FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS
75265-5906

December 17, 1998

Notice 98-118

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

Final Amendment to the Appraisal Standards for Federally Related Transactions

DETAILS

The Board of Governors of the Federal Reserve System has approved an amendment to Subpart G of Regulation Y, Appraisal Standards for Federally Related Transactions, which exempts from the Board's appraisal requirements transactions involving the underwriting or dealing of mortgage-backed securities. This amendment permits bank holding company subsidiaries engaged in underwriting and dealing in securities (so-called section 20 subsidiaries) to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements.

The amendment becomes effective December 28, 1998.

ATTACHMENT

A copy of the Board's notice as it appears on pages 65530–32, Vol. 63, No. 228 of the *Federal Register* dated November 27, 1998, is attached.

MORE INFORMATION

For more information, please contact Rob Jolley at (214) 922-6071. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R–0990]

Appraisal Standards for Federally Related Transactions

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System has approved an amendment to Subpart G of the Board's Regulation Y, Appraisal Standards for Federally Related Transactions, which exempts from the Board's appraisal requirements transactions involving the underwriting or dealing of mortgage-backed securities. This amendment permits bank holding company subsidiaries engaged in underwriting and dealing in securities (so-called section 20 subsidiaries) to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements.

EFFECTIVE DATE: December 28, 1998.

FOR FURTHER INFORMATION CONTACT: Norah M. Barger, Assistant Director (202/452–2402), or Virginia M. Gibbs, Senior Supervisory Financial Analyst, (202/452–2521), Division of Banking Supervision and Regulation; or Mark Van Der Weide, Attorney (202/452-2263), Legal Division; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

The Board is adopting an amendment to its appraisal regulation that exempts from the Board's appraisal regulation transactions involving the underwriting or dealing of mortgage-backed securities. The amendment is designed to address the concerns raised by bank holding companies regarding the extent to which the Board's appraisal regulation restricts the ability of section 20 subsidiaries to actively participate in the commercial mortgage-backed securities (CMBS) market.

In 1990, the Board adopted its appraisal regulation pursuant to the requirements of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (12 U.S.C. 3331 *et seq.*). Title XI directed the federal banking agencies (the agencies) to publish appraisal rules for federally related transactions [1] within the jurisdiction of each agency. The stated purpose of the legislation is to protect federal financial and public policy interests in real estate-related financial transactions by requiring that real estate appraisals utilized in connection with federally related transactions are performed in writing, in accordance with uniform standards, and by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision.[2] In their appraisal regulations, the agencies exempted certain categories of real estate-related financial transactions that do not require the services of an appraiser in order to protect federal financial and public policy interests or to satisfy principles of safe and sound banking.

In June 1994, several existing exemptions to the agencies' appraisal regulations were modified and new exemptions were added. At that time, the agencies clarified that a regulated institution investing in, underwriting, or dealing in a mortgage-backed security or similar instrument need not obtain new Title XI appraisals for the underlying real estate-secured loans so long as the loans met regulatory appraisal requirements for the institution at the time the loans were originated.[3]

When the agencies adopted the 1994 amendments to their appraisal rules, the mortgage-backed securities market consisted of securitized 1-to-4 family residential loans, most of which were generated in accordance with the agencies' appraisal requirements. Since 1994, the commercial real estate market has recovered and a market in CMBS has emerged and expanded significantly with the wider acceptance of collateralized securities. Because many commercial mortgages are originated by non-regulated institutions, they often do not fully meet the agencies' appraisal regulations. As a result, banking organizations have effectively been restricted in their ability to participate in the CMBS market.

In December 1997, the Board issued a proposal to amend its real estate appraisal regulation to permit bank holding companies and their nonbank subsidiaries to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements.[4] In issuing this proposal, the Board acknowledged that the amendment would affect only section 20 subsidiaries because section 20 subsidiaries are the only nonbank entities subject to the Board's appraisal regulation that are permitted to underwrite or deal in mortgage-backed securities.

Summary of Comments and Description of the Final Rule

The Board received eleven comments on the proposed amendment to the appraisal regulation: four from banking associations, one from a bank holding company, one from a professional appraiser association, and five from Federal Reserve Banks. Ten of the commenters strongly favored the proposed amendment. The professional appraiser association did not express support for the proposal and urged the Board to consider whether a uniform due diligence standard should be developed for the CMBS market before adopting this amendment.

Several of the commenters stated that the appraisal regulation made it difficult for bank holding companies and their section 20 subsidiaries to participate in the CMBS market. As one commenter stated, the amendment would strengthen the competitiveness of bank holding companies by placing their section 20 subsidiaries on a more equal footing with nonbank competitors. Ten commenters stated that the public rating and due diligence required by the market for mortgage-backed securities provided sufficient information for the regulated institution to assess risks. One commenter noted that the rating agencies perform sophisticated stress tests of mortgage-backed securities, which examine the ability of the real estate collateral to meet the associated debt obligation under adverse market conditions, to ensure the soundness of their rating.

One commenter contended that the CMBS market attributed little value to appraisals and that other characteristics of the CMBS market, such as public ratings and due diligence requirements, typically provide more protection to investors than the appraisal requirement. Another commenter stated that obtaining appraisals is a costly and time-consuming process that is impossible to complete in the time constraints applicable to underwriting and dealing in CMBS.

