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Testimony by

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Federal Reserve System

before the

Subcommittee on General Oversight and Investigations
of the

Committee on Banking, Finance and Urban Affairs
United States House of Representatives

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I am pleased to appear before you this morning to discuss the implementation and effectiveness of the real estate appraisal requirements contained in Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"). Title XI contemplates a dual state and federal role in fulfilling its goal which, as indicated in its statement of purpose, is to provide "that federal financial and public policy interests in real estate-related transactions will be protected by requiring that real estate appraisals utilized in connection with federally related transactions are performed in writing, in accordance with uniform standards, by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision."

At the federal level, Title XI required the federal financial institutions regulatory agencies to issue regulations prescribing appropriate appraisal standards for those real estate-related transactions that would require the services of a licensed or certified appraiser under the statute and, therefore, are federally related. The agencies were also required to distinguish between those transactions that require the services of a state certified appraiser (the senior designation) and those requiring a state licensed appraiser (the junior designation).

The states also play a vital role under the statute. Title XI contemplates that the states will establish appraiser certification and licensing agencies, as well as set minimum requirements for individuals who are qualified to perform appraisals in connection with federally related transactions.

After December 31, 1992, state certified or licensed appraisers must be used for all federally related transactions, unless a temporary waiver is granted in accordance with provisions contained in Title XI.

At the outset I should make clear that the Board shares Congress' desire to ensure that banks establish sound loan underwriting and administrative procedures. An integral part of such procedures, of course, is a prudent and effective appraisal program. Indeed, the loss experience of depository institutions in recent years has demonstrated the critical importance of sound underwriting standards in promoting the safety of financial institutions and protecting the interests of depositors.

The Committee's letter of invitation provides that this hearing generally will examine the implementation and effectiveness of Title XI, and, as well, requests that the Board address a number of specific questions. The individual questions are addressed in an attachment to this testimony. However, given the interest that has been expressed on the issue of a threshold above which appraisals are required, I will address that issue later in my statement.

Since the enactment of FIRREA on August 9, 1989, the Federal Reserve has been working extensively with the other federal financial institutions regulatory agencies to implement the requirements of Title XI. These efforts fall into several categories, as required by Title XI. One set of initiatives is the establishment of the Appraisal Subcommittee of the Federal

Financial Institutions Examination Council and our continued representation on that Subcommittee. Regarding the activities of the Appraisal Subcommittee, I will defer to the statement of the Appraisal Subcommittee Chairman, Fred Finke, to the Subcommittee today.

A second area in which each of the agencies has expended considerable effort is prescribing appropriate standards for the performance of real estate appraisals. In developing the regulation, the Board has attempted to comply with both the letter and the spirit of Title XI, while at the same time remaining sensitive to the potential costs and burdens that the regulation could impose, particularly on consumers and small businesses seeking real estate loans. Title XI required the Board to adopt appraisal standards in its regulation that incorporated the appraisal standards in the Uniform Standards of Professional Appraisal Practice ("USPAP"). Moreover, the Board was also permitted by Title XI to require compliance with additional standards, if necessary, to properly carry out its statutory responsibilities.

At the time the Board sought public comment on adopting its appraisal regulation, the USPAP was in the process of being revised, and the Board, as well as the other financial institutions regulatory agencies, were uncertain whether the substance of the final version would fully satisfy the purposes and the requirements of Title XI. As a result, to ensure that the requirements of Title XI were met, the Board, along with the

other regulatory agencies, adopted its own set of appraisal standards that were substantially similar to those proposed in the USPAP.

In June 1990, the Board adopted the appraisal regulation containing the agencies' additional appraisal standards, and, at the same time, the USPAP revisions were finalized. Our experience with appraisals since the adoption of the revised USPAP standards appears to indicate that these standards adequately address the concerns expressed in the legislative history of FIRREA regarding the sufficiency of appraisal standards. Accordingly, the Board and the other regulatory agencies are considering the deletion of the portion of their appraisal regulations containing standards that are substantially similar to the revised USPAP standards. Given reports that some appraisers maintain that the standards specified in the agencies' regulations constitute an additional set of standards requiring separate analysis, deferring more fully to the USPAP should reduce regulatory burden and the commensurate costs to the public and depository institutions.

