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Report to Congressional Committees

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BANK AND THRIFT REGULATION

Better Guidance Is Needed for Real Estate Evaluations

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The Honorable Donald W. Riegle, Jr.
Chairman
The Honorable Alfonse M. D'Amato
Ranking Minority Member
Committee on Banking, Housing, and
Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable James A. Leach
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives

The Housing and Community Development Act of 1992 (P.L. 102-550) mandated that we assess the de minimis appraisal threshold. This threshold is the dollar level set by federal financial regulators to exempt real estate loans made by federally insured financial institutions from statutory appraisal requirements. Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) established appraisal requirements to promote safe and sound banking practices and protect federal financial and public policy interests. FIRREA required appraisals to be written, performed in accordance with generally accepted appraisal standards, and done by appraisers who have met state requirements for licensing or certification. To reduce regulatory burden and foster economic growth, federal banking and thrift regulators issued a proposed rule in June 1993 to, among other things, increase the de minimis appraisal threshold from $100,000 to $250,000 for both residential and commercial real estate loans. This increase would exempt more loans from statutory appraisal requirements. For loans of $250,000 and below, financial institutions would be permitted to use a real estate evaluation instead of an appraisal. An evaluation serves the same purpose as an appraisal but is generally a simpler assessment of real estate market value performed by individuals who need not be state licensed or certified.

Some members of Congress, consumer groups, and the appraisal industry have expressed concern that raising the de minimis appraisal threshold could adversely affect the safety and soundness of financial institutions. They have also expressed concern about the consumer's ability to be protected from and take action against questionable evaluation practices. In testimony on March 1, 1994, we provided interim results of our work on the proposed change in the de minimis appraisal threshold.[1]

As agreed with your offices, this report focuses on federal policies related to real estate evaluations. Specifically, this report assesses the regulatory guidance provided to financial institutions on evaluations, examination procedures provided to examiners on financial institutions' evaluation practices, and federal policies to protect consumers from questionable evaluation practices.

Results in Brief

Title XI of FIRREA established statutory appraisal requirements to promote safe and sound banking practices and protect federal financial and public policy interests. In enacting title XI, Congress responded to concerns that faulty or fraudulent appraisals played a role in the gradual weakening and collapse of some financial institutions in the 1980s. Financial regulators have since said that by permitting financial institutions to use evaluations in lieu of title XI appraisals for more transactions, they can provide regulatory relief while still ensuring safe and sound banking practices. However, we found that financial regulators did not provide (1) financial institutions adequate guidance establishing minimum standards on key aspects of evaluations and (2) examiners specific examination procedures for their examiners on reviewing financial institutions' evaluation practices. Without such guidance and procedures, regulators cannot adequately ensure that (1) financial institutions use evaluations in a manner that will ensure safe and sound real estate lending practices while reducing regulatory burden and (2) examiners provide consistent federal scrutiny of evaluation practices.

The guidance provided to financial institutions was deliberately intended to be broad to allow institutions latitude in evaluation practices (see app. I for a summary of regulatory guidance). However, this guidance is inadequate to address the goals of FIRREA to ensure safe and sound banking practices. Regulators did not provide guidance establishing minimum standards on (1) the qualifications and independence of people conducting evaluations and (2) the content of evaluations. As a result, we found wide variances in the qualifications and independence of people performing the evaluations as well as the content of the evaluations at 14 judgmentally selected banks and thrifts. For example, we found cases where evaluations

[1] Bank and Thrift Regulation: Observations on Proposed Changes to Appraisal Requirement (GAO/T-GGD-94-102, Mar. 1, 1994).

were conducted by people who had no training or were loan officers lacking independence from the loan decision-making process. Further, we found cases where the evaluation reports were unclear on how the market value information was obtained or the analysis was based primarily on a drive-by inspection of the property. Without guidance establishing minimum standards, financial institutions may either obtain evaluations that are more extensive than necessary or run the risk that their evaluations will not meet minimum regulatory expectations of competence, independence, and content. Guidance establishing minimum standards would also help alleviate financial institutions' concerns that examiners could interpret evaluation requirements inconsistently.

