JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

C. Focus on Appraisal Reform

1. Conferences

a. "Impact of Appraisal Reform on Lenders, Developers, and the Appraisal Business', held with the help of the UW Baltimore Alumni Chapter, Baltimore, MD. April 23,1987. Congressman Douglas Barnard, Jr. speaking at invitation of James A. Graaskamp

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REMARKS OF

CONGRESSMAN DOUG BARNARD JR., CHAIRMAN
COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
U.S. HOUSE OF REPRESENTATIVES

AT A SEMINAR SPONSORED BY
THE UNIVERSITY OF WISCONSIN REAL ESTATE ALUMNI
BALTIMORE-WASHINGTON CHAPTER

"IMPACT OF APPRAISAL REFORM ON LENDERS
DEVELOPERS, AND THE APPRAISAL BUSINESS"

BALTIMORE, MARYLAND

APRIL 23, 1987

I'M DELIGHTED TO BE HERE TODAY TO PARTICIPATE WITH YOU IN THIS IMPORTANT SEMINAR ON "THE IMPACT OF APPRAISAL REFORM ON LENDERS, DEVELOPERS AND THE APPRAISAL BUSINESS." I MUST CONFESS, HOWEVER, TO SOME NERVOUSNESS AT HAVING TO DELIVER A LECTURE ON A SUBJECT ABOUT WHICH THE AUDIENCE ALREADY KNOWS SO MUCH. IN FACT, I FEEL A LITTLE LIKE ZSA ZSA GABOR'S FIFTH HUSBAND MUST HAVE FELT ON THEIR WEDDING NIGHT -- I KNOW WHAT I'M SUPPOSED TO DO BUT I'M NOT SURE I CAN MAKE IT INTERESTING!

SERIOUSLY THOUGH, MY PURPOSE THIS MORNING IS NOT TO BE "INTERESTING," BUT RATHER TO ENLIST YOUR SUPPORT IN WHAT COULD BECOME A BRUISING BATTLE IN CONGRESS OVER LEGISLATIVE REFORM OF THE APPRAISAL INDUSTRY. IN JUST A FEW WEEKS, I WILL INTRODUCE A BILL IN THE HOUSE THAT WILL CREATE A SELF-REGULATORY ORGANIZATION (SRO) FOR YOUR PROFESSION. ITS PURPOSE IS TO STEM THE HEMORRHAGING NOW TAKING PLACE IN MANY OF OUR

FINANCIAL MARKETS BECAUSE ABUSIVE APPRAISALS ARE BEING USED -- AT GREAT ECONOMIC COST -- TO JUSTIFY THOUSANDS OF UNSAFE AND UNSOUND REAL ESTATE TRANSACTIONS.

FRANKLY, THERE ARE SOME ECONOMIC FORCES IN THIS COUNTRY WHO DON'T WANT THE STATUS QUO DISTURBED; WHO DON'T WANT THE BROKERING OF REAL ESTATE DEALS TO BE "ENCUMBERED" BY OBJECTIVE APPRAISALS. IF THESE FORCES DECIDE TO OPPOSE MEANINGFUL LEGISLATIVE REFORM OF THE APPRAISAL BUSINESS, THEN ONLY KNOWLEDGEABLE PRIVATE SECTOR INDIVIDUALS, LIKE YOURSELVES, WILL BE ABLE TO CONVINCE CONGRESS THAT CHANGE IS NOT ONLY DESIRABLE, BUT ESSENTIAL.

I HAD ANOTHER REASON FOR ACCEPTING JIM GRAASKAMP'S KIND INVITATION TO COME HERE TODAY. THE CENTRAL FEATURE OF MY APPRAISAL LEGISLATION -- WHICH I WILL DESCRIBE LATER IN MY REMARKS -- IS THE ESTABLISHMENT OF A GOVERNMENT CHARTERED APPRAISAL INDUSTRY FOUNDATION, WHICH WOULD

PROMULGATE NATIONAL APPRAISAL STANDARDS AND SET APPRAISER CERTIFICATION REQUIREMENTS. SINCE SO MUCH OF THE COUNTRY'S APPRAISAL EXPERTISE RESIDES AT YOUR ALMA MATER -- THE UNIVERSITY OF WISCONSIN'S SCHOOL OF BUSINESS -- IT WOULD MAKE MY LEGISLATIVE EFFORTS SO MUCH EASIER IF WE COULD JUST TRANSFORM THE REAL ESTATE AND URBAN LAND ECONOMICS SCHOOL INTO THE APPRAISAL FOUNDATION CREATED BY MY BILL! IT ALSO OCCURRED TO ME THAT THIS IDEA MIGHT APPEAL TO THE FELLOW FROM WISCONSIN WHO CHAIRS THE SENATE BANKING COMMITTEE AND HELP GUARANTEE QUICK SENATE PASSAGE! D Brown

AS MOST OF YOU KNOW, THE HOUSE COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE, WHICH I CHAIR, ISSUED A REPORT LAST SEPTEMBER 25TH -- AFTER A YEAR-LONG INVESTIGATION -- THAT DETAILED THE NATURE, EXTENT AND CONSEQUENCES OF THE NATION'S APPRAISAL PROBLEMS. MUCH OF THE REPORT FOCUSED ON HOW ABUSIVE APPRAISAL PRACTICES IMPACTED FEDERAL PROGRAMS. I INTEND TO TAKE SOME

TIME THIS MORNING DISCUSSING THE SPECIFIC FINDINGS OF OUR INVESTIGATION; SUMMARIZING THE PROGRESS THAT HAS ALREADY BEEN MADE TOWARD ASSURING THE KIND OF INDEPENDENT APPRAISALS WE ALL SEEK; AND DESCRIBING THE LEGISLATION I WILL SOON BE INTRODUCING. I ALSO WANT TO MAKE SOME BRIEF OBSERVATIONS ABOUT HOW THE PHENOMENON OF APPRAISAL ABUSES FITS INTO THE LARGER FRAMEWORK OF FINANCIAL SERVICES ISSUES FACING THE 100TH CONGRESS. BUT BEFORE I DO ALL THAT, I WANT TO TAKE A MOMENT TO PAY TRIBUTE TO YOU AND MOST OF YOUR COLLEAGUES IN THE APPRAISAL PROFESSION, FOR THE COURAGEOUS WAY IN WHICH YOU HAVE RESPONDED TO YOUR INDUSTRY'S PROBLEMS.

I HAVE BEEN AROUND STATE AND FEDERAL POLITICS LONG ENOUGH TO HAVE WITNESSED HOW VARIOUS INDUSTRY GROUPS CONFRONT EVIDENCE OF IMPROPER OR SHARP PRACTICES BY THEIR OWN MEMBERS. I CAN THINK OF NO OTHER INDUSTRY THAT HAS FACED ITS PROBLEMS MORE FORTHRIGHTLY THAN YOURS. IF ONE EXAMINES

MAJOR INITIATIVES BY CONGRESS TO END INDUSTRY MALPRACTICES, ONE FREQUENTLY FINDS MISSED OPPORTUNITIES, BY INDUSTRIES, TO PUT THEIR OWN HOUSES IN ORDER AND THEREBY AVOID MASSIVE GOVERNMENTAL INTERVENTION. LET ME CITE A FEW EXAMPLES: IN THE 1960'S, BANKERS WERE BESIEGED WITH, BUT TURNED A DEAF EAR TO, BORROWER COMPLAINTS THAT THEY WEREN'T BEING TOLD THE REAL COST OF INTEREST ON THEIR LOANS. BUT CONGRESS LISTENED AND THE RESULT WAS TRUTH-IN-LENDING LEGISLATION. IN THE EARLY 1970'S, FOOD MANUFACTURERS KNEW THAT GROCERY SHOPPERS WERE CONFUSED BY MULTIPLE PACKAGE SIZES AND WEIGHTS AND WERE UNABLE TO MAKE PRICE AND QUANTITY COMPARISONS. THEY DID NOTHING AND GOT TRUTH-IN-PACKAGING FOR THEIR NON-EFFORTS. U.S. AUTO MAKERS WERE INTENT ON PRODUCING GAS GUZZLING, UNSAFE CARS THAT WERE PROGRAMMED TO SELF-DESTRUCT AS SOON AS THE WARRANTY EXPIRED. WHAT THEY REALLY PRODUCED WAS RALPH NADER, THE

JAPANESE IMPORT AND A SLEW OF AUTO SAFETY AND FUEL ECONOMY LAWS.

THE POINT HERE IS THAT EVEN IN THE CYNICAL WORLD OF POLITICS, ATTEMPTING TO "TOUGH OUT" PROBLEMS CAN BE COSTLY -- COSTLY TO INDUSTRY AND EVEN, UNINTENTIONALLY, "COSTLY" TO THOSE WHO CONGRESS IS SEEKING TO PROTECT. CONVERSELY, VIRTUE CAN BE ITS OWN REWARD. AND WHILE I THINK IT WILL BE FOR THE APPRAISAL INDUSTRY, THE WIDESPREAD NATURE AND SEVERE CONSEQUENCES OF APPRAISAL ABUSES MAKE INEVITABLE A FEDERAL ROLE IN APPRAISAL REFORM -- PARTICULARLY BECAUSE THE FEDERAL INTEREST IS SO STRONG IN THIS AREA.

IN ORDER TO UNDERSTAND THE RATIONALE BEHIND MY LEGISLATIVE PROPOSAL, IT IS NECESSARY FOR YOU TO RECOGNIZE THAT THERE IS A GROWING CONVICTION IN WASHINGTON, D.C., THAT APPRAISAL ABUSES ARE A MAJOR CONTRIBUTOR TO LARGER PROBLEMS FACING OUR FINANCIAL MARKETPLACE. ACCORDINGLY, THE QUESTION OF WHAT TO DO ABOUT THE NATIONAL EPIDEMIC OF

APPRAISAL ABUSES, HAS BECOME TIED TO LARGER DECISIONS THAT ARE NOW BEING MADE DURING THE 100TH CONGRESS: DECISIONS ON HOW TO STEM THE TIDE OF FAILED OR FAILING FINANCIAL INSTITUTIONS AND HOW TO RESTORE SOLVENCY TO OUR SYSTEM OF FEDERAL DEPOSIT INSURANCE. DECISIONS CONCERNING EXPANSION OF FINANCIAL SERVICES AND THE INCREASINGLY IMPORTANT ROLE OF OUR BANK SUPERVISORY AGENCIES IN A DEREGULATED MARKETPLACE. AND MOST PARTICULARLY, DECISIONS CONCERNING THE APPARENT EAGERNESS OF MANY LENDERS TO RISK DEPOSITORS' OR INVESTORS' FUNDS IN SELF-SERVING OR SPECULATIVE VENTURES, EITHER FOR INSTITUTIONAL PROFIT OR FOR QUESTIONABLE PERSONAL GAIN.

AN INDICATION OF HOW THESE ISSUES ARE TIED TOGETHER, IS THAT MY SUBCOMMITTEE'S APPRAISAL INVESTIGATION WAS TRIGGERED BY A SERIES OF HEARINGS UNRELATED TO THIS ISSUE -- HEARINGS THAT WERE DESIGNED TO EXAMINE THE STATUS OF THE DEPOSIT

INSURANCE FUNDS, THE CAUSES OF RECENT FINANCIAL INSTITUTION FAILURES, AND WHY THE FEDERAL REGULATORY AGENCIES COULDN'T PREVENT THOSE FAILURES. AMONG THE INSOLVENCIES STUDIED WERE THE PENN SQUARE BANK OF OKLAHOMA, UNITED AMERICAN BANK (THE JAKE BUTCHER BANKS) OF KNOXVILLE, TENNESSEE, AND EMPIRE SAVINGS AND LOAN ASSOCIATION OF MESQUITE, TEXAS. THE DEMISE OF THESE INSTITUTIONS WAS DUE IN LARGE MEASURE TO FRAUD AND SELF-DEALING BY INSIDERS. BUT TO A SIGNIFICANT DEGREE IN THE EMPIRE AND UAB FAILURES, AND TO A SLIGHTLY LESSER EXTENT WITH PENN SQUARE, FAULTY AND FRAUDULENT REAL ESTATE APPRAISALS WERE UTILIZED TO FACILITATE THE FRAUD AND TO FOOL THE BANK EXAMINER.

REGRETTABLY, IT IS IMPOSSIBLE TO TALK ABOUT APPRAISALS WITHOUT ALSO TALKING ABOUT CRIMINAL MISCONDUCT INSIDE OUR NATION'S FINANCIAL INSTITUTIONS. THREE YEARS AGO, AFTER THE MOST COMPREHENSIVE STUDY EVER CONDUCTED BY CONGRESS

OF WHY FINANCIAL INSTITUTIONS FAIL, MY SUBCOMMITTEE CONCLUDED THAT 50 PERCENT OF THE COMMERCIAL BANK INSOLVENCIES AND 25 TO 35 PERCENT OF THRIFT FAILURES ARE DUE IN LARGE MEASURE TO FRAUD AND SELF-DEALING BY OFFICERS, DIRECTORS AND INSIDERS. <u>IN MANY OF THE 150 FAILED OR PROBLEM INSTITUTIONS STUDIED, ABUSIVE APPRAISAL PRACTICES WERE AN INTEGRAL PART OF THE PROBLEM.</u> THIS DISTURBING PATTERN OF APPRAISAL ABUSES AND THEIR RELATIONSHIP TO FINANCIAL INSTITUTION FAILURES PROMPTED LAST YEAR'S INVESTIGATION AND REPORT BY MY SUBCOMMITTEE.

GIVEN THIS BACKGROUND, WE WERE NOT SURPRISED TO LEARN THAT APPRAISAL ABUSES ALMOST ALWAYS RESULT FROM <u>EXTREME</u> BORROWER AND LENDER PRESSURES ON APPRAISERS TO PRODUCE INFLATED MARKET VALUES THAT WILL JUSTIFY A LOAN OR INVESTMENT.

BUT IF APPRAISAL ABUSES ARE SO CLOSELY TIED TO PRESSURES FROM BORROWERS AND LENDERS AND IF THEY ARE ABETTED BY INEFFECTIVE BANK

SUPERVISORS -- AND THEY ARE -- THEN WHY IS EVERYONE COMING DOWN ON APPRAISERS? BECAUSE, IN MY JUDGMENT, THE APPRAISAL IS THE CRITICAL DOCUMENT WITHOUT WHICH THE DEAL CAN'T BE MADE! IN VIRTUALLY EVERY REAL ESTATE VENTURE AND IN VIRTUALLY EVERY DERIVATIVE PRIMARY AND SECONDARY MARKET TRANSACTION, THE VALUE OF THE UNDERLYING PROPERTY -- AS ESTABLISHED BY THE APPRAISER -- IS THE KEY ELEMENT. LENDERS, BORROWERS, BROKERS, INVESTORS, INSURERS AND REGULATORS ALL LOOK TO THE APPRAISAL TO VALIDATE THE LEGITIMACY OR WISDOM OF THE TRANSACTION. MOREOVER, IN THE EVENT OF A DEFAULT ON A REAL ESTATE LOAN OR A FAILURE TO PAY INTEREST ON MORTGAGE-BACKED SECURITIES, THE MARKET VALUE OF THE COLLATERAL IS OFTEN THE ONLY THING THAT STANDS BETWEEN THE LENDER OR INVESTOR AND A LOSS.

BECAUSE APPRAISAL ABUSES ARE A CRITICAL FACTOR IN SO MANY REAL ESTATE TRANSACTIONS THAT HAVE GONE SOUR, IT MIGHT BE USEFUL FOR ME TO PAINT

A PICTURE OF THE TROUBLED BACKDROP AGAINST WHICH THE APPRAISAL ISSUE IS BEING CONSIDERED. IT'S A PRETTY DEPRESSING LANDSCAPE:

-- LET'S LOOK, FIRST, AT THE GROWING NUMBER OF FINANCIAL INSTITUTION INSOLVENCIES: IN 1984, 79 FDIC-INSURED BANKS FAILED. IN 1985, 120 FAILED. IN 1986, 145 BANKS HAD TO BE CLOSED BY THE FDIC.

THE THRIFT INDUSTRY PICTURE IS IN MANY WAYS WORSE: IN 1984, 28 THRIFTS WERE CLOSED OR MERGED OUT OF EXISTENCE BY THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION. IN 1985, THAT NUMBER GREW TO 60. IN 1986, 113 S&L'S WERE EITHER DECLARED INSOLVENT, PLACED UNDER A MANAGEMENT CONSIGNMENT PROGRAM, OR FORCIBLY MERGED.

-- THIS INCREASE IN FINANCIAL INSTITUTION FAILURES IS THREATENING THE SOLVENCY OF OUR FEDERAL DEPOSIT INSURANCE FUNDS. SOME WOULD ARGUE THAT TECHNICALLY, FSLIC IS ALREADY INSOLVENT. BETWEEN 1984 AND 1986, THE THRIFT DEPOSIT

INSURANCE FUND LOST CLOSE TO $10 BILLION. THE USEABLE ASSETS OF THE FSLIC HAVE NOW SHRUNK TO LESS THAN $2 BILLION. IF ALL THE OPEN THRIFT INSTITUTIONS THAT ARE INSOLVENT UNDER GENERALLY ACCEPTED ACCOUNTING PRINCIPALS, WERE FORCED TO CLOSE, THE FSLIC FUND WOULD HAVE TO PAY OUT AT LEAST $20 BILLION MORE THAN IT CURRENTLY HAS. AND, THE LOSSES ARE GROWING.

TOTAL LOSSES TO THE FDIC FUND IN 1984, '85 AND '86 WERE ABOUT $6 BILLION. ALTHOUGH IT APPEARS TO BE IN GOOD CONDITION WITH $18 BILLION IN ASSETS, THE INSOLVENCY OF A SINGLE MONEY CENTER BANK COULD, BY ITSELF, PUT THE FUND INTO BANKRUPTCY.

-- ANOTHER PART OF THE BACKDROP AGAINST WHICH THE APPRAISAL ISSUE IS BEING CONSIDERED IS THE ETHICS QUOTIENT OF THE BANKING PROFESSION. SOME WOULD SUGGEST THAT THE TERM "ETHICS IN BANKING" IS AN OXYMORON LIKE "CAFETERIA FOOD." AS I MENTIONED A MOMENT AGO, MY SUBCOMMITTEE ISSUED A REPORT THREE YEARS AGO ON CRIMINAL

MISCONDUCT INSIDE OUR NATION'S FINANCIAL INSTITUTIONS WHICH FOUND

> "A DEEPLY DISTURBING PICTURE OF AN INDUSTRY THAT SUFFERS TOO MANY FAILURES DUE TO INSIDER FRAUD, A BANK SUPERVISORY SYSTEM THAT FREQUENTLY FAILS TO DETECT, INVESTIGATE OR PENALIZE SUCH FRAUD, AND A CRIMINAL LAW ENFORCEMENT SYSTEM THAT FREQUENTLY FAILS TO PROSECUTE IT."

THE SITUATION TODAY IS ONLY SLIGHTLY IMPROVED. WHILE THE FEDERAL BANKING AGENCIES AND THE JUSTICE DEPARTMENT HAVE MADE MODEST IMPROVEMENTS IN THEIR RESPONSES TO INSIDER FRAUD, THE INCIDENCE OF THAT FRAUD CONTINUES AT UNACCEPTABLY HIGH LEVELS. RECENTLY, ATTORNEY GENERAL MEESE REPORTED TO THE SUBCOMMITTEE THAT PENDING CRIMINAL BANK FRAUD CASES, <u>EACH</u> INVOLVING LOSSES OF AT LEAST $100,000, HAD INCREASED FROM 2,500 IN SEPTEMBER 1985 TO APPROXIMATELY 3,000 IN JUNE OF 1986. THESE CASES REPRESENT A <u>MINIMUM</u> OF $300 MILLION LOSS TO THE FDIC AND FSLIC.

BUT IS THE ROLE OF APPRAISAL ABUSES IN ALL OF THIS BEING EXAGGERATED? I DON'T THINK SO. LET'S LOOK AT THE RECORD:

WHEN THE SUBCOMMITTEE INITIATED ITS FORMAL HEARINGS INTO APPRAISAL PROBLEMS IN DECEMBER 1985, I STATED THAT THE HEARINGS SOUGHT ANSWERS TO THE FOLLOWING QUESTIONS:

> "HOW EXTENSIVE ARE APPRAISAL ABUSES AND HOW MUCH OF A ROLE DO THEY PLAY IN CREATING FINANCIAL LOSSES AND OTHER ADVERSE CONSEQUENCES IN THE REAL ESTATE AND FINANCIAL MARKETS? ARE FALSE AND FRAUDULENT APPRAISAL MERELY INCIDENTAL TO THESE ADVERSE CONSEQUENCES OR ARE THEY CENTRAL? IF ABUSIVE APPRAISAL PRACTICES HAVE A SIGNIFICANT NEGATIVE IMPACT ON REAL ESTATE FINANCING AND INVESTMENT, WHAT SPECIFIC ACTION SHOULD BE TAKEN TO ADDRESS THE PROBLEM?"

