75 *Federal Register* 66554 (October 28, 2010). The rule implements Section 129E of the Truth in Lending Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which established new requirements for appraisal independence for credit transactions secured by the consumer's principal dwelling. FHFA supports the Interim Final Rule's objectives to ensure that valuations of a consumer's primary dwelling to support creditor underwriting decisions are based on the appraiser's independent professional judgment and free from conflicts of interest, coercive practices and inappropriate influence.

While the Interim Final Rule covers origination of mortgage loans secured by a borrower's principal residence and as such would not affect Fannie Mae's or Freddie Mac's underwriting requirements or their ability to establish, change or modify requirements for appraisal independence that may exceed those specified in the rule, FHFA provides comments here that may serve to enhance the rule's operations.[1] FHFA's comments in no way alter our strong support for a rule along the lines that the Board of Governors set forth in the Interim Final Rule.

1. Prevention of valuation conflict of interest through separation of functions.

In a residential mortgage transaction, valuations of the dwelling securing the loan provide necessary underwriting quality control to assure the lender and investor that there is sufficient collateral to cover the loan if the borrower defaults. Valuations also serve to protect the consumer by ensuring

[1] Through the long-standing and recently re-affirmed exemption granted for loans that qualify for sale to a government sponsored agency, the Board recognized that the Enterprises may establish more stringent appraisal requirements for their book of mortgage loans and banks should be careful to adhere to them. "Final Interagency Appraisal and Evaluation Guidelines" (December 2, 2010).

that the consumer is not saddled with a larger mortgage because of an inflated appraisal. To realize these consumer and underwriting benefits from a valuation requires professional independence that, among other things, ensures separation of the valuation or valuation management functions from the loan production function. The Interim Final Regulation goes a long way to achieve this goal. Without a requirement of appraisal independence to separate the appraisal function from the loan production function, a bias would exist towards appraisals not reflecting accurate valuation. FHFA supports the Interim Final Rule's separation of the valuation and valuation management functions from the loan production function to eliminate biased valuations.

The staff interpretation for Section 226.42(c)(1) currently states, "A covered person also may provide incentives, such as additional compensation, to a person that prepares valuations or performs valuation management functions under § 226.42(c)(1), as long as the covered person does not cause or attempt to cause the value assigned to the consumer's principal dwelling to be based on a factor other than the independent judgment of the person that prepares valuations." 75 *Federal Register* at 66582. On its face, the Staff Interpretation could appear to condone loan production personnel paying "incentives, such as additional compensation" to persons who conduct valuations or who manage the valuation function. This seems inconsistent on a plain reading of the Interim Final Rule's objective of separating loan production personnel from the valuation management process.

Staff discussion could clarify that such practices, while perhaps not "coercive" within the meaning of the rule, nevertheless violate the "conflict of interest" prohibitions of the rule designed to further separation of functions to achieve appraisal independence or otherwise clarify the intended purpose of the staff interpretation.

2. Staff interpretation on "conflict of interest" and separation of function in the process of the selecting, retaining and influencing the selection or retention of persons performing valuation or valuation management functions.

The staff interpretation of a "prohibited interest in the transaction" on the part of a person who prepares a valuation or performs a valuation management function could benefit from a discussion of the situation where such person has been selected or retained by someone involved in the loan production function or compensated based on the loan closing. Currently, the staff interpretation of Section 226.42(d)(1)(i) provides two examples of a "prohibited conflict of interest" – (1) where a person performing valuation or valuation management functions or an affiliate also provides loan production or settlement services for the transaction, and (2) where the person performing valuation or valuation management functions is compensated based on whether the transaction is consummated. 75 *Federal Register* at 66584. Neither example addresses appropriate separation of function in the creditor's process for selecting, retaining or influencing the selection or retaining persons conducting valuations or performing valuation management functions where the appraiser is unaffiliated with the loan production personnel, or where the appraiser is compensated on a fixed fee basis. As drafted, the staff interpretation does not appear to prohibit, as a conflict of interest, a situation where the person performing valuation or valuation management functions is selected or retained by a person involved in a loan production function where the two persons are not affiliated.

Clarification of this section could address the practice of having persons involved in a creditor's loan production function, including loan officers or mortgage brokers, select and retain the persons conducting the valuations or the valuation management functions, short circuiting a creditor's risk controls and introducing a bias on the part of the valuation function.[2] A revised regulation could specify that a "prohibited interest in the transaction" on the part of an appraiser or person performing a valuation management function includes one who was not selected or retained in a manner consistent with paragraphs 226.42(d)(2) or (d)(3).

3. Reasonable diligence standard could require reliance on a second valuation that is equal to or more comprehensive than the initial valuation.

Section 226.42(e) prohibits a creditor that knows of violations in Sections 226.42(c) (covering coercive conduct) or 226.42(d) (covering prohibited conflicts of interest in connection with a valuation for a covered transaction) from extending credit unless that creditor documents that it has acted with "reasonable diligence to determine that the valuation does not materially misstate or misrepresent the value of the consumer's principal dwelling." 75 *Federal Register* at 66581-82. In order for the creditor to determine whether the valuation "materially" misstates the value of the dwelling, *i.e.*, whether the misstatement affects the credit decision, the creditor's only reasonable diligence procedure is to perform and rely on a subsequent independent valuation of the dwelling. Such subsequent independent valuation should be equal to or more comprehensive than the initial valuation.

On behalf of FHFA, I hope these comments are constructive and I reiterate, again, FHFA's support of the Interim Final Rule. Please do not hesitate to contact me at (202) 414-3788 or Ming-Yuen Meyer-Fong at (202) 414-3798 if you have questions or wish to discuss further.

With all best wishes I am

Sincerely,

Alfred M. Pollard
General Counsel

[2] An independent report, by the Charles A. Dice Center for Research in Financial Economics, states "A potential obstacle to inflating transactions, whether within the lenders' guidelines or beyond them, is the appraiser's judgment. According to common appraisal rules, appraisers should value homes as if they were purchased for cash, without any financial or other incentives to the buyer. . . However, appraisers' incentives are distorted. During the sample period, appraisers were appointed by the mortgage originators (e.g., mortgage brokers) and as such had the incentive to approve even an inflated transactions price in order to satisfy the originator and obtain future appraisal assignments." See "Financial Constraints and Inflated Home Prices during the Real-Estate Boom," Nov. 2010, available at http://www.ssrn.com/abstract=991387 (last visited Dec. 21, 2010).