During the course of its consideration of its real estate appraisal regulation, the Board remained sensitive to the need for minimizing potential costs and burdens that the regulation could impose while, at the same time, not jeopardizing safety and soundness considerations and the purposes of Title XI. In that light, the Board promulgated its final regulation with a \$100,000 threshold above which appraisals would be required for

federally related transactions. After considerable comment, the Board subsequently issued a proposed rule to reconsider the level of the threshold. Before making a final determination on this issue, the Board will review the results of the recently completed OMB study mandated by FDICIA and a pending GAO study, both related to the appraisal threshold issue, as well as over 2,800 comment letters received in response to the Board's own proposal. Clearly this is a controversial issue and one in which some members of Congress have expressed considerable interest.

The Board initially prescribed the \$100,000 threshold because in its view transactions below the threshold did not appear to implicate the federal financial and public policy interests addressed by Title XI, nor did they pose a significant risk of loss to institutions covered under the statute. In the Board's experience with its regulated institutions, credit losses arising from inadequate appraisals of 1-to-4 family residential loans, which comprise the vast majority of real estate-related transactions falling below the threshold, have not been a significant cause of failures of commercial banking organizations. Further, the threshold lessens the potential costs and burdens that the regulation could have on small businesses and individuals seeking real estate loans.

The Board's supervisory experience also suggests that employees of community banks have made reasonable assessments in the past of real estate collateral values for residential loans. Moreover, the majority of all 1-to-4 family residential loans are

originated for potential sale to the secondary mortgage market. In this regard, the Board understands that FHA, VA, FNMA and FHLMC as well as many private mortgage insurers will require appraisals performed by licensed or certified appraisers for residential loans insured or guaranteed by them.

We are not unconcerned about problems stemming from relatively small- or medium-size loans which, of course, can and do result in some losses to banks. It is for this reason that our supervisory appraisal and evaluation policies cover loans of all sizes. Nevertheless, our experience with commercial banking organizations has suggested that losses on residential loans have not contributed significantly to bank failures; and, in any case, that significant losses to banks on 1-to-4 family residential loans less than the \$100,000 threshold have not resulted from faulty appraisals.

Moreover, we believe that the prudential standards contained in our supervisory appraisal guidelines, together with annual on-site examinations, have helped to mitigate the risks associated with transactions below the threshold. Further, discussions with state agency representatives and public comments suggest that an employee of a community bank in a rural area, where it may be difficult to obtain the experience required by many state licensing authorities, is likely to be at least as knowledgeable about the value of local properties as an out-of-area appraiser.

In contrast, it has primarily been loans collateralized

by larger commercial buildings, condominiums, shopping centers, and agricultural and other commercial properties that have caused major credit losses and, in some cases, failures within the commercial banking system. As an indication of the loss experience of insured banks and savings banks on 1-to-4 family residential loans, compared to typically larger commercial real estate loans, I note that for 1991 the nonperforming loan and loan charge-off ratios for 1-to-4 family loans were 1.65 percent and 0.20 percent, respectively, compared to 5.81 percent and 1.24 percent for commercial real estate loans. In this regard, the Board believes that Title XI is particularly helpful in standardizing and strengthening appraisal procedures for large real estate loans that historically have been a major source of problems for some banking institutions. Accordingly, the Federal Reserve's regulation requires the use of certified appraisers for all commercial transactions exceeding \$250,000 in value.

In sum, I believe that the approach we have adopted in our regulation represents a reasonable attempt to implement the purposes of Title XI, while remaining sensitive to the concerns of smaller institutions, the possible impact on the cost of appraisals, and the potential burden associated with additional regulation. In developing the regulation, Board staff has worked closely with representatives of the other bank regulatory agencies to establish a consistent approach for commercial banking organizations.

Mr. Chairman, your invitation letter states that one

purpose of this hearing is to examine the effectiveness of Title XI. As I have already noted, the Board believes that Title XI has contributed to strengthening appraisal procedures within depository institutions. Having said that, I must also caution that the Board believes that the appraisal process is not an exact science nor should it be the sole focus of an examiner's review of a commercial real estate loan. Work still must be done on refining the appraisal process to avoid the use of dubious assumptions that can contribute to exaggerated valuations in both the upside and downside phases of the real estate cycle. Further, as the agencies indicated in their November 7, 1991, guidance to examiners, the focus of an examiner's review of a commercial real estate loan must be an assessment of the borrower's ability to repay the loan in an orderly and timely manner. The principal factors that bear on this assessment are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms and from the borrower's other resources, if necessary.