HERE IS WHAT WE FOUND:

1. <u>Savings and loans</u>:

Hundreds of savings and loans insured by the FSLIC have been severely weakened or declared insolvent because faulty and fraudulent real estate appraisals provided documentation for loans larger than justified by the collateral's real value. Corresponding losses to the financial institutions and the FSLIC have been in the many billions of dollars. In just two thrifts studied in-depth by the subcommittee -- the Sunrise Savings and Loan Association of Florida and the Community Savings and Loan of Maryland -- appraisal-related losses were estimated at more than $300 million.

A. Between January 1983 and mid-October 1985, the real estate loan portfolios of more than 800, or 25 percent, of the approximately 3,200 federally insured thrifts were

FOUND TO HAVE SIGNIFICANT APPRAISAL DEFICIENCIES. IN MORE THAN 300 OF THESE INSTITUTIONS, APPRAISAL-RELATED PROBLEMS CONTRIBUTED SIGNIFICANTLY TO THEIR BEING PLACED IN PROBLEM STATUS OR DECLARED INSOLVENT. THE PROBLEM APPRAISALS FOUND IN THESE 800-PLUS ASSOCIATIONS IMPROPERLY OVERVALUED THE COLLATERAL SECURING REAL ESTATE LOANS BY AN AGGREGATE OF $3 BILLION.

B. DURING THE SAME 1983-1985 PERIOD, MORE THAN HALF OF THE FHLBB'S 115 CEASE-AND-DESIST, REMOVAL AND PROHIBITION ORDERS INVOLVED SERIOUS APPRAISAL PROBLEMS.

2. <u>COMMERCIAL BANKS</u>:

SIGNIFICANT APPRAISAL PROBLEMS HAVE ALSO PLAGUED LARGE NUMBERS OF COMMERCIAL BANKS CONTRIBUTING TO HUNDREDS OF MILLIONS OF DOLLARS IN LOSSES, HUNDREDS OF WEAKENED AND/OR

FAILED INSTITUTIONS, AND HUNDREDS OF ENFORCEMENT ACTIONS.

A. Of the hundreds of enforcement actions taken by the Federal Reserve against State member banks and bank holding companies between January 1983 and mid-November 1985, many involved the institutions' failure to obtain adequate appraisals.

B. (i) The FDIC found evidence of faulty or fraudulent appraisals in 30 institutions between January 1983 and November 1985. Criminal referrals and/or civil enforcement actions against the institutions involved were made in <u>all</u> 30 cases.

(ii) During its rescue of the failing Continental Illinois National Bank, the FDIC acquired approximately $400 million of that bank's problem real estate loans. The reappraised value of the 21

LARGEST PROPERTIES TOTALED $184.4 MILLION -- A 64 PERCENT DECLINE FROM THEIR ORIGINALLY APPRAISED VALUE OF $518.4 MILLION. OF THE 10 REAL ESTATE APPRAISALS IN THIS PORTFOLIO EXPRESSLY EXAMINED BY THE FDIC AT THE SUBCOMMITTEE'S REQUEST, THE FDIC FOUND EXTENSIVE, SERIOUS APPRAISAL DEFICIENCIES IN ALL 10. THE FDIC PROJECTS A $200 MILLION LOSS FROM THESE 21 PROBLEM LOANS.

c. IN RECENT YEARS, THE OCC HAS TAKEN MANY APPRAISAL RELATED CIVIL ENFORCEMENT ACTIONS AGAINST INSTITUTIONS IT REGULATES. BANK OF AMERICA, WELLS FARGO BANK, AND CONTINENTAL ILLINOIS HAVE EXPERIENCED COMBINED APPRAISAL-RELATED LOSSES FROM REAL ESTATE LOANS OR MORTGAGE-BACKED SECURITIES THAT ARE EXPECTED TO EXCEED $300 MILLION.

3. THE <u>VETERANS ADMINISTRATION, FHA AND PRIVATE MORTGAGE INSURERS</u> HAVE SUFFERED MAJOR LOSSES

ATTRIBUTABLE TO PROBLEM APPRAISALS AND POOR APPRAISER PERFORMANCE. ESTIMATES SUGGEST THAT AS MUCH AS 40 PERCENT OF VA'S $420 MILLION LOAN GUARANTEE PROGRAM LOSS FOR FISCAL YEAR 1985, WAS CAUSED BY PROBLEM APPRAISALS. THE DRAMATIC INCREASES IN THE NUMBER OF VA DISCIPLINARY ACTIONS AGAINST APPRAISERS FOR INCOMPETENCY OR UNETHICAL BEHAVIOR FURTHER ILLUSTRATES THE SITUATION: IN FISCAL YEAR 1983, IT WAS 348. IN '84 IT WAS 505. IN FY '85 IT WAS 631. AND IN FISCAL 1986 IT GREW TO 1,200! FHA HAS BEEN SIMILARLY VICTIMIZED. PRIVATE MORTGAGE INSURERS TESTIFIED THAT BETWEEN 10 AND 15 PERCENT OF ITS $1.3 BILLION IN LOSSES IN 1984 AND 1985 WERE ATTRIBUTABLE TO FAULTY AND FRAUDULENT APPRAISALS PERFORMED IN CONNECTION WITH THE MORTGAGES THEY INSURED.

4. <u>FANNIE MAE</u> AND TO A SOMEWHAT LESSER EXTENT FREDDIE MAC, HAVE ALSO EXPERIENCED SIGNIFICANT APPRAISAL

RELATED PROBLEMS AND LOSSES. BETWEEN JULY 1984 AND SEPTEMBER 1985, FANNIE MAE UNDERTOOK MORE THAN 400 SEVERE PENALTY ACTIONS AGAINST LENDERS BECAUSE OF APPRAISAL PROBLEMS IN CONNECTION WITH REAL ESTATE LOANS IT HAD PURCHASED FROM THEM. DURING THE SAME PERIOD, FANNIE MAE SOLD 4,307 PROPERTIES ACQUIRED AS A RESULT OF DEFAULT AT AN AGGREGATE SALES PRICE WHICH WAS $63 MILLION LESS THAN THEIR ORIGINAL APPRAISED VALUE, AN AVERAGE LOSS IN VALUE OF 22 PERCENT.

5. THE FAST GROWING MULTI-BILLION DOLLAR PRIVATE MARKET <u>FOR MORTGAGE-BACKED SECURITIES</u> IS EXTREMELY VULNERABLE TO APPRAISAL ABUSES. AND I KNOW THAT SOME OF YOU ARE DEEPLY CONCERNED ABOUT PENSION PLAN INVESTMENTS IN REAL ESTATE THAT ARE OSTENSIBLY PROTECTED BY THE LABOR DEPARTMENT UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1978 (ERISA). THE RECENT COLLAPSE OF THE EQUITY PROGRAMS INVESTMENT

> CORPORATION (EPIC) (HEADQUARTERED IN WASHINGTON, DC) WAS ATTRIBUTABLE IN SUBSTANTIAL PART TO APPRAISAL ABUSES WHICH OVERVALUED PROPERTIES BY AT LEAST 25 PERCENT ABOVE ACTUAL MARKET VALUE. FRAUDULENT APPRAISALS APPEAR TO BE ENDEMIC ON THE WEST COAST. LAST YEAR, THE BANK OF AMERICA TOOK A $95 MILLION LOSS BECAUSE OF FRAUDULENT APPRAISALS ON SOME HOUSTON AND SOUTHERN CALIFORNIA PROPERTIES IN CONNECTION WITH MORTGAGE-BACKED SECURITIES THAT IT SOLD TO INVESTORS.

MOST RECENTLY, THE SUBCOMMITTEE HAS DEVELOPED INFORMATION THAT OF THE 28 THRIFT INSTITUTION FAILURES IN CALIFORNIA OVER THE PAST TWO YEARS, ALMOST <u>ALL</u> INVOLVED ABUSIVE APPRAISALS AND/OR FRAUD BY INSIDERS. IN LATE MAY OR EARLY JUNE, THE COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE WILL HOLD HEARINGS IN CALIFORNIA TO EXAMINE THESE ISSUES.

HAPPILY, HOWEVER, MANY STEPS HAVE ALREADY BEEN TAKEN AND OTHERS ARE PLANNED TO REDRESS THIS

CONTINUING NATIONAL PROBLEM. THE MOST IMPORTANT ARE THOSE OF THE MAJOR PROFESSIONAL APPRAISAL GROUPS THEMSELVES, PARTICULARLY THE CREATION OF SELECT COMMITTEES ON APPRAISAL STANDARDS AND IMPLEMENTATION. MY STAFF HAS BEEN WORKING CLOSELY WITH THE LEADERSHIP OF THESE COMMITTEES IN AN EFFORT TO DEVELOP A CONSENSUS FOR LEGISLATIVE REFORM. ALTHOUGH THE LEGISLATION IS NOT QUITE COMPLETED, I WANT TO DESCRIBE ITS BROAD-BRUSH OUTLINE:

LET ME MAKE TWO POINTS AT THE OUTSET: THE <u>FIRST</u> IS THAT THE BILL I AM DRAFTING RELATES ONLY TO <u>REAL ESTATE APPRAISING</u>. RECENTLY, MY SUBCOMMITTEE HAS BEEN CONTACTED BY SEVERAL <u>PERSONAL PROPERTY</u> APPRAISAL GROUPS WHO BELIEVE THAT THEY SHOULD ALSO BE INCLUDED IN THE NEW LEGISLATION. WHILE THE LEGISLATIVE HEARING PROCESS MAY ULTIMATELY DO THAT, OUR INVESTIGATION INDICATED THAT TROUBLED REAL ESTATE TRANSACTIONS

COMPRISE THE BULK OF THE PROBLEM. ACCORDINGLY, MY BILL WILL ONLY ADDRESS REAL ESTATE APPRAISING.

THE SECOND POINT IS THAT MY BILL PLACES PRIMARY RESPONSIBILITY FOR ESTABLISHING APPRAISAL STANDARDS AND CERTIFICATION REQUIREMENTS IN THE HANDS OF PRIVATE SECTOR APPRAISERS, WHO WOULD CONTROL THE APPRAISAL FOUNDATION. AND, IT LEAVES TO THE STATES, ENFORCEMENT OF THOSE STANDARDS AND REQUIREMENTS. HOWEVER, IN RECOGNITION OF THE STRONG FEDERAL INTEREST IN PREVENTING APPRAISAL ABUSES, THE LEGISLATION CREATES A FEDERAL OVERSIGHT ENTITY THAT COULD EXERCISE AUTHORITY IF THE PRIVATE SECTOR FOUNDATION AND THE STATES FAILED TO ACT EFFECTIVELY.

THE LEGISLATION WILL CREATE A SELF-REGULATORY STRUCTURE COMPRISED OF THREE PARTS: THE FIRST PART IS A FEDERALLY CHARTERED APPRAISAL INDUSTRY FOUNDATION, THE MAJORITY OF WHOSE MEMBERS WILL BE FROM THE APPRAISAL PROFESSION. THE SECOND PART AUTHORIZES CREATION OF STATE BOARDS OF

PROFESSIONAL APPRAISER RESPONSIBILITY WHICH WOULD LICENSE AND DISCIPLINE APPRAISERS. AND, THIRDLY, THE BILL ESTABLISHES A FEDERAL INTERAGENCY APPRAISAL COUNCIL TO OVERSEE THE WORK OF THE FOUNDATION AND THE STATE BOARDS.

THE APPRAISAL INDUSTRY FOUNDATION WOULD PERFORM TWO MAJOR FUNCTIONS: IT WOULD ESTABLISH NATIONAL REAL ESTATE APPRAISAL STANDARDS -- THAT IS, HOW AN APPRAISAL SHOULD BE PERFORMED AND THE FACTORS THAT MUST BE CONSIDERED IN ESTABLISHING A PROPERTY'S MARKET VALUE. AND, IT WOULD PROMULGATE APPRAISER CERTIFICATION OR LICENSING REQUIREMENTS -- THAT IS, THE EDUCATIONAL, WORK EXPERIENCE, AND CONTINUING EDUCATION QUALIFICATIONS NECESSARY TO BE AN APPRAISER.

MY LEGISLATION GIVES THE 50 STATES AN EXTREMELY IMPORTANT ROLE TO PLAY. EACH STATE WOULD BE AUTHORIZED TO ESTABLISH BOARDS OF PROFESSIONAL APPRAISER RESPONSIBILITY WHOSE FUNCTION WOULD BE TO LICENSE APPRAISERS WHO MEET

THE FOUNDATION'S CERTIFICATION REQUIREMENTS; AND TO DISCIPLINE THOSE WHO FAIL TO ADHERE TO THE STANDARDS OF PRACTICE SET BY THE FOUNDATION. THE BOARDS WOULD BE AUTHORIZED TO PROMULGATE APPRAISAL STANDARDS AND CERTIFICATION REQUIREMENTS HIGHER, BUT NOT LOWER, THAN THOSE ESTABLISHED BY THE FOUNDATION; AND THEY COULD USE CIVIL ENFORCEMENT MECHANISMS TO REMOVE, SUSPEND, FINE OR OTHERWISE DISCIPLINE UNETHICAL OR NEGLIGENT BEHAVIOR. ESSENTIALLY, THE STATES WOULD LICENSE AND DISCIPLINE APPRAISERS IN MUCH THE SAME WAY THAT THEY CURRENTLY LICENSE AND DISCIPLINE DOCTORS, LAWYERS AND OTHER PROFESSIONAL GROUPS.

THE FEDERAL INTERAGENCY APPRAISAL COUNCIL WOULD OVERSEE THE WORK OF BOTH THE FOUNDATION AND THE STATE BOARDS. REPRESENTATIVES OF FEDERAL AGENCIES MOST DIRECTLY CONCERNED WITH THE INTEGRITY OF THE APPRAISAL PROCESS -- THE FEDERAL BANKING AGENCIES, THE SECURITIES AND EXCHANGE

COMMISSION, THE VA AND FHA, AND FANNIE MAE AND FREDDIE MAC -- WOULD MAKE UP THE COUNCIL'S MEMBERSHIP. OTHER FEDERAL AGENCIES MIGHT BE INVITED TO PARTICIPATE ON AN ADVISORY BASIS. IN SOME WAYS, THE COUNCIL WOULD OPERATE A LITTLE LIKE THE EXISTING FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL.

THE APPRAISAL COUNCIL WOULD BE AUTHORIZED, UNDER PROPER DUE PROCESS SAFEGUARDS, TO AMEND THE FOUNDATION'S APPRAISAL STANDARDS AND TO STRENGTHEN ENFORCEMENT OF CERTIFICATION/LICENSING REQUIREMENTS, BUT ONLY IF THE FOUNDATION AND THE STATES FAILED TO EXERCISE THESE RESPONSIBILITIES ADEQUATELY. APPRAISAL STANDARDS WOULD BE AMENDED BY REGULATION UNDER THE ADMINISTRATIVE PROCEDURE ACT, AFTER PUBLIC NOTICE AND A HEARING. CERTIFICATION REQUIREMENTS COULD BE ENFORCED BY THE COUNCIL THROUGH THE USE OF CIVIL ENFORCEMENT ACTIONS SUCH AS CEASE-AND-DESIST ORDERS. AGAIN, THE COUNCIL WOULD ACT ONLY

IF THE FOUNDATION'S APPRAISAL STANDARDS WERE SERIOUSLY INADEQUATE; OR ONLY IF THE STATE BOARDS LICENSED INCOMPETENT APPRAISERS OR REFUSED TO DISCIPLINE APPRAISERS WHO ENGAGED IN UNETHICAL BEHAVIOR.

A KEY FEATURE OF MY LEGISLATION IS THAT EACH STATE WOULD BE GIVEN A SPECIFIED PERIOD OF TIME -- PROBABLY 24 MONTHS -- DURING WHICH IT WOULD HAVE TO DECIDE WHETHER OR NOT TO PARTICIPATE IN THIS SYSTEM. IF ANY STATE DECLINED TO DO SO, THEN THE FEDERAL INTERAGENCY COUNCIL WOULD BE REQUIRED TO PROHIBIT ANY APPRAISER IN THAT STATE FROM PERFORMING AN APPRAISAL WHERE THERE IS A "COVERED FEDERAL INTEREST" -- A TERM I WILL EXPLAIN IN A MOMENT. IT IS MY INTENTION, HOWEVER, TO PERMIT THE COUNCIL SOME OPPORTUNITY TO EXTEND THE 24-MONTH DEADLINE, IF THERE IS GOOD CAUSE TO DO SO.

ONE OF THE COUNCIL'S MOST IMPORTANT FUNCTIONS WOULD BE TO DETERMINE WHICH SPECIFIC FEDERAL INTERESTS WOULD BE "COVERED" BY THE

FOUNDATION'S APPRAISAL STANDARDS AND CERTIFICATION REQUIREMENTS. FOR EXAMPLE, THE COUNCIL MIGHT DECIDE THAT ALL APPRAISALS INVOLVING MULTI-FAMILY AND COMMERCIAL LOANS OR INVESTMENTS BY FEDERALLY INSURED FINANCIAL INSTITUTIONS, WOULD BE COVERED; WHILE APPRAISALS PERFORMED FOR MORTGAGE LOANS ON SINGLE FAMILY RESIDENTIAL PROPERTIES, WOULD NOT BE COVERED. THE COUNCIL MIGHT DECIDE THAT APPRAISALS PERFORMED IN CONNECTION WITH THE SALE TO THE PUBLIC OF MORTGAGE-BACKED SECURITIES UNDER FEDERAL SECURITIES LAWS, WOULD BE COVERED; WHEREAS PRIVATE PLACEMENTS OF SUCH SECURITIES WOULD NOT BE. THE COUNCIL MIGHT DETERMINE THAT MORTGAGE LOANS INSURED OR GUARANTEED BY VA, FHA OR THE FARMERS HOME ADMINISTRATION, WOULD BE A COVERED ACTIVITY; BUT THAT APPRAISALS USED IN CONNECTION WITH FEDERAL EMINENT DOMAIN PROCEEDINGS WOULD NOT BE. THE COUNCIL MIGHT DECIDE THAT MORTGAGES PURCHASED BY FANNIE MAE AND FREDDIE MAC WOULD BE COVERED; BUT

THAT APPRAISALS PERFORMED IN CONNECTION WITH ESTATE OR OTHER TAX ISSUES, WOULD NOT BE.

THE POINT HERE IS THAT THE INTERAGENCY COUNCIL WOULD BE REQUIRED TO PROMULGATE BY REGULATION, EXACTLY WHICH FEDERAL INTERESTS WERE OF SUFFICIENT IMPORTANCE TO JUSTIFY THEIR INCLUSION IN THE APPRAISAL STANDARD AND CERTIFICATION PROGRAM.

GIVEN THE STRONG EMPHASIS IN MY LEGISLATION ON THE PRIMACY OF THE APPRAISAL INDUSTRY AND ON THE ROLE OF THE STATES; AND GIVEN THE CONTINUING NATURE OF THE APPRAISAL PROBLEM, MY HOPE IS THAT THE BILL WILL BE SUPPORTED ENTHUSIASTICALLY BY ALL THE MAJOR APPRAISER GROUPS AND RECEIVE FAVORABLE CONSIDERATION IN CONGRESS. HOWEVER, UNTIL LEGISLATION IS ENACTED, THE APPRAISAL INDUSTRY MUST CONTINUE ITS ADMIRABLE SELF-ENFORCEMENT EFFORTS; AND CONCERNED FEDERAL AGENCIES MUST USE EXISTING POWERS AGAINST APPRAISERS, LENDERS, BORROWERS AND OTHERS WHO

ABUSE THE INTEGRITY OF THE APPRAISAL PROCESS. IN THIS REGARD, I AM ENCOURAGED BY TWO DEVELOPMENTS: THE FIRST IS THAT THE APPRAISAL GROUPS COMPRISING THE SELECT COMMITTEES ARE PREPARED TO ESTABLISH THEIR OWN PRIVATELY INCORPORATED APPRAISAL FOUNDATION, WHICH WOULD ENCOURAGE -- BUT COULD NOT REQUIRE -- USE OF UNIFORM APPRAISAL STANDARDS AND MORE RESPONSIBLE APPRAISAL PRACTICES. THE SECOND DEVELOPMENT IS THAT THERE IS NOW IN PLACE, A FUNCTIONING FEDERAL INTERAGENCY TASK FORCE THAT IS WORKING TO RESOLVE APPRAISAL PROBLEMS AT THE ADMINISTRATIVE LEVEL.

IN THE FINAL ANALYSIS, HOWEVER, ONLY A LEGISLATIVE SOLUTION CAN RESTORE SAFETY TO OUR FINANCIAL INSTITUTIONS, SOLVENCY TO THE DEPOSIT INSURANCE SYSTEMS, AND SOUNDNESS TO ALL THE OTHER REAL ESTATE TRANSACTIONS THAT RELY ON HONEST APPRAISALS. AND ONLY LEGISLATION CAN ELEVATE APPRAISERS TO THEIR PROPER ROLE AS PROFESSIONALS

WHO ARE TRULY INDEPENDENT OF BORROWER AND LENDER PRESSURES.