One commenter suggested that the Board consider adopting additional exemptions from the appraisal regulation for transactions involving: (1) the investment in investment-grade CMBS by bank holding companies and their bank and nonbank affiliates and (2) the warehousing of commercial real estate loans by bank holding companies and their nonbank affiliates for the purpose of packaging and selling them as CMBS.

In contrast, the comment letter from the professional appraiser association contended that federal oversight and underwriting criteria, as well as due diligence procedures used by market participants, may not adequately address all safety and soundness issues that exist in the CMBS market. The commenter expressed concern that without guidance from the agencies regarding due diligence standards for CMBS, federally insured institutions could assume undue or unacceptable risk. Further, this commenter contended that many of the underwriting criteria and investment decisions involving CMBS require that an appraisal be performed to check the validity, quality, and quantity of cash flow from the underlying property. The commenter also expressed concern that increased competition in the commercial real estate market may lead to increased risk taking and raised concern about the use of federally-insured deposits to fund CMBS activity.

The Board believes that permitting section 20 subsidiaries to underwrite and deal in mortgage-backed securities without obtaining appraisals that meet the Board's appraisal requirements is not likely to create significant additional risks for bank holding companies or pose a systemic risk to the banking system. The Board notes that bank holding companies have substantial expertise in analyzing the risks associated with loans secured by residential and commercial real estate, and that section 20 subsidiaries have developed the necessary procedures to evaluate the credit risks involved in underwriting and dealing in mortgage-backed securities. In addition, section 20 subsidiaries that seek to underwrite or deal in CMBS are subject to an operational and managerial infrastructure inspection prior to being permitted to engage in such activities. Periodic inspections by the Federal Reserve verify that proper underwriting

[1] Section 1121(4) of FIRREA, 12 U.S.C. 3350(4), defines a federally related transaction as a real estate-related financial transaction that is regulated or engaged in by a federal financial institutions regulatory agency and requires the services of an appraiser. Section 1121(5), in turn, defines a real estate-related financial transaction as any transaction that involves: (1) the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof; (2) the refinancing of real property or interests in real property; and (3) the use of real property or interests in real property as security for a loan or investment, *including mortgage-backed securities* (emphasis added).

[2] *See* Title XI's Statement of Purpose. 12 U.S.C. 3331.

[3] *See* 59 FR 29482 (1994).

[4] *See* 62 FR 64997 (1997).

and risk management procedures are in place at section 20 subsidiaries.

When a section 20 subsidiary serves as lead underwriter, it is responsible for performing adequate due diligence. In other instances, such as the dealing of an outstanding debt security, a section 20 subsidiary may rely on the due diligence performed by independent rating agencies. Due diligence efforts conducted by a section 20 subsidiary or an independent rating agency often include analyses of factors such as payment history, mortgage and security structure, borrower's income or property cash flow, credit enhancements, and seasoning. In most CMBS transactions, the underlying loans have demonstrated their ability to perform over a period of time. As the underlying commercial real estate loans in a CMBS pool season, appraisals obtained at origination become increasingly less relevant to an investor's decision to purchase the related CMBS because the market assumptions upon which the appraisals were based may have become obsolete. Further, the public rating or due diligence that must be obtained or conducted for CMBS provides investors with sufficient information to assess the risks associated with the CMBS. A majority of the commenters agreed with this assessment of the CMBS market.

In response to the concerns expressed by one commenter that exempting CMBS transactions from the appraisal regulation would pose undue or unacceptable risk to federally-insured depository institutions, the Board notes that the proposed amendment relates solely to section 20 subsidiaries of bank holding companies and would not affect the appraisal requirements applicable to any federally-insured depository institution. In addition, transactions between a federally-insured depository institution and an affiliated section 20 subsidiary would continue to be subject to applicable restrictions in section 23A and 23B of the Federal Reserve Act (12 U.S.C. 37k, 37k–1). At this time, the Board is not considering any additional exemptions from the appraisal regulation for other transactions related to the CMBS market. Further, since the agencies have uniform appraisal regulations, any proposal to exempt CMBS-related transactions for federally-insured depository institutions would be addressed on an interagency basis.

Regulatory Flexibility Act Analysis

This amendment is not expected to have a significant economic impact on a substantial number of small business entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) because this amendment will only affect bank holding companies that have section 20 subsidiaries, which generally are among the largest bank holding companies. Further, the amendment is not expected to impose any additional burdens on regulated institutions.

Paperwork Reduction Act

No collection of information pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*) is contained in this rulemaking.

List of Subjects in 12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, the Board amends 12 CFR part 225 as set forth below:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828o, 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. In Subpart G, § 225.63 is amended by removing the word "or" at the end of paragraph (a)(11), by redesignating paragraph (a)(12) as paragraph (a)(13), and by adding a new paragraph (a)(12) to read as follows:

§ 225.63 Appraisals required; transactions requiring a State certified or licensed appraiser.

(a) * * *

(12) The transaction involves underwriting or dealing in mortgage-backed securities; or

* * * * *

By order of the Board of Governors of the Federal Reserve System.

Dated: November 20, 1998.

Robert deV. Frierson,

Associate Secretary of the Board.

[FR Doc. 98–31602 Filed 11–25–98; 8:45 am]

BILLING CODE 6210–01–P