As we proceed in implementing Title XI, I want to assure you that we will monitor the effectiveness and impact of the Board's appraisal regulation. As is true of any new regulation, we recognize that adjustments may have to be made in order to accomplish desired objectives. In this regard, the Federal Reserve will not hesitate, in coordination with the other Federal agencies, to consider, and, if appropriate, adopt changes

or refinements that are deemed to be necessary to strengthen our implementation of Title XI or to assure the safety and soundness of our nation's depository institutions.

**Federal Reserve Board's
Responses to Questions Submitted by
Congressman Hubbard
for the September 16, 1992 Hearing
on the Implementation and Effectiveness of Title XI**

- 1. The current status of implementation of state agencies and the effects this has on federal regulations requiring appraisals.**

While FDICIA extended the federal effective date for the requirement to use the services of licensed or certified appraisers in a federally related transaction to January 1, 1993, individual states have the latitude to set an earlier effective date for licensed and certified appraisers for purposes of state law. In fact, many states have already implemented their state appraisal regulatory programs.

This difference has caused some confusion among regulated financial institutions as to what is required of them. The Board has provided guidance to our examiners and regulated institutions that institutions are expected to adhere to any state law requirements, including an earlier implementation date, for a particular state appraisal regulatory scheme.

- 2. The impact of requiring a professionally prepared appraisal on all real estate related transactions regardless of the amount, compared to requiring appraisals only on the real estate related transactions above \$50,000 and \$100,000.**

Since the majority of such transactions are 1-to-4 family residential loans, the impact of a change in the appraisal threshold would for the most part affect the cost and closing time for residential mortgages. Considering the relatively low loss experience on residential mortgages, financial institutions believe that the appraisal costs far exceed the benefits. Rather, loss experience is more readily attributed to underwriting mortgage loans with high loan-to-value ratios which are then highly susceptible to problems arising from deteriorating market conditions or the borrower's personal financial difficulties.

In that regard, the majority of comments on the Board's appraisal regulation received from financial institutions reported minimal historical losses on 1-to-4 family residential loans of amounts between \$50,000 and \$100,000. Data on charge-offs also indicate that 1-to-4 family residential loans have had comparatively low loss experience and significantly better experience than other types of real estate loans.

3. **The effect on the safety and soundness of financial institutions if real estate transactions under \$100,000 are exempt from an appraisal.**

While the Board does not require an appraisal by a state certified or licensed appraiser for a transaction below \$100,000, the Board requires an appropriate evaluation of the real estate collateral as outlined in supervisory guidelines. These supervisory guidelines underscore the responsibility of bank boards of directors to ensure that their institutions have well-defined and effective programs for appraising and evaluating real estate in support of their lending activities.

Our Reserve Banks report that there have been no bank failures or significant problems or losses because of inadequate evaluations and appraisals on loans under \$100,000. In the past four years, the Reserve Banks reported only 24 corrective actions that cited appraisal deficiencies or problems, and most of these cases dealt with the appraisals on transactions over \$100,000.

4. **The likelihood of a significant shortage of appraisers, other than localized anomalies, after January 1, 1993. Please include your estimate of how many licensed and certified appraisers are necessary to meet current and expected demand.**

The issue of the availability of licensed and certified appraisers has been one of the major issues cited by banks, particularly rural community bankers, as affecting the implementation of Title XI. The question of whether there is a shortage of appraisers may be influenced by an uneven distribution of appraisers between metropolitan areas and rural communities, with fewer appraisers in rural areas of the country.

Since all states have not implemented their licensing and certification programs, there is insufficient data, at this time, to determine whether there is an adequate number of certified and licensed appraisers. Further, the general slowdown in most real estate markets has also reduced the demand for appraisal services. Regulated institutions have expressed concern that when the market does pick up that a shortage will develop. Indeed, in certain areas of the country, financial institutions are experiencing significant delays in receiving appraisals. This is especially true for residential appraisals because of the significant volume of refinancings due to lower interest rates.

Institutions have commented to our Reserve Banks that currently it is taking 2 to 4 weeks to receive an appraisal once a request for an appraisal is made when, in the past, it would take 7 to 10 days. Information is not available to isolate the effect on appraisal costs and delivery time of the increased volume of residential refinancings versus the newly enacted state requirements for qualified appraisers. Institutions also commented that part of the availability problem is a shortage of qualified appraisers for complex and specialized projects.

In some of the Federal Reserve districts, banks located in rural and remote areas have reported experiencing significant delays. The consequence is that a delay in the appraisal delays the loan closing. Some smaller institutions have commented that the burden caused by the appraisal regulation may force them out of real estate lending.

