

COMMENTS to the Federal Reserve Board
[Regulation Z; Docket No. R-1394]
12 CFR Part 226: Truth in Lending
Interim Final Rule on Appraisal Independence Standards
by the National Consumer Law Center
on behalf of its low-income clients
and for the
National Association of Consumer Advocates

The National Consumer Law Center¹ ("NCLC") respectfully submits the following comments on behalf of its low income clients, as well as for the National Association of Consumer Advocates,² on the Board's interim final rules implementing the new appraisal independence standards promulgated in the Dodd-Frank Act.³

Summary of the Issue and Our Recommendations

The mortgage marketplace in the years before the meltdown in 2008 provided incentives to mortgage originators to extend home-secured credit even when the loan amount exceeded the real value of the home. This regularly happened in states where real estate values were not rising as quickly as other parts of the nation. The problem of inflated appraisals was so pervasive that it was extensively reported upon,⁴ litigated about,⁵ and, in 2008, the Federal Reserve Board promulgated rules designed to stop it.⁶

¹ The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of eighteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (7th ed. 2010 (forthcoming)), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (4th ed. 2009), and *Foreclosures* (3rd ed. 2010), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. These comments were written by NCLC attorneys Margot Saunders and Diane E. Thompson.

² The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

³ Dodd-Frank § 1472, *to be codified at* 15 U.S.C 1639E.

⁴ Kenneth R. Harney, *Appraisal Inflation*, Wash. Post, Apr. 21, 2007, at F1 (trade association of appraisers tells federal regulators that subprime lenders were guilty of "systematic inattention" to the reliability of valuation); David Cho, *Housing Boom Tied to Sham Mortgages, Lax Lending Aided Real Estate Fraud*, Wash. Post., Apr. 10, 2007, at A1 (mortgages lenders acknowledged failure to review or underwrite hundreds of loans in large property flipping scheme); Michael Moss and Andrew Jacobs, *Blue Skies and Green Yards, All Lost to Red Ink*, N.Y. Times, Apr. 11, 2004, at sect. 1, at 1 (division of Chase Manhattan continued lending on suspect home loans arranged by builder until Freddie Mac notified Chase that it was beginning investigation). *Cf.* Ira J. Goldstein,

There were two contexts for inflated appraisals, each with a different driving dynamic. One form that became especially problematic in the early 2000s⁷ involved inflated values assigned to home purchases. Dilapidated older homes were purchased, superficial changes were made to mask the condition of the homes, and then the homes were resold at puffed up prices. The home purchase scenario generally involved some collusion between loan originators and appraisers, as well as sellers of the homes, and was a major source of fraud in home lending in recent years. Occasionally, home builders were also involved in over-valuations of newly built homes.⁸ The seller, whether an individual, investor, or home builder, always benefits from a higher home price. The loan originator benefited because the higher sale price meant a higher loan amount, which in turn created more income for the originator. The appraiser only benefitted from the higher value assigned to the home because it meant satisfied customers who were likely to return for more business. More business for the appraiser meant more income.

The second type of inflated appraisals involved overstated values applied to homes in refinance loan transactions. These problems were generally “just” the fault of the loan

