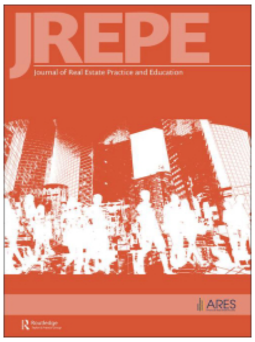

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CASE REPORT

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A Primer on Regulations and the Practice of Residential Property Appraisal

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ABSTRACT
This paper presents a chronology, beginning in the early 1900s, of the regulatory environment faced by residential real estate appraisers in the United States. The presentation informs the reader about two financial crises, the savings and loan crisis and the Subprime mortgage crisis. The conditions that led to each crisis, the response of Congress to address each crisis, and the effect of both on residential real estate appraisers are included in the presentation. Prior to these crises, appraisers were basically self-regulated, but today because of concern that inflated appraisals were a contributing cause of the crises they are subject to rules and regulations imposed by both federal, and state authorities. The regulatory measures instituted to address the savings and loan crisis failed to prevent the subsequent Subprime mortgage crisis, and measures instituted to end the Subprime mortgage crisis had unintended negative effects. This begs the question, will the regulations in place now prevent the occurrence of a future crisis.

KEYWORDS
Dodd-Frank; FIRREA; mortgages; regulation; savings and loan crisis; Subprime mortgage crisis

In the United States, the real estate appraisal industry operated largely under the radar of state and federal regulatory authorities for over a century. Real estate appraisers worked closely with mortgage loan originators who were the frequent target of the United States Congress and the agencies it created to monitor and regulate them. Appraisers, on the other hand, were left to their own devices to provide informed property value estimates without the benefit of government-imposed rules and regulations.

The laisse fare attitude of Congress towards appraisers changed as concern that appraisers may have played a role in what became known as the savings and loan crisis (AKA the thrift crisis). Congress attempted to solve the crisis with the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 which included a section, Title XI, that brought the appraisal industry into the federal regulatory fold. Following FIRREA, Congress generated a series of acts that modified portions of FIRREA and, of course, added new regulations. Most notable among these is the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 enacted in response to massive borrower defaults on home mortgage loans in the 2000s.

Background

When a significant amount of money is involved in the ownership transfer of an asset, the principals to the transaction might appreciate an independent opinion of the asset's value. So, as the demand for single-family homes grew in the United States during the early 1900s, residential appraisal slowly blossomed from a job into a profession and became an important occupational specialization. Despite their important role in the mortgage origination process, throughout most of the 20th century appraisers escaped the attention (and regulation) that Congress devoted to other parties in the process, especially commercial banks and other suppliers of mortgage funds.

At the state level, laws focused on the real estate appraisal industry varied from non-existent to

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minimal. An example of the latter resulted from the invention of the appraisal management company (AMC) about sixty years ago. AMCs are companies whose primary asset consisted of large groups of appraisers. Banks invented AMCs because of the persistent accusation that they could influence an appraiser's opinion of value if the bank was responsible for selecting the appraiser. To solve the dilemma the AMCs stood contractually between the bank looking for an appraiser and the appraiser selected for the assignment. Some, but not all states, enacted statutes that required an AMC had to be registered in the state where the appraisal was to be conducted. AMCs, however, were not widely employed until fairly recently.

Almost all states had laws (adopted at various points in time till 1989) that were limited to specifying occupational entrance criteria and these criteria tended to be minimal; requiring that an individual (1) be licenced by the state to conduct a real property appraisal, (2) have reached the specified minimum age to obtain a licence, and (3) pay a one-time and/or periodic fee to the state. Some states included a minimal educational requirement. By 1989, there was one state that required only that the applicant has reached the age of majority. So, the degree of difficulty in obtaining official permission to appraise real property was low. With regard to federal regulation, prior to 1989, the appraisal industry was basically self-regulated.

Professional Appraisal Associations

Nobody knows with certainty the reason(s) behind the formation of every one of the numerous professional appraisal associations, formed during the 20th century, each claiming they would be the best organization to represent the interests of appraisers. Hopefully, each association organiser was motivated by a sincere desire to benefit the appraisal industry. Some, however, may have been motivated for less altruistic reasons. In any event, these professional associations helped stave off government regulation by setting and enforcing rules on their membership. Members of other occupations (e.g., barbers, real estate brokers, and undertakers) have long been required to, at least, be registered and/or licensed with state authorities. Appraisers were not required to be registered in the state where they worked until 1989 when the federal government decided it was time to start doing that.

Some of the professional associations that commenced operations before 1989 have survived to this day (e.g., National Association of Real Estate Appraisers (founded 1966), Appraisers Association of America, Inc. (founded 1949), and The American Association of Professional Appraisers (founded 1952) with the merger of The American Society of Technical Appraisers (founded 1936) and the Technical Valuation Society (founded 1939). Newer associations include The National Association of Appraisers (founded 2010) and the Appraisal Institute, founded in 1991 with the merger of the American Institute of Real Estate Appraisers (founded 1932) and the Society of Real Estate Appraisers (founded 1935). In 2023, the Appraisal Institute, which publishes a respected quarterly periodical, The Appraisal Journal, had over 16,000 members and chapters throughout the United States, Canada, and overseas. Appraisal associations offer their members: networking opportunities, mentoring, training, education, ethical standards, rules, appraisal leads, credentialing, and representation on local, state and national legislative issues. They also reserved the right to discipline, including expulsion, any member who violated their association's code of ethics.