Most financial regulators did not establish specific examination procedures for their examiners to use in reviewing financial institutions' evaluation practices. Only one federal regulator, the Federal Reserve Board (FRB), had specific examination procedures designed to help ensure federal scrutiny of financial institutions using evaluations. Our prior work has indicated that specific examination policies help ensure that financial institutions' evaluation practices are consistently examined and that examiners detect unsafe and unsound practices promptly.[2] Likewise, the lack of specific examination procedures on assessing financial institutions' evaluation practices creates the potential for inconsistencies in examination coverage and practices between regulators and between examiners.

Current federal policies and other efforts designed to ensure that consumers are protected against questionable evaluation practices included a recent regulatory amendment and the regulators' investigation of consumer complaints. FRB clarified consumer access to evaluation reports in a December 10, 1993, amendment to its Regulation B: Equal Credit Opportunity. The amendment required all insured financial institutions to provide a copy of the evaluation to the loan applicant, just as institutions were required to provide a copy of the appraisal. Although consumers' rights to take action against questionable evaluation practices were not ensured by any specific federal policy or directive, regulators said that consumer complaints about questionable evaluation practices filed at a financial institution or sent to a regulator would receive prompt and serious investigation by examiners.

[2]Bank Examination Quality: FDIC Examinations Do Not Fully Assess Bank Safety and Soundness (GAO/AFMD-93-12, Feb. 16, 1993).

Background

Evaluations, like appraisals, provide information about and estimates of the value of real estate. However, unlike appraisals, they are generally simpler assessments of market value and are governed by federal guidance rather than statute or regulation. Financial institutions and consumers can obtain an appraisal or evaluation to help determine the underlying value of real estate. Financial institutions consider the information obtained from an appraisal or evaluation to be an integral part of the loan-underwriting process. This information, however, is only one factor available to them in determining whether to make the loan. Financial institutions use appraisals or evaluations to help ensure that a reasonable margin of protection exists should the borrower fail to repay the loan. Consumers can also obtain real estate appraisals or evaluations to help them validate the value of the real estate they plan to buy or refinance.

Congress enacted appraisal reform provisions in FIRREA in response to concerns that faulty or fraudulent real estate appraisals played a role in the gradual weakening and ultimate collapse of some financial institutions in the 1980s. Title XI of FIRREA required all appraisals performed in connection with federally related real estate transactions[3] to be performed by individuals certified or licensed in accordance with the FIRREA provisions. Title XI also established a joint federal-state mechanism for the implementation of its requirements. States were required to develop and implement programs for licensing and certifying appraisers. Generally, a certified appraiser must meet higher qualification standards than a licensed appraiser.

In addition, title XI required the financial regulators—the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), Federal Deposit Insurance Corporation (FDIC), and National Credit Union Association (NCUA)—and the Resolution Trust Corporation (RTC) to issue regulations prescribing (1) the categories of federally related real estate transactions requiring appraisals by a certified versus a licensed appraiser and (2) appropriate standards for the performance of appraisals for transactions made by federally regulated

[3]Federally related transactions include real estate transactions entered into by a financial institution regulated by the federal government that require the services of an appraiser. These include banks, thrifts, and credit unions. Not included are real estate transactions of mortgage bankers, brokers, pension funds, and insurance companies.

financial institutions. Accordingly, the regulators and RTC published separate appraisal regulations in July and August of 1990.[4]

On the basis of their experience, each regulator and RTC concluded that title XI and safety and soundness banking principles did not require an appraisal for all real estate transactions and established a dollar threshold level under which an appraisal was not required. The regulators and RTC permitted financial institutions to use evaluations or appraisals for loans under the de minimis appraisal threshold. The Housing and Community Development Act of 1992 affirmed the regulators' authority to establish a de minimis appraisal threshold but required them to certify that raising the threshold would not threaten the safety and soundness of financial institutions.

In June 1993, FRB, OCC, FDIC, and OTS proposed a rule change that would raise the de minimis appraisal threshold from $100,000 to $250,000, exempting more real estate loans from the appraisal requirement. The regulators contended that the proposed rule change would reduce regulatory burden, improve credit availability, and serve federal financial and public policy interests without threatening the safety and soundness of financial institutions. The proposed increase in the de minimis appraisal threshold elicited contentious public reaction from some Members of Congress, consumer groups, and the appraisal industry. In response to concerns about insubstantial evidence to justify the change, the regulators provided supplemental information on November 10, 1993, and invited additional public comment. On March 9 and May 3, 1994, FRB and FDIC, respectively, approved increasing their thresholds to $250,000. OCC and OTS officials told us they expect to approve the $250,000 threshold soon.