The Reinvestment Fund, *Lost Values: A Study of Predatory Lending in Philadelphia* 58–59 (2007), available at www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf (in neighborhoods in Philadelphia with low house prices, “the average principal amount due dramatically exceeded the average estimated value of the homes in foreclosure” although house prices in low value areas were “relatively stable” during the relevant time period); *id.* at 65 (18% of all properties in Philadelphia had loans that exceeded their estimated value); M. Diane Pendley, Glenn Costello & Mary Kelsch, Fitch Ratings, *The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance* 4–5 (Nov. 28, 2007), available at www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=356624 (most of the files reviewed had evidence of fraud in the origination file, including 51% which showed an inflated appraisal value and 16% which had evidence of either a straw buyer or a flip); “Appraisal Reviews Are Important to Safe Banking”, *Financial Update*, Federal Reserve Bank of Atlanta, 4th Quarter, 2004, found at [http://www.frbatlanta.org/invoke.cfm?objectid=48322F80-C5A6-D175-9F7DA14278E89F4B&method=display%20target=%22_blank](http://www.frbatlanta.org/invoke.cfm?objectid=48322F80-C5A6-D175-9F7DA14278E89F4B&method=display%20target=%22_blank;); Blanche Evans, *The Appraisal Crisis And The FBI*, Realty Times, February 2, 2005, available at http://realtymtimes.com/rtpages/20050202_appraisalcrisis.htm; Richard C. Sorenson, “Appraisals: A Wink and a Nod?” 81 J. of Lending & Credit Risk Management 66-69 (Feb. 1999), available at <https://docs.google.com/viewer?a=v&pid=gmail&attid=0.1&thid=124111379f970b7c&mt=application/msword&url=https://mail.google.com/mail/?ui%3D2%26ik%3Da22ac302f6%26view%3Datt%26th%3D124111379f970b7c%26attid%3D0.1%26disp%3Datt%26zw&sig=AHIEtbSYL6e0pMMNOqzoxUNoUhJLVU1kVw&pli=1>; James R. Hagerty and Ruth Simon, “New Headache For Homeowners: Inflated Appraisals, Rosy Valuations, Common In Boom, Now Haunt Sellers; It’s Pay-the-Piper Time”, *The Wall Street Journal* July 22, 2006, Page A1.

⁵ *United States v. Owens*, 301 F.3d 521, 528 (6th Cir. 2002) (describing appraiser’s key role in a property flipping scheme); *Vaughn v. Consumer Home Mortgage, Inc.*, 2003 WL 21241669 (E.D.N.Y. Mar. 23, 2003);

⁶ Reg. Z. § 226.36; 73 Fed. Reg. 44,522, 44,604 (July 30, 2008).

⁷ Inflated appraisals have a long and sordid history, of course. Both kinds of inflated appraisals underlay much of the savings and loan crisis, and were motivating factors in FIERRA’s enactment.

⁸ *Hoffman v. Stamper*, 867 A.2d 276 (Md. 2005) (description of a property flipping scam in Baltimore). *See, e.g.*, *United States v. Geig*, 176 Fed. Appx. 638, 639 (6th Cir. 2006) (upholding restitution award and prison term for participant in property flipping scheme that “left buyers with overvalued properties with a high risk of foreclosure”); David Cho, *Housing Boom Tied to Sham Mortgages, Lax Lending Aided Real Estate Fraud*, *Wash. Post.*, Apr. 10, 2007, at A1 (more than 300 homes go into disrepair and foreclosure in wake of property flipping scheme, surrounding homeowners lose as much as 50% of the value of their homes); *see also* *Ingalls v. United States*, 2007 U.S. Dist. LEXIS 1820, 2007 WL 119161 (D.N.J. Jan. 10, 2007) (real estate agent participated in property flipping and drug money laundering scheme, whereby unqualified buyers were put in substandard houses with HUD-insured mortgages).

originators and the appraisers. The loan originators benefited because the inflated value made the transaction work, and fueled the refinancing boom that kept subprime lending alive: ever increasing home values allowed lenders to continue flipping borrowers into ever more unaffordable loans.⁹ The appraisers benefitted because they had more satisfied customers, and thus more business.