In 1986, nine appraisal organizations from the U.S. and Canada formed the Ad Hoc Committee on the Uniform Standards of Professional Appraisal Practice (USPAP).[1] In 1987, the eight U.S. committee members adopted those standards and established the Appraisal Foundation to implement USPAP which is recognized throughout the United States as the generally accepted standards of professional appraisal practice. It is worth emphasizing that both the Foundation and USPAP originated from the efforts of professional appraisal associations, not the government.

Prior to 1989, appraisers liked to (correctly) say they were not regulated, they simply followed guidelines in forming their value estimates. Today, in many regards, the associations have taken a back seat to federal authorities. For example, associations typically instruct their members to follow the Uniform Standards of Professional Appraisal Practices (USPAP). This instruction has created a redundancy and both the association and the appraiser know that this practice is now required by the Financial Institution Reform, Recovery and Enforcement Act (FIRREA).

In 1989, when FIRREA became law only thirty percent of appraisers were members of a national appraisal organization. The other seventy percent were accountable only to their clients for any incompetent or unethical behaviour. Because appraisers are human, they sometimes make such mistakes. The U.S. Congress has a history of making unethical behaviour illegal. And that is what appears to be, at least, a possible explanation for the attention paid to the appraisal industry in FIRREA.

The Savings and Loan Crisis (Early 1980s–Mid 1990s)

The savings and loan (S&L) crisis was the first severe financial crisis in the United States since the Great Depression. Examination of Table 1 will reveal the precarious condition of the S&L industry during the 1980s. Note that in 1980 there were 3,993 state- and federally chartered S&Ls insured by the Federal Savings and Loan Insurance Corporation (FSLIC). That same year, another 509 S&Ls were insured by state sponsored programs (all of which have since collapsed or were abandoned). Eighty percent of the federally insured S&Ls were stock associations; the other 20% were mutually owned. In the 45 years preceding those shown in Table 1, 143 S&Ls failed; an average of 3.2 per year; considerably less than the 62.6 average number of failures per year during the nine years depicted in Table 1. The information in the two rightmost columns of Table 1 indicate that 1,131 mergers occurred during the years leading up to the S&L crisis with just under 30% consummated at the insistence of S&L regulators.

From the end of World War II through the 1960s it did not require a financial genius to run an S&L. Over this time period the yield curve was upward sloping and fairly stable. S&Ls obtained the funds needed to originate mortgages as customers made deposits to savings accounts paying regulated, low, fixed rates; then rode the yield curve writing 30-year fixed rate mortgages. Owning an S&L in those days was a lot like owning your own money machine. As market interest rates increased in the late 1970s and continued their ascent into the 1980s, the market value of S&L's mortgage portfolios plummeted. And then, as became customary, real estate appraisers came under fire accused of submitting inflated value estimates to support the loan applications for those mortgages.

Those rapidly increasing interest rates caused another problem for S&Ls (and other depository financial institutions); disintermediation. As the interest rates on other short-term investment opportunities exceeded the maximum rate S&Ls could pay on deposits. People were quick to realize they could earn more by purchasing U.S. Treasury Bills and withdrew their deposits to do so. The Treasury, in turn, quickly grew tired of keeping track of the dramatically increasing number of small purchases and raised the minimum purchase from $1,000 to $10,000 effectively preventing thousands of individuals from participating in the T-Bill market. This move by the Treasury also gave rise to a new financial intermediary, Money Market Funds (MMF), who pooled small investors funds and invested in T-Bills, negotiable certificates of deposit, and other short-term investments that required more money than small investors could afford on their own. So, the ex-depositors next moved their money from T-Bills to the new MMFs. Until depository institutions were granted regulatory permission to pay market rates,

Table 1. Selected statistics for FSLIC insured savings and loans: 1980–1988.

Year	Number of S&Ls	Total assets*	Net income*	FSLIC reserves*	New S&Ls	Failures	Supervisory mergers	Voluntary mergers
1980	3,993	604	0.8	6.5	68	11	21	63
1981	3,751	640	−4.6	6.2	25	34	54	215
1982	3,287	686	−4.1	6.3	26	73	184	215
1983	3,146	814	1.9	6.4	47	51	34	83
1984	3,136	976	1,0	5.6	133	26	14	31
1985	3,246	1,068	3.7	4.6	88	54	10	47
1986	3,220	1,162	0.1	−6.3	27	65	5	45
1987	3,147	1,249	−7.8	−13.7	na	59	5	74
1988	2,949	1,349	−13.4	−75.0	na	190	6	25
Total					414	563	333	798

*in Billions of dollars.
Source: Federal Deposit Insurance Corporation (1997).

they were hard-pressed to attract the low-cost funds they had relied on for decades.

