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THE USE OF AUTOMATIC COLLATERAL EVALUATION PRODUCTS IN RESIDENTIAL MORTGAGE TRANSACTIONS: *BIG BANKS USE THEM AS BAIT TO TRAP CONSUMERS INTO RISKY MORTGAGES*

ROKSANA GALLUS

I. INTRODUCTION

The nine most terrifying words in the English language are I'm from the government and I'm here to help.

– Ronald Reagan[1]

Big banks are once again getting ahead of themselves and

1. *See* Litz v. Maryland Department of the Environment, 446 Md. 254, 257 (Md. Ct. Spec. App. 2016) (quoting Ronald Regan at a news conference on August 12, 1986).

diminishing the stringent standards that Congress implemented to protect consumers in residential mortgage transactions. The recent financial collapse of 2007-2009 illustrates the big banks' consequences of ignoring risk while carelessly funding mortgage borrowing.[2] The mortgage loan crises of the 1980s and 2007-2009 revealed that inflated real estate appraisals played a key role in the collapse of major banking institutions and the real estate housing market.[3]

However, many still believe that the largest sector of the mortgage market remains "safe" because two government-chartered companies support it: the Federal National Mortgage Association ("Fannie Mae"), and the Federal Home Loan Mortgage Corporation (Freddie Mac").[4] The assumption is that the federal government would bail out these two institutions if they were unable to meet their debt obligation.[5] Over the past few decades, social trends and government policies exacerbated both the mortgage capital over-supply and the risk-valuation disconnect.[6] In an attempt to deal with consequences of careless mortgage lending, Congress passed series of regulations to combat the issue of inflated real estate appraisals.[7] These regulations serve a dual role of keeping financial conglomerates from employing deceptive lending tactics while protecting consumers against mortgage fraud.

While the real estate market is slowly recovering from the 2007-2009 housing crash, privately owned companies, such as Freddie Mac, are pushing for the use of automated collateral evaluation products ("ACEs") to bypass the use of a traditional appraisal in residential mortgage transactions.[8] This undermines the integrity of the loan application process, which relies heavily on the accuracy of real estate appraisals.[9] Ultimately, the real estate industry is moving away from stringent appraisal regulations implemented by Congress toward an era that relies on computer-generated data, which fails to recognize the unique nature of each parcel of real estate. The appraisal industry is raising serious concerns over ACEs by accusing big banks of not bearing the

2. Andrea J. Boyack, *Lessons in Price Stability from the U.S. Real Estate Market Collapse*, 2010 MICH. ST. L. REV. 925, 926 (2010).

3. Kevin J. Murray, *Issues in Appraisal Regulation: The Cracks in the Foundation of the Mortgage Lending Process*, 43 LOY. L.A. L. REV. 1301, 1302 (2010).

4. David Reiss, *The Federal Government's Implied Guarantee Of Fannie Mae And Freddie Mac's Obligations: Uncle Sam Will Pick Up The Tab*, 24 GA. L. REV. 1019, 1022 (2008).

5. *Id.* at 1022.

6. Boyack, *supra* note 2, at 922.

7. Murray, *supra* note 3, at 1307.

8. Freddie Mac Guide, *Automated Collateral Evaluation*, FREDDIE MAC, www.freddiemac.com/learn/pdfs/uw/ace.pdf (July 2018).

9. *See* Murray, *supra* note 3, at 1307 (noting that when inflated appraisals are used to support home mortgages, borrowers are saddled with debts that exceed home values).

consequences of risk.[10] This is a dangerous step for the loan origination process, which could lead to disastrous consequences, such as those seen in the most recent financial crisis.[11] In short, we may be heading towards another housing crash.

This Article critiques the regulatory gaps in the appraisal industry that facilitate production of inaccurate residential real estate appraisals and the increasing use of automated collateral evaluation products ("ACEs"). Part I briefly introduces the focus of this article. Part II discusses different types of real estate appraisal and provides background information on their role in mortgage transactions. This section also examines how the recent 2007-2009 financial crisis resulted in the passage of the Dodd-Frank Act. Additionally, it considers the role of large financial institutions, such as Freddie Mac, and the increasing use of ACEs in residential mortgage transactions. Part III explores the two competing appraisal approaches (i.e. ACEs and traditional appraisals) and how they both affect real estate transactions. Part IV proposes solutions to current regulatory gaps in the appraisal industry, and advises as to what can be done to improve appraisal credibility. Finally, Part V concludes that the use of ACEs in residential mortgage transactions should be limited to non-mortgage transactions.

