

March 14, 2003

Rules Docket Clerk
Office of General Counsel
Room 10276
US Department of Housing and Urban Development
451 7th Street, SW
Washington, DC 20410-0500

**Re: Docket No. FR 4722-P-01
FHA Single Family Mortgage Insurance;
Lender Accountability for Appraisals**

Dear Sir or Madam:

The American Bankers Association (ABA), American Financial Services Association (AFSA), America's Community Bankers (ACB), Consumer Bankers Association (CBA), Consumer Mortgage Coalition (CMC), and the Mortgage Bankers Association of America (MBA) welcome this opportunity to comment on the Department of Housing and Urban Development's (HUD) proposed regulation to hold Direct Endorsement mortgagees, as well as their loan correspondent lenders, strictly responsible for the quality of appraisals submitted (hereafter "Proposed Rule").

The Proposed Rule, published January 13, 2003, would amend 24 CFR parts 25 and 203 to state that a lender and an appraiser bear "equal responsibility" for the quality of the appraisal in meeting FHA guidelines. The rule further states that should a Direct Endorsement (DE) mortgagee or its loan correspondent submit or cause to be submitted an appraisal that is not satisfactory to FHA, then the same are subject to administrative sanctions by the Mortgagee Review Board. The proposed rule also reasserts that mortgagees must select an appraiser from FHA's Appraiser Roster.

HUD cites the need for this rule to address issues of predatory lending and lender pressure of appraisers. HUD believes that the proposed rule will protect the FHA Insurance Fund, ensure better compliance with appraisal standards, and ensure that homebuyers receive an accurate statement of appraised value.

We are aware that since the enactment of the Cranston-Gonzalez National Affordable Housing Act, permitting lenders to contract with HUD approved appraisers of their choice, there have been some who believe that lenders should therefore, also be

equally and strictly accountable for the appraisal performed. During the early 1990s, HUD issued several mortgagee letters stating its intention to hold lenders accountable, culminating in a 1994 Final Rule published in the federal register.

While the 1994 Final Rule was abandoned in 1996, the issue of appraisal oversight was not. A 1998 General Accounting Office (GAO) report discovered poor FHA appraisals and poor HUD oversight on a small number of properties. This report was followed by a 1999 GAO report. The 1999 Report investigated how well HUD monitored appraisers and held them accountable for their work. The report found that HUD was not performing adequate oversight of the appraisers on its roster, nor performing the required amount of field reviews of appraisals.

Fraudulent schemes involving inflated appraisals that have occurred since the issuance of the 1999 GAO report have further fueled the pressure for FHA to enact changes to its policies and management of FHA appraisals. Given this context, we understand HUD's rationale for the proposed rule under consideration. We have been and will continue to be constructive partners with FHA, just as we will continue to work to oppose predatory and abusive lending practices. We have historically and consistently supported policies to directly resolve deficiencies within FHA programs that do not unduly burden a lender's ability to extend FHA financing to families who might otherwise not be able to obtain financing to purchase and own their own home.

We, as representatives of the entire spectrum of FHA lenders, strongly object to this proposed rule. We believe that HUD is moving beyond the bounds of accepted business practices and Congressionally delegated authority to implement a rule that may diminish the effectiveness of FHA insurance. The issues of fraud and predatory lending cited by HUD could be more effectively addressed by strengthening existing programs and finalizing other proposed rules.

We have reached this conclusion based on three points:

- I. The Proposed Rule reaches beyond the bounds of established business practices and further impairs the effectiveness of FHA financing in reaching minorities and first time homebuyers;**
- II. FHA already has a number of mechanisms, and is considering a number more, that better address the issue of predatory lending and strengthen the FHA Insurance Fund, and**
- III. FHA does not have the statutory or regulatory authority to hold lenders equally accountable for appraisals.**

We would like to elaborate on each of these points.

I. The Proposed Rule reaches beyond the bounds of established business practices and further impairs the effectiveness of FHA financing in reaching minorities and first time homebuyers.