Both kinds of appraisal fraud were key drivers in creating the financial crisis of 2007-08. The increase in home values, a major factor permitting the market to become overheated and bad loans to be made, was enabled and, to some extent, dictated by widespread appraisal fraud. By the mid-2000s, in our legal practices representing low-income people, it was commonplace to hear appraisers complain that there were no longer any legitimate comparables to which to anchor valuation. Having borrowers “under water” or “upside down” by owing more than their homes are worth may also have kept borrowers from refinancing into lower cost loans with competitors and facilitated in-house flipping.¹⁰

This should not have happened. The appraisal industry was – and continues to be – regulated under strict and comprehensive standards – USPAP.¹¹ Moreover, the industry standards in place throughout the years preceding 2008 required loan originators to conduct thorough evaluations of the appraisals; in effect, an entire review of the appraisal process and the appraisal itself, was mandatory for almost all home loans. These mandates came from federal law,¹² banking regulators,¹³ the GSEs,¹⁴ and the expectations of the investors purchasing these loans.¹⁵ The problems erupted in the industry despite these clear and mandatory procedures, in large part because originators simply ignored them.

Originators were free to ignore these procedures because they did not bear the risk of the loans. Originators sold the loans. Securitization made vast amounts of cash available

⁹ See, e.g., Office of Pol’y & Res. Dev., Dept. of Housing and Urban Dev., Report to Congress on the Root Causes of the Foreclosure Crisis 29 (2010), available at http://www.huduser.org/publications/pdf/Foreclosure_09.pdf; *Wall Street and the Financial Crisis: The Role of High Risk Home Loans: Hearing Before the Subcomm. on Investigations of S. Comm. on Homeland Security and Governmental Affairs*, 111th Cong. 2d Sess. 3 (2010) (memorandum by Sen. Carl Levin, Chair, & Sen. Tom Coburn, Ranking Minority Member) (“A significant portion of Washington Mutual’s Option ARM business consisted of refinancing existing loans.”), available at <http://levin.senate.gov/newsroom/supporting/2010/PSI.LevinCoburnmemo.041310.pdf> (noting Washington Mutual’s reliance on refinancing to support its Option ARM business).

¹⁰ See, e.g., *Tocco v. Argent Mortgage Co., L.L.C.*, 2007 WL 170855 (E.D. Mich. Jan. 18, 2007) (describing a borrower’s inability to refinance an Argent loan when the appraisal for the refinancing came in \$300,000 lower than the appraisal, performed less than a year previously, on which the original loan had been based).

¹¹ USPAP stands for Uniform Standards Of Professional Appraisal Practice developed by the Appraisal Standards Board of the Appraisal Foundation. See, Uniform Standards of Professional Appraisal Practice. http://www.uspap.org/2010USPAP/USPAP/frwrdr/uspap_toc.htm.

¹² See, e.g. Title XI, Financial Institutions Recovery, Reform, and Enforcement Act of 1989, 12 U.S.C. § 3331.

¹³ See, e.g. Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions, by Office of the Comptroller of the Currency; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Office of Thrift Supervision; and National Credit Union Administration, March 22, 2005; Lender Accountability for Appraisals, 24 CFR 203, 69 Fed. Reg. 43504, July 20, 2004.

¹⁴ See, e.g. Freddie Mac, *Discover Gold Through Quality Control*: <http://www.freddiemac.com/dqtc>. “Your quality control program ... operate independently of your mortgage origination and underwriting departments.” (@p. QC2-1).

¹⁵ See, e.g. Standard & Poor, U.S. Residential Subprime Mortgage Criteria (2006).

to subprime lenders with very little corresponding liability. In some cases, the loan trusts into which these loans are sold were insured against this kind of fraud, and so the bond insurer, not the lender, bears the risk of loss.¹⁶ The originators had no risk from using bad appraisals. The buyers of the loans would have to deal with the consequences of reduced values of the home; but only if the borrowers defaulted. The agreements governing the sale of these mortgage loans generally required that the originators buy-back loans that had not been originated properly: such as were based on appraisals that were not conducted according to USPAP standards. Originators are typically fighting – and often winning -- buy-back demands from investors, relying on the significant proof problems that the investors have to enforce these agreements.¹⁷

USPAP standards include detailed and numerous guidelines in an attempt to make uniform what is in essence a judgment call in most instances. Three different valuation models are provided for in USPAP: the price the home would bring on the open market, the income it would yield, and the cost of replacing it. The income producing part of the evaluation is rarely counted as relevant in most home appraisals. The replacement cost section is driven by the price given to the land and the depreciation value assigned by the appraiser – both of which are subjective. This leaves the market price as the primary basis for determining an objective valuation.