The reduction in regulatory burden that may be achieved through the use of evaluations rather than appraisals involves reduced costs and time delays associated with obtaining a title XI appraisal. As we stated in our March 1994 testimony, the fees at that time for evaluations—which ranged from zero to $175 for residential and commercial real estate—were lower than those for appraisals—which ranged from $150 to $450 for residential real estate and from $350 to $7,500 for commercial real estate. We also reported that some officials of financial institutions, particularly those in rural areas, told us that shortages of licensed or certified appraisers had caused delays in loan processing.

[4]The regulators defined an appraisal as a written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date and supported by the presentation and analysis of relevant market information.

Objectives, Scope, and Methodology

Our objectives were to assess whether the design of (1) regulatory guidance on evaluations should result in safe and sound real estate lending practices while reducing regulatory burden, (2) examination procedures should result in consistent federal scrutiny of evaluation practices, and (3) federal policies should protect consumers from questionable evaluation practices. We focused this review on evaluations and did not determine the extent to which evaluations differ from appraisals in terms of quality. Because NCUA and RTC were not proposing to increase their de minimis appraisal threshold to $250,000, they were not included in this review.

To assess whether the design of regulatory guidance on evaluations provided to financial institutions adequately result in safe and sound real estate lending practices, we examined federal guidance to financial institutions. We visited 14 banks and thrifts located in California, the District of Columbia, Maryland, North Dakota, Virginia, and Washington. We judgmentally selected the institutions, which cannot be projected beyond the sample, to obtain a mix of small, large, rural, and urban financial institutions as well as geographic dispersion. At these institutions, we interviewed officials to obtain their views on their institutions' real estate evaluation practices and regulatory guidance on evaluations. We also obtained copies of institutions' evaluation reports and supporting documentation.

To assess the consistency of examination procedures, we interviewed FRB, OCC, FDIC, and OTS regulatory officials and FDIC and OCC examiners to discuss their evaluation procedures, policies, and practices. In addition, we reviewed examination policies and procedures on evaluations issued by FRB, OCC, FDIC, and OTS to examiners.

To assess whether consumer protection existed, we reviewed federal legislation and FRB regulations governing loan applicants' rights to appraisal reports. We also interviewed officials from the banks and thrifts visited, regulatory officials, and a leading consumer protection group to discuss consumer protection issues and concerns.

We did our work from September 1993 to April 1994 in accordance with generally accepted government auditing standards. We discussed our preliminary findings, conclusions, and recommendations in exit conferences attended by responsible regulatory officials, including the Associate Director for Policy, FDIC; a National Bank Examiner for Bank Supervision Policy, OCC; a Deputy Associate Director for Bank Supervision and Regulation, FRB; and the Acting Deputy Assistant Director for Policy, OTS. Their comments are presented and evaluated later in this report. Other changes resulting from their comments were made in the body of the report as appropriate.

Extent Evaluations Will Be Used Is Unknown

Although increasing the de minimis appraisal threshold will exempt many more loans from title XI appraisal requirements, the actual extent to which financial institutions will use evaluations is unknown. Financial institutions may continue to obtain appraisals for many loans with amounts under the de minimis appraisal threshold due to the requirements of the secondary residential loan market. In addition, financial institutions may begin to use a limited appraisal, which was recently introduced by the appraisal industry as a faster and less costly alternative to a full appraisal.

Secondary Residential Loan Market Requires Appraisals

Financial institutions may still use appraisals for many loans under $250,000 even if the de minimis appraisal threshold is raised to $250,000. They may continue to use appraisals largely because the major buyers of residential loans in the secondary loan market, such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, require that appraisals have been done for the residential loans they purchase. The proportion of residential loans purchased by federal credit agencies and federally sponsored mortgage pools has exceeded 60 percent of all such loan originations from 1990 to 1992. Thus, increasing the de minimis threshold should not affect loans destined for the secondary loan market.

Limited Appraisals Might Affect Use of Evaluations

The appraisal industry is introducing a modified appraisal approach, known as a limited appraisal, as an option intended to meet the needs of the market. These limited appraisals would allow appraisers greater latitude in the amount of research performed and the detail included in the written report. However, it is too early to gauge the impact of limited appraisals on the need for and use of evaluations.