Other factors contributed to the S&L crisis. As Congress became aware of the difficulties S&Ls were experiencing, they crafted several pieces of legislation, mostly designed to set depositories free from previous federal regulation. The Depository Institutions Deregulation and Monetary Control Act (DIDMAC), signed into law on March 31, 1980 included provisions that worked to both the benefit and detriment of S&Ls. To help depository financial institutions (DFI) battle disintermediation, DIDMAC removed the long-standing, regulator-imposed, interest rate cap that all DFI could pay on time deposits, but that meant that S&Ls now had to pay a higher rate to attract time deposits. The Act also required S&Ls, for the first time, to hold a small portion of their deposits as non-interest earning reserve accounts. In essence, DIDMAC may or may not have increased the financial pressure on S&Ls by enabling them to attract more expensive deposits while reducing the portion of deposits the S&Ls could use to conduct business.

When deposit insurance was introduced in 1933, coverage was for $2,000 per account. Over the years the coverage amount was periodically increased, With the passage of DIDMAC, coverage was increased from $40,000 to $100,000 per account. As a result, a moral hazard was created; most customers stopped being concerned with how S&Ls were investing their money because even if an S&L lost money, the government had guaranteed their deposits.

The purpose of the Garn–St. Germain Depository Institutions Act of 1982 was to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans. Garn-St. Germain enabled S&Ls to expand their operations into more risky areas in which they had no particular expertise (e.g., mortgage loans for large commercial developments). Many S&Ls jumped at these new investment opportunities. Unfortunately, with great frequency, their foray into the newly authorized ventures failed miserably. Again, a federal law provided S&L managers with the perfect vehicle to rationalize the gambles they took. If the gambles paid off, the manager had saved the S&L; or if the gambles failed the managers believed their depositors would not be hurt because of deposit insurance (required for federally-chartered S&Ls with the passage of the National Housing Act in 1934).

Federal regulators, who recognized the problem too late, could not do much to save the S&L industry. Regulators normally had several options when they identified a S&L that was judged to be in such bad condition that current ownership should be replaced. (1) try and find a healthy S&L to take over the failed S&L, (2) operate the S&L themselves until a willing healthy S&L could be located, and (3) close the failed S&L and pay off its insured depositors. Problem was, at some point, there were no more S&Ls willing to take over a failed S&L, and the (now defunct) FSLIC did not have enough personnel to run the failed S&Ls and had run out of money to pay off insured depositors. So, hundreds of S&Ls with negative equity were allowed to stay open for business. They became known as zombie S&Ls because they were the walking dead.

How bad did it get? After giving a luncheon speech to a group of businessmen, the FSLIC Chairman entertained questions from the audience. One of the first asked was, "How many S&Ls do you expect to close this year? "104," the Chairman immediately replied. After a stunned silence, the next question was, "How can you be so precise? "Simple," replied the Chairman, "we can only close 2 a week and there are only 52 weeks in a year." But in practically no time at all the FSLIC efficiency improved, and they were soon closing over 200 zombies per year. In 1980, before the crisis there were over 4,000 S&Ls in the United States. According to the FDIC, as of year-end 2021, there were only 608 FDIC-insured S&Ls remaining in business.

To summarize, the S&L crisis resulted from the behavior of five groups: (1) S&L managers who followed risky investment practices, (2) S&L customers with reduced interest in monitoring the S&Ls activities, (3) the U.S. Congress which passed various laws (from 1934 to 1982) which enabled the S&L managers to take on risky investments and created (4) regulatory agencies which failed to recognize the problems until it was too late, and (5) those real property appraisers who succummed to pressure from loan originators to provide inflated value estimates.

Financial Institutions Reform, Recovery, and Enforcement Act (1989)

The response of Congress to the S&L crisis was FIRREA; promulgated on August 9, 1989. Most of the Act focused on the supervision and enforcement powers over thrifts (i.e., S&Ls and savings banks), not appraisers. FIRREA specified actions to accomplish the following objectives. (1) To more intensively regulate deposit insurance in thrifts, and to create an actuarily sound schedule of rates to charge both banks and thrifts for deposit insurance. (2) To improve the coordination of the regulatory and supervisory functions of federal and state authorities with jurisdiction over thrifts and banks. (3) To increase the effectiveness of the liquidation or other disposition of insolvent thrifts.

Only one section of FIRREA, (Title XI), focused on the appraisal industry. Title XI was intended to provide protection of Federal financial and public policy interests by upholding requirements for appraisals performed for "federally related transactions" referred to as FRTs in the appraisal industry (e.g., loans made by any federal-insured lender, or a loan originated by any lender that is backed by the federal government (e.g., FHA-insured or V.A.-guaranteed). Title XI contained significant changes to the structure and responsibilities of various agencies, and required those with oversight responsibilities to do so with enhanced monitoring.