In the typical real estate transaction, non-staff appraisers are independent contractors just like a pest inspector, home inspector, title insurer or other independent entities providing services to lenders and borrowers. The proposed rule would require FHA lenders to guarantee the work of appraisers beyond a lender's level of expertise. No more should lenders be held "equally accountable" for the quality of appraisals than they should be held accountable for the quality of a title review.

The business relationship between FHA and lenders has always held that lenders are accountable for fraud and for material deficiencies that they knew about or should have known about. The Proposed Rule, as written, exceeds this arrangement and imparts much greater risk unto lenders over specific appraisal issues they do not have knowledge of or control over. The additional burden created by the Proposed Rule adds another disincentive for lenders to qualify borrowers through FHA.

Lenders are neither licensed nor qualified to be held "equally accountable" along with appraisers for the quality of appraisals.

FHA lenders should not be "equally accountable" for valuation determinations or other aspects of the appraisal report that rely upon specialized knowledge and training of appraisers. FHA lenders can be expected to ensure that appraisal reports are complete and consistent with FHA regulations and other documents in the case binder. The proposed rule does not make this distinction. In today's market place, DE underwriters are often reviewing loans from hundreds of miles away and never visit the property. Lenders specifically rely on appraisers for their knowledge of the local market as well as for their specialized training in valuation procedures.

FHA already has recourse against appraisers.

In its management of appraisers, FHA has a number of options to hold appraisers accountable for the work that they do. These options include removing an appraiser from the FHA Roster, debarment of the appraiser from HUD programs, the imposition of civil money penalties, filing a claim against the appraiser's Errors and Omissions insurance, even bringing criminal charges. The most glaring finding in the 1999 GAO report was the lack of monitoring and enforcement by FHA. We believe the proposed rule merely seeks relief from a second entity (in this case, lenders) when FHA itself is not using the tools it has in place to monitor the quality of appraisers and appraisals. The most effective manner of increasing appraisal quality would be to fully implement these tools, as well as others that FHA is considering (mentioned below).

Unlike other users of appraisal services, FHA adds additional requirements and regulations beyond the Uniform Standards of Professional Appraisal Practice.

While Fannie Mae and Freddie Mac recognize that lenders have some responsibility for the work of appraisers, they do not impose requirements above the Uniform Standards of Professional Appraisal Practice (USPAP) nor do they have a Mortgagee Review

Board structure that can seek indemnifications or impose civil money penalties. FHA, on the other hand, has implemented its Congressionally endowed authority to establish appraisal quality standards by creating an array of FHA specific valuation policies, including reporting on the condition of the property, that go beyond conventional financing. Additionally, FHA has created an appraisal roster specifically designed to regulate the quality of appraisers. Freddie Mac and Fannie Mae do not maintain a roster of appraisers, do not require nor issue any guidance to appraisers above the industry-accepted USP AP, and merely require that appraisers be licensed or certified in accordance with the minimum licensing criteria established by the Appraiser Qualifications Board of the The Appraisal Foundation. It is unfair for FHA to apply additional requirements and manage a roster while holding lenders completely accountable for the outcome.

Appraiser independence is important for both lender and borrower.

Since the passage of the *Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)*, and the creation of the Appraisal Subcommittee of the Federal Financial Institutions Examination Council, progress has been made to strengthen the appraisal field as a stand-alone profession with its own standards, practices and specialized knowledge. The Appraisal Foundation, recognized by Congress, serves as a parent organization for two independent boards: The Appraiser Qualifications Board (AQB) and the Appraisal Standards Board (ASB).

The system though, needs improvement. The system is a patchwork of state licensing laws and regulations that make both appraisal quality and appraiser enforcement uneven. Improvements in the quality of appraisers and appraisals should be sought through improving this system, of which HUD is a participant through the Appraisal Subcommittee. Users of appraisals, including borrowers, will obtain better quality reports if the above-mentioned oversight is strengthened.

