JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

E. Realtor Associations

1. "Impact of Appraisal Reform on Availability and Affordability of Housing and Housing Credit", prepared for the Third Annual Real Estate Finance Roundtable, sponsored by the National Association of Realtors, Chicago, IL, October 12, 1987. Includes his talk plus correspondence

Index

REALTOR®

NATIONAL ASSOCIATION OF REALTORS®

William M. Moore, President
Nestor R. Weigand, Jr., President-elect
Ira Gribin, First Vice President

Real Estate Finance Division
777 14th Street, N.W., Washington, D.C. 20005
Telephone 202 383 1102

October 6, 1987

Mr. James A. Graaskamp
Chairman, Real Estate & Urban
Land Economics
University of Wisconsin - Madison
1155 Observatory Dr.
Madison, WI 53706

Dear Mr. Graaskamp:

I am delighted that you are joining us for the Third Annual Real Estate Finance Roundtable, sponsored by the NATIONAL ASSOCIATION OF REALTORS®. I am excited about the program we have planned this year, and I am confident that the sessions will be productive.

I have enclosed a copy of the meeting materials, including the agenda, logistical details and copies of the presentors' papers.

As a reminder, a room has been reserved for you at the Ritz-Carlton, and room and tax have been placed on the ASSOCIATION'S master account.

If you require additional information about the Roundtable, please feel free to contact Sonja R. Taylor of the ASSOCIATION'S staff. She can be reached at (202) 383-1206.

I look forward to meeting you at the opening reception on Sunday evening (6:00 p.m.)!

Sincerely yours,

William M. Moore

WILLIAM M. MOORE
President

Attachments

NATIONAL ASSOCIATION OF REALTORS®
THIRD ANNUAL REAL ESTATE FINANCE ROUNDTABLE
OCTOBER 11-12, 1987
THE RITZ-CARLTON
CHICAGO, ILLINOIS

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NATIONAL ASSOCIATION OF REALTORS®
THIRD ANNUAL REAL ESTATE FINANCE ROUNDTABLE
OCTOBER 11-12, 1987

AGENDA

SUNDAY, OCTOBER 11, 1987

6:00 p.m. - 7:00 p.m. Vendome Room	Reception
7:00 p.m. - 8:15 p.m. Vendome Room	Welcoming Remarks: William Moore, President Dinner Keynote Speaker: "Housing Needs through the Year 2000" Anthony Downs, Senior Fellow, The Brookings Institution
8:15 p.m. - 9:00 p.m.	Question and Answer Session Moderator: William Moore, President

MONDAY, OCTOBER 12, 1987

7:00 a.m. - 8:00 a.m. Salon Room	Welcoming Remarks: Nestor Weigand, Jr. President-Elect Breakfast
8:15 a.m. - 9:00 a.m. Salon Room	"Growing Problems with Affordability" Presentor: Kermit Baker Moderator: Ira Gribin
9:15 a.m. - 9:45 a.m. Vendome and Salon Rooms	Break-out Sessions
10:00 a.m. - 10:30 a.m. Salon Room	General Session
10:30 a.m. - 11:15 a.m. Salon Room	"Innovative Mortgage Security Topics" Presentor: John Biasucci Moderator: Stan Sabin
11:30 a.m. - 12:00 p.m. Vendome and Salon Rooms	Break-out Sessions
12:10 p.m. - 12:40 p.m. Salon Room	General Session
12:45 p.m. - 2:00 p.m. Glass Room	Lunch
2:15 p.m. - 3:00 p.m. Salon Room	"Increasing Problems Associated with the Appraisal Industry" Presentor: Professor James Graaskamp Moderator: Norman Flynn
3:15 p.m. - 3:45 p.m. Vendome and Salon Rooms	Break-out Sessions
4:00 p.m. - 4:30 p.m. Salon Room	Final General Session

Adjournment

JAMES A GRAASKAMP

CHAIRMAN, DEPARTMENT OF REAL ESTATE

AND URBAN LAND ECONOMICS

MADISON, WISCONSIN

Professor James A. Graaskamp, Ph.D., SREA, and CRE has a double career as educator and real estate consultant. He is presently chairman of the Department of Real Estate & Urban Land Economics at the University of Wisconsin-Madison and president of Landmark Research, Inc., established in 1968, a consulting firm specializing in courtroom appraisals, feasibility, and institutional investment. He has a background in home building and land development, and is well known for his work in feasibility analysis.

He is a former member of the Board of Directors of the Wisconsin Housing Finance Authority, a ULI Trustee and Research Fellow, and a member of the Salomon Brothers Real Estate Research Advisory Committee.