Title XI replaced two of the S&L industry's principal regulators. The Federal Home Loan Bank Board was replaced by the Office of Thrift Supervision (OTS) which was created as a federal agency under the Department of the Treasury to charter, supervise, and regulate all savings banks and S&Ls. Title XI also transferred the responsibilities of the depleted Federal Savings and Loan Insurance Corporation (FSLIC), which had been in place since 1934, to the Savings Association Insurance Fund (SAIF), as the primary insurer of thrift deposits and the Bank Insurance Fund (BIF) also insured some thrift deposits. Both operated under the supervision of the Federal Deposit Insurance Corporation (FDIC). The Deposit Insurance Reform Act of 2005 authorized the SAIF-BIF merger by creating one Deposit Insurance Fund (DIF) which became effective on March 31, 2006.

Title XI congressionally authorized the previously mentioned Appraisal Foundation (TAF) to develop standards and qualifications for real estate appraisers. The Foundation is overseen by the Appraisal Subcommittee (ASC), a subcommittee of the Federal Financial Institutions Examination Council, charged with filing a report to Congress each year on TAF activities. The ASC whose membership includes representatives from five federal financial institution regulators (the Federal Reserve Board, the Consumer Finance Protection Bureau, the Office of the Comptroller the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Administration) and representatives from two federal agencies with direct ties to the real estate industry: the Federal Housing Finance Agency and Housing and Urban Development, monitors and reviews TAF and oversees state licensing agencies.

The ASC has an interactive map of the United States on their web site [www.asc.gov] where interested parties can click on a particular state to learn more about the state agency's rating and the number and type of registered appraisers in the state. As of this writing, according to ASC there were 90,141 registered appraisers (7,753 Licensed, 43,184 Certified Residential, and 39,204 Certified General).[2] Each one should be especially interested in the performance of their state licensing agency because if ASC determines that a state's appraiser regulation and certification program does not meet Appraiser Qualifications Board (AQB) and the Appraisal Standards Board (ASB) requirements, it has the authority to impose penalties including prohibiting the state's licensed appraisers from performing FRT appraisals.

The AQB is included in the Foundation structure as a subcommittee to develop and promote meaningful criteria by which the competence of appraisers could be measured. To achieve this objective, the AQB sets the minimum education and experience requirements needed to become an appraiser. And it is the AQB that is responsible for the contents of the National Uniform Licensing and Certification Exam which appraisal candidates must pass to obtain state certification. Another subcommittee, the ASB is responsible for writing, amending, and interpreting USPAP. The ASB issues Exposure Drafts on proposed changes to USPAP and obtains feedback at public meetings throughout the year in various regions of the country.

Title XI gave states three years to write and implement statutes detailing their minimum:

education, experience, and age requirements to lawfully appraise various types of real property in their state. All fifty states complied with this mandate, but the exact requirements vary by state because Title XI allowed states to set higher requirements than the national standards for each license type. State real estate boards stand ready to answer questions about the specific licensing requirements in their state.

Another important (although temporary) addition to the group of agencies created to address the S&L crisis was the creation of the Resolution Trust Corporation (RTC) to resolve the status of failed savings and loan institutions. As previously mentioned, the S&L crisis broke the FSLIC which complicated the issue of indemnifying insured S&L depositors. And, unfortunately, there was no room in the national budget to include the significant amount of cash needed by the RTC without triggering mandatory across the board Graham-Rudman cuts if Congress did not make prescribed progress towards a balanced budget.[3] No problem; Title XI established the RTC as an off-budget entity which could raise as much money as was needed without any Graham-Rudman consequences. To avert taxpayer complaints, RTC raised the needed funds to close the remaining 747 troubled S&Ls by issuing zero-coupon, long-term bonds (in the true spirit of: let the kids and grandkids pay for this mess). The 747 zombies the RTC closed had assets worth over $407 billion, but the process still cost (both living and unborn taxpayers) $124 billion. Another reason there are fewer S&Ls in existence today is because many of those that survived the crisis, reorganized as Savings Banks to avoid the stigma still associated with the term Savings and Loan.

The Subprime Mortgage Crisis (2008–2010)

Some authorities peg the start of the subprime mortgage crisis at the day Bear Stearns, a New York City-based global investment bank and financial company failed – March 16, 2008. Bear Sterns, began operations in 1923, survived both the 1929 stock market crash and the Great Depression and by the turn of the century was one of the largest investment banks in the world. But, during the 1980s Bear Sterns was heavily invested in mortgage-backed securities that turned toxic when the underlying loans began to default. The company was ultimately sold to JPMorgan Chase for $10 a share, well below its value before the crisis. The collapse of Bear Stearns precipitated a wider collapse in the investment banking industry, which also took down major players like Lehman Brothers.

The creation of the secondary mortgage market with all kinds of mortgage-backed securities (MBS) including, but not limited to: Ginnie Mae, Fannie Mae, and Freddie Mac passthroughs resulted in more lending opportunities in the primary mortgage market. Before the advent of the secondary markets, mortgage lenders were very reluctant to lend to prospects with below average credit ratings due to the higher risk of default that they posed. Lenders were also somewhat restricted by scarcity of money to lend because as an old expression goes before they could write their next loan they had to "wait for enough deposits to walk through the door." However, the secondary mortgage markets allowed lenders to originate mortgages, and quickly recoup the amount loaned by repackaging the mortgages into securities and selling the securities to investors globally.