On March 22, 1994, The Appraisal Standards Board of the Appraisal Foundation adopted a statement establishing a limited appraisal option and more reporting options for licensed and certified appraisers to use. The standards issued by The Appraisal Standards Board, known as the Uniform Standards of Professional Appraisal Practice (USPAP), must be followed by licensed and certified appraisers. The Appraisal Standards

Board's objective was to clarify that the licensed and certified appraiser can provide a faster and less costly alternative to a full appraisal.

The limited appraisals would still be governed by USPAP, with some specific departure provisions allowed. For example, the appraiser could use a departure provision to limit an appraisal to just one of the usual valuation approaches, such as the use of only the comparable sales approach for residential real estate. However, the limited appraisal report would typically have to explain and support the exclusion of the two other usual valuation approaches, cost (replacement or construction cost) and income (rental or leasing revenues).

Five of the financial institution officials we interviewed were not aware of the limited appraisal concept and did not know how this product would affect their current appraisal and evaluation practices. Some financial institution officials said that unless limited appraisals meet the secondary loan market and regulatory requirements, they did not foresee their institutions using limited appraisals. Others said that they welcomed the additional product but that the cost, timing, and usefulness of limited appraisals would dictate their financial institutions' use of the product.

Regulatory Guidance Should Establish Minimum Standards

To help ensure safe and sound real estate lending practices while reducing regulatory burden, financial regulators need to provide financial institutions guidance establishing minimum standards on (1) the qualifications and independence of people conducting evaluations and (2) the content of evaluations. An evaluation, like an appraisal, is a necessary part of a sound loan-underwriting process in that it should provide objective information and analysis to help the lender decide whether to make the loan. The regulators believe their proposal to exempt more transactions from title XI appraisal requirements could reduce costs to financial institutions and consumers while ensuring safe and sound banking practices. However, we found the regulators' guidance to financial institutions on evaluations, which is intentionally broad, does not establish the necessary standards to help accomplish this. Without minimum standards, financial institutions' evaluation practices can vary significantly and could result in evaluations that are either more extensive than necessary or risk not meeting minimum regulatory expectations of competence, independence, and content. All the regulators except FDIC said they plan to revise their evaluation guidance to financial institutions. FDIC officials told us they did not plan to revise FDIC's guidance unless the other regulators revise theirs.

Federal Guidance on Evaluations Did Not Establish Minimum Standards

The regulators did not provide guidance establishing minimum standards for financial institutions on key aspects of evaluations. In their regulatory guidance to financial institutions, the four regulators required that evaluations be written, signed, and dated and include the preparer's name and address. The regulatory guidance was deliberately intended to be broad to allow financial institutions latitude in evaluation practices.

Regulatory guidance to financial institutions did not specifically address the following issues:

- Qualifications: The four regulators stated that individuals performing evaluations must have real estate-related training or experience relevant to the type of property assessed. However, none of the regulators provided guidance establishing minimum standards on the types or quantity of training or experience.
- Independence: The four regulators stated that evaluations must be done by competent persons capable of rendering an unbiased estimate of value. However, none of the regulators provided guidance establishing minimum standards for meeting the independence requirement. Further, the guidance did not provide examples of those individuals who would be considered not qualified to render an unbiased estimate.
- Content: The four regulators stated that a more detailed evaluation is required for more complex transactions or as the institution's exposure in a real estate transaction increases. However, none of the regulators defined what would be considered to be a more complex transaction or a more detailed evaluation.

Financial Institutions' Practices Varied Widely

Our visits to 14 banks and thrifts indicated that there was no standard interpretation of what an evaluation comprises. We found differences in (1) the qualifications of the individuals conducting evaluations, (2) the independence of the individuals conducting evaluations from those making the loan decisions, and (3) the content of the evaluations. For example, we found cases where (1) the individuals conducting the evaluations had no training or were not independent of the loan-underwriting process and (2) the evaluations did not indicate how the information was developed or were based on drive-by inspections. Specifically, we found the following:

- The education and training of individuals conducting evaluations ranged from no formal training to training meeting the state's criteria for a licensed appraiser. Four financial institutions we visited could not provide us the qualifications, training, and experience of the individuals used by their contractors to perform evaluations.