I HOPE I WILL HAVE YOUR HELP IN ACHIEVING THESE OBJECTIVES.

Union Calendar No. 536

99th Congress, 2d Session - - - - - - - - - - - - House Report 99-891

IMPACT OF APPRAISAL PROBLEMS ON REAL ESTATE LENDING, MORTGAGE INSURANCE, AND INVESTMENT IN THE SECONDARY MARKET

FORTY-EIGHTH REPORT

BY THE

COMMITTEE ON GOVERNMENT OPERATIONS

SEPTEMBER 25, 1986.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE

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LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
Washington, DC, September 25, 1986.

Hon. THOMAS P. O'NEILL, Jr.,
Speaker of the House of Representatives,
Washington, DC.

DEAR MR. SPEAKER: By direction of the Committee on Government Operations, I submit herewith the committee's forty-eighth report to the 99th Congress. The committee's report is based on a study made by its Commerce, Consumer, and Monetary Affairs Subcommittee.

JACK BROOKS, *Chairman.*

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IMPACT OF APPRAISAL PROBLEMS ON REAL ESTATE LENDING, MORTGAGE INSURANCE, AND INVESTMENT IN THE SECONDARY MARKET

SEPTEMBER 25, 1986.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. BROOKS, from the Committee on Government Operations, submitted the following

FORTY-EIGHTH REPORT

BASED ON A STUDY BY THE COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

On September 23, 1986, the Committee on Government Operations approved and adopted a report entitled "Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investment in the Secondary Market." The chairman was directed to transmit a copy to the Speaker of the House.

I. INTRODUCTION

In accordance with its oversight jurisdiction for the activities and operations of the Federal banking regulatory agencies,[1] the Commerce, Consumer, and Monetary Affairs Subcommittee has investigated the circumstances surrounding major financial institution failures, including those of the Penn Square Bank of Oklahoma City, OK, United American Bank of Knoxville, TN, and Empire Savings and Loan Association of Mesquite, TX. The demise of these institutions typically involved elements of fraud, self-dealing, extreme concentrations of credit, and pervasive managerial negligence or incompetence. To a significant degree in the Empire and UAB failures, and to a lesser extent with Penn Square, faulty and fraudulent real estate appraisals also were found to have played a

[1] The Federal Home Loan Bank Board (FHLBB), Federal Deposit Insurance Corporation (FDIC), Comptroller of the Currency (OCC), Federal Reserve Board (Fed), and the National Credit Union Administration (NCUA).

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crucial role in their gradual weakening and ultimate collapse.[2] The disturbing pattern of appraisal abuses identified in these investigations and their negative impact on the affected institutions prompted a separate inquiry into these problems, the results of which are the subject of this report.

The report examines the impact of faulty and fraudulent appraisals on the real estate loans of federally insured financial institutions; on residential loans guaranteed by the Veterans Administration (VA) and Federal Housing Administration (FHA); on the purchase of mortgages by the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac); and, on the mortgage insurance industry and mortgage-backed securities markets. It is based on an extensive hearing record, analysis of thousands of pages of documents, and interviews with knowledgeable public and private sector sources.

The report seeks to answer a number of questions posed by subcommittee chairman, Congressman Doug Barnard, Jr., in his opening remarks at the December 1985 hearings on the appraisal issue, as follows:

> How extensive are appraisal abuses and how much of a role do they play in creating financial losses and other adverse consequences in the real estate and financial markets? Are false and fraudulent appraisals merely incidental to these adverse consequences or are they central?
>
> Have the Federal agency and private sector responses to abusive appraisal practices been adequate?
>
> What percentage of defective appraisals are due merely to incompetency and what percentage to the deliberate actions of the appraiser?
>
> If abusive appraisal practices have a significant negative impact on real estate financing and investment, what specific actions should be taken to address the problem?

II. Background

Real estate appraisals have become an intrinsic part of the mortgage loan underwriting process, beginning with the 1930's when the Great Depression exposed the virtual non-existence of property valuation standards and methods within the residential and commercial real estate markets. In the wake of the stock market collapse of 1929, tens of thousands of home owners faced foreclosure and operating costs far exceeded income for office and apartment

[2] In the respective reports, "Federal Supervision and Failure of the United American Bank in Knoxville, Tenn., and Affiliated Banks," H. Report No. 98-573, November 18, 1983 and "Federal Home Loan Bank Board Supervision and Failure of Empire Savings and Loan Association of Mesquite, Tex.," H. Report 98-953, August 6, 1984, the subcommittee recommended that the FHLBB and FDIC ". . . give serious consideration to systematically seeking civil liability recoveries from real estate appraisers when appraisals prove to be the result of improper influence or failure to adhere to adequate professional appraisal standards. Moreover, . . . [they] should widely publicize . . . [their] intent to seek civil liability recoveries from appraisers." In the reports, additional recommendations were made urging: FDIC examiners and supervisory personnel to carefully monitor insider lending, including the verification of collateral and detection of excessive appraisals; and, that in FHLBB institutions where appraisals have been found to be a problem, a specific officer be designated to certify in writing that appraisal reports satisfy appropriate regulatory requirements. While the FHLBB, for the most part, has responded effectively to the recommendations addressed to it (see, Hearings, pp. 793–794), the FDIC, in general, decided against taking action along the lines suggested.

buildings, causing the Federal Government, the financial community, and real estate industry to develop new lending institutions and procedures to correct the abuses and inadequacies identified. A critically important part of these governmental and private sector efforts was a requirement that mortgage loan applications henceforth include an estimate of property value based on some type of standard methodology. With this and other new requirements serving as the point of departure, real estate appraisal practices and procedures have undergone continuous development and refinement over the ensuing half-century, culminating in the comparatively sophisticated system of concepts and methods utilized in contemporary mortgage lending activities.

For the purpose of this report, a real estate appraisal is defined as those methods, procedures, and documents which, collectively, lead to and support an estimate of the market value of the collateral securing a mortgage loan or investment. In the event of a default, the collateral's market value is what stands between the lender or investor and a loss. If performed competently and honestly, an appraisal is conducted independently of the other parties—borrower, lender, broker, et al.—who have a vested interest in a loan transaction's completion. In this respect, only the appraiser is considered to be neutral and only the appraiser is responsible for certifying the value estimate.

The appraisal function is neither entirely an art nor wholly scientific. It consists of a dynamic blend of subjective judgment and objective methodology, depending on the assignment involved. However, notwithstanding the inherent subjectivity involved, objective appraisal approaches and techniques have reached a state of development and sophistication that affords considerable accuracy in determining value estimates.

The real estate appraisal serves a variety of purposes, which affect investment choices, insurance decisions, and regulatory activities, in addition to the primary area of loan origination.[3] In the case of lending institution officials, it provides market information and other critically important data to support sound underwriting decisions on risk exposure, loan-to-value ratios, and maximum loan amounts. The appraisal also serves as an essential part of the process by which public (e.g., VA and FHA) and private sector mortgage insurers attempt to assure themselves of an acceptable risk of loss. Similarly, and particularly in recent years that have seen tremendous growth in the secondary mortgage market and in the sale of mortgage-backed securities, the appraisal serves as one of the principal means by which individual investors and institutions (e.g., Fannie Mae, Freddie Mac, and thrifts) evaluate the quality of the loans they purchase. Finally, the appraisal serves as an important tool used by Federal and State regulators who supervise the Nation's financial institutions, to monitor loan portfolio quality

[3] The role of the appraisal extends further into people's everyday lives than is commonly realized. For instance, appraisals are used by assessors to assist them in calculating property tax bills. Government agencies outside of those discussed in this report, such as the Internal Revenue Service and the U.S. Department of Transportation, use appraisals in various ways; e.g., to settle estate disputes and those involving eminent domain. Appraisals also frequently serve as a means by which parties to a civil proceeding, such as a divorce, can arrive at an agreed upon property settlement.

both in terms of the institutions' overall soundness and the potential risk exposure to State and Federal (FDIC and FSLIC) insurance funds.

In short, accurate and reliable appraisals have come to serve new and increasingly important functions. They are essential, not only in the loan origination context, but in the broader realm of the public's perception of and confidence in the Nation's real estate finance and mortgage insurance and investment industries.

III. Findings and Conclusions

A. SUMMARY

Faulty and fraudulent real estate appraisals have become an increasingly serious national problem. Their harmful effects are widespread, pervasive, and costly. They have seriously damaged and contributed directly to the insolvency of hundreds of the Nation's financial institutions and have helped cause billions of dollars in losses to lenders, private mortgage insurers, investors, and Federal insurance funds. Responsibility for this problem rests with those who perform appraisals or base lending and related mortgage insurance/investment decisions on appraisals they know or should have known were improper or inaccurate. Equally culpable are the Federal agencies that regulate or oversee lending and mortgage insurance/investment activities and programs. The nature and extent of the appraisal problem suggest that for meaningful changes to occur, a broad array of corrective measures will have to be developed and instituted by Federal regulatory authorities, the appraisal industry, and real estate finance and investment interests.

B. NATURE AND EXTENT OF THE PROBLEM

1. *Savings and loans:*

Hundreds of savings and loans chartered by the FHLBB or insured by the FSLIC have been severely weakened or declared insolvent because faulty and fraudulent real estate appraisals provided documentation for loans larger than justified by the collateral's real value. Corresponding losses to the financial institutions and the FSLIC have been in the hundreds of millions of dollars.

a. Between January 1983 and mid-October 1985, the real estate loan portfolios of more than 800, or 25 percent, of the approximately 3,200 federally insured thrifts were found to have significant appraisal deficiencies. In more than 300 of these institutions, appraisal-related problems contributed significantly to their being placed in problem status or declared insolvent. The problem appraisals found in these 800-plus associations overvalued the collateral securing real estate loans by an aggregate of $3 billion. In 70 percent of these associations' loans, the reappraised value of the collateral property was significantly less than the market value cited in the original appraisal.

b. During the same 1983–1985 period, more than half of the FHLBB's 115 cease-and-desist, removal and prohibition orders involved serious appraisal problems. A "very substantial number" of

270 separate supervisory agreements also addressed appraisal problems in these associations.

c. Two thrifts studied in-depth by the subcommittee—the Sunrise Savings and Loan Association of Florida and the Community Savings and Loan of Maryland—were found to have failed in large part due to major appraisal problems and abuses, with resultant appraisal-related losses estimated at more than $300 million.

2. *Banks and credit unions:*

Significant appraisal problems have also plagued large numbers of commercial banks and credit unions regulated and/or insured by the FDIC, OCC, Federal Reserve, and NCUA. Appraisal abuses and deficiencies have, in varying degrees, contributed to hundreds of millions of dollars in losses, hundreds of weakened and/or failed institutions, and hundreds of enforcement actions.

a. Of the hundreds of enforcement actions taken by the Federal Reserve between January 1983 and mid-November 1985 against State member banks and bank holding companies, many involved the institutions' failure to obtain adequate appraisals or to obtain and maintain in their files supporting loan documentation, including appraisals. In at least two instances, Fed-supervised institutions became insolvent or were liquidated because of circumstances in which fraudulent appraisals played a significant role.

b. (i) In connection with its examination responsibilities regarding open banks and its insurance role as receiver for closed banks, the FDIC found evidence of faulty or fraudulent appraisals in 30 institutions between January 1983 and November 1985. Criminal referrals and/or civil enforcement actions against the institutions involved were made in all 30 cases.

(ii) Pursuant to its involvement in the effort to rescue the failing Continental Illinois National Bank and Trust Company, the FDIC acquired approximately $400 million of that bank's problem real estate loans. The reappraised value of the 21 largest properties totaled $184.4 million—a 64 percent decline from their originally appraised value of $518.4 million. Of the 10 real estate appraisals in this portfolio expressly examined by the FDIC at the subcommittee's request, the FDIC found extensive, serious deficiencies in all 10; which, in part, accounts for FDIC's projected $200 million loss from these problem loans.

c. In recent years, the OCC has taken many enforcement actions against institutions it regulates—formal agreements and cease-and-desist orders, as well as informal memorandums of understanding—designed to address significant deficiencies in underwriting practices, including appraisals. At least three major OCC-supervised institutions, the Bank of America, Wells Fargo Bank, and Continental Illinois National Bank and Trust Company, have experienced combined appraisal-related losses from real estate loans or mortgage-backed securities that are expected to exceed $300 million. (see 2-b(ii), above and 5-b, below)

d. According to the NCUA, appraisal problems—inflated property values due to self-dealing and the failure to obtain adequate appraisals from a qualified appraiser—in connection with real estate loans have become a cause for serious concern. The NCUA reports that such abuses have been linked directly to losses of $1.2 million in two insured credit unions, both of which ultimately failed.

3. *VA, FHA, and private mortgage insurers:*

Public and private sector mortgage insurers have suffered major losses attributable to problem appraisals and poor appraiser performance:

a. Estimates suggest that from 10 percent to as much as 40 percent of the VA's $420 million loan guaranty program loss for FY 1985 was caused by inaccurate or dishonest appraisals and internal appraisal-related administrative deficiencies. According to the VA's Inspector General, between 1981 and 1984 original home loan guaranty program appraisals frequently overvalued properties, resulting in higher claim losses and increased veteran indebtedness. The IG also found major deficiencies in the performance of VA-approved appraisers and home loan guaranty program officials responsible for important appraisal-related functions. In FY 1985, for example, about 10 percent of the VA's approved appraisers were suspended or removed. Also, a nationwide series of major swindles perpetrated against the FHA involved VA appraisers and appraisal documentation.

b. In FY 1985, the FHA's mortgage insurance program lost more than $200 million, attributable to a number of factors, including faulty and fraudulent appraisals. For the past several years, the FHA has been victimized by a continuing series of fraudulent schemes, which relied on falsified and highly inflated appraisal documents. Investigations regarding these schemes are in varying stages of progress in at least six cities nationwide, with possible losses of millions of dollars. HUD's Inspector General has found problems both in the performance of FHA appraisers and the response of responsible FHA officials to appraisal abuses. In FY 1985, the FHA instituted 1,200 disciplinary actions involving its pool of 5,000 approved appraisers. Eight hundred of these actions consisted of warnings, while the remainder were more severe measures that resulted in temporary suspensions and denials of appraiser participation or recertification.

c. At least 10–15 percent of the $1.3 billion in losses experienced by private mortgage insurers in 1984 and 1985 can be attributed to faulty and fraudulent appraisals performed in connection with the mortgages they insured. Private mortgage insurers have found appraiser incompetence, negligence, and misconduct to be widespread. For example, a major insurer's review of 300 defaulted loans it had insured disclosed that 40 percent of the appraisals were defective. In accordance with such findings, the private mortgage insurance companies have declared hundreds of appraisers to be unacceptable and have placed some 200 appraisal companies on "watch lists." (see 5–a, below)

4. *Fannie Mae and Freddie Mac:*

Government-chartered, private sector corporations that package and sell mortgages in secondary markets have experienced significant appraisal problems and/or associated losses:

a. Appraisal abuses and deficiencies constitute about 10 percent of all the significant findings developed under Fannie Mae's post-purchase review system. As a result, for example, between July 1984 and September 1985, Fannie Mae undertook more than 400 severe penalty actions against lenders because of appraisal problems in connection with real estate loans it had purchased from

them. Approximately half of these actions required the lender to repurchase the mortgages in question. During the same period, Fannie Mae sold 4,307 properties acquired as a result of default, the aggregate sales price of which was $63.2 million less than their original appraised value—an average loss in value of 22 percent. (see also 5–b, below)

b. Between January 1984 and November 1985, Freddie Mac required 70 participating lenders to repurchase slightly more than 300 mortgages (about one-fifth of the total number of repurchases) for unacceptable, inadequate, or missing appraisals. The estimated dollar value of these appraisal-related repurchases was $15.2 million.

5. *Mortgage-backed securities:*

The fast-growing markets for mortgage-backed securities not guaranteed by an agency of the Federal Government, and for mortgage loan participations by out-of-area institutions, are extremely vulnerable to appraisal abuses. This was evidenced by two cases studied by the subcommittee where hundreds of millions of dollars were lost as a result of schemes in which fraudulent or grossly inflated appraisals played a key role:

a. The recent collapse of the Equity Programs Investment Corporation (EPIC) is attributable in part to endemic appraisal abuses, wherein investment properties were systematically overvalued by at least 25 percent of the actual market value. About $1.4 billion of EPIC mortgages were packaged and sold to scores of FSLIC-insured thrifts, FDIC-insured banks, and other investors, such as Fannie Mae and Salomon Bros. The financial institutions and other investors face possible aggregate losses in the hundreds of millions of dollars. In addition, as a direct result of its involvement in insuring EPIC mortgages, one leading private mortgage insurance company (TICOR) has been placed under State conservatorship. The collective loss exposure of this private mortgage insurance company and two other major ones similarly involved with EPIC is nearly $350 million. Moreover, as a result of its affiliation with EPIC, a thrift insured by the State of Maryland, the Community Savings and Loan, was declared insolvent, with attendant appraisal-related losses estimated at about $100 million.

b. Highly inflated and fraudulent appraisals played an essential part in an intricate scheme that resulted in losses of some $95 million to the Bank of America, which (along with the Wells Fargo Bank) served as trustee/escrow agent for mortgage-backed securities that were packaged by the National Mortgage Equity Corporation (NMEC) and sold to 21 federally insured savings and loans in the Northeast and Middle West. If the Bank of America had not assumed liability, six of the investor thrifts would have found themselves in a negative net worth position and others could have been classified as problem institutions by the FHLBB. At least another 27 banks and thrifts have suffered significant losses because of similar faulty or fraudulent appraisals performed in connection with NMEC activities.

C. SOURCES AND CAUSES OF THE PROBLEM

6. *The appraisal industry:*

a. Appraiser ineptitude, negligence, and misconduct are widespread. Of greatest concern is "client advocacy appraising," wherein large numbers of appraisers willingly agree, or otherwise succumb, to pressure brought to bear by lenders, borrowers, and others involved in the loan origination and underwriting process. Essentially, in exchange for an implicit or explicit promise of future business, so-called "advocacy appraisers" provide the numbers needed "to make the deal work," instead of the independent value estimate they are supposed to furnish.

b. The real estate appraisal industry is fragmented and its members are not generally subject to effective discipline. Only about one-third of the estimated 150,000 to 250,000 appraisers are affiliated with a highly regarded professional trade organization. However, even those organizations are not able to successfully discipline their members, as indicated by 1983-1985 data furnished by four of the largest ones with a combined membership of about 40,000. These data show that out of some 1,600 complaints against appraisers screened and submitted for further consideration, just 40 resulted in suspension or expulsion and another 125 resulted in lesser sanctions such as admonishment or censure.

7. *Lenders:*

a. Alarming numbers of lending institution officials regard appraisals as an obstacle to be overcome or a rubberstamp necessary in order to make a real estate loan under consideration. Loan officers are particularly suspect in this regard, since they are typically under explicit pressure to book as many loans as possible.

b. Many lending institution officers, directors, and managers are demonstrably more interested in up-front fees and other tangible benefits accruing from a completed loan transaction, than they are with being assured that their institution's risk exposure is minimized by an accurate assessment of the actual market value of the loan's underlying collateral.

c. Most lending institutions have no or little appraisal review capability and, in many cases where such capability does exist, it is largely suspect because it is housed in or passes through officials and departments with a vested interest in seeing a loan transaction through to completion.