II. BACKGROUND

In a typical residential mortgage transaction, an appraisal is essential to determine the fair market value of real property.[12] Appraisals are vital to mortgage lenders, who regularly use them in the credit decision process.[13] A borrower promises to make periodic

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10. Kelsey Ramirez, *Appraisers Raise Concerns Over Fannie, Freddie Automated Appraisals,* HOUSING WIRE, (Aug. 25, 2017) www.housingwire.com/articles/41097-appraisers-raise-concerns-over-fannie-freddie-automated-appraisals.

11. *Id.*

12. Janet Wickell, *Residential Real Estate Appraisals*, BALANCE, (Nov. 13, 2018) www.thebalance.com/facts-about-residential-real-estate-appraisals-1797691.

13. Murray*, supra* note 3*,* at 1307. To ensure its recovery of the outstanding mortgage balance, the lender typically lends only a percentage-typically 80 percent of the market value of the home. *Id*. The 80 % LTV (loan-to-value) is the maximum that amount that can be extended while reasonably ensuring the lender's ability to recover the outstanding balance of the principal loan through a foreclosure sale in case of borrower's default. *Id*. at 1308. However, there are many loan programs with a LTV ranging anywhere from 90% LTV to 96.5 LTV% to even 100% LTV such as Veteran's loan. *Id.; see also* FANNIE MAE, *Know Your Options By Fannie Mae* www.knowyouroptions.com/buy/buying-process/qualify-for-a-mortgage (discussing different mortgage buying options); *see* Michael L. Weissman, *Real Estate Collateral – Commercial and Industrial Loan Documentation,* IICLE*,* at 8 (2014), www.iicle.com/iicleonline/detail/30025 (discussing lender's reliance on real estate appraisals).

payments on the loan and gives the lender a lien on the home as collateral to secure the mortgage.[14] The lender's mortgage approval decision is based on both the borrower's financial status and the value of the underlying real property.[15] The lender then hires an appraiser to generate an appraisal report based on his opinion of value of the underlying real property.[16] In the event that the borrower defaults, the lender relies upon the value of the home to recover the outstanding balance of the loan through a foreclosure sale.[17]

The background section is divided into five parts. Section "A" discusses the role of an appraisal in residential mortgage transactions. Section "B" explains three different types of traditional real estate appraisals. Section "C" provides the historical background of the last two financial crises: The Savings and Loan Crisis of 1980s, and the Great Recession of 2007-2009. Section "D" discusses current challenges in appraisal regulation. Section "E" introduces the concept of automated collateral evaluation products (ACEs) and their endorsement by big financial institutions, such as Freddie Mac.

A. The Role of an Appraisal in Residential Mortgage Transactions

The real estate lending process may be simplistically described as a "triangle" composed of a borrower, a lender, and an appraiser.[18] An appraisal of real property has been defined as a "written statement that contains an estimate of value of an adequately described real property as of a specified date, supported by the presentation and analysis of relevant market data."[19] "The objective of the appraisal is to determine *the highest and best use* of the property, *i.e.*, the reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported, and financially feasible, and that results in the highest value."[20]

An appraiser's job is to issue a credible opinion of value based on comprehensive research and market analysis.[21] Because lenders use appraisal reports as one of the more important underwriting

14. Murray, *supra* note 3, at 1307.

15. Cherokee W. Wooley, *Regulation of Real Estate Appraisers and Appraisals: The Effects of FIRRERA*, 43 EMORY L.J. 357, 358 (1994).

16. *Id.*

17. Murray, *supra* note 3, at 1307.

18. Wooley, *supra* note 15, at 358.

19. *Id.* at 368.

20. *See* Weissman, *supra* note 13 (noting that he highest and best use of real property must meet legal permissibility, physical possibility, financial feasibility, and maximum profitability).

21. Murray, *supra* note 3, at 1308.

tools, regulatory agencies have set forth basic information requirements that every appraisal must contain.[22] The report itself provides very useful information pertaining to current market conditions, characteristics of a particular neighborhood in which the property is located, value of land and any improvements, and current rental rates and operating expenses.[23]

In a residential mortgage transaction, appraisals are typically required any time a federally regulated institution makes a loan secured by real property, subject to certain regulatory exceptions.[24] One of these exceptions is the *de minimis*[25] appraisal threshold. In short, banks are not required to obtain an appraisal for any federal loans under $250,000.[26] This means that the current threshold exempts a majority of all residential real estate loans from the

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22. Weissman, *supra* note 13, at 5.

23. *Id.*

24. 12 U.S.C. § 3350(4). (The term 'federally related transaction' means any real estate related financial transaction which; (a) a federal financial institutions regulatory agency or the Resolution Trust Corporation engages in, contracts for, or regulates; and (b) requires the services of an appraiser"); *see also* Weissman, *supra* note 13, at 6 (explaining that appraisal regulations recognize that there are circumstances when a prudent lending decision can be made on a loan secured by real estate without an appraisal).