- The independence of individuals conducting evaluations from those making the loan decisions varied among institutions. Four institutions used in-house staff, including the chief executive officer or loan officers, to conduct evaluations. The others used contract personnel to conduct the evaluations.
- The content and analytical basis for evaluations also varied among institutions. For example, two financial institutions relied on evaluations where the property's value was based solely on a drive-by inspection of the property combined with the use of comparable sales. One financial institution used evaluations that were based on a drive-by inspection of the property's exterior combined with the consideration of the market, cost, and income valuation approaches. Three financial institutions obtained written evaluation reports that showed only the property's estimated value without a clear indication of how the value was estimated.

Guidance establishing standards on key aspects of evaluations could reduce the uncertainty that financial institutions said they face in deciding what the minimum standards are for an evaluation. In our earlier work on small business lending, many bankers said they felt forced to do more detailed evaluations than the transactions warranted.[5] Many bankers also said they did this as a defense measure against adverse examiner comments. Several bankers expressed a fear of being subjected to substantial civil money penalties if the examiner's judgment was too strict. This view was also expressed by officials from some of the financial institutions we visited for this review. Specifically, they said that the vague regulatory guidance on evaluations allowed for a high degree of interpretation. Broad guidance can introduce uncertainties for financial institutions because they viewed such guidance as allowing federal examiners the latitude to inconsistently interpret what is required. Further, without minimum evaluation standards, financial institutions may perform evaluations in a manner that undermines safety and soundness in that they fail to meet minimum regulatory expectations for competence, independence, and content.

[5]Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed (GAO/GGD-93-121, Sept. 7, 1993).

Specific Examination Procedures to Ensure Federal Scrutiny Lacking

The Housing and Community Development Act of 1992 required financial regulators to certify that increases in the de minimis threshold would not affect financial institutions' safety and soundness. However, without specific examination procedures, regulators cannot effectively ensure this. Our prior work indicated that specific examination procedures help ensure that financial institutions are examined consistently and that examiners detect unsafe and unsound practices promptly. As of April 1994, only FRB had specific procedures in place to help ensure that its examiners, in making their safety and soundness assessments, review and consider a financial institution's use of evaluations. OCC, FDIC, and OTS had not updated their examination requirements to address evaluations. This lack of specific examination procedures on assessing financial institutions' evaluation practices creates the potential for inconsistences in examination coverage and practices between regulators and between examiners. OCC and OTS officials said they plan to revise their examination procedures on assessing evaluation practices. Although FDIC officials said they would revise their evaluation guidance to financial institutions if the other regulators revise theirs, they said they did not plan to change FDIC's examination procedures because the level of guidance provided was sufficient for its examiners.

FRB revised its examination procedures in September 1992 to incorporate specific references and examination procedures on evaluations. In addition to including the evaluation guidance sent to financial institutions, FRB's examination procedures contained specific examination objectives, procedures, and internal control questions for examiners to use in reviewing a financial institution's evaluation practices. For example, one examination objective directed examiners to determine whether policies, procedures, and internal controls regarding real estate appraisals and evaluations were adequate. In addition, FRB's examination procedures contained five specific internal control questions requiring examiners to assess the independence and competency of the individuals performing evaluations as well as the content and sufficiency of the evaluations on a sample basis.

In contrast, OCC, FDIC, and OTS did not provide examination procedures on evaluations beyond the guidance provided to financial institutions. They explained that standard examination procedures require examiners to review the financial institution's loan underwriting policies and procedures, including appraisal and evaluation policies and procedures. Examiners would not be expected to specifically look for loans based on evaluations unless they suspected a problem or had concerns about the financial institution's evaluation program. However, examiners would be expected to review the quality of any evaluation reports used to support loans reviewed during the examination of the real estate lending function. In our discussion with several examiners, we found that they did not typically look at evaluations because they were not used for the loans reviewed.

OCC and OTS are in the process of updating their examination procedures and plan to include specific requirements and examination procedures on evaluations. OCC had already begun working on revising its examination procedures to incorporate specific requirements on evaluations. While these regulators were taking action to revise their manuals, they were not ready to share with us the details of the examination procedures that would be provided. Therefore, we could not assess the adequacy of the updated procedures on evaluations.