With a plentiful supply of money and the risk of mortgage default passed on to the purchaser of the mortgage-backed securities lenders began targeting subprime mortgage borrowers, (customers with below average credit ratings). The loans to subprime borrowers frequently carried an interest rate that was adjustable annually beginning one or more years after loan initiation. The increased availability of mortgage credit caused the demand for homes to rise which caused prices of residential properties to increase at above normal rates which, in turn, induced expectations of continued price increases in the future.

To spur economic growth, the Federal Reserve gradually reduced the interest rate it charged financial institutions for short-term loans from 6 to 1 percent. This move supported the sustained boom in the residential property sector. However, between 2004 and 2006, the boom caused inflation to rise and to contain inflation, the Federal Reserve reversed course and continually raised interest rates from 1 percent to eventually 5.5 percent. This, in turn, meant that the interest rate on those adjustable-rate loans, to subprime investors and others, increased resulting in a higher payment than many of the borrowers could afford.

The new higher payment on the adjustable-rate mortgages caused borrowers to default on their mortgage repayments. The repercussions of the defaults were felt in the secondary mortgage markets because some of the MBS contained subprime mortgages. Hence the collapse of the home mortgage market led to the collapse of the securities markets that were the main source of funding for new originations in the primary mortgage market. The overall effect was reduction in new mortgages, which eased pressure on demand in the residential property market so that instead of rising home prices began to fall and the housing bubble burst. Soon after, subprime mortgage lenders started filing for bankruptcy.

Examination of Table 2 is inciteful. Shown in the second column from the left is the value of all outstanding mortgages issued by thrift institutions. Notice the dramatic reduction in this number during the 2000s. The decline is surprising because thrift institutions were established to meet the needs of individuals, in no small part, by providing them with mortgage money. The numbers in each "delinquent" column refer to loans where the borrower was behind the repayment schedule by 60 or more days. There is a very old saying among financial analysts that states, "If you owe a lender a thousand dollars and can't pay, you're in trouble; if you owe a lender a million dollars and can't pay, the lender is in trouble." The delinquency rates for the first several years shown in the table are not unreasonable. The rates shown in the rightmost column for 2009 and 2010 suggests S&Ls were in trouble.

Before the "official" start of the subprime mortgage crisis, regulatory agencies and other real estate authorities came to believe that a factor contributing to the rollercoaster ride of the housing market was appraisal fraud committed by appraisers who had succumbed to pressure from one or more of multiple sources. Most mortgage loan characteristics were selected by both the lender and the borrower, only the lender selected the appraiser and lenders had a motive to encourage an appraised value high enough to close the loan and collect their fees. Sales agents and brokers, incentivized to close sales even at the cost of long-term loan performance, were pressuring appraisers to support market values that allowed for the largest possible loans to close and increase brokerage commissions. Even some buyers may have applied pressure on appraisers to support a higher loan amount; especially if they did not intend to repay the loan.

Concern over the behaviour of appraisers was regularly expressed by regulatory authorities during the 2000s. A 2003 report by the October Research Corp. found that 55% of appraisers surveyed had faced pressure to adjust values (Appraisers say pressure on them to fudge values is up sharply (2007). Murphy (2014) reported that 10% to 40% of overall fraud incidents reported to the MIDEX mortgage fraud database from 2000 to 2004 was appraisal fraud. The report, updated in 2007, found that 90% of appraisers surveyed had felt uncomfortable pressure to adjust values and that 75% reported losing

Table 2. OTS-regulated thrift industry foreclosures and delinquent mortgage loans (select years).

	Total Assets#	Mortgage Portfolio #	Loans Foreclosed #	Mortgage Loans #	Mortgage Total Assets	Delinquent Mortgage Portfolio	Foreclosed % Total Assets	Delinquent % Mortgage Portfolio
1975	330,259	272,456	1,086	4,060	0.33	0.40	1.23	1.49
1980	603,777	528,763	917	7,325	0.15	0.17	1.21	1.39
1985	1,109,789	766,266	8,675	21,658	0.78	1.13	1.95	2.83
1990	1,029,165	762,186	22,862	19,790	2.22	3.00	1.92	2.60
1995	770,982	572,388	2,506	12,447	0. 33	0.44	1.61	2.17
2000	928,548	650,064	900	9,056	0.10	0.14	0.98	1.39
2001	977,715	671,333	896	10,759	0.09	0.13	1.10	1.60
2002	1,004,532	689,663	903	11,529	0.09	0.13	1.15	1.67
2003	1,092,630	677,306	938	11,510	0.09	0.14	1.05	1.70
2004	1,306,790	878,715	729	10,213	0.06	0.08	0.78	1.16
2005	1,464,121	980,207	738	15,278	0.05	0.08	1.04	1.56
2006	1,410,817	909,561	1,263	16,895	0.09	0.14	1.20	1.86
2007	1,508,352	923,788	2,990	39,190	0.20	0.32	2.60	4.24
2008	1,197,263	662,457	3,834	41,494	0.32	0.58	3.47	6.26
2009	941,705	454,039	4,269	23,182	0.45	0.94	2.46	5.11
2010	931,507	433,138	3,644	30,574	0.39	0.84	3.28	7.06

