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January 19, 2009

Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, DC 20219

Federal Reserve Board
20Th Street and Constitution Ave. NW
Washington, DC 20551

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Ladies and Gentlemen:,

We would like to express our appreciation for the time and effort the Agencies have put into the proposed Interagency Appraisal and Evaluation Guidelines. Recent events in the financial markets have underscored the need for our nation's lenders, purchasers of loans, and state and federal regulators to refocus on the cornerstone 3 C's of risk management - the borrower's credit, the borrower's capacity to repay, and the collateral.

As the nation's leading provider of risk mitigation and regulatory compliance tools for the financial services industry, Interthinx sees on a daily basis the pervasive nature of fraud in financial services. We frequently find gross misrepresentation, fraud, and incompetence in the collateral valuation process and reports we review. As the Agencies read the comments generated by your proposal, and as you consider the environment in which our financial system currently exists, it is our sincere hope and belief that we all learn from past mistakes and not be afraid to take bold steps to help protect the integrity of our financial system and regulate intelligently and in such a manner that promotes fair and uniform lending standards for federally regulated institutions and protects the consumer from fraud. We believe that the following comments will assist the agencies as final determinations are made on these important guideline revisions.

The request for comments specifically asks for comments on three issues. Following our comments regarding these issues we will also provide other commentary. The three specific questions/issues are:

I. "*the clarity of the proposed Guidelines regarding the interpretations of the thirteen appraisal exemptions discussed in Appendix A*."

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II. *"the appropriateness of risk management expectations and controls in the evaluations process including those discussed in Appendix B"*

III. *"expectation in the proposed Guidelines on reviewing appraisals and evaluations"* Specifically*, "the use of automated tools or sampling methods that the proposed Guidelines allow for reviews of appraisal or evaluations supporting lower risk single-family residential mortgages is appropriate for other low risk mortgage transactions and whether appropriate constraints can be placed on the use of these tools and methods to ensure the overall integrity of the institution's appraisal process for those low risk mortgages."*

I. <u>Clarity of the proposed Guidelines regarding the interpretations of the thirteen appraisal exemptions discussed in Appendix A."</u>

1. <u>Appraisal Threshold</u>

The current threshold of $250,000 should be reduced to $50,000. The $250,000 allows a significant number of federally related transactions to occur with only "evaluations" as the means of determining the collateral value and marketability. Currently there is no clear definition of an "evaluation". There are no industry wide standards or qualification criteria, no established quality control process, and virtually no oversight. The opportunities for and occurrences of fraud are significant. Given the recent diminution of property values across the country and likelihood of continued declines, a majority of single family residential loans could quality for evaluations below the $250,000 threshold. The current threshold also unfairly deprives lower income borrowers from receiving the same level of risk protection that borrowers of higher priced properties enjoy.

Our own experience at Interthinx shows that valuations associated with loans of less than $250,000 are just as likely, if not more so, to include examples of gross misrepresentation or even fraud.

<u>Exemptions 2-6 – No Comment</u>

7. <u>Renewals, Refinancing, and Other Subsequent Transactions</u>

This exemption states that renewals, refinancing, and other subsequent transactions may be supported by evaluations rather than appraisals.

"*An evaluation is permitted for renewals of existing extensions of credit when either:*
(1) No new funds are advanced (other than for reasonable closing costs); or
(2) No obvious and material changes in market conditions or the physical aspects of the property threaten the institution's real estate protection after the transaction."

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Given that there is no accepted definition of an "*evaluation*", in this document or in the industry, allowing this broad use is inappropriate. Provision #2 must be clarified. "*Obvious and material changes*" is vague and requires more guidance. Most evaluation products (i.e. Automated Valuation Models) do not provide specific information regarding market conditions or physical aspects of the property. In fact, most evaluations (AVMs) are performed without any type of property inspection so the physical aspects (even its existence) of the property are never actually confirmed. Evaluation products are not subject to any type of industry standards or qualification criteria. Without standards and enforcement the opportunities and likelihood of fraud is tremendous.