FDIC does not provide specific examination procedures for its examiners to follow during examinations. FDIC officials explained that FDIC's philosophy is that examinations are best guided by policies, not detailed procedures. The officials added that the training and guidance given to examiners on real estate lending practices, including the use of evaluations, prepare them to assess the adequacy of a financial institution's practices. This position is similar to those expressed by FDIC in response to our prior work. Specifically, FDIC said that it relies on the integrity, judgment, and discretion of the individual examiner to perform whatever procedures are appropriate for the circumstances. We believe it is the breadth of examiner discretion that creates uncertainty for financial institutions and therefore concerns over vague evaluation requirements.

Broad procedures and examination inconsistencies were identified as concerns in our prior work. For example, we noted in our report on regulatory burden[6] that bankers contended that inconsistent examination practices were unfair to bankers and examiners alike and arose from a lack of clarity on how to satisfactorily meet the intent of regulation. Further, we noted in our report on examination quality that inconsistencies in examination coverage and practices do occur.[7] More importantly, we noted that the lack of minimum examination requirements

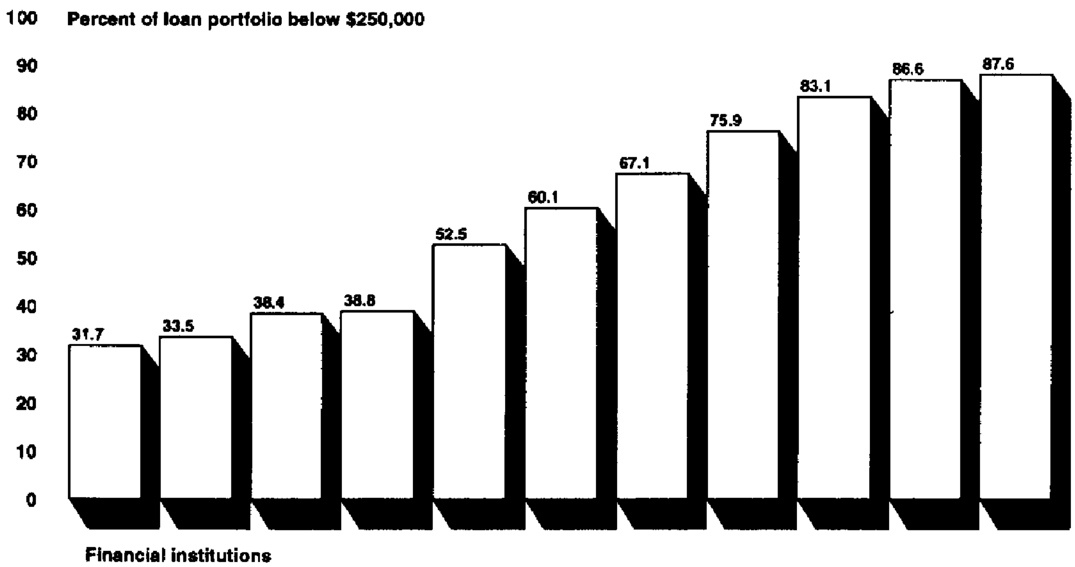
[6]Regulatory Burden: Recent Studies, Industry Issues, and Agency Initiatives (GAO/GGD-94-28, Dec. 13, 1993).

[7]Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure (GAO/AFMD-93-15, Feb. 16, 1993).

leads to a lack of assurance that examiners are able to detect unsafe and unsound conditions promptly.

Inconsistent examination practices could take on greater significance when more of a financial institution's loan portfolio is exempt from the appraisal requirement. For example, our discussions with the 14 banks and thrifts sampled indicated that the $250,000 threshold could result in the exemption of significant portions of an institution's real estate loan portfolio from appraisal requirements. As shown in figure 1, the portion of these institutions' real estate loan portfolios that would be exempt under the $250,000 threshold ranged from 32 to 88 percent. Of the top six institutions in terms of the portion of their loan portfolio under $250,000, four were banks with total assets ranging from $23 million to $110 million, and two were thrifts with total assets of $16 billion and $28 billion, respectively.

Figure 1: Portion of Real Estate Loan Portfolio Below $250,000 at the Banks and Thrifts GAO Visited



Note 1: Three of the financial institutions we visited were unable to provide breakouts of their loan portfolios by loan amount.

Note 2: Financial institutions are shown in ascending order of percentage of loan portfolios under $250,000.

Source: GAO analysis of data provided by the financial institutions visited.