[#]Dollars in millions.
Source: Office of Thrift Supervision/2010 Fact Book (2011).

a client or not being paid if they refused to modify their value estimates (Appraisers say pressure on them to fudge values is up sharply (2007). In 2006 the Appraisal Foundation held a conference on appraisal fraud at which the President of the Appraisal Institute stated: "The business of home appraisals too often gravitates to the least qualified, least experienced appraisers as lenders and brokers consider price and turnaround time as their most important criteria when choosing an appraiser.... We have called on Congress to address weaknesses in the appraisal regulatory structure for several years and we remain vigilant about the need for more resources for federal and state appraiser regulators (Appraisal Institute, 2006). In 2007 a former President of the Appraisal Institute testifying to the Senate Banking Committee, said "Too often, appraisers, either by turning a blind eye, or through incompetence facilitate bad mortgage loans. The testimony also described the use by lenders of blacklists of honest appraisers (Hummel & Government Relations Committee, 2007). And so the stage was set for Congress to step to the plate and take another swing at creating a piece of legislation that would solve what had come to be known as the Subprime mortgage crisis.

Dodd-Frank Wall Street Reform and Consumer Protection Act (2010)

In response to the subprime mortgage crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Bill which was promulgated on July 21, 2010. It is generally considered to be the most comprehensive financial regulatory reform measure enacted in the United States since the Great Depression. It created 243 new rules and 12 new regulatory agencies. Dodd-Frank amended numerous portions of FIRREA including appraiser independence standards, in part, by splitting residential and commercial appraisal oversight. Rulemaking and oversight for residential mortgage appraisers now fall under the Consumer Financial Protection Bureau (CFPB) while commercial real estate appraisal authority remains with the Appraisal Subcommittee. Dodd-Frank made another important change regarding the oversight of the real property appraisal industry. The functions of the OTS, (created by FIRREA as one of the industry's principal regulators) were transferred to the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corp. (FDIC), the Federal Reserve Board, and the Consumer Financial Protection Bureau (CFPB) effective as of July 21, 2011. This change alone gives the appraisal industry an additional net three regulators to be concerned with pleasing.

Members of Congress became convinced that, in no small part, lack of appraiser independence, was resulting in inflated appraisals, and was a contributing cause of the subprime mortgage crisis. Consequently, Dodd-Frank was crafted to eliminate the interaction between the lender or mortgage broker and the appraiser and assure the independence of the latter. Towards this end, Dodd-Frank amended FIRREA, and mandated a national registry for any AMC that meets the statutory panel size threshold. The threshold is any AMC that oversees an appraiser panel of more than 15 state-certified or licensed appraisers in a single state, or 25 or more state-certified or licensed appraisers in two or more states. For the purposes of calculating the number of appraisers on an AMC's appraiser panel, the count is based on the number of appraisers listed on the AMC's roster who are potentially available to perform appraisals rather than the number of appraisers actually engaged in performing appraisals.

Dodd-Frank also required that all states implement laws that required AMCs (some of which had been operating unregulated for a half a century) that wished to do business in the state, register their company with, and be subject to supervision by, the regulatory agencies in that state. As of this writing, ASC reports 4,718 AMCs have registered with state authorities. Dodd-Frank specified that each state law should: specify that only licensed and certified appraisers should be used for federally related transactions, assure that appraisals comply with USPAP; and require that in the conduct of an appraisal adherence to existing appraisal independence standards should be maintained. Note that Dodd-Frank does not mandate that lenders use AMCs. So long as lenders act in accordance with the provisions of Dodd-Frank, they are at liberty to pursue whatever appraisal acquisition model they desire. And while Dodd-Frank addressed some appraiser certification and education standards, the legislation left most of the requirements up to the individual states.

The Act did what it could to reduce or eliminate the problematic subprime mortgages, that defaulted in mass during the subprime mortgage crisis, by specifying that mortgage loans to subprime borrowers cannot be done without a written appraisal, and a physical visit to the subject property. It is difficult to imagine that an appraisal could be accomplished any other way, but the fact that these requirements were included in the Act suggests that loans were granted during the crisis that failed to meet these criteria. The Act also required that a certified/licensed appraiser who hails from the state where the subject property is located conduct the appraisal, and must perform the appraisal according to the provisions of the USPAP and Title XI of FIRREA.

Some of the provisions in Dodd-Frank actually protect appraisers. For example, Dodd-Frank attempted to enhance appraiser independence by criminalizing violations of appraisal independence including transactions in which a person with an interest in the transaction attempts by any means to influence the appraiser's estimate of value to be based on any factor other than the independent judgment of the appraiser. Further, the Act calls for customary and reasonable payment to appraisers to ensure their independence; requiring lenders and their agents to compensate appraisers at a rate that is customary and reasonable for appraisal services performed in the market area of the subject property.

Other provisions in Dodd-Frank have been modified by a host of authorities. For example, the five federal financial institution regulatory bodies that are members of ASC jointly published (and later updated) Appraisal and Evaluation Guidelines to clarify appraisal regulations and supervisory guidance to federally-chartered institutions and examiners about prudent appraisal and evaluation programs. Each set of Guidelines update and replace existing supervisory guidance documents to reflect developments concerning appraisals, changes in appraisal standards and advancements in regulated institutions' collateral valuation methods.