IMPACT OF APPRAISAL REFORM ON AVAILABILITY AND AFFORDABILITY OF HOUSING AND HOUSING CREDIT

prepared by

Professor James A. Graaskamp

University of Wisconsin School of Business

For

Third Annual Real Estate Finance Roundtable

sponsored by

National Association of Realtors

Ritz Carlton Hotel

Monday, October 12, 1987

Chicago, Illinois

NAR Roundtable

I. The Hope of Appraisal Reform

A. Affordability, availability, suitability all adversely affected by honest appraisal.

B. Federal pressure--Barnard Report

C. Competetive pressure--the accountants and economists

D. Public pressure on savings institutions to represent the saver

E. Legal pressure on those who sell securities

F. Internal professional concern for integrity

II. Impacts On Residential Finance

A. Short term--single family

B. Long term--single family

C. Short term--multi-family rental

D. Long term--multi-family rental

E. Short term--multi-unit condos

F. Long term--multi-unit condos

CHANGING APPRAISAL STANDARDS AND AFFORDABILITY OF HOUSING

I. Introduction

Long overdue reforms of the appraisal process will begin to impact residential real estate finance during the next three (3) years with some adverse impact on the availability, suitability, and affordability of housing and housing credit. The housing consumer, particularly the renter, has been subsidized by the subversion of appraisers to those who prosper from overproduction. Oversupply has held rents down at the cost of billions to investors, mortgage lenders, the U.S. Treasury, and ultimately the guarantor of our financial institutions. These losses probably exceed the direct subsidies to specific housing units from Section 8, 236, and shallow subsidy programs like 221(d)4/tandem plans.

A. The Barnard Report

The significant role of faulty appraisal in undermining our housing credit institutions has now been recognized, measured, and targeted as a major area of reform. The Barnard Report (1) not only underscored the need for appraisal reform in all of our housing credit institutions, but in addition is the basis for newly proposed federal legislation (2) which will require the appraiser to work directly for the lender and not as an advocate for the borrower. New projects will require intensive market analysis and feasibility,

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(1) "Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investment in the Secondary Market" 48th Report by the Committee on Government Operations, Commerce, Consumer and Monetary Affairs Subcommittee, Congressman Douglas Barnard, Jr., Democrat-Georgia, Chair; Printed U.S. Government Printing Office, Washington, 1986.

(2) New legislation will be introduced in the House of Representatives in October, 1987, by Congressman Doug Bernard, Jr., implementing recommendations on Page 13 of the previously sited report.

integrated into the appraisal together with a series of value added measurements over time to protect the lender against unrealistic assumptions about project pace, price appreciation, or operating performance. Moreover, the loan officers will be required to sign-off on the appraisal and to utilize only nationally certified appraisers approved by the credit institutions board of directors.

B. HHLB R41A, B, C, D, . . .

Even before the Barnard Report, the Federal Home Loan Bank Board had been attempting to bring the appraisal process under control through an evolution which currently finds R41C in place with clarifications in process leading to R41D. The details are included in Appendix A, not only to underline the heavy emphasis placed on primary and secondary market data but to suggest the minimum standards recommended for all Federally Guaranteed Institutions in the proposed federal legislation. It should be noted that much of the regulation imposes heavy responsibility on lending institutes to produce objective, state-of-the-art appraisal. Lenders who once endorsed minimal appraisals in an implicit conspiracy with the production sector, now find a Gresham's law has driven the reliable market analyst out of the business so that the availability of appraisers with objectivity, integrity, and technique has become an expensive bottleneck in the apartment development loan process.

C. Appraisal Standards Board

The revelations of the Barnard Committee and ferment within the credit industry including banks, private guarantors, and securities outlets have finally pushed the appraisal industry to establish both an appraisal standards board and a national set of certification standards for appraisers to be administered primarily by the States. The system will be modeled after the Financial Accounting Standards Board (FASB), and the Certified Public Accountant Designation (CPA) Program. (3) The big debate currently is the role which the federal government will play in financing and selecting of trustees and staff to implement the program. This role will be defined in the legislation to be introduced by Congressman Barnard. In any event, those dealing with federally insured institutions will need to use certified qualified appraisers appropriate to the project type to be financed.

D. Shifting Underwriting Concern for Appraisal

Financing for the housing industry through the traditional sources has been drastically altered by the rise of the secondary market, particularly the financing of single family mortgage loans. The loans are generally credit enhanced through public and private mortgage insurance, the credit of the issuer, or over-collateralization. The value of the underlying real estate asset is not the real collateral so that the appraisal is of primary significance to regulatory requirements or interest rate premiums built on loan-to-real estate value ratios. Automation of the underwriting and servicing process may ultimately lead to automation of the appraisal process with the former appraiser becoming a due diligence, property inspector. For existing single family homes form appraisals and property inspection sheets may merge and lower the emphasis on value relative to condition and neighborhood context.

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(3) A committee of eight major appraisal organizations has announced formation of a foundation whose trustees will be responsible for establishing a standards board and a certification board.

The upheaval in the appraisal industry will impact various housing credit matters quite differently, both in the short run and in the long run. This essay will try to demonstrate that appraisals will become much more expensive and relevant due to tight public and private procurement standards and a shortage of trained people. At the same time appraisals may depress the condominium market because of the new requirement that fair market value reflect cash equivalency. Cash equivalency means all financing or special concessions by the seller must be discounted from nominal sales price. In the single family market availability and affordability may be slightly enhanced as the function of the appraisal changes from confirmation of purchase price to control of structural and locational quality, causing price erosion of properties not scoring well on some sort of risk matrix underwriting system.

II. Short Term Appraisal Reform Impact on Housing Availability and Affordability

Historically, the consumer of multi-renting housing has always benefited from chronic oversupply (4) and a tendency for developers to provide quality features to create some monopoly advantage without testing the relative desirability of these features with the consumer. If appraisal and tax reforms are successful, the production of new rental units will shift from a fee and finance justification for the producer to a market demand justification, reflecting preferences of the ultimate consumer. Demand driven production will eliminate oversupply and encourage a better fit of product to market segment.