Federal Regulations Address Borrower Access to Evaluation Reports, but Other Concerns Exist

On December 10, 1993, FRB amended its regulations to clarify the right of loan applicants to receive a copy of the appraisal or evaluation report used in processing their loan applications. This amendment applies to all loan applications secured by residential real estate, including those processed by federally insured banks and thrifts. However, no federal policy explicitly addresses procedures a loan applicant could use to take action against questionable evaluation practices.

FRB Action Should Ensure Borrower Access to Evaluation Reports

The right of loan applicants to receive copies of evaluations was clarified by an amendment to Regulation B: Equal Credit Opportunity, which implements the Equal Credit Opportunity Act.[8] All federally insured banks and thrifts are subject to the requirements of this regulation. FRB writes and amends regulation B and other consumer-oriented banking regulations under rulemaking authority delegated to it by legislation.

Before FRB adopted the amendment, the Federal Deposit Insurance Corporation Act of 1991 (FDICIA) required creditors to promptly provide loan applicants with a copy of the written appraisal report for loans secured by residential property. Because FDICIA referred explicitly to appraisal reports, its applicability to evaluations was a matter of interpretation. For example, officials of two financial institutions we spoke with said they did not believe they were required to provide copies of the evaluation reports to loan applicants.

To ensure the right of loan applicants to receive copies of the evaluation reports, FRB amended regulation B on December 10, 1993, to define appraisal reports as "the documents relied upon by a creditor in evaluating the value of the dwelling." FRB officials said this language clearly established the loan applicant's right to receive a copy of the evaluation report.

No Policy Explicitly Addresses Loan Applicant Rights Against Questionable Evaluations

Regulators have not explicitly addressed the actions that loan applicants can take in response to evaluation practices they perceive as questionable or inequitable unless they were performed by a licensed or certified appraiser. States are responsible under title XI for licensing and certifying appraisers. Thus, loan applicants can file complaints with the state licensing or certifying agency. The state licensing agency has the authority

[8]Section 223(d) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended the Equal Credit Opportunity Act of 1974 to require creditors to furnish applicants with a copy of the appraisal report used in connection with certain loans if applicants request such information in writing.

to revoke an appraiser's license or certification for negligent or incompetent behavior.

Regulators acknowledged the lack of an explicit complaint policy for evaluations that are not performed by a licensed or certified appraiser. They said that most loan applicants who are dissatisfied with evaluations are more likely to complain directly to the financial institution or the regulator than to the state agency licensing or certifying appraisers. They also said that any complaint on file at the institution or sent to regulators would receive prompt and serious investigation by the examiners.

FRB officials pointed out that regulators can take action against contractors performing evaluations and other financial institution affiliated parties under authority granted to them by FIRREA. Independent contractors, such as those hired to perform evaluations, are subject to administrative enforcement orders if they knowingly or recklessly participate in any (1) violation of any law or regulation, (2) breach of fiduciary duty, or (3) unsafe and unsound practice. The officials explained that this mechanism would roughly be equivalent to revoking the appraiser's license or certification because the contractor would be precluded from performing evaluations for the financial institution.

Conclusions

Title XI of FIRREA established statutory appraisal requirements to promote safe and sound banking practices and protect federal financial and public policy interests. In raising the de minimis appraisal threshold from $100,000 to $250,000, regulators will expose many more loans to coverage by often vague federal evaluation guidance that is far less specific than title XI appraisal requirements. We are concerned that the regulators moved to exempt loans from the appraisal requirement without first establishing guidance that would provide minimum standards on evaluations. The broad federal guidance on evaluations has allowed (1) varying and inconsistent practices by the financial institutions we visited and (2) practices that may not ensure safe and sound real estate lending practices. The broad guidance has caused some financial institutions to be concerned that examiners' interpretations of the guidance may be inconsistent with their own. Guidance establishing minimum evaluation standards would serve the interests of safety and soundness as well as reduce uncertainties for financial institutions.

Our concern about federal guidance on evaluations extends to the regulators' examination of financial institutions. The lack of specific examination procedures increases the possibility that examiners will neither adequately nor consistently review the financial institutions' evaluation practices for safety and soundness. Although FRB provides specific examination procedures, OCC, FDIC, and OTS do not. OCC and OTS told us that they intend to revise their current examination procedures on evaluations. We believe that FDIC also needs to revise its examination procedures.