Literature Review

Researchers have investigated both the S&L crisis and the Subprime mortgage crisis as well as the role appraisers played in both episodes. The results of their work presented in this section should provide the reader with some interesting insights. One cause of poor-quality mortgage underwriting is appraisal inflation and it played a role in both crises. When appraisals are inflated, the loan collateral appears more valuable than it actually is. Researchers have provided evidence that poor appraisal quality can have detrimental effects on loan outcomes; primarily by focusing on appraisal estimates in excess of fair value. LaCour-Little and Malpezzi (2003) for example, found that appraisals above hedonic estimates were significantly related to higher mortgage default rates. Agarwal et al. (2015) examined the difference in appraised property values between purchase and refinance mortgages as a gage of appraisal inflation and concluded that appraisals conducted for loans to financially constrained borrowers, evidenced by high loan to value ratios, had severely inflated appraisals and a higher likelihood of subsequent defaults.

Maybe appraisers were not completely innocent. Mayer and Nothaft (2022) reported that appraisal bias was still occurring in 2015 and 2016. They discovered an interesting strategy employed, either knowingly or unknowingly, by appraisers which the researchers identified as an underlying cause of appraisal bias. Namely that when estimating the value of the subject property using the sales comparison approach appraisers tend to select comps with higher prices than the subject property, and that appraisers are more likely to adjust upward the price of lower priced comps, but less likely to adjust downward the price of higher priced comps. Conklin et al. (2020) investigated whether competition in the appraisal industry affects appraisal bias. They modelled appraiser behaviour given a loan officer's preference for appraisal values at least as high as the proposed transaction prices. If appraisers cater to loan officers to increase the probability of winning future business, the researcher's model predicts more inflated appraisals in more competitive markets. The prediction was confirmed using a sample of purchase mortgages originated between 2003 and 2006 by a large subprime mortgage lender. Furthermore, the effect was stronger in areas experiencing high house price growth.

If overvalued appraisals are bad, are undervalued appraisals good? Maybe for the home purchaser. Fout et al. (2022) examined home purchase loan application data to study buyer responses to the uncommon occurrence of the appraised value coming in below the contract price. They concluded that when this happens it raises the probability of a downward transaction price renegotiation. They find that low appraisals do result in lower renegotiated prices without substantially lowering the likelihood of a loan application leading to loan origination or notably longer times from contract signing to consummation of the sale.

During, and after, the mortgage crisis it was clearly understood that as lending standards collapsed during the housing boom, appraisers were pressured from all sides. When the appraiser did not deliver a satisfactory price, the deal did not get done, and the broker, agent and lender did not get their fees" (Streitfeld, 2009). USPAP addressed this problem by requiring appraisers to certify that their engagement or payment was not dependent on reporting predetermined results. It was hoped that the recent increase use of appraisal management companies would greatly reduce this problem.

Why is the real estate appraisal industry blamed for the subprime mortgage crisis? The United States Financial Crisis Inquiry Commission (2011) offers the following: From 2000 to 2007 a coalition of appraisal organizations circulated and ultimately delivered to Washington officials a public petition; signed by 11,000 appraisers and including the name and address of each, it charged that lenders were pressuring appraisers to place artificially high prices on properties. According to the petition, lenders were "blacklisting honest appraisers" and instead assigning business only to appraisers who would hit the desired price targets.

When the Dodd-Frank legislation was being debated, lawmakers believed that national and state registration of AMCs offered the best hope to solve the appraiser independence problem. Finkeistein (2012) reports, however, that Dodd-Frank pushed a lot of responsibility to the state level, with each state moving farther and farther away from the original intent of Dodd-Frank by writing rules and regulations that have nothing to do with appraiser independence.

A number of people, from within and outside of the appraisal business, seem to be unhappy with Dodd-Frank. Collins (2016) reported a shortage of appraisers in rural areas. Several lawmakers believe the shortage may be due to increased government regulations which fail to take into account the increased difficulty associated with a rural appraisal compared to an urban appraisal (e.g., lack of properties comparable to the subject property) and some members of the AMC industry predict that the trend in state-level rules may put some of them out of business. Some researchers assert that Dodd-Frank hurts relatively small financial institutions. McKee and Kagan (2019), for example, observe that while provisions of Dodd-Frank increase the transparency of real estate transactions between financial institutions and consumers, the Act imposes substantial compliance costs on all financial institutions. Using a dataset of non-metro credit unions and all agricultural credit associations, they found that compliance costs decreased cooperative financial institution financial performance. They concluded that the Dodd-Frank regulatory framework will not sit comfortably with cooperative lenders investigating entering a rural real estate market because doing so will increase their cost of business and constrain their cost efficiency. An opinion piece by Hensarling (2015) is consistent with the findings of McKee and Kagan. He opines that Dodd-Frank has crushed small banks, restricted access to credit, and planted the seeds of financial instability.