An unintended consequence of this proposed rule is the diminishment of the value of the FHA insurance promise, prompting lenders to seek non-FHA loans.

In the normal course of business, lenders make FHA loans because they find value in the “incontestability” feature of FHA insurance. This feature assures lenders that once insurance is in place, it will remain in place regardless of the performance or underwriting of the loan. This feature is mandated by law:

(e) Contract of insurance as evidence of eligibility

Any contract of insurance heretofore or hereafter executed by the Secretary under this subchapter shall be conclusive evidence of the eligibility of the loan or mortgage for insurance, and the validity of any contract of insurance so executed *shall be incontestable* in the hands of an approved financial institution or approved mortgagee from the date of the execution of such contract, except for fraud or misrepresentation on the part of such approved financial institution or approved mortgagee. 12 USC 1709 (e) (emphasis added)

The Proposed Rule compromises this feature of FHA insurance because it potentially makes the lender accountable for any appraisal deficiency, not just known fraud or

misrepresentation. This accountability could result in a referral to the Mortgagee Review Board, which typically results in civil money penalties and indemnifications on the loans in question.

In evaluating the risk the Proposed Rule imposes on them, lenders will question whether originating an FHA mortgage is worthwhile. A possible consequence will be lenders either dropping out of the FHA market or increasing costs to borrowers to compensate for this transfer of risk. Certainly, this is in contrast to the work that HUD is doing in reforming the Real Estate Settlement Procedures Act (RESPA), with the goal of lowering the complexities of the homebuying process, and therefore its costs.

It should be noted that the burden of the increased risk imposed by this rule would be particularly difficult for smaller lenders. Smaller lenders have less ability to fully attest to the quality of independent third-party contractors and, more importantly, less ability to absorb the additional risk this rule would force upon them.

HUD will further limit FHA's ability to serve prospective homebuyers, especially first-time and minority homebuyers.

Since its creation in 1934, FHA has had the historic role of creating homeownership markets that allowed increasing numbers of Americans to own their own home. FHA financing today is particularly important to minority and first-time homebuyers. A recent study by HUD's Office of Policy Development and Research (Issue Brief No. IV, December 2000) indicated that for 1999, 37.7% of FHA-insured loans went to minorities, as compared with 16.3% of loans bought by Fannie Mae or Freddie Mac. The paper further indicates that 82% of FHA purchase loans are made to first-time homebuyers, as compared to 50% of all home purchase loans nationwide. The statistics presented above clearly demonstrate how minority and first-time homebuyers have benefited by lenders use of FHA products. Therefore, in analyzing the impact that this Proposed Rule will have on lenders' future use of FHA products, HUD should not overlook the potential impact it can have on minority and first-time homebuyers, particularly in light of the Bush Administration's stated goal of creating an additional 5.5 million minority homeowners in the next 5 years.

FHA's historically dominant position in the market has dramatically dropped off over the past 2 decades. FHA's market share of purchase loans in recent years hovers at 16%. MBA members report the same phenomena within their own companies: lenders that in the past had 80% of their originations in government loans, now find themselves originating 15% or less. In gauging the difficulties of using the FHA program and the risks involved, originators are increasingly gravitating away from FHA and toward the Government Sponsored Enterprises (GSEs) and other market players. We believe that a strong FHA is necessary to ensure a competitive marketplace with opportunities for a wide range of homebuyers to find financing.

At a time when a major issue in the national homeownership discussion is focused on closing the minority homeownership gap, a strong FHA financing program is extremely important. The Proposed Rule, by moving FHA away from the accepted business

relationship with lenders, threatens to further diminish the industry's ability to close this gap.

II. FHA already has a number of mechanisms, and is considering a number more, that serve to improve appraisal quality and more directly address the issue of predatory lending cited in the proposed rule.

FHA has implemented a number of reforms that have sought to address the issue of predatory lending and to protect FHA's insurance fund.