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(4) During the 1970's, the rent index averaged 60 percent of the housing index and the general CPI index thanks to lax financing and general tax shelter ploys.

A. End of Appraisal Conflicts of Interest

Traditionally there has been an implicit conspiracy between the broker, buyer, lender, and appraiser which expects the appraiser to confirm the purchase price or desired loan-to-value ratio. This conspiracy tends to support higher, less efficient market prices and reduce the incentive of the buyer to negotiate hard. The appraiser was hired by the broker/buyer so that he had little incentive to kill the deal by reporting his observations to the lender. Even though the form appraisals to be used under R41C or secondary market agencies are the same as before, the appraiser would be hired by the lender to report to the lender, and the lender himself must seriously review the form report and sign on it as personally involved in the process. This certainly will reduce the overstatement of value and excess lending encouraged by the confusion of roles for the appraiser. Of great significance is the new emphasis by lender and appraiser on reporting cash equivalency value (5) and then adjusting from this common denominator for creative financing, payment of points by the seller, or other terms of sale. Cash equivalency generally means reduced prices and, therefore, a ceiling on first mortgage loans requiring bigger down payments or price concessions to fit the price of the home to the means of the buyer.

B. Organized Market Data Coops

Another major reform is the requirement that lenders pool their data on properties and appraisers. The lender is expected to share sale and rental data with the appraiser to improve the efficiency of

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(5) See R41C in Appendix A for definition of Market Value.

market analysis. Federally insured lenders are expected to pool data on appraisers, as well, so that sanctions can be applied to those who continue to represent the buyer at the expense of the lender.

C. Short Term Impacts

A short term result of cash equivalency and pooled market data on single family and condominium homes will be a write-down of values during the reappraisal process of existing portfolios for loans acquired during high interest periods when the ambiguities of creative financing and hard sell were rampant. Resale prices will also be reduced from nominal purchase price, preventing the purchaser from selling to move up with accumulated equity, discouraging first time buyers from a second purchase adventure, or making the next home less affordable.

The availability and affordability of multi-family rentals should be adversely affected in the short run by the requirements of honest appraisals built on legitimate market studies thus blocking redundant construction. The oversupply should gradually be reduced so that rent structures will more adequately reflect the capital cost of the apartment project. Affordability will be reduced because renters have enjoyed huge indirect subsidies from losses to lenders and equity investors both in actual dollars and in terms of opportunity costs of excess investment. Availability will also be reduced as projects are postponed until justified by effective demand and limited choices of low vacancy.

III. Long Term Appraisal Reform Impact on Availability, Affordability, and Suitability

A. Single Family Impacts

Appraisal reform will have little long term impact on single family detached housing other than to remove the cost to the system of concealing creative financing and marketing ploys in the appraisal ofthe property. Cash equivalency is simply a refinement of Truth-In-Lending. Moreover, the appraisal itself is of less significance when the loans will move into the secondary market and receive the benefit of various forms of credit enhancement and over-collateralalization. Due diligence will emphasize property inspection while underwriting will place more emphasis on community economic base, SIC code factors, and the SIC code of the borrower in addition to his character and capacity. Perhaps sellers of single family homes will be educated to recognize that property values in many areas have declined and that reality cannot be concealed with prices which include creative financing and other incentives from the seller. To the degree that reporting real appraisal value educates sellers to expect less, there should be greater availability and affordability for single family homes.

B. Condominium Impacts

The condominium unit in most markets is in oversupply and at depressed values for most price ranges, with some notable exceptions. Condominium appraisers ignored cash equivalency but that is no longer possible. However the inventory overhang may not be as significant as the disenchantment of many housing consumers with the problems of mutual management, the interdependency of resale values and the social cohesiveness of the project, and the spread between first owner price during the high intensity marketing phase and the resale price when the sales effort is left to a single broker with only one listing in the project. Under the new rules the appraiser is obliged to assemble a 3-5 year sales history of the unit to be valued and the project of which it is a part, not to mention a search for comparable unit resales in other projects. The focus on resale prices and cash flow equivalency will depress values, financing, and, therefore, effective demand. Availability and affordability are less of a question than desirability and the appraiser will be required to do primary research on the little distinctions among each comparable project.

C. Large Multi-family Rental Impacts

Large scale multi-family rental properties will experience a major adverse impact, particularly for new construction, as a result of changing underwriting standards and appraisal reform. A recent manual, Underwriting Income Property Mortgages, prepared for the National Association of Review Appraisers and Mortgage Underwriters, concludes that lenders shift emphasis from appraisal value toward careful, realistic, projections, of future income available for debt service. (6) At the very least no financing commitments can be made

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(6) See conclusions in Underwriting Income Property Mortgages; John M. Clapp and Stephen M. Miller, published by National Association of Review Appraisers and Mortgage Underwriters, 1986, Scottsdale, Arizona.

until the developer expends a large sum for market analysis, feasibility analysis, and a detailed project program in terms of scheduling, absorption, and operating costs. (7) These costs were once funded after the fact on the first draw but now must be incurred before any commitment can be made. Moreover, there are few appraisal firms with credibility so that an acceptable market study may be delayed as the developer waits in queue for the required appraiser. The cost may be five times what the developer was accustomed to pay and may require 3-4 months to complete due to the need for survey research and other detail. Lenders require fire insurance costing one percent (1%) of the project value each year to be paid at the closing in case the project should burn down. Good risk management should pay at least one percent (1%) of the project to see if it will rent up because that is the real collateral. Over time projects properly designed in response to existing market demand may result in greater availability of mortgage funds and reduce construction loan premiums because of a better match of supply to immediate demand and reduced indirect cost of vacancy.