8. *Federal bank regulatory agencies:*

a. Among all the Federal banking agencies, only the FHLBB has a highly developed and comprehensive system regarding appraisal policies, practices and procedures. This system includes detailed guidelines for how appraisals are to be performed (Memorandum #R-41b), thorough procedures for reviewing appraisals, and FHLBB staff appraisers in all district offices.

b. The Fed, OCC, FDIC, and NCUA have some appraisal-related policies and procedures, but there is little consistency among them and glaring omissions or gaps exist in key areas. For example, while the FHLBB, Fed, and NCUA require their examiners to verify the existence, accuracy, and adequacy of appraisals as they review real estate loans during regular examinations, neither the OCC nor FDIC have such requirements. Only the FHLBB and OCC require their examiners to undergo training that focuses specifically on appraisals and how to verify their accuracy and adequacy. Similarly, while the FHLBB and Fed require an appraisal for each real estate loan, neither the FDIC, OCC, nor NCUA have such a requirement. Furthermore, while the Fed and OCC may direct member banks to establish internal procedures regarding an appraisal program, no specific guidance is provided as to how that program should be structured and operated by the institution, or monitored by agency examiners.

c. As a matter of supervisory outlook, the FDIC and OCC place major emphasis on a borrower's apparent creditworthiness, and little emphasis on the value of loan collateral as established by an appraiser. However, in the face of significant, continuing real estate loan losses, borrower insolvencies and appraisal abuses occurring within the institutions they supervise, the FDIC/OCC attitude toward appraisals is at best naive and at worst irresponsible. There is evidence that because bankers, borrowers, and appraisers know of the FDIC/OCC's minimal concern regarding careful review of appraisal accuracy and adequacy during regular examinations, some commercial real estate borrowers have begun to move their business to banks, away from thrifts and their stricter appraisal requirements.

d. None of the bank regulatory agencies have conducted studies specifically directed at appraisal problems and their effects on the institutions they supervise. Nor, with the exception of the FHLBB, do any of them regularly and systematically collect appraisal-related data—either in connection with ongoing examination and supervisory functions or regarding insolvent institutions and any attendant liquidation of the latter's assets. It is not surprising, therefore, that the Fed, FDIC, OCC, and NCUA have been and remain essentially uninformed about the extent and consequences of existing appraisal defects and abuses.

e. None of the bank regulatory agencies have adequate policies and procedures regarding the quality and control of appraisals performed in connection with out-of-area or interstate real estate loan participations, mortgage-backed securities, and other types of mortgage-related investments. Such participations and purchases have proliferated in the present deregulated banking environment, resulting in enormous consequent appraisal-related losses and other major adverse effects.

f. None of the bank regulatory agencies have specific requirements covering the qualifications—education, training, experience, and character references—needed to perform an appraisal on loans underwritten or owned by a supervised institution.

g. The bank regulatory agencies as a rule do not coordinate or share information on problem appraisers with institutions under their respective jurisdictions, among themselves at the supervisory level, with other interested Government agencies such as the VA and FHA, and/or with appraisal industry organizations. Such failure to share information helps to explain, in part, how a certain appraiser—who Federal officials described as having wrought havoc up and down the East Coast for years—can still be performing appraisals for federally insured thrifts and FDIC-insured, OCC-supervised banks.

h. The bank regulatory agencies have been deficient in taking actions—e.g., cease-and-desist orders, civil suits, or criminal referrals—against individual problem appraisers, either because they don't have sufficient authority or because they choose not to exercise the authority they do possess.

i. The subcommittee's investigation regarding the Bank of America, Continental Illinois Bank, and Sunrise Savings and Loan emphatically show how responsible regulatory agencies have been unaware of serious appraisal problems or have failed to adequately respond to such problems even in cases where they were known to exist:

(1) In the Sunrise case, more than 2½ years elapsed before the FHLBB took decisive enforcement action in response to serious appraisal problems in a number of the association's major commercial real estate loans, initially found in 1982 by its examiners. In the interim, Sunrise's assets grew at an astounding rate, e.g., from $88 million in August 1982 to $1 billion in May 1984—fueled in large part by the same kind of commercial real estate loans already identified as being highly likely to involve major appraisal deficiencies. The FHLBB's delay in responding decisively to this association's major appraisal problems helped to assure its collapse and increase the losses from appraisal-tainted nonperforming loans.

(2) The OCC, per its regulation of national banks, failed to discover the major appraisal abuses that were present in the Continental Illinois Bank's $3.3 billion (as of December 1983) real estate loan portfolio.

(3) Similarly, the OCC failed to discover the fraudulently appraised mortgage-backed securities (amounting to $134 million) sold to investors by the National Mortgage Equity Corporation and backed by the Bank of America and Wells Fargo Bank. The OCC was unaware of this activity, which had begun in 1982, until late in 1984. Indeed, it appears that it was only by virtue of a complaint from an affected savings and loan association that the OCC finally learned of the major problem the Bank of America was facing with regard to these mortgage-backed securities.[4]

9. *Government and private mortgage insurers and secondary market institutions:*

a. The VA, FHA, Fannie Mae, Freddie Mac, and private mortgage insurers are inadequately informed about the nature, extent, and impact of appraisal problems in their respective areas of activity, since none regularly or systematically collect detailed appraisal/appraiser-related data. Nor, with a few exceptions among the private mortgage insurance companies, have any formal or informal studies been conducted of the relationship between faulty and fraudulent appraisals and losses experienced.

b. Significant and widespread problems have resulted from the VA's appraisal-related policies and procedures, especially the failure on the part of responsible officials to effectively monitor and supervise appraiser performance and review the adequacy of their

[4] The FDIC cannot escape responsibility for lax enforcement regarding appraisals. For instance, in connection with the subcommittee's recent investigation of the United American Bank of Knoxville, TN, it was determined that the FDIC failed to take decisive action against this institution's blatant unsafe and unsound banking practices. Included among the latter were a continuous pattern of questionable real estate loans involving missing, outdated, and/or inflated appraisals. FDIC examiners reported such major appraisal deficiencies in each of the regular examinations conducted from 1979 through 1982. See, also, footnote 45, p. 23.

appraisal findings. VA field reviews are not performed as frequently or thoroughly as required; e.g., VA staff reviewed none of the 500 appraisals tied to the fraudulent schemes perpetrated against the FHA in Camden, NJ, in the early 1980's. Furthermore, in many cases where field reviews or other sources disclosed unsatisfactory performance, the VA disciplined the implicated appraiser either insufficiently or not at all.

c. Despite the FHA's repeated failure to respond forthrightly to subcommittee requests for data showing the nature and extent of appraisal problems affecting its mortgage insurance activities, there is strong evidence that such abuses and deficiencies are major and widespread. For instance, the series of schemes involving the fraudulant use of VA appraisal documentation to obtain FHA mortgage insurance—the extent of which was either unknown to or concealed by FHA officials when they testified before the subcommittee—clearly demonstrate how easily their appraisal-related internal controls can be circumvented. Similarly, HUD's Inspector General recently reported that FHA field office personnel failed to adequately discipline appraisers with records of blatantly poor performance and that they inadequately monitored and reviewed Coinsurance Program appraisal activities. The latter has resulted in overvalued properties and correspondingly increased risks of claims losses.

d. Neither Fannie Mae nor Freddie Mac assert direct authority over appraisals and appraisers but, instead, place all such responsibility with the lender. They maintain that lenders have sufficient incentive to be observant because of Fannie Mae/Freddie Mac internal controls—including spot checks and field reviews—and warranty provisions that can require the lender to repurchase a faulty loan. Such procedures, however, are wholly ineffective in cases where a lender no longer has the financial capacity to repurchase a faulty loan. (The latter is precisely the predicament presently facing Fannie Mae in conjunction with its purchase of more than $100 million of questionable loans from the failed Equity Programs Investment Corporation.)

e. In recent years, virtually all private mortgage insurers (PMIs) have failed in varying degrees to effectively control appraisal quality, both in terms of their underwriting procedures and post-transaction review requirements. The failure of the Equity Programs Investment Corporation, in which several PMIs face potential aggregate claims of between $300 and $400 million, amply demonstrates and underscores this pattern of lapses in appraisal quality assurance.

10. *State authority over appraisers:*

a. Only 12 States have appraiser-related licensing or certification procedures. Moreover, even among these 12, their procedures fail to address appraiser qualification and performance standards, in large part, because they are typically *included among statutes focusing on the sale of real estate* and are under the jurisdiction of a real estate commission.

b. In many States, such as Texas, appraisal quality and accuracy are adversely affected by sparse, non-existent, or not readily available real estate sales and loan origination data. This, for example, can make it difficult to obtain timely information on "comparables"—a critically important feature of the appraisal process in which sales and other relevant data regarding recently sold properties similar to and nearby the one being appraised are used to help establish the latter's comparative worth. Accordingly, appraisers in such States often are forced to rely on inadequate information and/or parties who, in some cases, stand to benefit by passing on incomplete or inaccurate data.

IV. Recommendations

A. INTRODUCTION

During or in response to the subcommittee's investigation, a number of promising actions were initiated or completed regarding the various appraisal problems outlined above. Prior to the investigation's start, the VA, FHA, Fannie Mae, and Freddie Mac agreed to develop a common appraisal form, which is likely to be in full use by early 1987. The VA, FHA, Fannie Mae, and the private mortgage insurance companies have lately tightened their appraisal-related underwriting procedures and monitoring requirements. The FHLBB has developed a successor to its Memorandum #R-41b that establishes expanded and more definitive procedures regarding appropriate appraisal practices. Also, an OCC, FDIC, Federal Reserve interagency group developed guidelines—which include information on appraisal approaches and analytical assumptions—to be used by their examiners in reviewing and classifying troubled real estate loans.

Directly in response to the subcommittee's investigative efforts, Fannie Mae and Freddie Mac adopted a stricter definition of market value; requiring that an appraisal performed on a loan they subsequently purchase reflect the property's value exclusive of creative financing, sales concessions or other gimmicks. In addition, the FHLBB has recently submitted a legislative package to the Congress, parts of which seek to add real estate appraisers to the categories of individuals against whom major enforcement actions can be brought.[5] Relatedly, after being informed by subcommittee staff that Freddie Mac had liberalized its appraisal requirements for originator refinanced home mortgages, the FHLBB formally advised its supervisory agents that Freddie Mac's action should in no way affect existing FHLBB insurance regulations that require an appraisal of the security property's contemporary market value. Lastly, leading professional appraisal trade groups have begun to work together to develop uniform appraisal standards and legislative proposals aimed at fleshing out the concept of a self-regulatory system for the appraisal industry.

The above actions constitute positive steps in the right direction. However, as indicated in the recommendations that follow, a great deal remains to done.

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[5] This package became the "Savings Institutions Supervisory Amendments of 1986," H R. 4998, which was introduced on June 11, 1986, by Chairman St Germain of the Committee on Banking, Finance, and Urban Affairs.

B. RECOMMENDATIONS

1. *Banking agency authority over appraisers:*

Congress should provide the bank regulatory agencies with express authority to directly discipline appraisers who have willfully or through gross negligence misrepresented the value of real property serving as collateral for a loan made by a federally insured financial institution. Such discipline should include temporary suspensions or prohibitions from submitting future appraisals to any federally insured financial institution and/or civil penalties.[6]

2. *Banking agency regulation of appraisals:*

a. To reduce the damaging consequences of inconsistent regulatory approaches to and implementation of appraisal policies and procedures, the FHLBB, OCC, FDIC, Federal Reserve, and NCUA should establish uniform requirements regarding appraisals. Such regulations and procedures should include at least the following:

(i) an appraisal for every proposed real estate loan;

(ii) random, but routine, examiner review of appraisal accuracy and overall adequacy during regular examinations of real estate loan portfolio assets, and intensive review, when real estate loans enter "problem" or "classified" status;

(iii) examiner training regarding (1) the components of a good appraisal in order to review them effectively, and (2) internal institutional policies and procedures governing appraisals and appraisers;

(iv) assignment of qualified staff appraisers to regional or district offices and, in conjunction with such assignments, the establishment of comprehensive appraisal review policies and procedures;

(v) development and dissemination of appraisal guidelines utilizing the FHLBB's Memorandum #R-41b, as a model;

(vi) a prohibition against the use of an appraisal provided by the borrower unless a separate independent appraisal of the same property is performed at the lender's direction; and,

(vii) a requirement that a financial institution's policies and internal controls be especially strengthened for appraisals involving out-of-area real estate loans, loan participations, or purchases of mortgage-backed securities (MBS). Specifically, the banking agencies should require that financial institutions involved in such out-of-area activity: secure complete records of underwriting documents, including appraisals; inspect the properties securing such loans and MBS, individually, or jointly with other investing institutions; or, order independent inspections from knowledgeable, reputable appraisers in the locality concerned. Agency examiners should monitor compliance with such requirements during regular examinations.

3. *Lender accountability:*

a. The supervisory activities of the Federal banking agencies should place a substantially increased emphasis on the appraisal process in connection with real estate lending by institutions under their jurisdiction.

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[6] Subcommittee Chairman Doug Barnard, Jr., has introduced legislation, H.R. 4956 (99th Congress), which contains such authorizing provisions.

b. The FHLBB, OCC, FDIC, Federal Reserve, and NCUA should promulgate regulations (or seek additional statutory authority to do so, if necessary) to give them direct supervisory authority over the accuracy and overall adequacy of appraisals.[7] This effort should specifically address the actions of a supervised institution's directors, officers, and other relevant personnel or agents, including in-house, affiliated company, and retained independent fee appraisers.

c. In connection with this accountability effort, bank regulatory agency officials should specifically:

(i) add appraisers to the categories of individuals against whom enforcement actions, e.g., cease-and-desist and prohibition and removal orders, can be brought;

(ii) require that loan officers or others responsible for underwriting decisions within financial institutions undergo training regarding appraisals and attendant regulatory requirements;

(iii) develop a new form, as a requisite part of the final loan documentation package, on which a loan officer would certify that the appraisal had been reviewed and complied with applicable Government regulations; and,

(iv) develop appropriate sanctions or penalties for violations of the foregoing measures.

d. Officers and directors of financial institutions involved in real estate lending should initiate or improve already existing internal control and review systems to assure appraisal quality. In order to be maximally effective, any such system must be separated from the institution's loan development and underwriting operations and have direct access to and support from the highest levels of management.

4. *Public/private sector coordination of appraiser certification and review:*

a. A coordinated, concerted effort should be undertaken to establish a national, industry self-regulated appraiser certification and review system, to which all real estate appraisers would be subject.[8] At a minimum, such a system must include:

Uniform professional appraisal standards;

Appraiser qualification/certification requirements—education, experience, and testing;

Stringent recertification procedures, including mandatory review of the appraiser's work product;

Appraiser performance and review criteria; and,

Disciplinary principles and corresponding enforcement procedures.

b. To accomplish this end, a joint public/private sector task force should be constituted, consisting of, but not necessarily limited to, representatives of: the Federal bank regulatory agencies, VA, FHA,

[7] This recommendation also applies to any individual or concern not directly supervised by any Federal bank regulatory agency that is, nonetheless, involved in originating real estate loans. Two major groups fall into this category—mortgage bankers and mortgage brokers. The activities of both of these groups fall under the Federal Trade Commission's general jurisdiction and, thus, consideration of this recommendation's provisions as they pertain to them is addressed to the Commission.

[8] This system might be patterned after those developed for the accounting profession (the Financial Accounting Standards Board), securities dealers (the National Association of Securities Dealers), and futures brokers/traders (the National Futures Association).

and the Federal Trade Commission; financial institution trade associations, secondary mortgage market organizations, and private mortgage insurance companies; and, appraisal industry groups. This task force should build on and/or possibly be merged with the effort already initiated by leading appraisal industry organizations.

5. *Appraisal policies and procedures of government insurers and secondary market institutions:*

a. The VA and FHA should jointly establish procedures to protect against fraud in FHA's single-family insurance program involving the misuse of VA appraisal documentation.

b. The VA and FHA should act to correct ongoing deficiencies in their agencies' existing appraisal review and appraiser monitoring procedures, addressing:

(i) unwarranted and/or improperly documented increases in appraisal value estimates;

(ii) failure to remove or otherwise adequately discipline appraisers for cause; and,

(iii) failure to conduct required reviews of appraisal reports and appraiser performance.

c. The VA and HUD Inspectors General should closely monitor the effectiveness of corrective measures instituted. Furthermore, the committee questions whether the full extent of appraisal deficiencies and abuses affecting the FHA's mortgage insurance programs has been completely revealed and, therefore, recommends that HUD's Inspector General undertake a full-scale review of this situation similar to the one recently completed by the VA's Office of Inspector General.

d. To address weaknesses in their appraisal policies and procedures, Fannie Mae and Freddie Mac should consider reducing their complete reliance on lenders to be responsible for appraisal quality and appraiser selection or performance, in connection with loans packaged for sale to these corporations. Fannie Mae, for instance, should consider reinstituting key elements of its prior system of appraiser selection and control, discontinued in 1981.

6. *Data collection, information sharing:*

a. All Federal agencies concerned with real estate finance or mortgage insurance/investment should collect comprehensive data on appraisals and appraiser performance. Such efforts must be routine and systematic, and should focus particularly on: losses and related problems caused by faulty or fraudulent appraisals; the role of the appraiser in such losses or problems; and, the effectiveness of internal controls in identifying and responding to appraisal/appraiser problems.

b. The Federal bank regulatory agencies, VA, FHA, Fannie Mae, Freddie Mac, and other Government agencies that utilize appraisals—e.g., the Departments of Justice and Transportation and the Internal Revenue Service—should develop procedures for sharing information on problem appraisers with each other and with the appraisal industry. These efforts should concentrate on preventing problem appraisers from being able to continue to work for institutions insured or regulated by these governmental entities, once a pattern of unacceptable performance has been identified. To aid in accomplishing this end, the concerned Federal authorities should require supervised institutions and program personnel to regularly report information on foreclosed properties, which would include the appraiser's name, original appraised value, any subsequent reappraised value, and amount of actual or indicated losses.

7. *State real estate sales and loan origination data:*

To eliminate significant problems with appraisal accuracy caused by the unavailability of full real estate sales and loan origination data in many States, the National Conference of State Legislatures, the National Governors' Association, or some similarly constituted body, should consider the desirability and feasibility of requiring uniform and timely public disclosure of such information.

DISCUSSION

V. CASE STUDIES

A. INTRODUCTION

The subcommittee's examination of a number of savings and loan associations and banks that had either failed and/or experienced major losses conclusively demonstrates the widespread, pervasive, and costly effects of faulty and fraudulent appraisals on the Nation's financial institutions, secondary market, and private mortgage insurers.[9] Indeed, for example, among the four situations studied in detail—Sunrise Savings and Loan Association of Florida, Continental Illinois National Bank and Trust Company, Community Savings and Loan of Maryland/EPIC, and Bank of America/Wells Fargo Bank/NMEC—combined indicated and actual losses caused in part by faulty or fraudulent appraisals range between $750 million and $1 billion! The case studies regarding these financial institutions, moreover, clearly show how inadequate regulatory agency policies, procedures, and practices regarding appraisals, and these agencies' failure to take timely, decisive action when necessary, contributed to the formers' losses, weakened condition, and/or ultimate downfall.

B. SUNRISE SAVINGS AND LOAN ASSOCIATION

1. *Background and underlying causes of appraisal problems:*

The rise and fall of the Sunrise Savings and Loan Association of Florida demonstrates precisely how real estate appraisal problems can weaken and ultimately help to cause a financial institution's collapse. Additionally, it shows how the Federal bank regulatory agency responsible for monitoring and supervising Sunrise's lending activities, the FHLBB, failed to respond adequately to these appraisal problems, thereby unwittingly contributing to its demise.

A publicly held, State-chartered/federally insured savings and loan association, Sunrise was a shooting star among "Sunbelt" financial institutions during its 5-year existence.[10] Its lending philosophy was built on the premise that credit risk was preferable to interest-rate risk in the deregulated, high-interest-rate business environment in which it had to operate. In accordance with this outlook, Sunrise management deemphasized traditional thrift long-term, fixed-interest-rate residential lending, in favor of high-risk, short-term acquisition, development, and construction (ADC) loans. Between 1980 and 1985, Sunrise made hundreds of such ADC loans, fueling a spectacular growth in its assets, from $3 million to $1.5 billion.[11]

To all outward appearances, Sunrise seemed to be a sound, thriving, and well-run association. Based largely on up-front fees and interest income generated by the ADC loans, Sunrise showed profitability sufficient to boost the peak price of its stock to more than $30 a share. However, even as its apparent successes mounted, evidence was accumulating behind the scenes that its lending activities were riddled with questionable practices and procedures. Most notably, for example, borrowers were usually required to have little or no equity in a project financed by a Sunrise ADC loan. Sunrise officials successfully deflected concerns about this dubious practice by asserting that no loan received full financing unless an independent appraisal had determined that the project's value exceeded the loan amount by 25 percent or more. Pointedly, both in terms of what was really happening and Sunrise's ultimate safety and soundness, this explanation was misleading and, in many respects, completely false. Indeed, non-existent, overvalued and otherwise deficient appraisals were rife among Sunrise's loans, as demonstrated in four separate FHLBB examinations of the latter conducted between 1982 and 1985.

2. *Nature and extent of appraisal problems:*

Beginning with the FHLBB's second regular examination in August 1982, significant appraisal deficiencies were found in the review of eight major Sunrise loans ($250,000 or more). The examiner expressed particular concern about two of these loans, which she felt posed a threat of a potential loss of more than $600,000.[12] The next examination in December 1983, disclosed similar, but much more extensive and serious problems, since in the 16-month interval between it and the second examination, Sunrise had originated more than $543 million in loans, 163 of which involved amounts of $1 million or more.[13] The examiners' review of 31 of these 163 major loans (total value, $228 million) showed that two-thirds were based on inflated appraisals and on others either no appraisal had been done, it consisted of only a one- or two-page "letter of opinion," or was received after the loan had been closed.[14] In addition, it was found that appraisals performed in connection with major Sunrise loans were typically: (1) prepared for the borrower, (2) performed by appraisers unknown to association personnel, (3) not reviewed or critiqued internally, even when the properties involved were geographically distant, and (4) replete

[9] The subcommittee also reviewed additional information that confirmed the relationship between faulty and fraudulent appraisals and failures of a number of other federally insured financial institutions, including the Bell Savings Association (Texas) and the Beverly Hills and San Marino Savings and Loan Assocations (California). Relevant documentation regarding these institutions is located in the subcommittee's files.