FHA, with specific Congressional authorization, established the **Appraisal Roster** to provide a means by which FHA can monitor the quality of appraisers who perform appraisals for FHA single family mortgage insurance and to ensure that appraisers performing appraisals meet high competency standards. Additionally, FHA has issued Mortgage Letter 2000-30, August 7, 2000 that updated the sanctions matrix FHA uses in monitoring appraisers. On August 1, 1999, HUD launched reforms of the FHA appraisal process through its Homebuyer Protection Plan. The Appraiser Roster now requires that appraisers:

- Be State licensed or certified in accordance with the minimum licensing criteria established by the Appraiser Qualifications Board of The Appraisal Foundation,
- Not be listed on either the General Services Administration's Suspension and Debarment List, HUD's Limited Denial of Participation List, or HUD's Credit Alert Interactive Voice Response System, and
- Pass a HUD/FHA examination on appraisal methods and reporting.

We have supported the efforts FHA has made in developing and improving its Appraiser Roster. As previously noted, fully enforcing the appraiser roster and appraiser sanctions, would directly address the issue of appraisal quality. Just as FHA maintains and regulates a list of approved lenders, and holds these lenders accountable for their work, FHA should maintain the Appraiser Roster and hold appraisers accountable for their work.

We also believe FHA should take additional steps to cull negligent or fraudulent appraisers from the Appraiser Roster, or prevent such persons from ever getting on the roster. Some lenders have developed what is in essence an exclusionary list containing the names of persons or entities that, for reasons of past bad conduct, are no longer eligible to participate in the lenders' programs. Household Mortgage Services, for example, has developed an "Ineligible List" of appraisers and other settlement service providers that have been determined by a thorough investigations unit to be ineligible for continued participation in that lender's programs. Household Mortgage Services provides this list to its sellers, banking agencies, local law enforcement agencies and the FBI. Law enforcement agencies, particularly, have found this list very useful. This list is also being plugged into the third-party fraud screening systems that are now being used throughout the industry.

While we understand that FHA must follow appropriate due process to deny participation in FHA programs to any appraiser, we strongly believe more due diligence should be performed, making use of available warning lists, such as the one described above, and other commercially available fraud lists, before permitting appraisers to get on, or continue to be on, the FHA Appraiser Roster. At the very least, these lists should be used as a "red flag" for further investigation by the Department.

In addition, we recommend that FHA consider imposing additional insurance bonding requirements on appraisers that choose to provide appraisals on FHA loans. The appraisers should also be required to expressly certify that they understand the appraisal will be used in the underwriting of an FHA-insured mortgage loan. Finally, HUD should specify the government's potential remedies against appraisers who engage in fraudulent activities.

On July 23, 2002 FHA issued an Advanced Notice of Proposed Rulemaking concerning the **FHA Appraiser Watch Initiative**. Under this proposed rule, FHA would establish and monitor a performance standard that appraisers must meet to maintain their status on the FHA Appraiser Roster. The approach is expected to be modeled on FHA's Credit Watch Termination Initiative. A final rule has yet to be published.

We believe strongly that FHA needs to develop appropriate tools to monitor the performance of appraisers and the quality of appraisals. FHA lenders are already held responsible for the performance of the loans they originate through **FHA's Credit Watch Initiative** (Mortgagee Letter 02-2000). Using FHA's web-based Neighborhood Watch system, FHA approved lenders with a branch having an early default rate above a determined threshold of the HUD Field Office average will have that branch's authority to originate FHA loans terminated. This system already holds lenders accountable for early defaults, whether they are due to appraisal issues or other issues.

It should be noted that many of the cases of predatory lending mentioned in the Proposed Rule involved collusion between unscrupulous lenders and unscrupulous appraisers. This collusion would obviate the impact of the proposed lender accountability, because HUD already has the ability to hold lenders accountable for fraud that they knew or should have known about.