D. Impact of Better Market Information

Cumulative data in the community about the demand for rental units, the filtering of tenants among alternative projects, and the effective rent levels after the adjustment for concessions, may lead to intelligent subsidy of projects to selected segments of the renter market. To that degree honesty and marketing information may improve

(7) See sections 13 to 17 in R41C, Appendix A. This standard should apply to all fiduciaries and not just S & L's

availability and affordability but otherwise those elements have been artificially favorable in recent years due to inadvertent subsidies by those who invest in apartments.

One long-term benefit of appraisal reform is the important housing attribute of suitability, rather than availability and affordability. More primary research among renter households should improve the fit of new housing to market gaps that need to be filled. Justification of a project will require careful segmentation of renter groups to refine marketing targets and better match the inventory features as well as services provided to the consumer.

For existing projects there will be a trend toward financing in the secondary markets where appraised value is of less importance after the original loan to value ratio has been set and net income ratios to debt service and credit enhancements are all-important. In this area there is a possibility that capital pools of foreign money structured through multiple formats may produce a lower financing constant and, therefore, lower and more affordable apartments. The role of appraisal reform for the Wall Street fiduciary is less clear and mortgage collateral bonds may be the less efficient sector of the capital market to which developers will gravitate if they can avoid the hard questions of R41C and related federal standards. Honest appraisal, like honest financial rating systems may still serve to be a bottleneck for multi-family rental capital.

IV. Conclusions

Availability and affordability of housing has long enjoyed the subsidy of a conspiracy among brokers/buyers/lenders/and appraisers to shift the risk of poor market planning to the FHA, the secondary market, or ultimately the federal guarantors of saving institutions solvency.

The private investor in the pursuit of tax shelters also encouraged over production and subsidized the tenant with poor investment judgment.

If appraisal reform is not frustrated by the unwise lobbying of National Association of Realtors and groups that purport to represent the housing credit industry, then ultimately the housing supply will become more sensitive to the needs of all market segments and better matched in terms of supply and demand to permit fair pricing relative to the equitable interest of owner and tenant. Availability and affordability are ambiguous terms when they depend on gross over-supply and hidden destruction of capital pools. When those terms are carefully defined to represent normal vacancies to permit choice and choice is commensurate with product and service quality, then it is possible to recognize appraisal reform as good housing credit policy. To oppose tough appraisal reforms and the ability to apply sanctions against noncertified appraisers is to endorse a false sense of availability and affordability of housing subsidized by those who finance bankruptcy of the lender and project, and sell investments based on misleading tax shelters.

Appendix A

FEDERAL HOME LOAN BANK BOARD
OFFICE OF EXAMINATIONS AND SUPERVISION
MEMORANDUM R-41c

TO: Professional Staff— Examinations and Supervision

September 11, 1986

FROM: Francis M. Passarelli

Appraisal Policies and Practices of Insured Institutions and Service Corporations

SYNOPSIS: THIS MEMORANDUM REVISES AND REPLACES R-41b. IT DOES NOT REPRESENT ANY SHIFT IN BOARD POLICY BUT IT DOES ENCOMPASS SIGNIFICANTLY GREATER DETAIL, SPECIFICALLY WITH REGARD TO "APPRAISAL MANAGEMENT," ADDING GUIDELINES WHICH ARE APPROPRIATE TO ENSURE ACCEPTABLE APPRAISAL PROCEDURES IN THE CURRENT MARKET. THE GUIDELINES LISTED ARE GENERALLY STANDARDS OF PRACTICE UTILIZED BY THE LEADING NATIONAL PROFESSIONAL APPRAISAL ORGANIZATIONS. THE MEMORANDUM ALSO CONTAINS THE NEW DEFINITION OF MARKET VALUE, AS RECENTLY ADOPTED BY BOTH THE FEDERAL HOME LOAN MORTGAGE CORPORATION (FREDDIE MAC) AND THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (FANNIE MAE). R-41b IS HEREBY RENDERED OBSOLETE AND IS RESCINDED.

Introduction

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 appraisals utilized to support such transactions. This memorandum sets forth the standards and reporting requirements utilized by the Federal Home Loan Bank Board in determining compliance with the appraisal requirements of Insurance Regulation 563.17-1(c)(1)(iii).

Management Policies

Loan and investment policies established by an institution's board of directors should reflect both the overall operational policies of the institution as well as the regulatory limitations under which it must conduct its business. Such policies should be clearly defined and set forth in a manner that provides effective supervision of the institution's operations by the directors.

Prudent loan policy should identify the types of credit arrangements the institution offers as well as the procedures to be followed in the underwriting of each of these arrangements. In secured credit transactions, such policies should definitely address the need to establish the value of collateral offered by borrowers in order to ensure that the institution is appropriately protected throughout the life of the credit arrangement. To a great extent, the complexity and diversity of the credit arrangements offered will determine the types of appraisal services the institution's underwriting staff will require. It is the board of directors' and senior officers' responsibility to ensure that the appraisal services provided, whether by fee or staff appraisers, properly reflect the collateral lending posture of the institution, as well as its lending policies.