> Under regulations established by FIRERA, an appraisal performed by a state licensed appraiser is waived in real estate transactions in the following circumstances: (i) the transaction value is $250,000 or less, (ii) a lien on real property has been taken as collateral solely through an "abundance of caution" and, as consequence, where the terms of the transaction have not been made more favorable than they would have been in the absence of the lien, (iii) a real estate lease is entered into, (iv) the loan is a business loan of $1 million or less, and repayment does not depend on the sale of the real estate or rental income, (v) there is a loan renewal due to the maturation of an existing credit, and (vi) a regulated institution purchases a loan or interest in a loan, pooled loans, provided that appraisal for each pooled loan or interest met requirements of these regulations at the time or origination).

Id.

25. William H. Green, John Russell, Phillip Gainey, Gil Santana, & Linda Fusco, *Regulatory Issues Facing the Real Estate Appraisal Profession: Unintended Consequences of the Dodd-Frank Law and Potential Remedies*, AM. SOC'Y OF APPRAISERS, 1, 11 (2015), http://www.appraisers.org/docs/default-source/discipline_rp/regulatory-issues-facing-the-appraisal-profession_full-white-paper_042915.pdf?sfvrsn=2 (discussing the *di minimis* appraisal threshold exception). This exception is the dollar amount set by federal financial regulators exempting real estate loans under $250,000.00 made by federally insured financial institutions from certain statutory requirements. *Id.*

26. *See* ICAP Board, *Commercial Appraisal De Minis Proposal*, APPRAISER BLOGS, (Mar. 27, 2017), www.appraisersblogs.com/commercial-appraisal-threshold-increase (noting that the Illinois Association of Realtors 2015 Annual Report on the Illinois Housing Market, there were 155,676 sales of residential properties in Illinois in 2015, with a median sale price of $173,000 (31% below the current $250,000 appraisal threshold for residential mortgage loans)).

appraisal requirement.[27] With the real estate market slowly recovering, most residential purchases fall below the threshold amount of $250,000.[28]

The *de minimis* threshold exception removes layers of consumer protection, which assures residential purchasers that the value of the property supports the mortgage amount assumed.[29] Many groups have lobbied to reduce the *de minimis* threshold to no avail aside from Higher-Priced Mortgage Loans[30] ("HPML").[31] "In general, HPMLs are higher-priced mortgage loans with an annual percentage rate ("APR") higher than a benchmark rate called the Average Prime Offer Rate.[32]

B. Three Types of Appraisals

There are three basic types of property appraisals used depending on the type of real property being appraised; these consist of the (i) sale comparison approach, (ii) the cost approach, and (iii) the income capitalization approach.[33] For residential appraisals, appraisers most commonly use the sales comparison approach.[34]

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27. *Id.*

28. *See* USPAP*, 2018-2019 Uniform Standards of Professional Appraisal Practice*, APPRAISAL FOUNDATION, (Jan. 1, 2018), www.appraiserelearning.com/wp-content/uploads/2018/09/2018-19-electronic-copy-of-USPAP.pdf (discussing current real estate market trends); *see also* Steve Hurlburt, *Raising Appraisal De Minimis: Good or Bad For The Industry?* NERNEJ.COM, (Apr. 21, 2017) www.nerej.com/raising-appraisal-de-minimis-good-or-bad-for-the-industry-by-steve-hurlburt (noting that just recently, the federal regulatory agencies, Office of the Comptroller of the Currency, Treasury (OCC); board of governors of the Federal Reserve System (Board); and Federal Deposit Insurance Corporation (FDIC), agreed to raise the appraisal threshold level from $250,000 to $500,000 for commercial real estate appraisals). They left it untouched at $250,000 for residential. *Id.*

29. *Id.*

30. *See* Appraisal Rule Guide, *TILA Higher-Priced Mortgage Loans (HPML) Appraisal,* CONSUMER FIN. PROTECTION BUREAU *(*Jan. 13, 2014), www.files.consumerfinance.gov/f/201401_cfpb_tila-hpml_appraisal-rule-guide.pdf

> Defining HPML's as: "a consumer credit transaction secured by the consumer's principal dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points for loans secured by a first lien on a dwelling, or by 3.5 or more percentage points for loans secured by a subordinate lien on a dwelling."

Id.