There are dozens of data points within this analysis that allow for slippage, starting with the homes used as comparables, and including the number of rooms, the value of the allowances for the differences between the subject home and the comparables (how much is the different number of bedrooms, or the different amount of square feet, or the addition of a patio, really worth?). As anyone knows who has closely looked at deliberately inflated appraisals, the frauds can be obvious, or they can be surreptitious.¹⁸ Often any careful review of the appraisal – even by a person who is not schooled in appraisal standards – will reveal the frauds in the appraisal. But in order to prove the valuation incorrect it will almost always be necessary to conduct a retrospective appraisal (an evaluation of the property's value at a previous time).

The complaint filed by the Attorney General of New York against Wells Fargo described the dynamics by which inflated appraisals were generally solicited and suborned by loan originators.¹⁹ Essentially, appraisers were only used by loan originators if they reliably

¹⁶ Some of the notorious FAMCO loan trusts were insured by mortgage guaranty policies issued by MBIA Insurance Corporation. See Federal Trade Comm'n v. First Alliance Mortgage Co. *In re* First Alliance Mortgage Co., No. SA CV 00-964, Stipulation of Settlement (C.D. Cal. Feb. 25, 2002), available at www.ftc.gov/os/2002/03/famcostippart1.pdf; § 11.5, *supra* (short discussion of the FAMCO litigation).

¹⁷ See, e.g., Gretchen Morgenson, *Banks Say No. Too Bad Taxpayers Can't*, N.Y. Times, June 6, 2010, at BU1. To recover on the originators' failure to ensure that the appraisals were conducted according to USPAP standards, the investors must prove that point. Those are fact-specific and judgment based evaluations. The fact that the property is currently worth less than it was appraised for at the time the loan was made does not *ipso facto* prove that there was something wrong with the appraisal. There could have simply been a legitimate decrease in the value of the real estate.

¹⁸ The authors of these comments have each reviewed dozens of inflated appraisals.

¹⁹ *WAMU Appraisal Fraud – The People Of The State Of New York By Andrew Cuomo, Attorney General Of The State Of New York, Plaintiff-Respondent, v. First American Corporation, et al., Defendants*: <http://4closurefraud.org/2010/06/09/wamu-appraisal-fraud-the-people-of-the-state-of-new-york-by-andrew-cuomo-attorney-general-of-the-state-of-new-york-plaintiff-respondent-v-first-american-corporation-et-al->

provided appraisals which valued the subject property at the target value – or close to the value – sought by the originator. If the appraiser regularly failed to appraise the subject property at the target number, the appraiser would be dropped from the originator’s list. Appraisers responded in an understandable way. The lenders made it clear – both by statements and actions – that appraisers’ failure to provide appraisals at the targeted value would mean they would no longer be hired.

Unfortunately, the interim regulations will not significantly reduce this pressure. While the incentives to suborn inflated appraisals may always continue to exist, sufficiently strong regulations could eliminate a substantial portion of the perceived benefits to lenders to encourage and accept inflated appraisals. Yet the Board’s interim regulations addressing appraisal independence will not sufficiently change the dynamics in the industry to incentivize correct, rather than inflated, appraisals. Some originators may hesitate a bit before suborning inflated appraisals on a regular basis after implementation of the Board’s interim regulations. But, unfortunately, if inflated appraisals continue to be immediately remunerative to originators, there is little in these interim regulations that would dissuade them from activities that have long been illegal under other regulations and laws.