Similarly, the board of directors is responsible for establishing appropriate guidelines and procedures relative to other investments of an institution. Appraisal services utilized by the institution in evaluating such transactions should reflect the institution's regulatory obligation to operate in a safe and sound manner. Failure to ensure that appraisal services match the needs of the institution will be considered an abdication of this responsibility and is representative of an unsafe and unsound operating policy.

In formulating its loan and investment policies, the board of directors should recognize that appropriate appraisal services are most often produced by fee or staff appraisers, who are both competent and knowledgeable and have properly equipped facilities within which to prepare adequate appraisals. Each association or service corporation should be able to demonstrate that the appraisers approved by the board of directors possess the requisite experience, education and facilities to perform in an acceptable fashion.

Appraisal skills and technology are not static and attendance at courses and participation in the activities of professional appraisal organizations are factors to be considered by the board of directors in selecting both fee and staff appraisers. Memberships in professional appraisal organizations as well as continuous professional development should be encouraged to ensure that the appraisers whose services are being utilized are actively increasing their knowledge and skills over time. Management should periodically review the performance of all approved appraisers for compliance with the standards and reporting requirements of the Federal Home Loan Bank Board and take whatever steps are necessary to eliminate poor quality or inappropriate work products.

Appraisal Management

Appraisals serve as an important basis in the decision process involved in the underwriting of secured credit transactions as well as investment decisions involving interests in real property. Management must ensure that appraisals utilized in these decisions:

1. Are prepared in accordance with the standards and reporting requirements of the Federal Home Loan Bank Board and conform with the institution's written appraisal guidelines. Management should provide appraisers approved by the institution with a copy of both the board's requirements, as promulgated herein, and the institution's written guidelines. Management should also assist appraisers in obtaining the information needed to comply with these requirements. Such information includes leases, purchase agreements, profit and loss statements from the security property, etc.
2. Are sufficiently current to reduce the likelihood of material changes in actual market conditions from those upon which the loan or investment decision were predicated. (Though not exclusively definitive, "sufficiently current" may be deemed to be an appraisal made six months prior to the approval of the loan or investment.)
3. Reflect the market value of the rights in realty offered as security or involved with the transaction. All other values or interests appraised must be clearly labeled and segregated, i.e., value of chattels, value of financing terms, business value, furniture, furnishings and equipment value, etc.
4. Contain sufficient information to assist management and/or the board of directors in establishing the loan amount as well as other significant terms involved in the credit arrangement.
5. Support the classification of the asset as a real estate loan or other type of credit arrangement.
6. Are prepared by appraisers, independent from the borrower or the seller of the real estate, and approved by the institution's

(Continued on page 4)

(From page 3)

board of directors. It is suggested the board review the prior work and references of newly engaged appraisers. Final board of directors' approval should be recorded in the board's minutes.

7. Contain adequate information relative to both current and projected market conditions and their resulting impact upon the estimated value of the property to enable an institution to determine whether its financial position will be properly protected over the life of the credit arrangement or term of investment. The scope of such information will depend upon the property type, the structure of the credit or investment arrangement and the financial realities of the contemplated transaction.

8. Are presented in a narrative style format, unless *both* of the following conditions are met:
   a. A form report is utilized which is appropriate for the specific appraisal assignment, i.e., the form is designed for both the property type and the interests being appraised.
   b. A form report is utilized, including all attachments, that results in a totally self-contained appraisal, as defined elsewhere in this memorandum.

9. Are based upon the following definition of market value:
   The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
   a. buyer and seller are typically motivated;
   b. both parties are well informed or well advised, and each acting in what he considers his own best interest;
   c. a reasonable time is allowed for exposure in the open market;
   d. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
   e. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

10. Correctly employ all recognized appraisal methods and techniques that are necessary to produce a credible analysis, opinion, or conclusion. Exclusion or omission of any recognized method for cause must be fully justified.

11. Consider, analyze and disclose in reasonable detail:
    a. Any current agreement of sale, option, or listing of the property being appraised.
    b. Any prior sales of the property being appraised that occurred within the following time periods:
       (1) one year preceding the date when the appraisal was prepared for one to four family residential property, and
       (2) three years preceding the date when the appraisal was prepared for all other property types.
    c. A sales history of comparables, if the subject property is located in a speculative market, which has experienced dramatic price fluctuations relative to regional norms, covering the speculative time period involving the comparable sales.