31. Russell, *supra* note 25, at 11.

32. *Id.*

33. Wooley, *supra* note 15, at 360.

34. Murray, *supra* note 3*,* at 1308.

1. *The Sales Comparison Approach*

Under the sales comparison approach, the appraiser deems a property to have approximately the same value as other, comparable properties in the area.[35] To establish a baseline value for real property, the appraiser identifies recently sold comparable properties in the area and then adjusts this baseline value to reflect the value of any major differences between the comparables and the property being appraised.[36] In addition, appraisers must identify and analyze other variables[37] affecting the property's market value.[38] These market variables tend to be dynamic, ambiguous, and often difficult to quantify, which require the appraiser to make assumptions[39] based on the available information.[40] After carefully analyzing comparable sales data in the area and adjusting for other relevant variables, the appraiser should arrive at a "figure that reflects the fair market value of the appraised property."[41]

2. *The Cost Approach*

The cost approach is based on the appraised value of the land itself.[42]It adds the replacement or reproduction cost, such as the cost of improvements as if they were built at the time of the appraisal, then it subtracts all accrued depreciation of the improvements.[43] Generally, the cost approach method is best used for valuation of new or improved property with a unique purpose.[44] In addition, it is used when comparable sales are unavailable and the new or improved property does not produce income (i.e. schools, churches, or libraries).[45] A drawback of this method is that the actual market value often differs from the current cost to reproduce a particular structure.[46] In appraising older buildings, an accurate measure of depreciation may be impossible.[47]

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35. *Id*.
36. *Id*. at 1309.
37. *Id*. For example, an appraiser might consider the effects of existing or reasonably probable land-use regulations, zoning, or trends in the local real estate market. *Id*.
38. Wooley, *supra* note 15, at 360.
39. Murray, *supra* note 3, at 1309. For example, an appraiser evaluating a property subject to a potential zoning ordinance would need to make assumptions regarding both the likelihood of the ordinance's enactment and the effect of the ordinance on the property's market value. *Id*.
40. Murray, *supra* note 3, at 1309.
41. *Id.*
42. Wooley, *supra* note 15, at 363.
43. *Id*.
44. *Id.*
45. *Id*.
46. *Id.*
47. *Id*.

3. *The Income Capitalization Approach*

The income capitalization approach is a complex appraisal approach that tends to confuse courts and non-appraisers.[48] This approach is used to develop valuations for emerging developments.[49] It is based on the premise that a property's value is related to the income it can produce.[50] The income capitalization approach is commonly used to value commercial property, the worth of which is based on its earning capacity.[51] This involves a "determination of value by estimating the future income of a property, then using certain data and mathematical calculations to determine the present value of property."[52] In order to arrive at a credible opinion of value, the appraiser must accurately estimate income and expenses, select the proper capitalization rate, and use the proper technique to convert the projected net income stream into current value.[53] The most significant drawback of this system is that the appraiser makes a large number of estimates pertaining to a number of variables involved.[54]

C. *Real Estate Market Collapse*

1. *Savings and Loan Crisis of the 1980s*

During the savings and loan crisis of the 1980s, inaccurate and inflated real estate appraisals played a significant role in the collapse of hundreds of financial institutions and the loss of billions of dollars.[55] Lending institutions and banks relied on fraudulent and inflated appraisals in order to provide loans that were insufficiently[56] secured by the actual collateral value.[57] As a result,

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48. Id.

49. *Accessory Dwelling Units May Have Higher Values when Using Income Approach: The Appraisal Journal,* APPRAISAL INSTITUTE (Nov. 20, 2012), www.appraisalinstitute.org/accessory-dwelling-units-may-have-higher-values-when-using-income-approach-the-appraisal-journal/.

50. Wooley*, supra* note 15, at 361.

51. *Id.*

52. *Id.* at 362.

53. *Id.*

54. *Id.* For example, one of the most significant assumptions in the income approach is of the future income stream, which includes predictability of the rate of inflation essential to the capitalization rate selected. *Id.*

55. *See* USPAP, *supra* note 28 (explaining in detail history of the Loan and Savings Crisis of 1980s).

56. Murray, *supra* note 3*,* at 1303. In 1985, the portfolios of more than eight hundred federally insured the portfolios of more than eight hundred federally insured lending institutions contained under-secured loans supported by real estate appraisals that overvalued collateral properties by an aggregate of $3 billion. *Id.*

57. *Id.*

banking institutions went insolvent[58] when borrowers defaulted on these loans and were unable to recoup loan balances that exceeded collateral values.[59]

In response to the Savings and Loan Crisis[60] of 1980s, Congress conducted an extensive examination of the appraisal industry, which revealed that one factor in particular contributed to the inaccuracy of real estate appraisals – the frequency with which appraisers submitted to pressures from parties involved in the loan-origination process.[61] They were pressured to report sufficient predetermined property values for borrowers to qualify for the requested loan.[62] Such misconduct often went unchecked because the appraisal industry maintained its own policies and procedures, and industry participants were unwilling to cooperate and discipline dishonest or incompetent appraisers.[63]