For example, one of the authors of these comments remembers looking at an in-house desk review of an appraisal conducted in 1998. The appraisal was full of flaws – the comparables were all from more than a mile away, in an urban neighborhood, the pictures were of a different house, and the condition of the house was listed as “excellent,” despite the lack of functioning indoor plumbing and extensive deferred maintenance. The desk reviewer, who had never seen the house and was more than 2000 miles away from the neighborhood in question, flagged the appraisal as “suspicious” and recommended that the lender obtain a second appraisal. The lender in this case – a major national lender -- ignored this recommendation and reduced the loan amount by \$5,000, from \$55,000 to \$50,000, noting in the file that “anything has to be worth at least that much.” A subsequent retrospective appraisal found that the home was only worth \$23,000, not the \$50,000 extended by the lender. The same result could likely still happen under the Board’s proposed regulations: the Board does not require a second appraisal, the Board only requires “reasonable diligence,” and the Board creates a vague “materiality” standard. The Board’s interim final regulation would not require a creditor to obtain a non-fraudulent appraisal.

There are two fundamental problems with this interim final rule on appraisal independence:

- The protections are diluted by the safe harbors provided. Originators should unequivocally be tasked with the burden of determining the real value of the borrower’s property. Allowing originators to mechanically meet this obligation, by complying with the minimal requirements of one of the safe harbors without

defendants/. See also *People v. First Am. Corp.*, 878 N.Y.S.2d 860 (N.Y. Sup. Ct. 2009) (recounting allegations of lender control of appraisers in previous NY Attorney General complaint against an appraisal company).

- guaranteeing the underlying validity of the appraisal, winks at lenders who continue to rely on appraisals that they know to be false and harms consumer protection.²⁰
- Secondly, the regulations do not prohibit the most obvious – to all practitioners in the field – practice that leads to the subordination of inflated appraisals: providing the estimated value of the home to the appraiser. The best way to ensure that neither the originator, nor any other party who stands to benefit from the transaction do not suborn an inflated appraisal is to prohibit any of those parties from informing the appraiser of the estimated value of the home or the intended loan amount.²¹

The Dodd-Frank appraisal reform provisions are short and clear, on the other hand. They unequivocally prohibit:

- Any coercion, collusion, instructions, intimidations designed to influence the independent judgment of the appraiser;²²
- Mischaracterizing or suborning the mischaracterization of inflated values;²³
- Influencing the appraiser to encourage a targeted value;²⁴
- Using an appraisal in which the appraiser may have a direct, or indirect, financial interest in the completion of the loan transaction for which the appraisal is being performed;²⁵ and
- A creditor from providing any extension of credit in which any of these conditions exist.²⁶

The interim regulations dilute and weaken the clear mandates of the statute. Appraisal fraud undermined the validity of the mortgage lending market in this country and helped bring the global economy to its knees. Strong measures should be taken against appraisal fraud.

In the following section, we provide some detailed comments on the specifics of the Board's interim regulations, as well as the changes to the Official Staff Commentary. Our primary message to the Board is this: to accomplish the clear, articulated purposes of the Appraisal Independence provisions in Dodd-Frank, and rid the mortgage marketplace of deliberately inflated appraisals, all of the safe harbors in the interim regulations need to be removed, and everyone involved in the origination process should unequivocally be prohibited from informing the appraiser of the proposed loan amount or anyone's estimated value of the home.

²⁰ See, e.g., *Sage v. Blagg Appraisal Co.*, 209 P.3d 169, 174 n.8 (Ariz. Ct. App. 2009) (noting that buyers and borrowers always rely on the lender's review of the appraisal to return the actual value of the home).

²¹ These are distinct from the contract price, in a purchase context, which may often be the best indicator of value, assuming a true arms-length transaction. The contract price is required by USPAP, and review of prior contracts may often provide an appraiser with a needed warning as to the presence of property flipping or other price inflation.