[10] The FHLBB placed Sunrise in receivership on July 18, 1985, immediately reopened it under an interim contract management arrangement, and finally closed the association for good on September 12, 1986.

[11] Hearings, p. 134.

[12] Ibid., pp. 1535, 1539.

[13] Ibid., p. 1582.

[14] Ibid., pp. 1560, 1583-1585.

with technical deficiencies that violated established FHLBB requirements.[15]

The major appraisal deficiencies and abuses reported in this examination contributed significantly to the determination by the FHLBB examiners that $110 million of the $228 million in loans reviewed should be classified as substandard.[16] In addition, FHLBB officials considered the original appraisals on some of the 31 loans reviewed to have been so unacceptable that they ordered Sunrise to obtain, at its own cost, reappraisals of the properties in question. The reappraisals on four of these loans showed an aggregate decline in value of almost 50 percent from the original appraisal and, not surprisingly, all four of them were in foreclosure by the end of September 1985, with total indicated losses amounting to $18 million.[17]

Subsequent examinations in May and October 1984, disclosed the same disturbing pattern of appraisal problems, albeit with a correspondingly greater amount of assets classified as substandard ($586 million, or 45 percent of the total).[18] Specifically, as a result of these two examinations, major appraisal problems were identified in 53 loans with an aggregate value of $328.5 million.[19] According to the FHLBB, as of the latter part of 1985, 40 of these 53 loans were delinquent or in foreclosure.[20]

3. *Effects of the appraisal problems:*

The effects of the defective appraisals began to be felt as Sunrise's major ADC loans gradually fell due and the interest reserves for them were exhausted. Scores of these loans, a high percentage of which were made possible by defective appraisals,[21] became delinquent or were foreclosed. As a result, Sunrise abruptly found itself in a rapidly deteriorating situation, in response to which, *inter alia,* it voluntarily or at FHLBB direction moved to establish reserves sufficient to cover the anticipated losses from these failing loans. According to the FHLBB, Sunrise's loan-loss reserves, which amounted to just $1.5 million in December 1983, grew to $8.1 million by June 1984; $16.4 million by December 1984; and, $75.1 million by June 1985.[22] In part as a result of these increased provisions for loan losses, by early 1985 Sunrise's net worth had fallen well below the minimum level stipulated in FSLIC insurance regulations. From that point, the situation steadily worsened, and when Sunrise announced early in July that its combined reserves for loan-losses, foreclosed properties, and problem loans had doubled in

[15] Ibid., p. 149.

[16] Ibid., p 1580.

[17] Ibid., p. 140. The four loans referred to are: Monte Carlo Beach Club, Monte Carlo Country Club, Falls Chase Development Corp., and Masters at the Hills of Lakeway.

[18] Hearings, p 135.

[19] Ibid., p 142.

[20] Ibid.

[21] Remarks made by an FHLBB examiner regarding one of Sunrise's more notable defectively appraised ADC loans are illustrative: "In summary, Sunrise had loaned/invested in excess of $33.3 million in a project in which approximately $4.0 million was originally planned. . . . Had this project been adequately and accurately appraised in the beginning, competent management would never have made the first loan since the project likely would have been declared unfeasible." Hearings, p. 157. Similarly, referring to a foreclosed project with indicated losses of almost $4 million, Lamar Heath (Director of Examinations, FHLB Atlanta) declared in his prepared statement that "a competent appraisal at the outset would have kept this loan off the books." Hearings, p 136.

[22] Memo contained in subcommittee files.

the preceding 3 months from $174 million to $350 million, the association's soon-to-follow demise was all but assured.[23] Again, according to FHLBB sources, as of the end of March 1986, Sunrise's scheduled items amounted to $651 million, with indicated losses of $333 million.[24]

4. *Inadequate FHLBB response to appraisal problems:*

The FHLBB was first obliged to take action in response to reported appraisal deficiencies in connection with the second regular examination of Sunrise, which took place from August through October 1982. As a result of the examination, an informal supervisory letter was written directing Sunrise to inform all appraisers working for it about the requirements of Memorandum #R-41b[25] and that all appraisal reports on association loans be submitted in narrative form.[26] Association officials indicated that they would comply with the requested supervisory actions.

a. *Unacceptable delay between examinations:*

In connection with the subsequent examination, however, the FHLBB made the first in what became a chain of questionable or ill-conceived decisions that allowed Sunrise's appraisal and related lending problems to continue unchecked, thereby contributing directly to the association's decline and ultimate collapse. This decision consisted of the FHLBB agreeing, at Sunrise's request, to postpone the third regular examination, which had been preliminarily scheduled for late July/early August 1983.

This examination, therefore, did not begin until December 2, 1983, a 3- to 4-month delay which, in retrospect, a number of considerations should have worked to prevent. First, in view of the significant deficiencies disclosed in the prior examination,[27] FHLBB officials should have been intrinsically resistant to any delay in the start of the next one. Such initial resistance should have been further reinforced by Sunrise's reason for making the request, i.e., because its public accountants were there at the time auditing the association's records and adequate work space for the Federal examiners was therefore unavailable.[28] Still further reservations in agreeing to Sunrise's request should have arisen simply on the basis of the periodic reports filed by the association, which showed

[23] Hearings, p. 1705.

[24] Memo contained in subcommittee files. In early September 1986, the FSLIC filed a $250 million suit against 27 former Sunrise officers and directors, and the association's former law firm, Blank, Rome, Comisky & McCauley. Among the defendants are Robert C. Jacoby, the former chairman, president and chief executive officer, and Michael D. Foxman, a co-founder and former chairman of Sunrise and partner of the cited law firm.

[25] Memorandum #R-41b provides guidance to lending institution officials and appraisers on FHLBB appraisal requirements and assists the latter's examiners and supervisory personnel in assuring that its provisions are complied with. The memo, in part, states: "The soundness of an association's or service corporation's mortgage loans and real estate investments depends to a great extent upon the adequacy of the appraisals of the real estate. This memorandum provides guidelines for appraisal management and procedures to assist in determining compliance with the appraisal requirements of Insurance Regulation 563.17-1(c)(1)(iii)." On September 11, 1986, the FHLBB approved a successor to R-41b, which establishes expanded and more definitive procedures regarding appraisal requirements and appropriate appraisal practices.

[26] Hearings, pp. 134, 1544, 1547.

[27] In accordance with the evaluation reporting format in use at that time, appraisal and loan underwriting policies and practices were given a "C," the next to lowest rating. A "C" rating means that "material deficiencies" were found in the category or area of activity cited. See, also, Hearings, p. 1538.

[28] In an exchange with Congressman Spratt during the hearings, Lamar Heath (Director of Examinations, FHLB, Atlanta) pointedly acknowledged the mistake in acceding to Sunrise's request, stating that "we will certainly take the blame for it." Hearings, p. 247.

that since the prior examination it had made and was continuing to originate an enormous volume of major loans. Indeed, while it was notable enough that Sunrise's assets increased by more than $300 million between the start of the second examination and the projected start of the third, before the latter finally got underway, total assets had soared to $746 million—a staggering increase of slightly less than $350 million! [29] In effect, the decision to postpone the start of the scheduled examination permitted Sunrise's abnormal growth to continue unchecked for an extended period, during which it reached the peak in making the very kind of major ADC loans that ultimately helped to bring about its demise.

b. *The December 1983 examination—major problems, mild response:*

The comparatively mild FHLBB response to the results of the December 1983 examination constitutes another important regulatory decision regarding which questions necessarily arise. This examination, in addition to providing the statistical evidence of extensive and severe appraisal problems (see p. 17 above), yielded a number of important findings on Sunrise's policies and underlying management attitude regarding appraisals. It was found, for example, that staff appraisal reviews occurred almost entirely after-the-fact reflecting, in part, the association's openly acknowledged policy of allowing loans to be closed before the receipt of the supporting appraisal.

In addition, both senior managers and members of the board of directors were shown to have viewed appraisals as being necessary for little more than establishing the maximum loan amount. In an apparently unguarded moment, for example, the head of all Sunrise loan operations told an FHLBB examiner that the closing of a $15 million loan without an appraisal was merely a "technical violation" and that, in any event, management should have the authority "to waive appraisal and other requirements" as it sees fit.[30] Much the same attitude towards appraisals was reflected in the monthly board of directors reports for July 1982 through October 1983, which showed 16 instances of loans approved in amounts exceeding $1 million where the space for appraised value was left blank or checked "verbal," "incomplete," or "not in." [31]

Finally, the results of the December 1983 examination demonstrated conclusively that the significant appraisal deficiencies revealed in the prior examination 16 months earlier had not been corrected as Sunrise officials had vowed. The problems, in fact, had increased markedly, as indicated in the "D" rating assigned by the examiners in their evaluation of the association's appraisal policies and procedures. This rating, the lowest of the four designations used by the FHLBB at that time, indicated that the cited category of lending activity required "immediate forceful supervisory action." [32]

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[29] Memo contained in subcommittee files

[30] Hearings, p. 1581.

[31] Ibid., p. 1561.

[32] The overall composite evaluation of *Sunrise* declined from a "2" in the August 1982 examination to a "4" in the December 1983 examination. A "4" composite rating indicates that the institution has: "(1) *major and serious* problems which management appears to be unable or un-

Continued

The evidence of the danger posed by these massive appraisal problems was so compelling that even before the December 1983 examination was completed, both the Chief District Appraiser and the Assistant District Director of the Office of Examinations and Supervision of the Federal Home Loan Bank of Atlanta (the FHLBB regional office responsible for the area of South Florida in which Sunrise was located) recommended that formal enforcement action be brought against this association. These officials concluded that "without immediate control mechanisms being implemented," Sunrise's "viability could well be threatened," and, accordingly, urged that the association be ordered to cease and desist from closing all real estate loans until acceptable appraisal reports had been received and an effective "before-the-fact" appraisal review system had been instituted.[33] Essentially the same conclusion regarding the need for formal enforcement action was reached by Florida regulatory officials who, with initial support from their FHLB Atlanta counterparts, issued a temporary cease-and-desist order on April 23, 1984.[34]

In the end, however, FHLBB officials failed to follow through on these strong recommendations and attendant attempt to bring formal enforcement action against Sunrise. The temporary State order was rescinded on April 24, 1984, in favor of a FHLBB/FSLIC Supervisory Agreement which, although it contained many of the same general provisions found in its predecessor, was nonetheless an informal enforcement action that did not have the former's strength of purpose.[35] In this regard, it should be noted that a formal enforcement action, such as a cease-and-desist order, must be disclosed to the stockholders when brought against a publicly owned institution like Sunrise.

In short, in response to a situation that called for "immediate forceful supervisory action," Federal regulatory officials allowed Sunrise to get away with an informal agreement that left its managers comparatively free to go on doing business as they saw fit. Indeed, from management's standpoint the association clearly got the better of the deal, since by accepting the Supervisory Agreement it effectively got off the hook of any public disclosure requirement. Moreover, if that weren't enough, Sunrise officials were also able to neutralize some of the Supervisory Agreement's effect by insisting that it contain a statement that by having agreed to it, they were in no way admitting to any wrongdoing or having engaged in any unsafe or unsound practices.[36]

c. *The May 1984 examination—worsening situation, limited response:*

In conjunction with the institution of the Supervisory Agreement, FHLB Atlanta officials advised Sunrise management that: (1) reappraisals would have to be done on some 10 questionable loans

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willing to correct, or (2) problems which pose a threat to its continued corporate existence. In these cases, the problems may *not* be *insoluble*, but the situation is of such large dimensions and so critical that urgent corrective action by directorate or FHLBB appears necessary." *See, also,* Hearings, p. 1575.

[33] Hearings, p. 1556.

[34] Ibid., pp. 1602-1603.

[35] Ibid., p. 1604.

[36] Ibid., p. 189.

that were reviewed in the December 1983 examination; and, (2) a special examination would began almost immediately to look further into the association's major real estate loans and to monitor its compliance with said Agreement. This "special, limited" examination, which began on May 7 and was completed on July 11, 1984:

Confirmed the widespread and increasingly serious appraisal and underwriting problems in the association's major loan activities;

Showed the significant growth in the number and value of substandard assets and scheduled items; and,

Revealed that management had failed to make the changes in lending policies and procedures required by the Supervisory Agreement.[37]

The May 1984 examination also disclosed a clearly defined and premeditated pattern of management attempts to obstruct, disrupt, or otherwise compromise the examiners' efforts. On a scale not previously seen, for instance, Sunrise officials deliberately took weeks to reply to requests for essential documents and/or failed to respond entirely.[38]

As a result of these findings, Sunrise's composite evaluation was again a "4," with appraisals and numerous other categories of lending activities continuing to be rated "D."[39] Perhaps because such a short period of time had passed since the Supervisory Agreement was implemented, the FHLBB response to these examination results was limited, consisting of a lengthy supervisory letter and an announcement that yet another examination would soon follow.[40]

d. *The October 1984 examination—decisive action, too little, too late:*

The announced examination began in October 1984 and yielded much the same findings as the prior ones, as indicated by the following statement contained in an FHLB Atlanta submission to the subcommittee:

> This examination report contains 253 pages of comments on substandard assets which had grown to $586.4 million, or 45.17 [percent] of assets, disclosed that compliance with the supervisory agreement was essentially cosmetic, and was severely critical of management's attempt to cover up problems as well as demonstrating that management could not cope with the mounting problems and should not be trusted to do so.[41]

As a result, Sunrise's composite evaluation remained a "4," with appraisals and many other categories of lending activity still rated "D."

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[37] Ibid , p. 178.
[38] Ibid , pp. 1651-1652.
[39] Ibid , p. 1625.
[40] The supervisory letter expressed "grave concern about the [examination] findings and directed Sunrise's Board of Directors to adopt a more sound and conservative corporate strategy." It should also be noted that pursuant to this examination, a formal enforcement proceeding was requested, but quickly withdrawn. Instead, two FHLBB examiners were assigned to work with a Federal Grand Jury that was investigating the activities of Sunrise and certain of its major clients See Hearings, p. 178.
[41] Hearings, p. 178.

Also as before, these results prompted calls for formal enforcement action; this time from a FHLB Atlanta senior supervisory analyst, who outlined a 10-point proposed cease-and-desist order, five of which related directly or indirectly to appraisal-related problems.[42] Shortly afterwards, though, at a high-level meeting in Washington called to discuss what to do about Sunrise, an informal enforcement action was selected as the initial approach, to be followed by a cease-and-desist order held in reserve in case the association's board of directors balked at the measures they intended to impose.[43] The latter, a Supervisory Agreement containing detailed and stringent requirements—foremost among which was the removal of the chief executive officer and other senior association managers—was agreed to on April 30, 1985.[44] It is important to note, however, that from the standpoint of assessing the adequacy of FHLBB actions, this Agreement was formulated in response to examination findings that were virtually the same as those disclosed in the December 1983 and May 1984 examinations, leaving one to wonder why it could not have been instituted at least 8 or 9 months earlier.

e. *Conclusion:*

In conclusion, by the time the second Supervisory Agreement was signed in April 1985, more than 2½ years had elapsed since the recurring pattern of major appraisal and other lending problems had been first identified. In the interim, an unbroken stream of mounting evidence culled from no less than three examinations had emphatically shown that these problems and their effects were ongoing and reaching such proportions that Sunrise's safety and soundness was increasingly at risk. The overall regulatory response to this situation was clearly inadequate, having involved an unacceptable delay between examinations, missed opportunities to confront problems forcefully before they had gone too far, and a decided tendency to focus more on monitoring efforts than timely, decisive corrective action.[45] While it is difficult to know for certain whether earlier, more forceful FHLBB supervisory action could have prevented Sunrise's collapse, the persistent lack of such action over such a lengthy period: (1) allowed a problem situation to enlarge, grow progressively worse, and, finally, get entirely out-of-hand; and, (2) helped to cause tens, and quite likely hundreds, of millions of dollars of unnecessary additional losses. In effect, rather than serving to forestall Sunrise's ultimate failure, the overall regulatory response and specific supervisory actions taken unwittingly contributed to and even hastened the very outcome they were meant to avert.

C. CONTINENTAL ILLINOIS' REAL ESTATE LOANS

1. *Background and summary of appraisal-related losses:*

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[42] Ibid., p. 1675.
[43] Ibid., pp. 1683-1685.
[44] Ibid., pp. 200-210.
[45] This pattern—close monitoring, punctuated by a continuing failure on the part of responsible regulatory officials to take decisive, timely action—unfortunately, is a recurrent and long-lived one, having been highlighted in an ongoing series of subcommittee investigations of failed financial institutions conducted over the past 10 years. See, for example, House Report No. 98-573, p. 50, concerning the FDIC's supervision of the United American Bank of Knoxville, TN.

Serious appraisal abuses were found in the Continental Illinois Bank's nonperforming real estate loans assumed by the FDIC. The FDIC acquired approximately $400 million of the $2.5 billion in total real estate loans held by Continental Illinois at the time of its restructuring in the summer of 1984. The FDIC provided the subcommittee with a schedule of 21 of the largest nonperforming real estate loans, which encompassed condominiums, commercial real estate, or undeveloped land, primarily in Florida. The schedule shows that the original appraised value of these 21 properties totaled $518.4 million, while the current value, based on reappraisals ordered by the FDIC, totaled only $184.4 million or 64 percent less than the original value.[46]

The FDIC informed the subcommittee that serious underlying appraisal problems accounted for this huge disparity in appraised values:

> Many of the appraisals reviewed by the FDIC staff appear to have been a function of the deal arrived at between the bank and the workout contractor. Loan presentations noted that appraisals were expected to support the loan balance or that preliminary appraisal estimates support the value and that such reports would be delivered later. In appraising condominium properties, the appraiser typically arrived at a market value for individual units and then multiplied the value by the number of units to arrive at an appraised value. No allowance was made for holding costs, sales costs, or a discount that might be necessary for bulk sale. Similar practices were employed in valuing land holdings. In some cases the appraisals incorporated an assumption of high appreciation rates yielding high market values in 1988 and 1992 when the loans would become due. These appreciation rates, of course, were not supported by current market conditions. No recognition of vacancy rates, unabsorbed inventory or any other market information was included in the reports. Most of the appraisals appeared to have been developed to support the proposed loan rather than give a true current market value of the underlying collateral.[47]

Although many of these problem loans involved Florida properties, most of the faulty appraisals were performed by one Chicago appraisal firm, the principals of which hold the MAI designation of the American Institute of Real Estate Appraisers.[48]

2. *Nature and extent of appraisal abuses:*

At the subcommittee's request, the FDIC reviewed the appraisals and loan files for 10 of the 21 loans listed on its schedule (constituting the top 80 percent of the portfolio) and found, in each case, serious deficiencies unrelated to external factors. Often appraiser assumptions were based on unrealistic projections, prices of properties offered for sale but not sold, or false or irrelevant data. At

[46] The schedules referred to are reprinted in Hearings, p. 1720 and p. 1725.

[47] Hearings, p. 972; also confirmed during the testimony of Steven Seelig, Associate Director, Division of Liquidation, FDIC. Ibid., pp. 251-252.

[48] Hearings, p. 253.

times the appraised value increased, even though the market for some of the properties had collapsed. On some occasions, the appraisals were furnished after the loans were made.

The FDIC's evaluations of the appraisals for each of these 10 loans illustrate the flagrant and serious appraisal problems. Set forth below are some representative cases taken from the FDIC's summary (with assets unidentified).

Asset No. 6: The total original appraised value in 1983 was $9.5 million, while its reappraised value in 1985 was $8.8 million. FDIC told the subcommittee:

> . . . this asset was appraised three times between the end of March 1980 and November 1, 1983. The appraisals on a per acre basis ranged from a high of $26,000 per acre on the first appraisal down to $15,600 per acre in 1983. The same appraiser was used for updating the appraisals rather than changing appraisers to verify values. Additionally, the bank accepted letter appraisals and relied on appraisals that were prepared after the loans were made. [The appraisal reports] assumed away problems that might surround the sale of the property. Market data was either ignored or not obtained at all, and there was a lack of discounting or inadequate discounting for holding periods. Unit values were used and then multiplied by the number of units in order to obtain a higher large scale value. In those reports where market data was included distant comparables were used to increase the appraised value.[49]

Asset No. 18: FDIC Associate Director Seelig testified that this was one of the more blatant cases "where the appraiser took the amount of the loan, added the amount of the tax shelter to the amount of the loan and said that is the value of the property," as the instruction directed the appraiser to do.[50] This property, a group of condominium units, was originally appraised at $101 million, while the FDIC's reappraisal came in at $27.2 million.[51] The FDIC's summary of the appraisal abuses is, to put it succinctly, "mindboggling":

> . . . In an appraisal done in 1983 the appraiser based his value on a retail price list for the individual units sold as individual units, not sold as a group. The retail marketing period of 18 months was assumed with an appreciation rate of 10% occurring during this 18-month period. An 18-month sales period was used as an assumption despite the fact that the inventory of unsold units in that area was somewhat higher than the previous peak and that condo sales in the previous year were the lowest in ten years. The appraiser went on to rely on 39 reported contracts at a price of $93.64 per square foot to substantiate an appraised value of $92.08 per square foot. The appraiser treated these contracts as firm and used them to support market activity at high prices. *Subsequent events showed*

[49] Ibid., p. 1721.