Ultimately, appraisal inaccuracy became so pervasive that Congress declared it a "serious national problem" requiring broad corrective measures.[64] Taxpayers were ordered to bail out banking institutions and Congress was forced to act with significant legislative reform at the end of 1980's.[65] The most significant piece of legislation passed by Congress was the Financial Institutions Reform Recovery and Enforcement Act ("FIRRERA") of 1989[66] more commonly known as the Savings and Loan Bailout Bill.[67] "Title XI of FIRREA set up a real estate appraiser regulatory system involving federal and state government and The Appraisal Foundation."[68]

Title XI of the Act was designed to address the problem of incompetent and fraudulent appraisals, and promote the accuracy

58. Wooley, *supra* note 15, at 358. Many of the failed institutions held mortgages for which the appraisals were grossly inaccurate or insufficiently documented. *Id.* It was discovered that eighty-eight percent of failed savings and loans associations violated federal regulations, which required current appraisals for loans secured by real estate. *Id.*

59. Murray, *supra* note 3, at 1303.

60. *See Savings and Loan Crisis*, FED. RESERVE HISTORY, https://www.federalreservehistory.org/essays/savings_and_loan_crisis, (last visited on Apr. 22, 2019) (explaining that "in the 1980s, the financial sector suffered through a period of distress that was focused on the nation's savings and loan industry"). At the center of the crisis was the dramatic increase of inflation and interest rates during the 1970s and early 1980s. *Id.*

61. Murray, *supra* note 3, at 1303. Parties involved in the loan-originated process pressured appraisers to supply predetermined values rather than independent and accurate opinions of market value in exchange of promises for continued business. *Id.*

62. Weissman, *supra* note 13, at 10-12.

63. Murray, *supra* note 3, at 1303.

64. *Id.* at 1304.

65. *See Savings and Loan Crisis*, *supra* note 60 (discussing the taxpayer bailout).

66. Wooley, *supra* note 15, at 358.

67. USPAP, *supra* note 28.

68. *See id.* (discussing the history of FIRRERA of 1989).

and reliability of appraisals used in connection with federal mortgage loans.[69] The Act included a provision that mandated all appraisals be "independently and impartially prepared" in *writing*.[70] In addition, to promote transparency in the financial sector, Title XI also created a complex regulatory system[71] where "regulatory responsibilities are distributed among federal, state, and private agencies."[72] Consequently in 1989, Congress adopted the *Uniform Standards of Professional Appraisal Practice* (USPAP)[73] to set out the ethical performance standards for the appraisal profession in the United States.[74] Through FIRREA, the Federal government has mandated that the states enforce real property appraiser compliance with the USPAP standards.[75]

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69. Federal Financial Institutions Examination Council, *Legal-Framework*, APPRAISAL SUB-COMMITTEE, https://www.asc.gov/Legal-Framework/TitleXI.aspx (last visited on Apr. 22, 2019).

> Title XI's purpose is to provide that federal financial and public policy interests in real estate transactions will be protected by requiring that real estate appraisals utilized in connection with federally related transactions are performed in writing, in accordance with uniform standards, by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision.

Id.

70. Murray, *supra* note 3, at 1304.

71. *See* Federal Financial Institutions Examination Council, *supra* note 69 (explaining that the Appraisal Subcommittee (ACS) of the Federal Financial Institutions Examination Council (FFIEC) was created on August 9, 1989, pursuant to Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Title XI)).

> To carry out the purpose of Title XI, Congress empowered ACS to: (1) monitor requirements established by the States and their appraiser regulatory agencies for certification and licensing of appraisers, (2) maintain a national registry of state licensed and certified appraisers, (3) monitor and review practices, procedures, activities, and organizational structure of the Appraisal Foundation, and (4) monitor requirements established by the Agencies regarding appraisal standards for federally related transactions. Title XI also created a unique relationship between the States, private sector, and the Federal Government by authorizing the private sector to establish uniform appraisal-practice standards.

Id.