Loan Workouts or Modifications

Comments same as above.

Other Changes to Loan Terms

Comments same as above.

8. **Transactions Involving Real Estate Notes**

On page 47, the Guidelines state the following

> "*The institution should employ audit procedures and review a representative sample of appraisals supporting pooled loans or real estate notes in order to determine that the conditions of the exemption have been satisfied*."

It is not clear what is meant by the term "review". Many will read this to mean a USPAP compliant appraisal review and others will interpret review to mean something different, such as a comparison with an AVM. Additionally, since this statement specifically identifies appraisals it may imply that audit and review of evaluations associated with pooled loans is not required.

9. **Transactions Insured or Guaranteed by a U.S. Government Agency or U.S. Government-sponsored Agency**

Transactions insured or guaranteed by a U.S. Government Agency or Government Sponsored Agency should not be exempt from these guidelines. A significant percentage of loans in the U.S. are insured or guaranteed by a government agency. Allowing these exemptions creates significant confusion in the market place and on the part of regulators and law enforcement. They should be allowed to add additional requirements or guidelines but not be exempt from the Interagency Appraisal and Evaluation Guidelines.

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10. **<u>Transactions that Qualify for Sale to, or Meet the Appraisal Standards of, a U.S. Government Agency or U.S. Government-sponsored Agency</u>**

Transactions that qualify for sale to, or meet the appraisal standards of a U.S. Government Agency or Government Sponsored Agency <u>should not be exempt</u> from these guidelines. A significant percentage of loans in the U.S. are insured or guaranteed by a government agency. Allowing these exemptions creates confusion in the market place and on the part of regulators and law enforcement. They should be allowed to add additional requirements or guidelines but not be exempt from the Interagency Appraisal and Evaluation Guidelines.

11. **<u>Transactions by Regulated Institutions as Fiduciaries</u>**

No Comment

12. **<u>Appraisals Not Necessary to Protect Federal Financial and Public Policy Interests or the Safety and Soundness of Financial Institutions</u>**

No comment

13. **<u>Transactions Involving Underwriting or Dealing in Mortgage-backed Securities</u>**

This exemption should be stricken. Recent events in the mortgage backed securities markets demonstrate the necessity for those who are underwriting or dealing in mortgage backed securities to understand the value and marketability of the underlying collateral supporting the pools of loans. Without clear understanding of the nature and inherent risk associated with the underlying collateral it is impossible to appropriately price and reserve against the downside risk associated with certain types of collateral.

II. The appropriateness of risk management expectations and controls in the evaluations process including those discussed in Appendix B.

We recognize and support the concept that appropriate risk management can be carried out on certain low risk loans using an evaluation in place of an appraisal. However, there is a lack of clarity regarding evaluations that the agencies must address.

- There is no industry accepted definition of an evaluation. The proposed guidelines seem to imply that an evaluation is an AVM or TAV (Tax Assessment Valuation). However, for example, Broker Price Opinions (BPOs) are often used as evaluations.
- There are no industry accepted minimum standards for AVMs or BPOs

- AVMs may not provide estimates of value that comply with the Agencies definition of Market Value, which is:

> ***Market Value*** *– As defined in the Agencies' appraisal regulations, the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition are the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:*
>
> *• Buyer and seller are typically motivated;*
> *• Both parties are well informed or well advised, and acting in what they consider their own best interests;*
> *• A reasonable time is allowed for exposure in the open market;*
> *• Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
> *• The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*

In order to produce an estimate of value, based on this definition, the Valuer (or valuation system) must use comparable sales in the sale comparison approach to value that are also market value transactions. AVMs typically have no way of discerning whether or not the transactions used to derive the estimate of value comply.

<u>Page 53, Appendix B states</u>:

"*an institution should establish specific criteria for determining whether an AVM is an appropriate evaluation alternative for a particular transaction*."

Some of the stated criteria will not be evident based on the output from an AVM. For example:

<u>Property Location</u>

- Is the property located in a market with strong sales activity?
- Are aspects about the property's location typical or average for its market (such as the view of the surrounding area or proximity to public or private facilities or services)?