[50] Ibid., pp. 253-254.

[51] Ibid., p. 1725.

> *that these contracts were not bonafide [sic] and that they failed to close. The same appraiser reappraised the properties a year later, in March of 1984, and arrived at an appraised value of $136.87 per square foot. Again, the appraiser noted that vacant condos were at an all time high and that prices had in fact declined in the subject complex by 14% between 1982 and 1983. However, the appraiser used the $92 per square foot price for 1984 as a starting price, and assumed a 9% inflation rate for the purpose of arriving at a 1992 value.* Income from rental operations is projected by the appraiser despite the fact that units were *losing money*. . . . In no sense was this a market value of the underlying real properties securing the loan. Rather it was a value essential to support the size of the loan.[52] (Emphasis added.)

Asset No. 11: Several groups of condominium units, originally appraised at $9.3. million in mid-1983, were reappraised for the FDIC at $4.7 million in 1985. The comments in FDIC's evaluation of the appraisals are striking and also typical of other appraisals:

> . . . The bank relied upon the gross sell out value as the basis for the loan. . . . [T]he appraiser made no adjustments for holding, marketing, or closing costs. Additionally, market data on rentals and sales within the project appear to have been ignored. . . . However, it should be noted that the appraisal report clearly indicates that the function of the appraisal is to support the efforts of the borrower and the lenders in syndicating the units. With hindsight, this was clearly quite accurate. No mention is made in the statement of "purpose of the analysis" that the report is attempting to arrive at an appraised fair market value.[53]

As FDIC Associate Director Seelig testified:

> . . . I think what you had here is you had account officers getting appraisals to support whatever the purpose was, whether it was to put the loan on the books, whether it was to get an updated appraisal because the Comptroller of the Currency requested they get appraisals to support the values they were carrying.[54]

As a consequence of these disparities in real market value based on extremely faulty and meaningless appraisals, the FDIC's losses will probably be in the "neighborhood of $200 million." [55]

3. *OCC's lack of supervision of Continental's real estate loans and appraisal practices:*

The Office of the Comptroller of the Currency (OCC) was the principal supervisory agency for Continental Illinois. The OCC has denied the existence of any serious appraisal problems or abuses.[56]

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[52] Ibid., pp. 1721-1722.

[53] Ibid., pp. 1722-1723.

[54] Ibid., p. 253.

[55] Ibid., p. 253.

[56] In its February 19, 1986, follow-up response to the subcommittee, the OCC finally conceded that true market values did not always match appraised values, while it still continued to deny fraudulent or abusive appraisal practices. Ibid., p. 727.

In its November 25, 1985, response to the subcommittee, the OCC stated:

> OCC examinations did not disclose any real estate appraisal abuses warranting disciplinary action or criminal referral. Examiners did question certain real estate appraisals during their review of Continental's loan portfolio, but the questions arose primarily from external factors that had changed subsequent to the appraisal date, and not from appraisal abuses.[57]

While OCC contends that it was on "top" of the situation at Continental, its examination and supervisory actions concerning the real estate portfolio were unclear, and it did little to clarify them for the subcommittee. All of the evidence provided by both the OCC and the FDIC strongly indicate that OCC examiners either did not review or were not concerned about the appraisals on Continental's real estate loans.

OCC's second response, its formal submission at the subcommittee's December 1985 hearing, stated that: (1) all real estate credits over $10 million would have been reviewed by OCC examiners (it appears that 12 of the 21 properties listed on FDIC's schedule fall within this category); (2) the June 30, 1980, OCC examination found documentation deficiencies, although none relating to the absence of such documentation regarding the collateral; [58] and (3);

> Examiners assessed the adequacy of overall bank policies, practices, procedures, and internal controls and reviewed the Real Estate Internal Control Questionnaires as part of the examinations of Continental Illinois conducted during the period January 1, 1980 through July 1, 1984. As a result of this process, no special review of the bank's real estate and real estate construction policies, practices, procedures, or internal controls was deemed necessary.[59]

After persistent inquiries from the subcommittee, the OCC did finally admit that nine of the ten assets examined in-depth by the FDIC for appraisal problems had been "classified either substandard, doubtful, or loss in at least one of the three examinations cited [1982, 1983, and 1984]." Yet, holding fast to its position, it further stated that, "no fraudulent appraisal practices were noted." [60]

This case study, together with the one concerning the Bank of America (see below, p. 33), suggests a number of conclusions. First, the OCC has placed minimal importance on adequate and sound appraisals. Second, it does not have nearly enough experienced ex-

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[57] Hearings, p. 1011.

[58] It is important to remember that, unlike the Federal Home Loan Bank Board, the OCC does not require that an appraisal be obtained for a real estate loan.

[59] Hearings, pp. 495-496. An OCC supervisory memo set out below calls *into question* this assertion. The memo demonstrates that the OCC knew in late 1982 that Continental's internal controls on real estate loans were deficient. In a November 15, 1982, memorandum to the Deputy Comptroller for Multinational Banking, Senior National Bank Examiner, Richard Kovarik (assigned to Continental), commented on the causes of increasing levels of nonperforming loans and noted that new controls were needed. (See Hearings, pp. 1727-1728.) However, this management review had little effect on these appraisal abuses, as seven of the ten properties' appraisals in which the FDIC found *poor appraisal practices* were performed in 1983 or later. (Assets numbered 6, 11, 14, 15, 16, 18, and 20, from the FDIC's schedule to the subcommittee, reprinted in Hearings, p. 1725.)

[60] Ibid., p. 727.

aminers—an assertion by OCC staff made "off the record" because the Office of Management and Budget frowns on disclosures reflecting the effects of such staffing problems. Third, due to this examiner shortage, the OCC relies on member bank internal audit staffs and does little "hands-on examination of loans" for the larger national banks. Fourth, OCC's examination manual directives[61] either were not followed at Continental, were inadequate, or both. Finally, both the OCC's general directive that banks should utilize an appraisal program and its internal control questionnaire during examinations[62] are completely inadequate, since they furnish little guidance to examiners as to what is specifically required regarding appraisals.[63]

D. APPRAISAL ABUSES IN CONNECTION WITH MORTGAGE-BACKED SECURITIES

The subcommittee found substantial evidence of defective appraisals used to support real estate loans packaged and sold as mortgage-backed securities (shares or participations in pools of mortgage loans) to financial institutions and other investors around the country. The safety and soundness of mortgage-backed securities (MBS) not guaranteed by an agency of the Federal Government (VA or FHA) depends, in large measure, on the aggregate value of the real estate collateralizing the mortgages comprising the securities. This is even more so for private conduit MBS—those not issued by Fannie Mae or Freddie Mac, for example—where the underwriting standards may not be as high and the reputation (and clout) of the issuer/packager uncertain.[64]

The subcommittee came across several situations in which issues of nonfederally insured MBS were collateralized by properties that had been grossly overvalued. In two of these situations, numerous thrift institutions, usually located in States far from the properties involved, invested heavily in private conduit MBS and suffered losses as a result of fraud and inadequate collateral. These case studies demonstrate both the importance of accurate and legitimate appraisals to the MBS market and the need for the bank regulatory agencies to take more effective action to determine whether a valid appraisal was made and whether financial institutions' procedures concerning MBS-related appraisals are adequate.

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[61] OCC examiners should perform special reviews of each national bank's (1) policies, procedures, and internal controls regarding real estate loans, including appraisals, and (2) method for selecting appraisers.

[62] The OCC Examination Manual's "Internal Control Questionnaire" for Real Estate Loans states:

15. Regarding appraisals:
   a. Are appraisals required to be in writing, dated and signed?
   b. Is sales price and loan application information withheld from the appraisers?
   c. Are appraisers paid the same fee whether or not the loan is granted?
   d. If staff appraisers are used, does the bank periodically have test appraisals made by independent appraisers to check the bank's knowledge of trends, values, etc.?
   e. Does the bank follow a formal reappraisal program?
   f. If appraisers who are not employees of the bank are used, does the bank investigate their quality and reputations?

Reprinted from Hearings, p. 1024.

[63] For contrast, see the Federal Home Loan Bank Board's Memorandum #R-41b, Hearings, pp. 824 et seq.

[64] While no one has a complete grasp on the amount of such MBS issued in the last few years, it is at least $5 billion. They are very popular with financial institutions because they offer higher yields without all the work and expense of writing new mortgages.

1. Impact of fraudulent appraisals on Community Savings and Loan (Maryland) and Equity Programs Investment Corporation (EPIC)

a. *Background:*

The September 1985 collapse of the Community Savings and Loan—a thrift chartered and insured by the State of Maryland—and its real estate investment affiliate, the Equity Programs Investment Corporation (EPIC),[65] involved endemic appraisal deficiencies and abuses. EPIC was primarily concerned with setting up tax sheltered investment partnerships to buy single-family houses, financing such purchases by mortgage loans or mortgage-backed securities that were, in turn, sold to institutional investors. By the time of its collapse, somewhere between 6,000–7,000 investors had interests in some 350 EPIC partnerships worth between $175 and $200 million.[66] By the same time, the partnerships had purchased approximately 20,000 houses, the mortgages for which were sold to scores of federally insured financial institutions, Fannie Mae, et al. In addition, a number of private mortgage insurance companies (PMIs) became guarantors of a significant portion of the purchased mortgages and mortgage-backed securities.

In connection with these EPIC activities, the Community Savings and Loan provided capital for several purposes, foremost among which was to service debt the partnerships' income-generating capacity could not meet. From the time of its purchase by EPIC in 1982, Community advanced hundreds of millions of dollars to the partnerships, an estimated $100 million of which were outstanding at its demise.[67]

b. *The role of inflated appraisals:*

By design, the EPIC partnerships bought single-family houses—initially, model homes and unsold units in developments—to be rented out and then resold several years later. To finance these purchases, low down-payment loans were obtained through a sister company, which effectively acted as a mortgage broker. The amount of these loans systematically exceeded the houses' sales price, since the latter excluded discounts or rebates routinely provided by the seller.[68] In one recent case, for example, the purchase of a group of 45 houses with an aggregate sales price of $3.54 million was financed by a $3.52 million mortgage loan. The seller, however, rebated almost $700,000, so that the net loan amount exceeded the actual price by slightly more than $670,000.[69] In effect, by financing the partnerships' purchases with loans that exceeded the actual acquisition price, EPIC managers were thereby able to cover all loan origination and closing costs, as well as provide the promised tax benefits to the investors.[70] (This strategy—borrowing

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[65] EPIC purchased Community Savings and Loan in 1982 and subsequently restructured their corporate relationship so that the latter became the nominal parent. Effective control of both entities remained in the hands of EPIC's founders and senior managers.

[66] Memos contained in subcommittee files.

[67] Presentation to the State of Maryland Deposit Insurance Fund Corporation and the Unofficial Committee of Investors by Coldwell Banker Real Estate Group and Dean Witter Reynolds, Inc., November 1, 1985, p. 1.

[68] Hearings, p. 1518.

[69] Ibid., p. 1522.

[70] EPIC's prospectuses frequently advertised that for every $1 invested, $2 in deductions would be realized.

to purposely create large-scale mortgage debt—is widely regarded as being unacceptable, since it intrinsically involves major corresponding risks, e.g., if a property doesn't appreciate in value either quickly enough or by a sufficient amount to cover the loan amount and any other requisite expenses.)[71]

EPIC's borrowing strategy could not have been practiced effectively without appraisals capable of justifying the prototypical loans obtained pursuant to it. However, given these loans' extremely high loan-to-value ratio (95 percent and higher) and seller discounts/rebates, a supporting appraisal as a matter of course would have to have been significantly inflated. Just how EPIC obtained such appraisals is suggested by the following exchange from the December 1985 hearings between Chairman Barnard and Richard Hewitt, former Chief District Appraiser of the FHLB, Atlanta:

> Mr. BARNARD. Mr. Hewitt, I understand that you had an encounter with an independent appraiser who had been removed from EPIC's appraiser list. Why had he been removed and what did this reveal about the appraisers EPIC was using in connection with its real estate ventures?
>
> Mr. HEWITT. We were retained by the Bank Board in the eligibility exams and asked to look at the various portfolios of those Maryland associations, one of them being Community. Part of that review was to determine the viability of appraisals, which we did, and also to try to get an estimate of the risk in the portfolio. Part of the information we looked over was the approved list of appraisers that EPIC maintained. There were a series of appraisers from all over the country, since they were involved in loans on single-family residences all over the country. I noticed that in some cases you would have an appraiser's name marked out and "Do not use" written in the margin.
>
> Interestingly enough, I found what I considered to be, based on my experience, some of the most proficient appraisers in the country being crossed out, "Do not use." One of these formerly worked with Freddie Mac who I knew and I called and asked him if he remembered any situation where he worked with EPIC, et cetera. His response was, "Yes, they asked me to appraise out of context." Essentially, it was a situation where he was asked to appraise 1 condominium unit in a total complex of some 200 and appraise it ignoring the influence of the other empty units in the entire complex. When he said that he could not very well do that, particularly in view of the fact that appraisal ethics would tell him he had to consider the impact of the other vacancies in that project as well as the general market area, they decided not to utilize him for the assignment. That was the story on that.[72]

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[71] This is precisely what happened in connection with the EPIC partnerships' loans, as reflected in comments from the FHLBB report written pursuant to its May 1985 examination regarding Community Savings and Loan's eligibility for Federal insurance: "The success of the 'EPIC Product' syndicated partnerships is predicated upon a minimum yearly appreciation in the market place of 8%. This has not occurred in the last year nor is it expected to do so in the next year." Hearings, p. 1519. See, also, footnote 75, p. 31 below.

[72] Hearings, p. 246.

In addition, according to the FHLBB, the appraisers retained by EPIC consistently engaged in a number of other practices that violated appraisal industry standards and Federal regulations. For example, in selecting the approach to be used to help determine the appraised value of a property, the EPIC appraisers failed to choose the most appropriate one.[73] Relatedly, the discounts/rebates provided by the seller were systematically excluded from the appraisers' cash equivalency analysis, which is one of the most important steps in determining a property's appraised value. This latter practice, in particular, made it possible for a typical "EPIC Product" purchase to be financed by a loan amount commonly at least 25 percent in excess of its actual market value, as shown by the following illustration:

TYPICAL PURCHASE OF "EPIC PRODUCT"

Seller

Purchase price		$50,000
Less:		
6.8 percent sales commission	$3,400	
Three months advanced rent	1,500	
Rental deficit contribution	*7,100	
Less total discounts (24.0 percent)		12,000
Net to seller		38,000

*Represents market interest rate paid to investor on mortgage plus maintenance costs of dwelling unit less rent received over a four year period which results in a deficit carrying cost.

Purchaser

Purchase price	$50,000
Less: Discounts from seller (24.0 percent)	12,000
Adjusted purchase price	38,000
Less: Mortgage (95 percent of purchase price)	47,500
Cash contributed to limited partnership	[74] 9,500

c. *Impact of the EPIC/Community Savings and Loan collapse:*

In combination with the high-risk nature of the EPIC mortgage loans, a number of unanticipated events[75] brought some of the partnerships to the point where they were unable to meet their monthly debt service payments. From the point of these initial delinquencies, the EPIC/Community problem snowballed, prompting, among other things, a run on the latter's deposits. In response, the State of Maryland first acted to halt the withdrawals taking place as a result of the run and, on September 5, 1985, placed Community under its conservatorship. These actions effectively reduced EPIC/Community's status to that of a failed institution, with at-

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[73] Of the three major appraisal approaches—market, cost, and income—the latter is the one most suitable for determining the value of properties that are primarily or solely to be used for rental purposes. *As the FHLBB's examiners noted in connection with their May 1985 review of* "a large sample of properties" owned by the EPIC partnerships: ". . . never was the income approach used," even though ". . . all of 17,689 dwellings owned by the 357 limited partnerships are for rental purposes." Hearings, p. 1517.

[74] Hearings, p. 1517.

[75] Two of these bear mention: (1) high vacancy rates among some EPIC partnership properties, caused by stagnant economic conditions and/or a glut in available rental units; and, (2) as a result of a crisis among Maryland thrift institutions, the Community Savings and Loan was required to undergo—and failed to pass—the previously cited FHLBB examination to see if it could qualify for Federal insurance.

tendant consequences that have been strongly felt throughout the financial services sector, secondary market, and real estate finance industry. The effects of EPIC/Community's collapse include:

(1) aggregate potential losses, in the hundreds of millions of dollars,[76] involving some or all of the following:

94 federally insured savings and loans, holding more than $700 million of EPIC mortgages/MBS;[77]

18 FDIC-insured financial institutions, holding just under $250 million of EPIC mortgages/MBS;[78]

Fannie Mae, holding slightly more than $100 million of EPIC mortgages/MBS;

The State of Maryland, with indicated losses of as much as $80 million; and[79]

The 6,000-7,000 limited partners, who hold interests in the EPIC partnerships amounting to between $175 and $200 million.

(2) a major upheaval in the private mortgage insurance industry, as reflected in:

The failure of TICOR,[80] the fourth largest PMI, as a result of its inability of cover its EPIC-related loss exposure of $166 million;

Significant potential losses regarding two other major PMIs—Mortgage Guaranty Insurance Company and Republic Mortgage Insurance Company—based on loss exposures of $75 million and $100 million,[81] respectively; and,

Diminished investor and public confidence in the PMIs, with the consequent effect, among others, of making it harder for them to obtain needed capital from domestic and foreign sources.

(3) reduced public confidence in the private secondary market which, for example, has forced sellers of private MBS to offer higher interest rates to attract investors.

(4) further indication of major financial institution problems concerning out-of-area loan participations and investments in MBS, which regulatory authorities continue to address ineffectively.

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[76] This estimate takes into account the anticipated benefits of a workout plan developed by an informal group of EPIC's creditors, chaired by Fannie Mae. As approved by a Federal bankruptcy judge in April 1986, the plan provides for the orderly sale of the 20,000 EPIC properties over a 5- to 7-year period. The proceeds realized from these sales are to be used first to satisfy EPIC's creditors and, then, if funds are available, to reimburse the limited partners for their investments. Actual losses will naturally depend on the degree of success achieved in disposing of the properties; but, at least for the near-term, the workout plan has helped forestall the development of a far more serious and costly situation.

[77] Hearings, p. 1519.

[78] Ibid

[79] In March 1986 the Mellon Bank Corp. agreed to take Community Savings and Loan off Maryland's hands for some $130 million in cash and a further commitment from State authorities that another $40 million would be made available to offset any other future losses arising from the thrift's holdings. Via this sale, Maryland officials believe they have reduced the State's ultimate loss potential from the EPIC/Community collapse by as much as $60 million. Maryland's final loss, however, will depend on the success of the previously mentioned workout plan, to which it is also a party.

[80] TICOR, now called TMIC Insurance Company, was placed under the conservatorship of the California Department of insurance on April 10, 1986, and is currently operating under a court-approved "rehabilitation plan." See, also, Hearings, p. 1532.

[81] Hearings, p. 1520.

2. *Impact of fraudulent appraisals on NMEC-packaged securities involving Bank of America, Wells Fargo Bank, and 21 thrift institutions*

a. *Background:*

Highly inflated and fraudulent appraisals underlying MBS were essential to an intricate pyramid scheme that almost resulted in losses of at least $95 million to 21 thrift institutions in the Northeast and Middle West that had invested in these securities. If Bank of America had not assumed liability, six of the thrifts would have had a negative net worth[82] and others could have become problem institutions.

The participants in the scheme included a real estate company (West Pac), a finance company (Western Pacific Financial), two insurance companies (Pacific American and Glacier), all of which were owned or indirectly controlled by Kent Rogers; and, a packager associated with him, National Mortgage Equity Corporation (NMEC), owned by David Feldman.[83] West Pac/Kent Rogers would buy properties and become the mortgagor/borrower on a number of single loans for many of them, with Western Pacific Financial (of Nevada) providing the temporary financing. NMEC then packaged the mortgages into pools, shares in which were sold as securities to investors, with the Bank of America and Wells Fargo Bank acting as trustee/escrow agents for them. A brokerage firm in New York City sold portions of the pools to various thrift institutions.

Normally, financial institutions would be reluctant to buy non-Government guaranteed mortgage securities. However, because Bank of America's name or Wells Fargo's name was on the securities and the mortgage payments were insured by either the Pacific American or Glacier insurance companies, they did not hesitate to buy them. Indeed, such was their assurance in this regard, that they purchased the securities without inspecting the properties collateralizing the loans, checking on the principals involved, or investigating the financial conditions of the insurers.[84]

b. *The appraisals and the properties:*

I

The scheme involved expensive single family homes, apartments, and townhouse condominiums in Southern California and Texas. The appraised values of these properties were 2½ times higher than the actual purchase price. One witness, H.G. Icenhower, who worked with and sold other properties to Kent Rogers, was familiar with the role of fraudulent appraisals in connection with three properties in Houston:

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[82] Hearings, p. 469.