72. Murray, *supra* note 3, at 1304.

73. *See* USPAP, *supra* note 28, at 1 (requiring compliance for state-licensed and state-certified appraisals involved in federally related real estate transactions). USPAP is updated every two years in accordance with any market changes, and so that appraisers have proper information they need to deliver credible and unbiased opinions of value. *Id.*

74. *Id.*

75. *Id.*

2. *The 2007-2009 Real Estate Market Crash and the Great Recession*

In spite of the passage of Title XI by Congress, inaccurate and fraudulent appraisals remained very problematic.[76] During the early 2000s, inflated appraisals were commonly used to support subprime loans[77] that were sold to government-sponsored entities (GSEs), such as Fannie Mae and Freddie Mac.[78] The GSEs used mortgages and packaged them as mortgage-backed securities and sold them to investors on the secondary[79] mortgage market.[80] In such real estate transactions, lenders and investors rely on appraisals in evaluating the quality of the loans supporting the securities they purchased.[81]

The GSE secondary market significantly sped up the flow of mortgage finance capital, making real estate values more liquid, keeping interest rates low, spurring lenders to increase borrower demand creatively by offering mortgage products promising little or no equity and a small initial monthly payment.[82] As the real estate market was booming, these creative mortgage products were supported by inflated appraisals that fueled rapid and unsustainable growth[83] in the housing market."[84] In 2008, due to rapidly declining market conditions and home values dropping below seventy-five percent of the amounts owed on mortgages,[85] mortgage defaults sky-rocketed, causing losses to investors in mortgage-related securities.[86] Consequently in 2008, the Federal

76. Murray, *supra* note 3, at 1304.

77. *See* David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish the Secondary Mortgage Market*, 33 FLA. ST. U.L. REV. 985, 994 (2006) (noting that "subprime lending has been a significant and growing portion of this activity, reaching nearly 20% of all originations in 2004"). "Subprime lending is the extension of credit to those with lower incomes, less wealth, and riskier credit profiles than traditional, "prime" borrowers." *Id.*

78. Murray, *supra* note 3, at 1308.

79. *See* KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES § 1.1 (2005) (noting that the secondary mortgage market is easiest to visualize as "a network of lenders who sell and investors who buy existing mortgages or mortgage-backed securities). This infusion of capital from investors provides mortgage lenders and other loan originators with a market for their interests. *Id.*

80. Murray, *supra* note 3, at 1305.

81. *Id.* at 1308.

82. Boyack, *supra*, note 2, at 941.

83. *See id.* (noting that in 2010, the mortgage balances exceeded home values by an estimated $745 billion).

84. *Id.*

85. *See* Andrew J. Ceresney et al., *Regulatory Investigations and the Credit Crisis: The Search for Villains*, 46 AM. CRIM. L. REV. 225, 227-28 (2009) (discussing declining market conditions).

86. Ann Graham, *Introduction: Reforming the Secondary Mortgage Market*, 35 HAMLINE L. REV. 327, 330 (2012).

Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship.[87] "As of September 2010, the combined debt and obligations of these GSEs totaled $6.7 trillion – $2.7 trillion below the total publicly held debt of the USA.[88] In short, the "financial crisis of 2007-2009 caused trillions of dollars in losses to the general economy and led to hundreds of billions in federal bailouts."[89]

3. The Aftermath of the Great Recession

a. The 2010 Dodd-Frank Act

In response to the Subprime Mortgage and Financial Crisis of 2007-2009 (also known as the Great Recession), Congress signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("The Dodd-Frank Act").[90] This was Congress's attempt to address the shortcomings in federal regulatory oversight and risk management failures resulting in the Great Recession.[91] Most provisions of the Dodd-Frank Act relate to

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87. *See* FEDERAL HOUSING FINANCE AGENCY, *FHFA as Conservator of Fannie Mae and Freddie Mac*, www.fhfa.gov/Conservatorship/Pages/History-of-Fannie-Mae--Freddie-Conservatorships.aspx (last visited on Apr. 23, 2019) (describing that on July 30, 2008, President George W. Bush signed Public Law 110-289, the Housing and Economic Recovery Act of 2008 (HERA), which established FHFA, giving the agency authority to place regulated entities into conservatorship or receivership). Conservatorship is intended to stabilize troubled institutions with the objective of maintaining normal business operations and restoring financial safety and soundness. *Id*.

> On September 6, 2008, FHFA used its authorities to place Fannie Mae and Freddie Mac into conservatorship. This was in response to a substantial deterioration in the housing markets that severely damaged Fannie Mae and Freddie Macs' financial condition and left them unable to fulfill their mission without government intervention. It allows them to preserve and conserve their assets and property and restores them to a sound financial condition so they can continue to fulfill their statutory mission of promoting liquidity and efficiency in the nation's housing finance markets. A key component of the conservatorships is the commitment of the U.S. Department of the Treasury to provide financial support to Fannie Mae and Freddie Mac to enable them to continue to provide liquidity and stability to the mortgage market. The Treasury Department has provided $189.5 billion in support, which includes an initial placement of $1 billion in both Fannie Mae and Freddie Mac at the time of the conservatorships and an additional cumulative $187.5 billion investment from the Treasury Department.