²² Dodd-Frank § 1472(b)(1), *to be codified at* 15 U.S.C 1639E(b)(1).

²³ Dodd-Frank § 1472(b)(2), *to be codified at* 15 U.S.C 1639E(b)(2).

²⁴ Dodd-Frank § 1472(b)(3), *to be codified at* 15 U.S.C 1639E(b)(3).

²⁵ Dodd-Frank § 1472(d), *to be codified at* 15 U.S.C 1639E(d).

²⁶ Dodd-Frank § 1472(f), *to be codified at* 15 U.S.C 1639E(f).

Section by Section Analysis

Definitions – Section 226.42(b).

We approve of the definition of “covered persons” to include mortgage brokers, appraisers, appraisal management companies, and real estate agents.²⁷ Examples of people who are not considered “covered persons” are the consumer, the guarantor, or another person who resides in the principal dwelling.²⁸ None of these people should be covered by the reach of the regulation.

Appraisers, like all business people, are most sensitive to their largest and best customers. For appraisers, those will be the people who hire them again and again, or are a leading source of referrals, primarily lenders but also appraisal management companies and real estate agents. Appraisers are not likely to be unduly influenced by anything an individual consumer says; individual homeowners have little power over an appraiser.

Coercion – Section 226.42(c).

The basic prohibitions are appropriate here, as is the descriptive list of coercive activities that covered persons are prohibited from engaging in.²⁹ Additionally, the universal prohibition against mischaracterization of value³⁰ is a good distinction. The explicit prohibitions -- against materially falsifying or altering the valuation,³¹ or inducing another person to mischaracterize value or falsify or alter a valuation³² -- are also good. The list of permitted actions, which are examples of actions not considered to be falsifying or mischaracterization, are helpful clarifications: these are mostly relevant to asking for further information or correcting errors.³³

Materiality exceptions.

The materiality exceptions included in this section are problematic. These are applicable both to the misrepresentation and the falsification or alteration prohibitions.

- In section 226.42(c)(2)(i) misrepresentations are prohibited only when they are “material.” Material misrepresentations are defined only as those that “significantly affect the value assigned to the consumer’s principal dwelling.” In our experience, the misrepresentations that are typically included in inflated appraisals are often many small errors – each one of which is unlikely to be considered material, although in combination they result in a valuation which is not truthful. The materiality

²⁷ OSC §226.42(b)(1)1.

²⁸ *Id.*

²⁹ § 226.42(c)(i).

³⁰ § 226.42(c)(2)(i).

³¹ § 226.42(c)(2)(ii).

³² § 226.42(c)(2)(ii).

³³ *Id.*

exception should be applied to the valuation as a whole, rather than to any specific misrepresentation.

- Likewise, under the interim regulations an alteration or falsification is not prohibited unless it is material.³⁴ To be material it must be “likely to significantly affect the value assigned” to the dwelling. This is wrong. Any falsification or alteration of the valuation that affects the valuation in anything more than a *de minimis* amount should be considered material. Again, if there are multiple falsifications and alterations, the relevant test should be whether the falsifications and alterations overall impact the valuation, not whether any one does individually.

The regulation already includes a bona fide error exception.³⁵ This should be sufficient to protect inadvertent mistakes. We recommend that the materiality exceptions either be deleted altogether, or be changed to define materiality as anything more than *de minimis*.

Conflicts of Interest.

The specific prohibition passed by Congress is quite straightforward:

(d) PROHIBITIONS ON CONFLICTS OF INTEREST.--No certified or licensed appraiser conducting, and no appraisal management company procuring or facilitating, an appraisal in connection with a consumer credit transaction secured by the principal dwelling of a consumer may have a direct or indirect interest, financial or otherwise, in the property or transaction involving the appraisal.³⁶

Yet, in the interim final rule, the Board makes extensive exceptions and delineations based on the size of the creditor from this flat and clear prohibition. The goal of the statute is considerably weakened by the Board’s regulatory scheme.