[83] Both of these individuals at the time of the scheme had been convicted in Federal court, sentenced to prison, and had appeals pending—Kent Rogers for bankruptcy fraud and David Feldman for mail and wire fraud.

[84] Evidence obtained by the subcommittee from the Delaware Insurance Commissioner shows that Pacific American was undergoing severe financial problems in the spring of 1983 and 1984, before being placed in receivership in late Summer 1984. Also, this documentation confirms that Kent Rogers controlled Pacific American, first by lending it money and then by acquiring it. This resulted in expedited insurance for these mortgage pools because they were not required to undergo customary underwriting procedures.

. . . West Pac would purchase property for x amount of money; they would obtain a mortgage from a sister company for 2½ x, then obtain an appraisal at approximately 2½ to 3 x, then receive an insurance bond from the mortgage company for the amount of the loan, then sell the mortgage to a related company, National Mortgage, for 2½ x. West Pac would put the difference or 1½ x in its pocket. National Mortgage would sell the mortgage package to the financial institution S&L. In the case of the Houston properties, . . . the x in that case equaled $10 million for the three Houston properties; thus West Pac pocketed 1½ x or $15 million by buying these three properties simultaneous almost with the purchase of the properties.[85]

Mr. Icenhower provided the following data, which helps to illustrate how the scheme worked regarding the three Houston apartment complexes and what the consequent losses would be based on:

	Estimated Tuttle Appraised Value	Approx. West Pac Loans	West Pac Purchase Pric	1983 Market Value
Oxford Court	$17,500,000	$14,000,000	$6,000,000	$5,000,000
Bing'ham Manor	5,100,000	4,200,000	2,150,000	1,300,000
Park Place	4,000,000	3,200,000	1,650,000	[86] 1,400,000

Mr. Icenhower also described how the appraisals were obtained through an appraiser, Dale Tuttle, who was from Southern California and therefore, unfamiliar with the Houston real estate market.[87] In connection with the Oxford Court complex, for example, Mr. Icenhower testified that Tuttle:

> . . . valued them as condominiums when actually they were an apartment complex. Where it was a 302-unit complex, he set up 302 different loans, 302 different properties, and then he used three comparables for all 302 of those units, and the comparables he used were anywhere from 4 to 8 miles away.
>
> When there were very good comparables within half a mile or actually within blocks of there. But he had to go that far away to get appraisals that would justify the numbers that he used. What he compared those to [sic] were new condominiums 4 to 8 miles away where these [properties] were an apartment complex 17 years old in a much poorer location, and his appraisal was based on the contingency that these would be completely renovated and of course that was never done.
>
> The same happened in the case of Bingham Manor [and Park Place Apartments] . . .[88]

[85] Hearings, p. 256. With some of the extra money from the inflated appraisals, Kent Rogers allegedly bought a large pleasure boat and homes in Southern California and Mexico, placed funds in England, Mexico, Switzerland, and elsewhere, and otherwise lived very well. Moreover, according to Icenhower, Rogers intended to use fraudulent appraisals to buy more properties, from which they could "have pocketed about $150 million more than they did pocket in their scheme. I heard them refer to this as the second year of their 5-year pyramiding scheme." (Hearings, p. 257.)

[86] Ibid., p. 263.

[87] The fact that Tuttle was not from Houston is something that the trustee/escrow agents should have questioned immediately. As thrift representative Cecil Akre testified: The trustee bank "should have approached the deal as if they were advancing their own funds for the mortgages. This may have caused them to ask why a California appraiser is used for Houston property." Hearings, p. 275.

It is worth noting, moreover, that Mr. Tuttle was not an inexperienced appraiser, as indicated in an April 2, 1984, letter he sent to a company associated with Pacific American, which stated:

> My appraisal experience spans approximately thirty (30) years covering the Chicago area, Beverly Hills, Orange County and other sections of Southern California. I am primarily residential-orientated and hold an S.R.A. designation with the Society of Real Estate Appraisers of Chicago, Illinois. I am also qualified for V.A. and F.H.A. appraisals. Additionally, I have a Fanny Mae appraisal number.[89]

At the time this scheme was disclosed, only 43 of the 640 units in Houston were occupied. Indeed, West Pac had no intention of operating and maintaining these complexes after their acquisition and, accordingly, the units had been stripped of appliances, cabinets, carpets, etc. The City of Houston condemned one or more of the complexes, and another turned into a slum.[90] A special representative sent to Houston by some of the investing thrifts testified that he found that the properties were "suffering from a long period of neglect" and contained mostly "vacant units," in which appliances were missing, windows were broken, and vandalism was extensive.

II

Tuttle's name came up in connection with another West Pac property—Cabelleros Estates Condominiums in Palm Springs, CA—which collateralized part of the Bank of America/Wells Fargo MBS pools. In this case, apartments converted to condominiums were appraised at $300,000 as "time share units," even though the units were not sold as such. Based on telephone discussions with some of the owners, the subcommittee staff found that West Pac sold the units in the $90,000 to $125,000 price range, not for $200,000 or more which, according to Tuttle, was their market value. West Pac obtained the units for much less—some in the $50,000 range.[91] As with the Houston properties, West Pac (as borrower) was involved in paper transactions, not actual sales, in which it bought low, borrowed high from an affiliate on the basis of inflated appraisals, and then obtained surplus funds through a packager who sold investors securities collateralized by the overvalued properties. Once again, most of the units went unsold, and no

[88] Hearings, p. 269.

[89] Ibid., 1791. Attached to his letter was a resume, listing present clients, including Western Pacific and several thrifts and other financial institutions in Southern California.

[90] Hearings p. 264.

[91] Ibid., pp. 1791–1804. Additional documents are in the subcommittee's files.

one—neither the investing thrifts nor the two national banks acting as escrow agents—inspected the properties.[92]

III

The servicer, i.e., the collector of the mortgage payments, on some of the better single family homes in California that collateralized the Wells Fargo MBS, wrote a letter to Wells Fargo on December 17, 1982. In that letter, the servicer, Advance Mortgage (now part of Llomas and Nettleton), indicated that it wanted out of the deal because there were a high number of delinquencies, defaults, and foreclosures on these properties, and that the appraisals were highly inflated:

> Advance has ample reason to question the integrity of a number of the mortgage loans comprising the subject pools and therefore has grave doubts about the soundness of the pools themselves. We are sharing our concerns with you in order that you may assess your position in this matter and formulate your course of action.
>
> As a matter of illustration, Advance . . . recently commissioned a reputable appraiser to reappraise six properties which were randomly selected from the pool loan portfolios. All six loans were originated . . . between March and July, 1982, while the reappraisals were performed during the first two weeks of November, 1982. Although only four to eight months had passed between the original appraisals and the new ones, the reappraisals reflected property values from twenty-five to fifty percent less than those shown in the originals. In every case, assuming . . . an accurate assessment of the property values, the loans are substantially unsecured. . . . Advance is convinced that its investigation reveals material irregularities which demonstrate a sound basis for concern that the certificates are not fully secured.[93]

In subsequent correspondence, Wells Fargo denied the existence of the problem, refused to investigate, and turned to the packager (NMEC) to service the loans, although the latter had been implicated in possible wrongdoing.[94]

c. *Potential impact on investor savings and loans and the FHLBB's supervisory responsibilities:*

[92] The private placement memoranda given to the investors indicated that the properties would be 1-4 unit residential dwellings. This was not the case for the Houston properties, a fact that could have been quickly verified through one or two phone calls.

[93] Hearings, pp. 1808-1809.

[94] Unlike Bank of America which accepted its share of the blame, Wells Fargo has denied its responsibility, and three investor-thrifts are suing it for breaching its fiduciary and other responsibilities. The Bank of America's *own internal* investigation—done only after the OCC and the FHLBB became involved and not in response to Mr. Icenhower's continued attempts to stimulate their interest—confirmed the appraisal abuses. The Bank of America found: "Large numbers of loans were not accompanied by a written appraisal based on the appraiser's personal inspection of the property. When appraisals were provided, most were fraudulently inflated far beyond true market value." P. 16, National Mortgage Equity Corporation Mortgage Pool Scheme—Bank of America's Summary.

I

The 21 savings and loans holding $128.5 million in NMEC mortgages were, for the most part, made whole because the Bank of America accepted responsibility.[95] However, according to the FHLBB, if the Bank of America had not accepted responsibility, 6 of the 21 institutions would have suffered losses in excess of their net worth and another holding $20 million worth of securities would have been severely impacted.[96] The three thrifts holding Wells Fargo/NMEC MBS have filed suit against Wells Fargo, but the solvency of none of them hinges on the success of the lawsuit.[97]

II

The FHLBB's overall response to this situation has been mixed. On the one hand, after one of the affected thrifts brought the matter to the attention of New York Federal Home Loan Bank officials in October 1984, onsite examinations of all the other involved thrifts within that district were conducted and supervisory staff held discussions with the institutions' management, the FDIC, the OCC, FBI officials, and various attorneys. On the other hand, the FHLBB was unable to inform us about what actions it took concerning the 10 thrift institutions outside of the New York district bank's region.

Relatedly, the FHLBB's examination policy concerning documentation supporting MBS has been totally inadequate. For several of these institutions, the investments in the NMEC MBS were their largest assets. Yet, while FHLBB examiners are charged with verifying the accuracy/adequacy of appraisals during their review of an institution's real estate loans, no such requirement is imposed concerning large MBS investments.[98] Indeed, the absence of an appraisal review requirement regarding MBS, may partially explain why the FHLBB was unable to tell the subcommittee about the status of the above-mentioned thrifts outside the New York Federal Home Loan Bank's purview, i.e., the matter had not been brought to anyone's attention by an involved thrift as was the case in New York and examiners in other district banks had no specific reason to carefully review the MBS and supporting appraisals in question.

III

According to the FHLBB, insured member institutions own approximately $4.333 billion of nonfederally guaranteed MBS.[99] The amount of these securities and the need to treat them the same as real estate loans requiring examiner review of underwriting documents and appraisal practices, has prompted the FHLBB to pro-

[95] The Bank of America likely assumed liability because: it had failed to carry out the terms of the escrow agreement, such as releasing funds to NMEC before all documents were received; its trust department and branch employees were implicated; and the possibility that other breaches of its fiduciary duties as trustee would be found. See, Hearings, pp. 271 and 1770.

[96] Hearings, p. 469 and 1770. The FHLBB estimate assumes that the potential losses would have been equal to the total amounts of the pass-through securities purchased by the investing institutions.

[97] Ibid.

[98] As discussed below, the FHLBB has proposed a rule aimed at increasing its control over MBS.

[99] Hearings., p. 469.

pose a rule requiring: (1) closer monitoring of out-of-area lending and loan participations by member institutions; and, (2) better and more complete recordkeeping regarding underwriting documents, including appraisals.[100] Specifically, the FHLBB proposal would: (1) limit an insured institution's purchase of nationwide loans/participations, if the institution was or would be placed beyond its regulatory capital requirements or had a ratio of 4 percent or more of scheduled items/assets classified as "doubtful" or "loss"; (2) require insured institutions to purchase nationwide loans only from "approved lenders;" (3) require prior supervisory approval of an institution's purchases of loan participations; and (4) require that insured institutions keep more complete and better records, including an appraisal report,[101] both for all loan participations and for all loans made or purchased that are secured by real estate.

The FHLBB rule, if implemented, clearly will make it harder for persons to perpetrate future West Pac/NMEC type frauds, particularly if examiners carefully scrutinize both the institutions' compliance with the rule and the actual underlying appraisal reports and other documents. However, there are a number of important elements missing. For example, several categories of participations are exempt from these requirements, including Fannie Mae and Freddie Mac participations or participation interests that are in a pool of loans secured by first liens on homes at least 80 percent of which are owner-occupied.

In the case of the latter exemption, even if the rule containing it had been in effect, most of the thrift institutions participating in the West Pac/NMEC pools could still have purchased the MBS without any FHLBB oversight or review, as long as West Pac or NMEC had structured the loan documents to show that 80 percent of the loans were secured by owner-occupied homes. Clearly, this is a gap that the FHLBB should close, by requiring for instance, that the originator of loans/participations must be an "approved lender" retaining an unsubordinated interest in a home amounting to at least 10 percent of the outstanding loan balance if the loan is not owned by Freddie Mac or Fannie Mae.

Failure to require an actual inspection of this property is perhaps the most important element missing in the FHLBB proposal. As Cecil Akre, an attorney for one of the participating thrifts in this scheme, testified, "I was told of one investor, who after an inspection, decided he did not want the [NMEC/West Pac] deal." Akre further stated:

> I think a lending institution, making a loan, shouldn't take that appraisal as if it is gospel. Appraisals are, after all, an interpretation of some facts which he, the appraiser, sets forth. It is not an exact science, as has been said here before. I think a lending institution should have an officer look at the security that they are lending on. I have ridden around, worn out many a suit of pants looking at houses around this country. You can see the good ones and you can see the bad ones and you don't have to know a lot about the appraisal. You can just say hey, that one isn't worth it. Something might have happened from the time the appraisal was made——
>
> Mr. BARNARD. You think, though, that the initial lending institution has got to make that determination?
>
> Mr. AKRE. I think the initial lending institution should do that; yes, sir. And an officer should do that, someone responsible to the institution. An investor in the secondary market should also make an inspection.[102]

[100] Federal Register, Wednesday, May 14, 1986, p. 17634 et seq.

[101] The proposed rule states that an insured institution must maintain "one or more written appraisal reports, prepared at the request of the lender . . . and signed prior to the approval of such application by a person or persons duly appointed and qualified as appraisers by the board of directors of such lender . . . ." Ibid., p. 17642. The Bank Board's further explanation of this requirement states that: "Emphasis on the fact that appraisals are made for and upon the request of the insured institution gives notice that the lender is entitled to rely upon the appraisal and *that the appraiser will be liable to the lender* if loss occurs as a result of reliance on [a] grossly negligent or fraudulent appraisal." Ibid., p. 17638. (Emphasis added.)

The FHLBB's proposed rule states that the appraiser is liable to the lender for grossly negligent or fraudulent appraisals, but that the lender must be ultimately responsible for assuring that such appraisals are either rejected or otherwise not relied upon. In line with this view, we believe that the FHLBB—and the other bank regulatory agencies—should require lenders to verify property values and conditions. Agency rules could be amended to require that: (1) all lenders actually inspect out-of-territory properties securing either real estate loans or participations in MBS pools; (2) lenders order their own independent appraisals, separate from the appraisal done by the initial lender and packager; and/or (3) lenders order a reputable appraiser or real estate firm located in or near the same city as the subject property to inspect it and possibly provide a curbside appraisal. Of course, agency rules could give lenders discretion in selecting one or more of these three inspection alternatives, evidence of which would have to be maintained in the institutions' files.

d. *Mortgage backed securities activity by national banks and the OCC's supervisory responsibility:*

I

The subcommittee asked the OCC about the extent of national bank involvement with MBS, particularly where national banks were acting as trustees or escrow agents, as in the case of the Bank of America and Wells Fargo Bank's involvement with NMEC/West Pac. The OCC responded that, except for the Bank of America situation, it was unaware of any significant problems concerning properties collateralizing MBS handled by national banks. Beyond this, however, the OCC refused to name any large national banks involved in such activity, stating that:

> . . . there is no statutory requirement that banks notify the OCC of their entry in that market. While we are aware of several multinational banks engaged in the mortgage-backed securities business, we do not maintain aggregate statistics on this activity and cannot provide an exact number.[103]

[102] Hearings, p. 280.

[103] Ibid., p. 497.

II

The OCC was similarly uncooperative with regard to the subcommittee's specific questions concerning the Bank of America/Wells Fargo's involvement with the NMEC/West Pac securities.[104] Indeed, in only one instance did it provide complete information, and even this appeared to have been done begrudgingly. Specifically, in its initial response to the subcommittee (November 1985), the OCC indicated that its examiners had not visited the Bank of America's Los Angeles District Trust Office "for the purpose of reviewing escrow/documentation files for any NMEC related security." [105] Later, however in its formal hearing statement, it did finally admit that it:

> . . . was not aware of activities of Bank of America and Wells Fargo involving National Mortgage Equity Corporation until November 1984 when a complaint was filed against Bank of America by an institutional investor.[106]

III

There are two reasons why the OCC's examination procedures would not uncover this type of activity in the Bank of America, Wells Fargo Bank, and other large regional or multinational banks. First, the OCC's examination of large banks is very limited, both because of its insufficient and relatively inexperienced examination staff,[107] and its practice of relying heavily on member banks' own internal auditors. OCC staff advised us that its examination of the Bank of America would normally entail reviewing only 80 to 100 loans valued at $5 million or more each and that it would not be unusual for examiners not to visit any of its branches or district trust offices, absent an indication of a problem. Second, it was repeatedly emphasized that a bank is not required to notify the OCC that it is engaging in mortgage-backed securities business and that it is up to the examiner to gauge the scope of the review to uncover this activity.

IV

In response to the Bank of America and Wells Fargo situations, in June 1985 the OCC issued a supplement to its Handbook for National Trust Examiners, which added a number of questions to the agency's, "Internal Control Questionnaire for Corporate Trusts And Agencies." In accordance with this addition, it is expected that in situations where substantial MBS activity is uncovered, OCC examiners will review such activity to ensure that the bank's MBS

[104] The OCC simply ignored two sections of questions, one dealing with the Bank of America and the other with Wells Fargo, contained in the subcommittee's invitation to testify at the December hearings. OCC staff informally advised us that they would provide no information on these situations, and there were no references to the questions or the information requested in the formal hearing statement. While the OCC's behavior is highly unusual, we leave to others to speculate on its motivation and purpose.

[105] Hearings, p. 1012.

[106] Ibid., p. 499.

[107] Because of Federal salary ceilings, the OCC is unable to retain a large pool of experienced examiners and supervisory personnel. There have been attempts in Congress to exempt OCC examiners from these salary ceilings.

operations are conducted in a "safe and sound manner." [108] One of the added questions, it should be noted, requires the examiner to determine "whether the bank reviews the loan documentation and verifies the appraisal of the underlying properties." [109]

While the OCC is to be commended for recognizing the gap in its examination procedures regarding MBS, we believe that knowing when to implement these additional questions will be difficult, if not impossible, without a corresponding requirement that national banks inform the examiners about any MBS activity in which they are involved prior to the start of an examination. Without such required notification, for example, the questions posed in the examination manual would not have uncovered the Bank of America's and Wells Fargo's involvement in the West Pac/NMEC situation; nor, would they uncover a similar situation involving any large multinational bank. In short, unless the OCC addresses the problem of prior notification, its added requirements regarding MBS could have very little effect.

5. *Conclusion:*

The experiences of the financial institutions cited in the foregoing case studies should have alerted the bank regulatory agencies to the scope and national impact of MBS problems. It is clear that they did not and, thus, loan participations and MBS based on fraudulent appraisals have adversely affected many financial institutions around the country. Moreover, with the singular exception of the FHLBB, which is attempting to address the problem through its recent proposal, the FDIC, Federal Reserve, and OCC appear to be willing to let the banks they supervise continue to assume such risks without any requirements that they even obtain the appraisal and other underwriting documents, let alone conduct an inspection of the collateral property.

VI. Real Estate Appraising: A Troubled Profession

A. INTRODUCTION

In recent years, the real estate appraisal industry has been beset by serious problems and subjected to increasing criticism. The harmful effects of faulty and fraudulent appraisals—major losses, insolvencies, etc.—are described at length elsewhere in this report. However, what is less well-known or understood are the underlying causes of the problems that have helped to bring about the industry's present troubled state and well-earned notoriety.

B. CAUSES OF THE PROBLEMS

At least five factors have contributed significantly to the appraisal industry's present state:

1. *Lender ignorance/misunderstanding of appraisal role:*

Many lending institution executives, directors and loan officers are either essentially ignorant of or ill-informed about the proper role of the real estate appraisal in loan underwriting. The prevailing attitude among them is that the appraisal is simply an obstacle

[108] Hearings, p. 728.

[109] Ibid., p. 500.

to overcome or a rubberstamp needed to establish the maximum amount of a loan.[110] Worse still, many such officials maintain that it is not difficult to find an accommodating appraiser who can be counted on to come up with whatever results are desired.[111] Indeed, some of these same officials are among those who sarcastically refer to the prestigious "MAI" designation earned by members of one of the leading appraisal industry organizations as meaning "made-as-instructed." [112] Also, appraisals are often relegated to a comparatively minor status in the loan underwriting process, because among lenders there is far more interest in the up-front fees, interest income, and other tangible benefits accruing from a completed loan transaction than there is in assuring that the institution's risk exposure is minimized.