In its April 1991 study on the appraisal threshold, the Appraisal Institute, a professional appraisal organization, estimated that 32,800 appraisers would be needed to handle the annual volume of residential appraisals. This was based on the assumptions that there would be 8.2 million residential appraisals per year and that an appraiser could conduct 250 such appraisals annually. The Institute's estimate of the number of such transactions was based on doubling the number of the existing and new home sales reported by the National Association of Realtors in 1989. The Appraisal Institute concluded that there would be a sufficient pool of appraisers given their membership of approximately 60,000 appraisers.

The conclusion to be drawn from the Institute's analysis is limited, however, insofar as it did not address the fact that the location and availability of appraisers does not necessarily match the transactions' geographic and seasonal distribution. Further, there was no estimate given on the impact on commercial real estate appraisals, which require a greater level of expertise and time to prepare.

5. **How many real estate appraisers are currently licensed and certified pursuant to FIRREA requirements and how many more are in the process of becoming licensed and certified?**

A recent estimate of the Appraisal Subcommittee places the number of state certified and licensed appraisers at 58,000. The Appraisal Subcommittee estimates that there will be between 60,000 to 70,000 state certified or licensed appraisers by January 1, 1993.

6. **With appraisals currently being required for virtually all real estate loan transactions, is the requirement that appraisers be held accountable through a state-sanctioned, licensing program an additional burden?**

A major intent of Title XI was to ensure that professionals conducting appraisals for federally related transactions would be subject to effective supervision. By holding appraisers accountable to a code of professional conduct and to standards of performance, there is now a remedy for users of appraisal services to bring action against dishonest and incompetent appraisers.

7. **Please discuss the proper and required criteria for selection of an appraiser for federally related transactions.**

The Board's supervisory guidelines require financial institutions to have proper procedures for the selection of appraisers and monitoring of appraisers' work. An institution may either use its own staff or engage fee appraisers, as circumstances warrant. When the services of a fee appraiser are used, an institution or its agent is required to directly engage the appraiser.

In selecting an appraiser, a financial institution should consider whether the individual's experience and educational background adequately demonstrate the ability to appraise the particular real estate. The level of training, experience and knowledge should be commensurate with the type and complexity of the property to be valued. The fact that an individual is licensed or certified is not the sole qualifying factor.

The selected appraiser is prohibited from having a direct or indirect interest, financial or otherwise, in the property or transaction. Disclosure of a potential conflict of interest does not eliminate the conflict. This applies to both in-house staff of the bank or fee appraisers engaged by the bank to perform appraisals.

8. **Are the standards of the industry, the Uniform Standards of Professional Appraisal Practice (USPAP), a significant step in the evolution of professionalism within the appraisal community; and if so, why? Are these standards sufficient?**

At the time the Board sought public comment on adopting its appraisal regulation, the USPAP was in the process of being revised, and the Board was uncertain whether the substance of the final version would fully satisfy the purposes and

the requirements of Title XI. Therefore, the Board and the other financial institutions regulatory agencies adopted their own set of appraisal standards that were substantially similar to those proposed in the USPAP. Since that time, Board staff's experience with the appraisal regulation and the revised USPAP standards indicate that these new USPAP standards address the concerns expressed in the legislative history of FIRREA.

Board staff believes that the USPAP improved the quality and thoroughness of the appraisal report in that appraisers must fully disclose in writing the analysis and assumptions behind the opinion of value. However, it should be recognized that the appraisal process is not an exact science nor should it be the sole focus of an examiner's review of a real estate loan. The appraisal process needs to be refined to ensure that appraisers avoid using dubious assumptions which contribute to exaggerated valuations in both the upside and downside phases of the real estate cycle.

9. **How much validity is there to the argument that, with a high threshold for the use of a professionally prepared appraisal, many low- and moderate-income borrowers will not be given the same opportunity to have their choice of home appraised by a competent, accountable professional as borrowers of greater financial means?**

The Federal Reserve's experience relating to financial institutions' assessing collateral value for residential loans, especially loans under the \$100,000 threshold, has been that institutions historically have performed adequate assessments of the collateral value. This is supported by the fact that current and historical data show that loss experience for residential loans is minimal.

Requiring the use of licensed appraisers on transactions below \$100,000 would increase closing costs for low- and moderate-income borrowers seeking credit for residential loans, but not necessarily provide an assessment of the collateral's worth that is more precise than an evaluation prepared by the bank. However, the Board's appraisal regulation does not prohibit a borrower from requesting an appraisal performed by a certified or licensed appraiser. Of course, in most cases, the additional cost of the appraisal would be borne by the borrower.