Id.; Graham, *supra* note 86, at 2.

88. Graham, *supra* note 86, at 2.

89. Kristin Johnson, Steven A. Ramirez, & Cary Martin Shelby, *Diversifying to Mitigate Risk: Can Dodd-Frank Section 342 Help Stabilize Financial Sector?* 73 WASH. & LEE L. REV. 1795, 1819 (2016).

90. *Id*. at 1803.

91. Russell, *supra* note 25, at 6. The Dodd Frank Act expands protections to the federal oversight of the country's financial and economic health with respect to monitoring systematic risk posed by institutions that may be "too big to fail.

a system of federal regulatory controls of large financial institutions.[92]

Congress declared the Act "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, […] to protect the American taxpayers by ending bailouts, and to protect consumers from abusive financial services practices."[93] The Dodd-Frank Act also created three new federal agencies,[94] including the Consumer Financial Protection Bureau ("CFPB").[95] The CFPB has the rulemaking authority with respect to all institutions offering financial services or products to consumers and to all mortgage transactions.[96]

In short, this complex web of federal legislation[97] was designed to protect the general public from the negative consequences of bad business decisions of many financial institutions.[98] "The Dodd-Frank Act created sweeping changes for the regulation of real estate appraisers and appraisals in the United States."[99] One of the biggest changes is a set of new regulatory guidelines to combat fraudulent appraisals.[100] The goal is to prevent unscrupulous mortgage brokers from pressuring appraisers – whether by payments, threats, or promises – from delivering predetermined valuations.[101] The Dodd-Frank Act imposes registration and supervision of third-

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Id.

92. *See* Boyack, *supra* note 2, at 967 (stating that the Dodd-Frank Act authorizes the Federal Reserve to control the growth and financial products offered by institutions the failure of which would pose a "grave threat" to financial stability of the country, and includes the Volcker Rule, which disallows certain proprietary trading or investing by banks or related institutions).

93. USPAP, *supra* note 28.

94. *See* Boyack, *supra* note 2, at 967 (stating that the Financial Stability Oversight Council is made up of financial regulators from ten federal agencies and is tasked with identifying risks to nation's financial stability and protecting economic stability). The Office of Financial Research provides information to aid in the Council's function. *Id.*

95. *Id.*

96. *Id.* The CFPB also has five departments that focus on a wide range of issues including research, community affairs, complaint tracking, and collection, ensuring equitable access to credit and promoting financial literacy among consumers. *Id.*

97. Johnson, Ramirez, & Shelby, *supra* note 89, at 1798 (explaining that banking laws for example, include specific capital and reserve requirements, governance mandates, and detailed licensing standards, to reduce systemic risk). Federal securities laws include an intricate mandatory disclosure framework for public companies to protect investors and to promote efficient and transparent markets. *Id.*

98. Boyack, *supra* note 2, at 1798.

99. *See* Federal Financial Institutions Examination Council, *supra* note 69, at 1 (describing how the Dodd-Frank Act impacted appraisal regulation).

100. Beatrice Zagorski, *How Does the Dodd-Frank Act Impact the Appraisal Process*, MORTGAGE ORB (Dec. 14, 2011), www.mortgageorb.com/how-does-the-dodd-frank-act-impact-the-appraisal-process.

101. *Id.*

party appraisal management companies.[102] It also substantially amends Title XI of FIRREA, but it is still unclear how some of its provisions affect State and Federal regulation.[103]

b. The Appraisal Foundation

In 2011, the Appraiser Qualifications Board ("AQB") of the Appraisal Foundation[104] adopted changes to the appraiser qualifications criteria that became effective January 1, 2015.[105] These new changes establish minimum education, experience, and examination requirements[106] for real property appraisers to obtain a state license or certification.[107] Although the Appraisal Foundation is not an enforcement agency and does not have authority to receive or process complaints against the appraisers, states are nonetheless required to implement appraiser licensing and certification requirements that are no less stringent than those required by the AQB.[108]

c. 15 U.S.C. 1639H- Property Appraisal Requirements

In 2012, Congress passed 15 U.S.C. 1639H – Property Appraisal Requirements, which mandates the use of written appraisals for any higher-risk mortgage loan (also known as higher-priced mortgage loan)[109] by a licensed appraiser.[110] The statute also requires creditors to provide one copy of each appraisal to the applicant without charge, and at least three days prior to the closing date.[111] Section 1639H also imposes a $2,000 fine on any creditor who is found to have willfully failed to obtain an appraisal as

102. *See* Federal Financial Institutions Examination Council, *supra* note 69, at 1 (discussing required supervision under the Dodd-Frank Act of appraisal management companies).

