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United States Government Accountability Office
Washington, DC 20548

October 19, 2010

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

Subject: *Status of Study Concerning Appraisal Methods and the Home Valuation Code of Conduct*

This letter responds to a requirement in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that we report within 90 days on the status of a GAO study mandated by the act on real estate appraisal issues. Enacted on July 21, 2010, the act requires us to study the effectiveness and impact of options for selecting appraisers, different valuation methods, and the Home Valuation Code of Conduct (HVCC), which was designed to enhance appraiser independence. The act requires us to report to you on the results of our study within 12 months.

Background

Valuing real estate for sale or refinancing is key to mortgage lending, providing evidence that the collateral value of the property is sufficient to avoid losses if the borrower is unable to repay the loan. Lenders have several options open to them for selecting appraisers. These options include in-house appraisers; independent appraisers; and appraisal management companies, which often subcontract with independent appraisers. To develop an appraisal, appraisers may use one or a combination of three approaches—cost, income, and comparable sales:

- The cost approach estimates a property's value by calculating the costs of replacing or reproducing the property's improvements, less physical, functional, and external depreciation.¹
- The income approach estimates what a prudent investor would pay for a property and is based on the expected net income that the property would produce.
- The comparable sales approach compares and contrasts the property under appraisal with recent offerings and sales of similar properties.

Some mortgage transactions do not require appraisals, and lenders may use other methods of valuing the properties involved, such as obtaining an opinion of the probable selling price from a real estate agent or broker (broker price opinion) or calculating the value using a computer-generated estimate that draws on publicly available property and sales information (automated valuation model).

Appraisers are required to provide an impartial, objective, and independent opinion of value for a property as of a specific date. However, in some instances, appraisers have reported being pressured by lenders to overstate home values, despite regulations prohibiting such practices. HVCC, which has been in effect since May 2009, outlines additional rules aimed at enhancing appraiser independence and currently applies to all single-family mortgage loans sold to Fannie Mae and Freddie Mac. The act requires the Federal Reserve Board to promulgate new interim final rules on appraiser independence by October 19, 2010, at which time HVCC will expire.

Objectives of Our Study

For this engagement, we are focusing on appraisals of one-to-four unit residential properties. We have grouped the study objectives listed in the act under four broad questions:

- How often are different options for selecting appraisers and valuation methods used?
- What are the potential advantages and disadvantages of these options and methods, and how do policies, including HVCC, affect their use?

¹According to Fannie Mae's April 2009 guidance, physical depreciation is a loss in value caused by deterioration in the physical condition of the improvements. Functional depreciation is a loss in value caused by defects in the design of the structure (such as inadequacies in sizes and types of rooms) or changes in market preferences that result in some aspect of the improvements being considered obsolete by current standards (e.g., the location of a bedroom on a level with no bathroom). External depreciation is a loss in value caused by negative influences that are outside of the site (e.g., expressways or factories that are adjacent to the subject property).

- To what extent do valuation costs and disclosures to consumers vary by appraiser selection option and valuation method, and how has HVCC affected these costs and disclosures?
- How do federal and lender policies, including HVCC, address conflicts of interest in the valuation process, and how have these policies affected industry stakeholders?

Status of Study Design

We are continuing our efforts to develop methodologies to answer these questions. As we discuss in the following text, these efforts include evaluating potential data sources, analyzing federal policies and academic and industry research, and interviewing federal agency officials and appraisal industry stakeholders. Our preliminary work suggests that comprehensive data may not be available for all aspects of our study. To the extent that we encounter data limitations, our final report will discuss their impact on our analysis and findings.

To describe how often options for selecting appraisers and different valuation methods are used, we will explore the availability of relevant data on valuations done in purchase and mortgage refinance transactions. We have identified and will further evaluate data collected by federal regulators, Fannie Mae and Freddie Mac, and the Federal Housing Administration as well as by private vendors that provide valuation technology services to lenders. We will assess the reliability of any data obtained and, to the extent that reliable data are available, determine the frequency with which each selection option and valuation method is used. We are also conducting literature searches to identify what researchers have determined about how often different selection options and valuation methods are used. Finally, our ongoing interviews with federal agencies, lenders, appraisers, appraisal management companies, and other industry stakeholders will provide information and perspectives on the use of different selection options and valuation methods in mortgage transactions.

To identify the potential advantages and disadvantages of the different options for selecting appraisers and valuation methods, we are conducting a literature review of relevant studies and articles. This research includes studies that examine the strengths and limitations of the different selection options and valuation methods and the potential effects on the accuracy of appraisals. In addition, we will interview appraisers, lenders, industry stakeholders, and academic experts on the potential advantages and disadvantages that may affect the use of different options for selecting appraisers and valuation methods. To determine how federal policies affect the choices available for valuing a property, we are reviewing and summarizing federal regulations and agency guidance for choosing among the available options. We will also evaluate any changes in the requirements over time, such as those introduced by HVCC, and any effects of those changes. In addition, we expect to conduct interviews with federal regulators, Fannie Mae and Freddie Mac, lenders, and other industry stakeholders to gain insight into the effects of policies on the use of different selection options and valuation methods.

To determine the extent to which valuation costs are affected by appraiser selection option and valuation method, we will continue to explore the availability of government and industry data on appraisal fees and other valuation costs and will assess the reliability and usefulness of any data obtained. To the extent possible, we will analyze relevant data and interview lenders and industry representatives to identify the factors that may affect valuation costs. To determine the extent to which disclosures to consumers are affected by selection options and valuation methods, we plan to (1) review and summarize statutes and policies, such as the Real Estate Settlement Procedures Act, that govern the disclosures of costs and valuation documentation to consumers and (2) interview federal officials and lenders to ensure our understanding of these requirements. To assess how HVCC has affected costs and disclosures, we will review the relevant provisions in HVCC; analyze data (if available) on changes in costs that may be attributable to HVCC; and interview lenders, appraisers, and consumer groups, among other industry stakeholders.

To identify potential conflicts of interest that may arise during the valuation process and determine the effect they would have on estimated values, we are interviewing federal banking regulators and appraisal industry participants to find out what parties may have interests that interfere with producing an objective opinion of value and how these conflicts of interest may impact estimated values. To determine how federal policies, including HVCC, have addressed potential conflicts of interest, we will review and summarize statutes, regulations, guidance, and federal regulators' examination procedures covering appraiser independence requirements. In addition, we plan to analyze the internal policies, practices, and controls of selected lenders to identify the steps that they have taken to address conflicts of interest. Interviews with regulators and lenders will further inform our analysis of their policies and procedures. To assess how these policies have affected industry stakeholders, we plan to interview a variety of parties, including lenders, appraisers, mortgage brokers, consumer groups, and state regulators.

We are conducting our work in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We will be available to brief your staff as our job progresses.

This report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staffs have any questions or need additional information, please contact me at (202) 512-4325 or shearw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.



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