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Given that AVMs do not typically include an inspection or market analysis, it is unlikely that lenders will be able to determine the relative strength of sales activity in the market or whether or not location has a positive or negative effect on market value.

Property Condition

- *Is sufficient information available to assess whether the property is in average or above average condition consistent with its intended use?*
- *Is the area or neighborhood free of known adverse conditions that could affect the property's value (such as disrepair from a natural disaster or other events, defective building materials, or environmental concerns)?*

An AVM will not provide answers to either of these questions.

III. *"comment on the expectations in the proposed Guidelines on reviewing appraisals and evaluations"* *In particular, "the use of automated tools or sampling methods that the proposed Guidelines allow for reviews of appraisal or evaluations supporting lower risk single-family residential mortgages is appropriate for other low risk mortgage transactions and whether appropriate constraints can be placed on the use of these tools and methods to ensure the overall integrity of the institution's appraisal process for those low risk mortgages."*

We are pleased to see this new section added to the proposed Guidelines. The appraisal and evaluation review process is fundamental to an appropriate risk management strategy. The concepts and requirements put forth are a positive step however there are several areas that need further clarification:

Page 37 -1st paragraph states – "*This review should be performed prior to the final credit decision and ensure that the appraisal or evaluation adequately supports approval of the credit*." This should be reworded to say - this review should be performed prior to the final credit decision and ensure that the appraisal or evaluation adequately supports the credit decision.

The current wording could imply that adequate reviews are only needed to support credit approvals.

Page 37 2nd paragraph states – "*Small or rural institutions or branches with limited staff should implement prudent safeguards for accepting appraisals and evaluations when absolute lines of independence cannot be achieved. In these situations, the review may be part of the originating loan officer's overall credit analysis, as long as the originating loan officer abstains from directly or indirectly approving or voting to approve the loan*."

This caveat should be stricken. If an institution does not have the appropriate internal staff to maintain lines of independence those institutions should be required to outsource those functions in order to establish required levels of independence. Furthermore, no definition of

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small or rural institutions exists making it likely that some institutions will try and use this caveat to skirt these Guidelines.

Page 37 3rd paragraph states – "*Appraisals and evaluations supporting complex properties or high-risk transactions should be reviewed more comprehensively to assess the technical quality of the appraiser's analysis prior to making a final credit decision."*

This statement is confusing as it implies that evaluations may be acceptable for high risk transactions. Evaluations should never be used in lieu of an appraisal for high risk transactions. It also implies that evaluations are performed by appraisers when they generally are not.

Page 38 2nd paragraph states - *With prior approval from its primary regulator, an institution may employ various techniques, such as automated tools or sampling methods, for performing pre-funding reviews of appraisals or evaluations supporting lower risk single-family residential mortgages.*

This implies that an automated valuation model is an appraisal review technique when it is not. AVMs can be used as research tools or pre-screening methods but not to perform appraisal or evaluation reviews. Also the term, sampling methods, needs to be clarified. Sampling methods can be used effectively if applied correctly using accepted statistical techniques. However, if used inappropriately, sampling methods are ineffective and misleading.

Page 39 1st paragraph states – "*Any changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified state-certified or licensed appraiser in accordance with USPAP*."

This sentence should be reworded. Changing the estimate of value provided would be a fraudulent activity. The reviewer may produce an alternate value in accordance with USPAP but not change the appraisal.

Additional Comments:

Independence of the Appraisal and Valuation Program – pages 19-21

This section of the proposed Guidelines emphasizes the need for independence as part of an effective collateral valuation program. Specifically it states:

> "*Persons who perform appraisals must be independent of the loan production and collection processes and have no direct or indirect interest, financial or otherwise, in the property or transaction."*

We agree with this approach. However, the majority of loans and appraisal requests are originated by mortgage brokers. Brokers clearly fall within the category of loan production but are not specifically mentioned in the proposed Guidelines. Our experience shows that broker originated loans have a higher propensity for fraud overall. Mortgage broker's also tend to be the source of pressure on appraisers to hit values and or understate deficiencies with the collateral. Appraisals should be procured by the funding lender not the Broker.