Creditors may contract with outside settlement service providers or use in-house valuation companies. Which of the Board’s rules apply in either case depend on the size of the creditor. This is particularly problematic for in-house valuations, although potentially unnecessary and confusing for outside settlement service providers as well.

For creditors or affiliates with assets of more than \$250 million, the Board proposes to guard against conflicts of interest for in-house valuations with only the following provisions: a prohibition that neither the person performing the valuation, nor the supervisor of this person, is a part of the creditor’s loan production function; a prohibition against the salary of the person performing the valuation being based on the value in any valuation;³⁷ and a prohibition against any employee of the creditor’s loan production department being involved directly or indirectly with choosing the selection of the person

³⁴ § 226.42(c)(2)(ii).

³⁵ § 226.42(c)(2)(i).

³⁶ Dodd-Frank § 1472(d), *to be codified at* 15 U.S.C 1639E(d).

³⁷ Reg. Z, § 226.42(d)(2).

who does valuations.³⁸ Unlike the rules for smaller creditors discussed in the next paragraph, there appears to be no prohibition against the employee who conducts the valuation also being involved in the loan production function – so long as the employee does not report to someone in the loan production department.³⁹

For creditors or affiliates with assets of less than \$250 million, appraisers apparently may be supervised by a person whose salary is based on the value of the valuation. Persons involved in loan production, and whose salaries depend directly on the size of the loan and thus indirectly on the valuation, may select the person to perform the valuation. The only meaningful limitation on a conflict of interest for creditors with assets less than \$250 million is that the employee who orders, conducts or reviews the valuation is a) not permitted to have compensation based on the result of the valuation and b) is not permitted to approve or set the terms of the transaction.⁴⁰

These rules are complicated and arcane. It will be virtually impossible for individual consumers – the victims of inflated appraisals– to determine the size of the creditor, who is an employee of whom, who is supervising whom, whose compensation is based on what. With this level of complexity in the rules, it means that there will effectively be no private enforcement. And with no private enforcement, the natural result will be that the rules will be generally ignored. Private enforcement of this provision was specifically contemplated by Congress in the Act.⁴¹

The safe harbors created by these regulations have nothing to do with the harm to consumers resulting from inflated appraisals; and they have nothing to do with the problems that have led to the subornation of inflated appraisals by creditors. Creditors threatened appraisers, implicitly and explicitly, with a loss of their livelihood if they did not meet the numbers—numbers inflated by the creditors’ own desires to increase profits through endless refinancing and larger origination fees. Creditors’ own self-dealing and internal conflicts caused much of the inflated appraisal boom, and creditors need clear and stringent prohibitions against more of the same. The Board should address the cause of inflated appraisals, rather than creating complicated safe harbors.

The Board admits that these complexities and distinctions are inconsistent with the statutory language:

The Board recognizes that the literal language of the statutory prohibition on having a “direct or indirect interest, financial or otherwise” in the property or transaction can be interpreted to mean that a person or entity preparing a valuation or performing valuation management functions should be deemed to have a prohibited interest merely by token of being employed or owned by the creditor. An employee of the creditor could be deemed to have an “indirect” interest in the transaction, for example, because he or she might

³⁸ *Id.*

³⁹ *Id.*; see also OSC § 226.42(d)(2)1.

⁴⁰ Reg. Z, § 226.42(d)(3).