12. Contain the following information where an analysis, opinion or conclusion of a proposed project, improvement or change in use is involved: (i) plans, specifications, or other documentation in sufficient detail to identify the scope and character of the proposed improvements; (ii) evidence indicating the probable time of completion of the proposed improvements; (iii) clear and appropriate evidence supporting development costs, anticipated rent levels or per unit sales levels, occupancy projections, and the anticipated competition at the time of completion; and (iv) all value changes projected to occur from the conception of a project to its completion and/or stabilized occupancy should be set forth in sufficient detail so that the continuum of present value estimates over the life of the credit arrangement or investment can be reconciled with the values reported in the appraisal. Included as documentation should be an explanation of how discount and capitalization rates used in generating the present value estimates were deduced.
    In addition to the above requirements, whenever value is estimated as of completion and/or stabilized occupancy, the appraisal must contain the following information:
    a. The date or dates when the value estimate or estimates apply.
    b. Factual data supporting the reasonableness of all conditions and assumptions impacting each value conclusion cited in the appraisal. Such information must be presented in sufficient detail and directly linked to current market information so that the appraiser's logic, reasoning, judgment and analysis indicate to a third-party reader the reasonableness of the value or values reported.
    c. An explanation of the appraisal techniques selected and the data used to arrive at the final value estimate(s).
    d. A fully documented and supported highest and best use analysis and conclusion which coincides with the date(s) of the value estimate(s).
    e. A definitive statement as to whether the value estimate reflects the worth of the property at stabilized occupancy and whether the appraiser considered and included the effect of income and expenses during the projected absorption period in developing a value estimate as of the date of completion.

13. Accurately reflect the impact upon value of any changes in plans and specifications from those utilized in an appraiser's analysis of a proposed project, improvement or change in use.
    In all instances where an institution utilizes an appraisal based upon preliminary plans and specifications in a loan or investment decision, it shall take appropriate steps, prior to the disbursement of any funds, to ensure the validity of the appraisal, relative to the decision, has not been negated. Further, whenever significant changes in plans and specifications occur after a loan or investment decision has been made, the institution's management shall take appropriate steps to ensure its financial position is appropriately protected. Typically, such steps will involve either having the original appraiser recertify his value estimate after examining the final plans and specifications for the project or a new appraisal will be obtained based on the final plans and specifications.
    For the purposes of this paragraph, significant changes in plans and specifications are defined as those which directly affect the value of the property, e.g., changes in the scope, character or timing of the proposed improvements.

14. Contain a properly documented and supported estimate of the highest and best use of the property appraised, which is consistent with the definition of market value cited in this memorandum. Such estimate must consider the effect on use and value of the following factors: existing land use regulations, reasonably probable modifications of such land use regulations, economic demand, the physical adaptability of the property, neighborhood trends, and the optimal usage of the property. In addition, the appraisal must consider the effect on the property being appraised of anticipated improvements as of the appraisal date.

    In all appraisals, incuding those involving proposed construction, development or changes in use, the appraiser must specifically address and consider in his analysis the anticipated economic feasibility, as well as cite all significant market data utilized in developing his/her conclusions. Such analyses must be presented in sufficient detail to support the appraiser's forecast of the probable success and the conclusion of highest and best use of the project.

    In all instances where the appraiser relies on feasibility/marketability studies prepared by a third party to support his estimate of highest and best use, he must:

a. Attest that such study has been thoroughly examined and that he fully concurs with its findings and conclusions, and;
b. Specifically identify both the study examined as well as set forth within the body of the appraisal, a summary of the significant data, analyses and conclusions presented in the study. Such summary must be presented in sufficient detail, so that further reference to the study is unnecessary by a third-party reader of the appraisal, and;
c. Have available for future examination by users of the appraisal, a complete copy of the feasibility/marketability study prepared by the third party.

15. Report the market value to a single purchaser as of the date of completion for all properties, wherein a portion of the overall real property rights or physical asset would typically be sold to its ultimate users over some future time period. Valuations involving such properties must fully reflect all appropriate deductions and discounts as well as the anticipated cash flows to be derived from the disposition of the asset over time. Appropriate deductions and discounts are considered to be those which reflect all expenses associated with the disposition of the realty, as of the date of completion, as well as the cost of capital and entrepreneurial profit.

16. For properties under construction, conversion or proposed, report the market value of the subject property as of the date of completion, excepting those properties described in paragraph 15 immediately above, where anticipated market conditions indicate stabilized occupancy is not likely as of the date of completion. Such valuations shall fully reflect the impact upon the "as if completed value" of all pertinent operating expenses as well as the anticipated pattern of income during the absorption period. In addition, the value estimate must reflect the impact of rental and other concessions, including the costs associated with preparing the improvement for occupancy by tenants.

17. Contain a summary of actual income and expenses experienced by the subject property where it is an existing income or revenue producing property. In addition, all such appraisals must contain a complete reconciliation of all deviations projected by the appraiser in his forecast of future financial performance from those historically realized by the property.

18. Report the "as is" value of the subject property as of the date when either the appraisal was prepared or when the property was last inspected. The date of the "as is" value estimate should be sufficiently current to reduce the likelihood of material changes in the actual market conditions from those upon which the loan or investment decision were predicated. In addition to any other value estimates contained in an appraisal, the "as is" value must be reported.

19. Consider and report the effect on value, if any, of the terms and conditions of any agreement establishing a fractional interest or estate, where the objective of the report is to estimate the value of such fractional interest or estate. All such appraisals must clearly demonstrate that the value of any fractional part or estate has been evaluated by an analysis of appropriate market data. Such analyses must recognize that it is generally considered inappropriate to arrive at either the value of the whole or its parts by simply summing the fractional interests or subdividing the value of the whole into proportional parts.

All analyses involving fractional interests or estates, where the combined value of all interests or estates is not reported, must definitely establish with market evidence whether the terms and conditions of the agreement creating the estates or fractional interests reflects market rates and terms.