Not all mortgage defaults during the subprime mortgage crisis occurred due to rising interest rates and adjustable-rate loans. Some mortgage borrowers and/or mortgage originators may just have had bad intentions. Ben-David (2011) reported that during the housing boom, financially constrained home buyers artificially inflated transaction prices in order to draw larger mortgages. Using transaction data from Illinois that includes sellers' offers to inflate prices, the researcher estimated that in 2005–2008, up to 16 percent of highly leveraged transactions had inflated prices of up to 9 percent. He also reported that borrowers who inflated prices were more likely to default, and that inflated transactions were common in low-income neighborhoods and when intermediaries had a greater stake or an informational advantage. Carrillo (2013) examined data from residential real estate transactions from a large suburban county of a metropolitan area where mortgage foreclosure rates have been less than the national average and hence not an obvious location to test for mortgage fraud. To identify early payment default (EPD) he looked within the sample for a property that was sold during 2006, then listed again on the MLS as for-sale during 2007 or 2008, with the new listing containing the words "short-sale," "pre-foreclosure," or "foreclosure." He discovered evidence of a large and positive EPD premium that, on average, was 1.8% (about $9,000) of the home value. Because borrowers involved in a fraud-for-profit scheme would have no incentive to make any loan payments and would likely default shortly after the mortgage loan is granted, a search for additional circumstantial evidence to identify the possible presence of fraudulent transactions was conducted by checking whether the EDP premium was significantly negatively related to time-to-default. He looked for, and found, a negative correlation between the EPD premium and time-to-default.

Research indicates that some problems in the secondary mortgage market have persisted despite Dodd-Frank. Griffin and Maturana (2016) reported fraud among securitized nonagency loans which typically do not meet agency standards, consisting of Alt-A and subprime loans, using three indicators: unreported second liens, owner occupancy misreporting, and appraisal overstatements. They found that around 48% of loans exhibited at least one indicator of misrepresentation. Surprisingly, misreporting was similar in both low and full documentation loans and was associated with a 51% higher likelihood of delinquency. Two-thirds of loans with unreported second liens had the same originator issuing both the first and second lien! In addition, they reported that misrepresentations in mortgage-backed securities (MBS) pools can explain substantial cross-sectional differences in future losses which were initiated by MBS underwriters and loan originators. Sharma et al. (2022) find that Dodd–Frank regulations on credit rating agencies (CRAs) increase rated firms' risk of rating downgrades, regardless of their credit quality. Their estimates suggest that rated firms, which face steep costs from a further downgrade, significantly reduce their debt issuance and investments compared to similar unrated firms. Their results, not driven by credit supply or the financial crisis, indicate that greater regulatory pressure on CRAs leads to negative spillover effects on firms concerned about credit ratings, regardless of their credit quality.

Conclusion

Federal regulators admit the appraisal industry will experience ongoing attention from them. Historically, it seems the United States Congress must get a queezy feeling if they are not working on a new piece of legislation. The close relationship between mortgage lenders and residential appraisers in the past resulted in regulations. The same process is likely to continue. Other situations that will likely result in new rules and regulations for residential appraisers include regulator's propensity to occasionally tweak the most recent version of USPAP, or rearrange the various agencies with oversite of the appraisal industry. With no reason to suspect that this practice will stop, additional regulatory changes are possible. The relatively new requirement of national and state registration of AMCs was the first step toward additional regulations for AMCs, especially with the increasing number of transactions where AMCs are involved. Some basic regulations have already been introduced with more to come.

Finally, even though the Dodd-Frank Act was designed to prevent mortgage fraud; unfortunately, at some point fraud will likely make another appearance, but in a way that regulators have not envisioned. Whether the current regulatory system will be able to prevent the fraud from evolving into another financial crisis is debatable, but should one develop, Congress will most assuredly generate additional regulations. Whether the residential appraisal business will be caught up in the process is uncertain.

Notes

1. Member organizations were: the Appraisal Institute of Canada, American Institute of Real estate Appraisers (AIREA), American Society of Appraisers, American Society of Farm Managers and Rural Appraisers, International Association of Assessing Officers, International Right of Way Association, National Association of Independent Fee Appraisers, National Society of Real Estate Appraisers, and the Society of Real Estate Appraisers.
2. As of this writing, a Certified General Appraiser can appraise any real estate. A Certified Residential Appraiser is restricted to appraise property with up to four dwelling units, regardless of its value or complexity. A licensed appraiser may conduct an appraisal of uncomplicated residential dwellings up to

fourplexes with a maximum value of $1 million. Education/ training and experience requirements vary by appraiser classification.

3. The Gramm-Rudman-Hollings Act (1985), officially entitled the Balanced Budget and Emergency Deficit Control Act, and popularly referred to simply as Graham-Rudman was motivated by concern over large and growing federal deficits during the 1980s and the inability of Congress to cut spending or increase tax revenues enough to resolve the problem. The Act specified a schedule of gradually declining deficit targets leading to a balanced budget in 1991. It also specified that if any budget the administration and Congress agreed upon failed to come within $10 billion of the targets specified in the bill, automatic across-the-board spending reductions would be implemented in all programs except interest payments on the national debt, certain low-income entitlements, and social security.

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