2. *Pressure on appraisers by lenders, borrowers, et al.:*

Borrowers, particularly developers seeking to minimize or eliminate their personal equity investment in a proposed commercial venture, will often pressure appraisers into rendering estimates substantially above the project's actual value. Similarly, lenders may tend to exert pressure on appraisers to overvalue property collateralizing a loan, since the amount of the up-front fees the institution receives depends on the size of the loan—the bigger the loan, the greater the attendant fee income.[113] In the case of both borrowers and lenders, the implicit, and sometimes explicit, threat underlying the pressure brought to bear is that if the appraiser fails to "come up with the numbers," he or she will not get additional business from them.

The effects of such pressure are far-reaching and enormously harmful. For example, one witness at the hearings testified that he finds one major consequence, "client advocacy," in the reports of as many as 75 percent of the real estate appraisers with whom his institution works.[114] In addition, studies made regarding residential appraisal reports reveal that in as many as 98 percent of the cases reviewed, the appraised value of the property was identical to the sales price. In commenting on the latter, one knowledgeable appraisal industry source raised the obvious follow-on question: "If sales price is market value, the lender doesn't need the appraiser;" [115] i.e., why go to the trouble and expense of having an appraisal done in the first place?

3. *Fragmentation/disarray within the industry:*

Of the estimated 150,000 to 250,000 individuals performing appraisals on a full- or part-time basis, only a maximum of one-third of them are affiliated with a legitimate trade organization possessing professional standards and certification criteria, codes of conduct, and disciplinary procedures.[116] The remaining two-thirds of the appraisers are not affiliated with any such organization and, therefore, are neither necessarily subject to any education or training requirements, guided by any professional standards and ethics, nor accountable for their performance and behavior.[117]

Adding to the degree of fragmentation within the industry are dozens of so-called "diploma mills" that offer legitimate sounding professional credentials for a fee. Unlike their reputable counterparts, these organizations typically have minimal or no professional standards, ethics, or disciplinary procedures and their certification criteria are so general that it is possible for virtually anyone wishing to call himself an appraiser to qualify.

Further compounding this confusion and disarray, until quite recently the relationship among the leading appraisal groups was characterized by intra- and inter-organizational rivalry, squabbling, and mistrust. While this state of noncooperation and mistrust has by no means disappeared, these groups within the last year or two have made significant progress in beginning to work together on the common issues and problems facing them.[118]

4. *Grossly inadequate enforcement of professional standards and codes of conduct:*

Inadequate efforts to monitor and enforce existing codes of conduct and standards of professional practice have played a major part in diminishing the appraisal industry's overall credibility and professional standing. For many years, leading appraisal groups have had procedures for disciplining their members for cause, including admonishment, censure, reprimand, suspension, and expulsion. These procedures, however, have been applied so sparingly that they have become almost meaningless as an effective enforcement tool. Indicative of this industry-wide failure to deal with poor performance and misconduct, out of some 1,600 complaints screened and submitted for further consideration within four of the leading appraisal groups (combined membership about 40,000) between 1983 and 1985, just 40 or so resulted in suspension or expulsion and another 125 ended up in milder penalties such as admonishment or censure. In effect, only about 10 percent of the complaints resulted in meaningful disciplinary action; which translates to a minuscule four-tenths of 1 percent in terms of the total membership!

5. *Lack of regulation:*

Real estate appraisers are completely unregulated at the Federal level and only minimally so at the State level. Just 12 States have any form of appraiser licensing or certification and, moreover, in all but a very few of these the effects of such regulations are limited because they are essentially an extension of principles and standards applicable to real estate salespersons and brokers.

[110] Hearings, pp. 1556 and 1560. See also Sunrise Savings and Loan case study discussion, p. 34 above.

[111] Hearings, pp. 60 and 78.

[112] Ibid., p. 58.

[113] Ibid., p. 133.

[114] Ibid., p. 67.

[115] Fayette F. Arnold, "You Can't Have Fraud Without an Appraisal," Appraisal Review Journal, Winter, 1985, p. 54.

[116] Hearings, p. 349.

[117] It should also be noted that appraisal problems are not the sole province of either group; i.e., faulty and fraudulent appraisal work is done both by appraisers holding designations from legitimate professional organizations, as well as those not affiliated with any such group.

[118] *Inter alia,* representatives of some of the leading appraisal groups have been working jointly with the FHLBB since 1984 on issues of mutual concern and, especially, on ways to promote appraisal quality in thrift lending activities. Similarly, appraisal group representatives have worked together with Fannie Mae, Freddie Mac, VA, and FHA officials on developing a uniform single family residential appraisal form. Also, as of February 1986, the eight largest appraisal groups met jointly and formed a so-called Ad Hoc Committee on Uniform Standards of Professional Appraisal Practice. This committee has met several times since to consider the establishment of uniform standards of appraisal practice and a possible system for appraisal industry self-regulation. These latter efforts have taken place in concert with the subcommittee's investigation and are being coordinated with Chairman Barnard.

Indeed, that most State regulations place appraisers within the real estate licensing framework is fraught with potential problems since: (1) real estate sales stress wholly different legal, contractual, and client-agent relationships than those involved in an appraisal assignment; and, (2) unlike the appraiser, a real estate agent or broker has a vested interest in seeing that a sale/loan transaction is consummated.[119]

C. APPRAISER INCOMPETENCE/MISCONDUCT—AN INDIVIDUAL CASE STUDY

Illustrative of both the degree to which appraisers fail to be disciplined/regulated and the effect incompetent, negligent, or dishonest appraisers can have on financial institutions, is the performance of one appraiser who Federal regulators say has "wrought havoc up and down the East Coast" for years. Grossly inflated and otherwise defective appraisals by this individual, who at the time of the subcommittee's investigation held senior designations from three of the leading appraisal industry organizations, have been found in work he did for at least two failed federally insured savings and loan associations. Federal authorities assert that one of these institutions was declared insolvent as a direct result of losses incurred in connection with a major real estate project that had been grossly misappraised by this individual.[120] The actual losses sustained by the FSLIC on this project have passed $11 million, exceeding even the $7 million projected at the time of the institution's demise.[121] As of August 1986, this appraiser was still a member in good standing of the three industry groups whose designations he holds,[122] even though the above-mentioned institution had failed nearly 4 years earlier and his role in that situation had resulted in his being named in a criminal referral to the Justice Department and a $10 million suit brought by the FSLIC.[123] The disturbing, but not surprising, result of the total lack of disciplinary action against this appraiser,[124] is that he is still very much in business doing work for federally insured banks and thrifts, Federal and local government agencies, and other State and local lending institutions and private businesses.

[119] Hearings, pp. 106 and 124.

[120] Letter in subcommittee files dated January 17, 1983, from Rosemary Stewart, Acting Director of the Enforcement Division, Office of General Counsel, FHLBB, to Elsie L. Munsell, U.S. Attorney for the Eastern District of Virginia.

[121] Memo contained in subcommittee files.

[122] While officials of these respective organizations are bound by their rules not to disclose any information regarding a pending disciplinary proceeding against a member, it is clear that this appraiser is presently under investigation in all of them. The added problem in this respect is that the due process safeguards built into these organizations' disciplinary procedures make the effort a protracted one that may result in a year or two passing before a final decision is reached and action taken.

[123] According to FHLBB officials, the criminal referral failed to result in an indictment, and the civil suit was settled in de minimus fashion, with a payment by the appraiser to the FSLIC of about $5,000.

[124] As indicated in the Hearings (p. 654), subcommittee staff learned that this same individual was also on the VA's approved list of appraisers. Having been informed of this fact, the VA initiated an inquiry that resulted in his being removed from its appraiser roster on February 11, 1986. In addition, this appraiser's example raises further questions of how he is able to continue to find work in federally insured financial institutions and why no action has been taken against him by the concerned regulatory authorities. See related discussion below, p. 48.

D. NATIONAL REGULATION NEEDED

Among the differing views and ideas presented in the hearings testimony and separate documentary submissions to the subcommittee on how to address the appraisal industry's problems, a broad consensus emerged that the time has come for some form of national action to regulate appraiser performance and appraisal quality. Within this consensus, which reflects the views of individual appraisers, appraisal organization leaders, mortgage insurance industry officials, and Federal regulators,[125] there was almost unanimous further agreement that what they had in mind was a system patterned after the one established by and for the accounting profession in cooperation with the U.S. Securities and Exchange Commission.[126] While the details of such a self-regulatory system have yet to be worked out, several points regarding its general outline are often mentioned, including that it be applicable to anyone performing real estate appraisals and contain uniform appraisal standards, appraiser qualification/certification requirements, appraiser performance and review criteria, and disciplinary/enforcement procedures.

VII. Appraisal Problems Are Everyone's Fault

A. INTRODUCTION

In addition to the appraisal industry's obvious responsibility for many of the problems described elsewhere in this report, the other private sector institutions that use appraisals and the public sector agencies that oversee or regulate such usage are equally culpable.[127] In other words, literally all the organizations that came under scrutiny in the course of our investigation—the Federal bank regulatory agencies and the institutions they supervise, VA, FHA, Fannie Mae, Freddie Mac, and the PMIs—bear some responsibility for the appraisal problems extant in the real estate finance and mortgage insurance and investment communities.

B. REASONS

These organizations are responsible for appraisal problems to the extent that they have:

Treated appraisals as a secondary and comparatively unimportant aspect of sound loan underwriting practice;

Not developed adequate appraisal/appraiser-related policies and procedures or ignored, overlooked, or simply did not comply with the ones they had; and,

Failed to anticipate recent appraisal problems and to respond effectively once they became apparent.

[125] See, for example, Hearings, pp. 21, 79, 109, 296, 307, 411, and 621.

[126] Under the general oversight of the Securities and Exchange Commission, the accounting profession's self-regulatory system is organized around the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA). Created in 1973, FASB is an independent body that is responsible for establishing and improving financial accounting and reporting standards. The AICPA, the major public accounting membership organization, is responsible for professional certification and disciplinary procedures and actions.

[127] See, for example, Hearings, p. 287.

The subcommittee's findings along these lines are summarized in the following table:

	Lenders[1]	FHLBB	OCC	Fed	FDIC	NCUA	VA	FHA	/Fannie Mae	Freddie Mac	PMIs
Appraisals secondary/comparatively unimportant	X	....	X	X	X	....	X	....	....	....	....
Inadequate policies/procedures or non-compliance with same	X	X	X	X	X	X	X	X	X	X	X
Appraisal problems not anticipated or dealt with effectively	X	X	X	X	X	X	X	X	X	X	X

[1] Lenders include banks, savings and loans, mortgage bankers and brokers.

1. *Appraisals are secondary/unimportant—the OCC/FDIC view:* While appraisal-related policies and procedures among the bank regulatory agencies—with some exceptions in the case of the FHLBB—are inconsistent and filled with gaps, such is particularly true of the OCC and FDIC. In contrast to the other regulators, however, that the OCC and FDIC neither require an appraisal for each real estate loan nor that their examiners verify appraisal accuracy/adequacy during regular examinations,[128] reflects their view that appraisals are secondary to and far less important than the borrower's apparent creditworthiness. This outlook was evident at the hearings, as demonstrated in the following testimony by John F. Downey, Chief National Bank Examiner, OCC and Robert Mialovich, Associate Director, Division of Bank Supervision, FDIC:

> Mr. BARNARD. That brings up this question: Do the OCC, FDIC, and Federal Reserve feel that bad appraisals are not that much of a problem and appraisals in general are not that important? I mean, is it your judgment that because the institution you supervise doesn't make a lot of real estate loans, therefore this matter is not as important to you as some other things?
>
> Mr. DOWNEY. I think appraisal of collateral is important to all of us. I will speak for the OCC, it's important as one more element of a good——
>
> Mr. BARNARD. But it's not what you consider a loan to be based upon?
>
> Mr. DOWNEY. A loan should be based on the borrower's ability to repay that loan——
>
> Mr. BARNARD. And so the appraisal is secondary?
>
> Mr. DOWNEY. Yes, sir.
>
> Mr. MIALOVICH. Absolutely. The most important thing is evaluating the ability to repay and according to specified terms. The value of the collateral becomes increasingly important as one has to consider perhaps taking possession of that collateral and liquidating it as a fallback. Collateral and its value is what you have in the background, should the real source of repayment fail on you. So, the important thing is evaluating the borrower and the ability to repay.[129]

[128] Hearings, pp. 964-965, 1007-1008.

In our view, this outlook is at best naive and at worst grossly irresponsible. No matter how carefully loans are screened some fail, and even borrowers with spotless credit records can unexpectedly fall victim to circumstances that result in their being unable to meet their payment obligations. Moreover, in the highly competitive lending environment of recent years, the fact is loans are commonly not screened carefully, resulting in their being approved for far too many unqualified and disreputable borrowers. Thus, poor quality and risky loans—many of which were made possible by inaccurate or otherwise defective appraisal documentation—have become commonplace and, correspondingly, have appeared in steadily increasing numbers among the scheduled items of the Nation's financial institutions, including those supervised by the OCC and FDIC. In effect, the only way the OCC/FDIC appraisal outlook could possibly make sense is if none of their member banks had experienced significant losses or been otherwise damaged either as a direct result of faulty or fraudulent appraisals or circumstances in which the latter had played a meaningful role. Indeed, as has been shown previously, the Bank of America loss and Continental Illinois Bank and EPIC failures, demonstrate that precisely the opposite is true.

2. *Inadequate policies and procedures—appraisal information/data are lacking:* The absence of adequate appraisal information and data was one of the more glaring deficiencies found in the operations and activities of almost every organization surveyed by the subcommittee. With some exceptions among the PMIs and FHLBB, no other Government or private sector agency or institution systematically and regularly collect appraisal information; nor, have any of them informally or formally studied the relationship between faulty and fraudulent appraisals and problems—e.g., losses—they've experienced.

To the extent that these various agencies and institutions have failed to collect appraisal information or study the effects of appraisal deficiencies and abuses, questions necessarily arise as to assertions made by some of them—namely, the OCC, FDIC, FHA, and Freddie Mac—that they have experienced few, if any, appraisal problems.[130] Such was our concern in this regard, that after the hearings, Chairman Barnard raised it again in follow-up correspondence with the FHA—the Federal agency with the most flagrant appraisal data deficiencies—and Freddie Mac, respectively:

> Additionally, we are troubled by some apparent inconsistencies between your public testimony and your prior written submission (November 25, 1985). In the former, you minimize the impact of faulty and fraudulent appraisals and, yet, in your prior submission (p. 7, item #7) you appear to have no basis for such a contention, since you state that no specific analysis of the relationship between

[129] Ibid., p. 458.
[130] Hearings, pp. 967-968, 1009, 1147-1148, and 1259.

appraisal problems and claims has been done and, moreover, that the data that would enable you to do so has only just begun to be collected. Also, while you conceded, in response to my question at the hearing, that it would be reasonable to assume that appraiser suspensions or removals would likely involve losses, you did not indicate that you had any idea how extensive this might be.[131]

2d (i) Concerning the response to question 5 (page 8 of your November 15, 1985 submission), why is the requested appraisal-related data on Freddie Mac REO properties unavailable; does such data exist, for example, as a partial result of the reviews conducted of properties acquired through foreclosure?

(ii) If such data is either not available or does not exist, how is Freddie Mac able to confirm or deny the existence of some relationship between appraisals and losses experienced in its mortgage purchase activities?[132]

Further illustrating the impact of incomplete or wholly absent data, the FHA is still unable, even after the completion of a lengthy investigation, to provide an estimate of any projected and/or actual losses resulting from the fraudulent scheme perpetrated against it in Camden, NJ.[133] Underscoring the significance of this point, investigations of activities strikingly similar to those involved in the Camden scheme are in progress in at least five other major metropolitan areas: Washington, DC, Nashville, Atlanta, Houston, and Seattle. In effect, unless FHA data collection policies and procedures improve significantly, there is little reason to expect that it will be any more able in the future than it is now to accurately estimate projected or actual losses arising in the context of such investigations.

Finally, it is important to note that when such information is available—either in the form of regularly collected data or special studies—it can graphically show both the nature/extent of appraisal problems and their harmful effects. For example, a leading PMI, the Mortgage Guaranty Insurance Company, recently conducted a study of 300 pairs of appraisals on defaulted loans it had insured. In their review of these loans' appraisals—the original one and the one performed as part of the claims process—40 percent were found to have dropped in value by more than 20 percent due to appraiser incompetence, negligence, or fraudulent conduct.[134]

3. *Failure to anticipate/address appraisal problems—inadequate coordination and communication:*

During the hearings, no single issue excited more discussion and attendant indignation than the example of the appraiser who for years had "wrought havoc" in various savings and loan associations, but was still working steadily because no effective action had been taken against him, either by his professional peers or the regulatory authorities responsible for supervising the financial institutions he'd harmed.[135] The testimony presented by appraisers, regulatory officials, and others indicates that several points help to explain how such situations can arise and persist.

[131] Ibid., p. 737.
[132] Ibid., p. 762.
[133] Ibid., p. 744.
[134] Ibid., p. 1392.
[135] See above, p. 44.

First, and perhaps foremost, there are always lenders who will seek out such appraisers, as is reflected in the following exchange with former FHLB Atlanta Chief District Appraiser, Richard Hewitt:

> Mr. BARNARD. Did it appear there was a pattern of this appraiser being employed by an institution in order to get an appraisal that would support a projected loan?
>
> Mr. HEWITT. Yes, sir. As a practical matter those institutions would seek out this individual to hire him, to use him to get the numbers where they needed them to be.
>
> Mr. BARNARD. And the banks or savings and loans were not suspicious or did not hesitate to accept his appraisal?
>
> Mr. HEWITT. No, sir. As I indicated, usually there is quite a correlation between poor underwriting practice and the appraisal, but the sad part is that someone with that kind of image, that kind of background, experience and et cetera, was providing the numbers that needed to be there.[136]

Second, reflecting the effects of apparent legal constraints, inadequate authority, and/or a lack of resolve, public and private sector agencies and institutions have failed to establish procedures to share information with one another regarding problem appraisers. While the VA and FHA communicate with each other on appraisers suspended or removed for cause, for example, no such ties exist between them and the Federal bank regulatory agencies. This, in part, helps to explain why the VA remained ignorant of this particular appraiser's long history of unprofessional performance in connection with federally insured savings and loan associations.[137]

Similarly instructive in this regard are two exchanges that occurred at separate intervals during the hearings. The first of these was between Chairman Barnard and Steven Doehler, executive vice president of the Mortgage Insurance Companies of America:

> Mr. DOEHLER. Mr. Chairman, the association did a survey of the counsels in the various companies and asked them what legal actions they have taken. The problem in many cases is that you don't have an effective remedy to take against an appraiser. Especially one that you can address at the stage that the problem is uncovered. In other words, the cost of going through the legal process in all but cases of blatant fraud or misrepresentation is not an economic course of action. Putting an appraiser on a watch list is more practical.
>
> Mr. BARNARD. So, you all are just rolling the dice as far as appraisals are concerned.
>
> Mr. DOEHLER. And the unfortunate thing, Mr. Chairman, is that what happens is that appraiser, who may not be acceptable to mortgage insurer A, will then be sending his business or through the lender they will be sending

[136] Hearings, pp. 78–79.
[137] See p. 44, above for related discussion and action taken by the VA.

their business to other mortgage insurers in the industry.[138]

The second was with FHLBB Associate General Counsel, William K. Black:

> Mr. BARNARD. I think someone said just awhile ago that it would be a cause of legal action against you if you blacklisted this individual within your own agency or in another one.
>
> Mr. BLACK. Well, I think we would draw a suit, frankly, if we tried to do something like that. I know one of our district heads raised yesterday the problem of civil suit in this regard. One of my trial attorneys has a $1 billion suit pending against her in an individual capacity simply because she helped put an association run by some crooks into receivership. That has been pending for quite some time. It is difficult to buy your house when you have that.
>
> So, yes, there are significant problems to try to do something that would be portrayed as a blacklisting.[139]

Finally, among virtually all of those who perform, use, or oversee appraisals, it is accepted as a matter of fact that ". . . the appraisal industry, as it is presently structured, is ill-prepared to control abusive appraisal practices" on the part of its members.[140] This, in turn, helps to explain why Federal regulatory authorities and others have referred so few complaints concerning problem appraisers to the professional organizations whose certification they hold. Indeed, the disciplinary procedures among the reputable industry organizations are so encumbered by "due process" requirements that even in the comparatively few cases that do end in meaningful action, years may pass before the results are achieved and publicized adequately. Moreover, on top of this lengthy interval between complaint and remedy, virtually nothing stands in the way to prevent an appraiser, who has been severely disciplined, from continuing to seek out and/or be hired by accommodating clients willing to overlook his past record.

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[138] Hearings, p. 296. The PMIs also maintain that they are unable to share information on problem appraisers among one another for fear of violating Federal antitrust statutes. However, according to the testimony presented (p. 295), the industry's association has not asked the Department of Justice for an opinion on this matter.

[139] Hearings, p. 454.

[140] Ibid., p. 106.

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