In addition to the above requirements, all analyses involving fractional interests or estates must disclose whether the final value estimate of such fractional interests or estates included non-realty components, i.e., tenant or borrower's credit quality, other non-realty contractual arrangements, etc. Further, whenever such value estimate includes non-realty components, the value assignable to them must be specifically disclosed in the appraisal.

All appraisals, where there is a clear indication that the subject property is encumbered by a lease instrument or legal limitations upon its operation [e.g., when inspection reveals occupancy of the property by tenants or the property is subject to rent control statutes], must consider and report the impact of the terms of the lease or such legal limitations upon the value of the estate being appraised.

Appraisal Content

Prior to the approval of a loan or investment transaction, each appraisal accepted by an institution must be prepared in writing and contain sufficient information to enable the persons who receive or rely on the report to understand it properly. Appraisals which fail to set forth, in a clear and accurate manner, the analytical process followed by the appraiser, in a fashion that will not be misleading to the persons who receive or rely on the report, will be considered unacceptable.

The content of each appraisal accepted by an institution shall follow generally accepted and established appraisal practices, as reflected in the standards of nationally recognized professional appraisal organizations and as noted in the body of this memorandum.

Specifically, each appraisal must:

1. Be totally self-contained so that when read by any third party, the appraiser's logic, reasoning, judgment and analysis in arriving at a final conclusion indicate to the reader the reasonableness of the market value reported.
2. Identify via a legal description the real estate being appraised.
3. Identify the property rights be appraised.
4. Describe all salient features of the property being appraised.
5. State that the purpose of the appraisal is to estimate market value as defined in this memorandum.
6. Set forth the effective date of the value conclusion(s) and the date of the report.
7. Set forth all relevant data and the analytical process followed by the appraiser in arriving at the highest and best use conclusion.
8. Set forth the appraisal procedures followed, the data considered, and the reasoning that supports the analyses, opinions, and conclusions arrived at by the appraiser. The analytical process followed by the appraiser must be presented so that:
   (a)It includes a complete explanation of all comparable data adjustments utilized in the analysis together with appropriate market support for each adjustment, and;
   (b)It contains descriptive information for all comparable data presented with sufficient detail to demonstrate the transactions were conducted under the terms and conditions of the definition of value being estimated or have been adjusted to meet such conditions; have a highest and best use equivalent to the best use of the subject property, and; are physically and economically comparable to the subject property.
9. Set forth all assumptions and limiting conditions that affect the analyses, opinions, and conclusions in the report; however, such assumptions and limiting conditions must not result in either a non-market value estimate or one so limited in scope that the final product will not represent a complete appraisal. A summary of all such assumptions and limiting conditions must be presented in one physical location within the appraisal.
10. Include a manually signed certification by the appraiser that is similar in content to the following form:
    • the statements of fact contained in this report are true and correct.

(Continued on page 6)

R-41c

(From page 5)

- the reported analyses, opinions, and conclusions are limited only by the reported assumptions and limiting conditions, and are my personal, unbiased professional analyses, opinions, and conclusions.
- I have no present or prospective interest in the property that is the subject of this report, and I have no personal interest or bias with respect to the parties involved.
- my compensation is not contingent on an action or event resulting from the analyses, opinions, or conclusions in, or the use of, this report.
- my analyses, opinions, and conclusions were developed, and this report has been prepared, in accordance with the standards and reporting requirements of the Federal Home Loan Bank Board.
- I have made a personal inspection of the property that is the subject of this report. [If more than one person signs the report, this certification must clearly specify which individuals did and which individuals did not make a personal inspection of the appraised property.]
- no one provided significant professional assistance to the person signing this report. [If there are exceptions, the name of each individual providing significant professional assistance must be stated.]

Related Considerations

Appraisal reports prepared for the purpose of influencing in any way the action of a Federal Home Loan Bank, the Federal Home Loan Bank Board, a Federal Savings and Loan Association, any institution the accounts of which are insured by the FSLIC, any member of the Federal Home Loan Bank System, or the Federal Savings and Loan Insurance Corporation are subject to the provisions of Title 18, United States Code. It is encumbent upon all appraisers to diligently adhere to generally accepted professional appraisal standards of practice and the provisions and requirements of the Federal Home Loan Bank Board's standards and reporting requirements relating to the preparation of appraisal reports prepared for these entities.

Francis M. Passarelli
Director [FHLBB]