⁴¹ Dodd-Frank § 1472(k), *to be codified at* 15 U.S.C 1639E(k).

receive financial benefits, such as higher bonuses or more valuable stock options, as a result of the creditor's loan volume rising.⁴²

Yet the Board states that interpreting the statute “this way,” i.e., the way it is explicitly written, would be “impractical.”⁴³ The Board argues:

A broad prohibition could interfere with the functioning of many creditors and providers of valuations and valuation management functions, potentially disrupting the mortgage market at a vulnerable time.⁴⁴

The problem here is that the Board is not tasked with writing regulations for the convenience of the mortgage industry. As Congress articulated quite specifically in Section 105 of the Truth in Lending Act, the Board is to write regulations solely to accomplish the disclosure purposes of the Act.⁴⁵ The additional rule-writing mandate provided in Dodd-Frank does not provide any additional license to the Board to provide regulations for the expedience of the industry. Indeed, Congress apparently viewed inflated appraisals as such a significant problem to consumers that it required the Board to write regulations implementing this provision of Dodd-Frank well in advance of all the others.⁴⁶

The Board should scrap the entire subsection (d) on conflicts of interest and start again. Any employee who stands to benefit – either directly or indirectly – from the making of a home loan should have nothing to do with ordering or creating the appraisal. The only function relating to the appraisal process that should be permitted to an employee of the lender – or an affiliate of the lender – should be a review of the appraisal to assure its accuracy. In-house valuations always create at least an indirect conflict of interest and should always be banned.

Prohibition of Extension of Credit.

Congress was equally explicit when prohibiting creditors from extending credit based on an appraisal that violated the appraisal independence standards.

"(f) NO EXTENSION OF CREDIT.--In connection with a consumer credit transaction secured by a consumer's principal dwelling, a creditor who knows, at or before loan consummation, of a violation of the appraisal independence standards established in subsections (b) or (d) shall not extend credit based on such appraisal unless the creditor documents that the creditor has acted with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of such dwelling.

⁴² 75 Fed. Reg. 66554 (October 28, 2010) at 66563.

⁴³ 75 Fed. Reg. 66554 at 66563.

⁴⁴ 75 Fed. Reg. 66554 at 66563.

⁴⁵ (a) The Board shall prescribe regulations to carry out the purposes of this title. Except in the case of a mortgage referred to in section 103(aa), . . ." 15 U.S.C. § 1604(a).

⁴⁶ Dodd-Frank § 1472(g)(2), *to be codified at* 15 U.S.C 1639E(g)(2).

Unfortunately, rather than adding explicit direction to creditors, and more specifics to the prohibitions in this statutory exception, the Board allows creditors to demonstrate reasonable diligence without obtaining a second appraisal.⁴⁷ All a creditor need do is document in the file that “the appraisal does not materially misstate or misrepresent the value of the consumer’s principal dwelling.” No further investigation is required; no additional steps are mandated. No parameters as to additional documentation are imposed. Is the creditor’s subjective belief that “anything” will be at worth at least \$50,000 reasonable documentation? In failing to provide clear guidance, the Board increases litigation risk for both creditors and consumers.

Supervision and Compensation of Appraisers

The regulations properly also require that creditors and agents to compensate “fee appraisers” appropriately.⁴⁸ Failure to pay appraisers or conditioning payment on valuation is per se coercive.

Recommended Fixes to this Regulation.

The Board can easily fix this regulation, making it protect consumers in the way contemplated by Congress. The “materiality” exceptions should be changed to anything more than “*de minimis*.” All safe harbors in the regulation should be eliminated. The prohibition against creditors extending credit based on a flawed appraisal should be clarified, not weakened. Finally, all originators should be prohibited from providing any information about the targeted value to the appraiser.

The surest way to ensure that an appraiser will return the real value of the property is not to tell the appraiser anything about the targeted value. All of the covered parties involved in the origination and settlement process of the loan should be prohibited from informing the appraiser anything about the value of the home. All covered parties must be forbidden from considering any irrelevant and improper information—such as the projected loan amount or estimates of the value of the home—regardless of the source. In this way, the appraiser will do what the appraiser is supposed to do – determine the value of the property without knowing the magic number that will make the deal close. This will ensure truly independent appraisals.

⁴⁷ Official Staff Commentary, § 226.4(e)(1)

⁴⁸ Reg. Z, § 226.42(f)(4)(i)(A).