Furthermore, given the fact that principals of unscrupulous lenders disbarred by the Department can quickly open up under a new name, any lender held accountable under the proposed rule can be in operation again as a new firm. The result is that unscrupulous lenders can get around the system. Unscrupulous appraisers cannot play the system in the same manner, in that they cannot as easily change their name, qualifications, licensing etc. Under the Proposed Rule, therefore, unscrupulous appraisers may be more willing to commit fraud for unscrupulous lenders because they would have less accountability.

On September 5, 2001, HUD issued a Notice of Proposed Rulemaking called **Prohibition on Flipping in FHA's Single Family Housing Program**. We firmly believe this rule to be a more effective and less burdensome policy to address the issue of predatory lending. The proposed rule would prohibit FHA financing on properties sold within a certain number of months and/or homes not purchased from the owner of record. More potent than the Proposed Rule on appraisals, the Prohibition on Flipping rule will prevent much of the fraud experienced by FHA and FHA lenders in the recent past. We understand that a final rule is imminent and encourage FHA to move as quickly as possible in implementing it.

The recently released audit of FHA's Mutual Mortgage Fund for Federal Fiscal Year 2002, performed by KPMG, has calculated the Fund's capital ratio at 4.52%, more than twice the Congressionally-mandated 2.0% minimum and higher than last year's 3.75%. Given this report, it is reasonable to assume that many of the changes FHA has made over the past several years to protect the Fund are working and further restrictions, which would possibly drive up the cost and availability of FHA-insured loans or drive small lenders out of the market, are not prudent at this time. Implementation of the Appraiser Watch and the Anti-Flipping Rule would further prevent losses without compromising production.

III. FHA simply has questionable statutory or regulatory authority to hold lenders strictly accountable for appraisals.

It is generally established that HUD has the authority to hold lenders accountable for acts, errors, and omissions with regard to lenders' responsibilities in ensuring that the appraisal report meets FHA requirements (for example, that it is complete and consistent with other information in the file). The Proposed Rule though, imposes a form of "no-fault" liability indicating that HUD will hold the lender strictly liable for appraisal deficiencies even where the lender had no knowledge of, and may likewise be a victim of, appraiser fraud.

An extensive legal review of relevant statutory provisions, legislative history, judicial precedent, and existing FHA guidelines has been undertaken as part of efforts to understand this issue. The conclusion of this review significantly questions HUD's authority to implement the proposed rule, based on the following reasons:

- To the extent the Proposed Rule would hold lenders strictly liable for the errors and omissions of their independent contractors, it is inconsistent with both the statutory language and Congressional intent;
- The Proposed Rule conflicts with general and well-established principles of agency law; and
- The Proposed Rule's application to correspondent lenders contradicts existing FHA guidelines and obscures the distinction between mortgage brokers and mortgage lenders.

The legal opinion is attached and it provides the legal basis upon which we have reached the above-mentioned conclusions regarding the Proposed Rule. The opinion describes Congressional intent and agency law in relation to the Proposed Rule. It concludes that the Proposed Rule, as written, may be beyond HUD's legal authority and the intended relationship between FHA, lenders, and appraisers. It should be noted that this is the same conclusion that the Mortgagee Review Board reached in 1998 when they refused to hear a case concerning lender accountability for appraisal deficiencies that was referred to them by one of FHA's Homeownership Centers.

A collective goal of the lending industry is to strengthen FHA. These comments are submitted with that goal in mind. In opposing this rule as written, we seek to clarify the appropriate working relationship between lenders and FHA and to focus on policies that will go farther in addressing our mutual concern regarding the strength of the FHA fund and predatory lending.

This is one issue where the lenders and consumers share the common goal of identifying and excluding fraudulent appraisals. Lenders, consumers and communities all lose monetarily and/or personally when appraisers commit fraud.

Thank you for the opportunity to comment on the proposed rule and we look forward to working with you on these issues.

Sincerely,

American Bankers Association

American Financial Services Association

America's Community Bankers

Consumer Bankers Association

Consumer Mortgage Coalition

Mortgage Bankers Association of America