Kinnard Writing R-41c Seminar

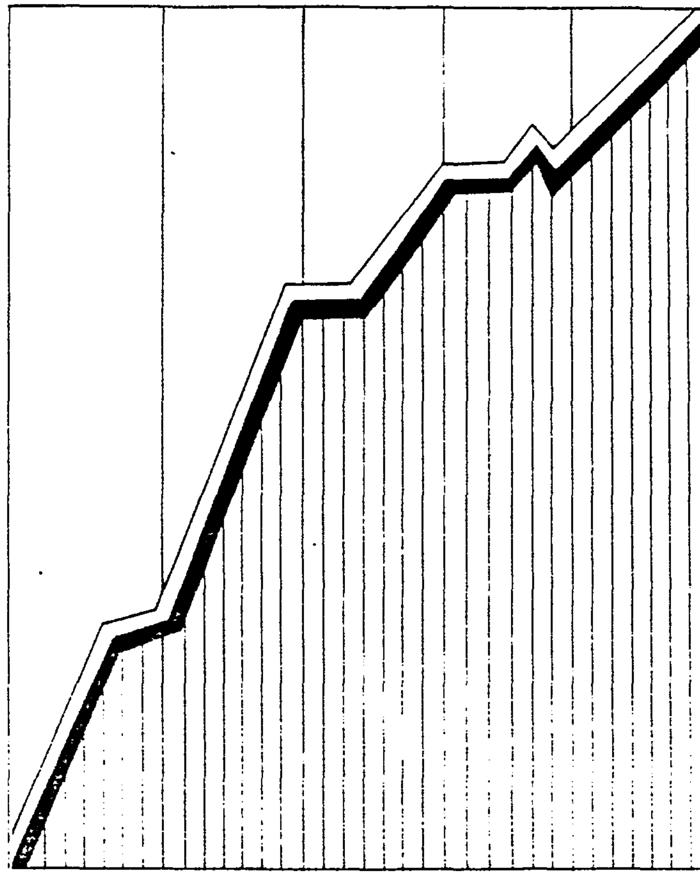
With the Federal Home Loan Bank Board's release of Memorandum R-41c, the Society is preparing an accompanying seminar.

Dr. William N. Kinnard, Jr., SREA, the author of "R-41b and the Appraiser," will also be the author of the Society's new R-41c offering.

The seminar should be available for chapter presentation by late 1986.

Pilot Presentation of R-41c and the Appraiser, Tucson, Arizona, Arizona Inn, November 7; Dr. William N. Kinnard, Jr., SREA, instructor. Contact: Thomas A. Baker, 2500 N. Tucson Blvd., Suite 100, Tucson, AZ 85716; (602) 881-1700; sponsored by Tucson #116; 7 hours recertification credit.

Pilot Presentation of R-41c and the Appraiser, San Diego, California, Inter-Continental Hotel, November 20; Dr. William N. Kinnard, Jr., SREA, instructor. Contact: Don Knox/Janan Fussell, 4452 Park Blvd., #302, San Diego, CA 92116; (619) 295-1670; sponsored by San Deigo #33; 7 hours recertification credit.



"Highest and Best Use," one of the four magazine advertisements which have been placed throughout the year to promote Society members, will appear during the latter part of 1986 in the following publications: *Corporate Real Estate, National Law Journal, Trial,* and *Mortgage Banking.*

During the last quarter of 1986, those who request copies of the Directory of Designated Members will receive the 1987 issue, which will be mailed in January. For those who need immediate information, copies of local listings from the current directory are available.

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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.*

APPENDIX B

CONTENTS

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99TH CONGRESS 2d Session | HOUSE OF REPRESENTATIVES | REPORT 99-891

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).

63-791 O

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 regulator requirements. While the FHLBB, for the most part, has responded effectively to the r lations addressed to it (see, Hearings, pp. 793-794), the FDIC, in general, decided again 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 arri 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 [illegible]on 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. [illegible] aminers reported such major appraisal deficiencies in each of the regular examinations [illegible] from 19[illegible]9 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. Th[illegible] example, can make it difficult to obtain timely informatio[illegible]mparables"—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.

[5] This package became the "Savings Institutions Supervisory Amendments of 1986," H.R. 4998, which w[illegible]troduced on June 11, 1986, by Chairman St Germain of the Committee on Banking, Fina[illegible]nd 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 [illegible]mission.

[8] This [illegible]t be patterned after those developed for the accounting profession (the Financial [illegible] Standards Board), securities dealers (the National Association of Securities Dealers), a[illegible] 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 pers[illegible] 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 Associations (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 $33.2 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 millio[illegible] Heath (Director of Examinations, FHLB Atlanta) declared in his prepared statemen[illegible] [illegible]ompetent appraisal at the outset would have kept this loan off the books." Hearings[illegible]
[22] Mem[illegible] 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, L[illegible] Heath (Director of Examinations, FHLB, Atlanta) pointedly acknowledged the mistake in [illegible]to Sunrise's request, stating that "we will certainly take the blame for it." Hearings, p[illegible]

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.

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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."

[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 Hear[illegible]. 178.

[41] Hearin[illegible]

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:*

[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 [illegible]e Report No. 98-573, p. 50, concerning the FDIC's supervision of the United American [illegible]f Knoxville, TN.

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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 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*

[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.

[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 [illegible]ive 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]

[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." Hea[illegible]519. See, also, footnote 75, p. 31 below.

[72] Hear[illegible]

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-

[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 rent[illegible]nd, (2) as a result of a crisis among Maryland thrift institutions, the Community Sav[illegible]n was required to undergo—and failed to pass—the previously cited FHLBB exa[illegible]o 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
Bingham 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 [illegible] caused them to ask why a California appraiser is used for Houston property." Hearin[illegible]

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.

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[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 f[illegible]

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:*

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[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-

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[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]

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]

[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* [illegible] *user will be liable to the lender* if loss occurs as a result of reliance on [a] grossly [illegible] fraudulent appraisal." Ibid., p. 17638. (Emphasis added.)

[102] Hearings, p. 290.

[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

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[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 De-cember 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

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[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]

[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, Winte[illegible] p. 54.

[116] Hearin[illegible]

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.

[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 th[illegible]ommittee'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.

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[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.

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[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 noncompliance 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] He[illegible] 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. 296), 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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