Page 20 2nd paragraph states – "*While the information provided to the appraiser by the institution should not unduly influence the appraiser, the institution may provide a copy of the sales contract for purchase transactions*."

Edit in the following manner:

While the information provided to the appraiser by the institution should not unduly influence the appraiser, the institution may provide a copy of the fully ratified sales contract for purchase transactions

Page 20 3rd paragraph states – "*For a small or rural institution or branch, it may not always be possible or practical to separate the collateral valuation program from the loan production process. If absolute lines of independence cannot be achieved, an institution should be able to demonstrate clearly that it has prudent safeguards to isolate its collateral valuation program from influence or interference from the loan production process. In such cases, another loan officer, other officer, or director of the institution may be the only person qualified to analyze the real estate collateral. To ensure their independence, such lending officials, officers, or directors should abstain from any vote or approval involving loans on which they performed, ordered, or reviewed the appraisal or evaluation.*"

A definition needs to be created and enforced regarding what constitutes a "small or rural" institution. Without a clear definition this clause will be applied inappropriately. If an institution is truly too small to have absolute lines of independence they should be required to outsource the function to create those lines of independence.

Page 32 – Qualification of Persons Who Perform Evaluations

There are no accepted industry standards or qualification criteria for individuals or companies performing or utilizing evaluations. There is not even a clear definition of what constitutes an evaluation. The proposed Guidelines state:

"An institution should select persons who are independent of the loan production process and the transaction, and have real estate-related training and experience to perform evaluations."

This statement is very problematic in that *real estate-related training and experience* is too ambiguous and unenforceable.

Page 33 2nd paragraph states - *An evaluation should support the institution's decision to engage in the transaction. While evaluation methodologies and tools may vary, all evaluations, at a minimum, should:*

- *Identify the location of the property;*
- *Provide a description of the property and its current and projected use;*
- *Indicate the source(s) of information used to value the property, including, but not limited to:*

    - o *External data sources;*
    - o *Previous sales data;*
    - o *Photos of the property;*
    - o *Property tax assessment data;*
    - o *Comparable sales information;*
    - o *Description of the neighborhood; and*
    - o *Local market conditions;*

- *Disclose the analysis that was performed and the supporting information used to value the property;*
- *Provide an estimate of the property's market value in its actual physical condition, use and zoning designation as of an effective date, with any limiting conditions, if applicable;*
- *Indicate the preparer's name and contact information; and*
- *Be documented in the credit file. Documentation content should be appropriate for the valuation methodology and tool used for the transaction.*

It should be noted that some of this information is outside the scope of most AVMs. Examples include: photos of the property, description of the neighborhood and local market conditions.

General Comments and Conclusions:

We applaud the Agencies for putting the obvious time and effort into the proposed Guidelines. We believe the proposed Guidelines are an important improvement from the 1994 Interagency Appraisal and Evaluation Guidelines. However, we strongly encourage the Agencies to carefully reflect on the current crisis engulfing our mortgage lending and financial markets. It is imperative that decisive action be taken to close loopholes, ambiguities, and mistakes that have been in place over the past 15 years. We agree completely with the Agencies assertion on page 10 that:

> ***Independent and reliable collateral valuations are core to a regulated institution's real estate credit decisions*.**

Although the proposed Guidelines take positive steps toward improving the collateral valuation process, the true key is enforcement. Since 1994 enforcement of the Interagency Appraisal and Evaluation Guidelines has been ineffective. We strongly encourage the Agencies to take the

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necessary steps to make enforcement a key ingredient of the new Guidelines once implemented. Without effective enforcement the Guidelines themselves are meaningless.

We appreciate the opportunity to provide feedback on this all important document. We stand ready to provide additional feedback if requested.

Sincerely,

James R. Park, Vice President
Chief Valuation Officer