Finally, it is not clear to what extent consumers are protected against questionable evaluation practices. Existing regulations provide loan applicants with the right to receive copies of the written appraisal and evaluation reports used by the financial institution. While current federal and state licensing and certification provisions provide loan applicants the right to take action against negligent or incompetent practices by licensed or certified appraisers, they do not extend to evaluations performed by other individuals. However, the regulators can take administrative action against those individuals conducting evaluations if they believe there is a threat to an institution's safety and soundness. It is too early to assess whether this administrative action will be an effective remedy.

Recommendations

To provide greater assurance that proposed changes in appraisal requirements reduce uncertainties and do not adversely affect the safety and soundness of financial institutions, we recommend that the Acting Chairman, Federal Deposit Insurance Corporation; the Chairman of the Board of Governors of the Federal Reserve System; the Comptroller of the Currency; and the Acting Director of the Office of Thrift Supervision ensure the following:

- Regulatory guidance to financial institutions should establish minimum standards on key aspects of evaluations. The revised guidance should provide minimum standards regarding the qualifications and independence of individuals performing evaluations and the contents, including the analytical basis, of the evaluations.
- Federal examination procedures should incorporate specific requirements that provide greater assurance that examiners consistently (1) assess financial institutions' evaluation practices and (2) consider evaluation practices in making safety and soundness determinations.

Agency Comments and Our Evaluation

We met with FDIC, FRB, OCC, and OTS officials on May 2 and 3, 1994, to discuss a draft of this report. With the exceptions noted below, those officials generally agreed with our recommendations.

FDIC, FRB, OCC, and OTS officials stated that any attempt to provide more specific guidance or criteria on evaluations would have to be balanced against the desire to provide regulatory relief. In addition, they said that financial institutions and examiners would still be required to use their best judgment in deciding specific evaluation needs on a case-by-case basis because it would be impossible to address all possibilities in the guidelines. We are not suggesting that regulatory guidance be overly restrictive or burdensome. To the contrary, we believe that added guidance that provides a reasonable framework to make consistent decisions would ease the burden on financial institutions and examiners in making their judgments.

FDIC officials disagreed with the need to provide special examination procedures on evaluations. As previously noted, FDIC's philosophy is that examinations are best guided by policies, not detailed procedures. As such, they said that their examiners have sufficient training and procedures to assess the adequacy of financial institutions' use of evaluations. However, our prior work has shown that this approach does not provide the necessary assurance that examiners consistently detect unsafe and unsound practices promptly. Further, we believe it is the breadth of examiner discretion that creates uncertainty for financial institutions and therefore concerns over vague evaluation requirements.

We are sending copies of this report to the Acting Chairman, FDIC; the Chairman of the Board of Governors of the Federal Reserve System; the Comptroller of the Currency; and the Acting Director of OTS. We will also make copies available to others on request.

Please call me on (202) 512-8678 if you or your offices have any questions about this report. Major contributors to this report are listed in appendix II.

Helen H. Hsing

Helen H. Hsing
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Institutions and Markets Issues

Summary of Regulators' Evaluation Guidelines

Guideline elements	FDIC	FRB	OCC	OTS
General				
Establish prudent standards for evaluations.	S	S	S	S
Determine an estimate of value to assist the institution in assessing the soundness of the transaction.	S	S	S	S
Perform a more detailed evaluation as the institution's exposure in a real estate-related financial transaction increases.	S	M	S	S
Contents of evaluation				
Support through documentation the estimate of value, including sufficient information for an individual to fully understand the analysis and assumptions.	S	S	S	S
Describe the property, including location, and a discussion of its use, especially for nonresidential property.	S	S	S	S
Ensure that evaluations are written, signed, and dated and include the preparer's name and address.	M	M	M	M
Include the calculations, supporting assumptions for the estimate of value, and, if utilized, a discussion of comparable property sales, information from a multiple listing service, or current tax assessed value in appropriate situations.	S	S	S	S
Qualifications of individuals performing evaluations				
Ensure that evaluations are done by competent persons capable of rendering an unbiased estimate of value.	S	M	M	M
Ensure that individuals who conduct evaluations have real estate-related training or experience relevant to the type of property.	S	S	M	M

Legend: S = should be followed
M = must be followed

Sources: FDIC FIL-69-92 Guidelines for Real Estate Appraisal and Evaluation Programs; FRB's Guidelines for Real Estate Appraisal and Evaluation Programs (Sept. 28, 1992); OCC Banking Circular 225; and OTS Thrift Bulletin 55.

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