103. *Id.*

104. *See* USPAP*, supra* note 28*,* at 1 *(*stating that the Appraisal Foundation was authorized by Congress as the source of appraisal standards and appraiser qualifications).

105. *Id.*

106. *See id. (*noting the following examples: national uniform licensing and certification examinations, background screening for new applicants as well as existing credential holders, good-standing rules regarding supervisory appraisers and trainee appraisers, added topics on green buildings, seller concessions, and developing opinions of value of real property in appraisals which include personal or business property).

107. *Id.*

108. *Id.*

109. *See* 12 C.F.R. § 1026.35 (2019) (providing a definition of a "higher-priced mortgage loan," which means "a closed-end consumer credit transaction" secured by the consumer's principal dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set).

110. Property Appraisal Requirements, 15 U.S.C. § 1639(h) (2015).

111. *Id.*

required per this section.[112]

d. The Bureau of Consumer Financial Protection

In 2015, the Bureau of Consumer Financial Protection ("CFPB") published financial rules implementing changes to the Dodd-Frank Act escrow requirements of higher-priced mortgage loans ("HPMLs")[113] under the Truth in Lending Act ("TILA").[114] The CFPB also adopted a new appraisal disclosure under the Equal Opportunity Credit Act ("EOCA"), and new appraisal rules for HPMLs.[115]

The adopted changes for HMPLs under TILA require creditors to obtain an appraisal performed by a licensed appraiser that meets certain proscribed standards.[116] Similar to 15 U.S.C. 1639H passed by Congress; new TILA requirements mandate that creditors provide mortgage applicants with an appraisal disclosure, and a copy of an appraisal report at no charge.[117] In addition, there are certain compliance requirements[118] for HPMLs, which lenders must

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112. *Id.*

113. *See* CONSUMER FIN. PROTECTION BUREAU, *supra* note 30, at 1 (defining HPML as a closed-end loan). In general, a higher-priced mortgage loan is one with an annual percentage rate, or APR, higher than a benchmark rate called the Average Prime Offer Rate, and that is secured by the consumer's principal dwelling. *Id.*

114. Laura Hobson-Brown, Laura Greco & Robert Savoie, *Dodd-Frank Act Requirements for Escrow Accounts, High-Cost Mortgages, Homeownership Counseling, and Appraisal Requirements Take Shape*, 69 BUS. LAWYER 563 (2014).

115. *Id.*

116. *Id.* (noting that the appraisal must be performed by a certified or licensed appraiser, who must conduct a physical visit of the interior of the property that will secure the loan).

117. *See* CONSUMER FIN. PROTECTION BUREAU, *supra* note 30, at 1.

118. *See* Hobson-Brown, Greco & Savoie, *supra* note 114 ("explaining that in order to avail itself of the safe harbor protections, a creditor must:

> (a) Order that the appraiser perform the appraisal in conformity with the Uniform Standards of Professional Appraisal Practice and Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") 78 and any implementing regulations then in effect; (b) verify through the National Registry that the appraiser who signed the appraiser's certification was a certified or licensed appraiser in the state where the appraised property is located as of the date the appraiser signed the appraiser's certification; (c) confirm that certain appraisal elements set forth in detail in Appendix N to Regulation Z are addressed in the written appraisal; and (d) have no actual knowledge contrary to the facts or certifications contained in the written appraisal.

Id.

satisfy[119] before they extend the loan to borrowers.[120] However, the HPML appraisal requirements do not apply to new construction loans, mobile home, boat, trailer, or bridge loans.[121]

To address shortcomings of the Great Recession, Congress passed series of financial regulations in 2010. The most recent financial collapse is a primary example of the painful effects of careless mortgage lending, fueled by deterioration in loan underwriting procedures and the quality of appraisals.[122]

D. Challenges in Appraisal Regulation

1. Current Problems in the Appraisal Industry

Despite Congress' efforts to address the 2007-2009 shortcomings in federal regulatory oversight and risk management failure, the appraisal industry still faces three major issues. [123] First, there is lack of appraisal accuracy because of the subjective nature and challenges in regulating external pressures.[124] Second, there is lack of legal liability and weak disciplinary avenues for appraiser misconduct.[125] Third, federal regulation is far removed from the transactional issues on the state level.[126]

2. Lack of Accuracy and Challenges in Regulating Pressure

Despite Congress' well-grounded legislative efforts under Title XI mandating that appraisals be performed independently and impartially, the degree of subjectivity and the margin of error are still problematic in all mortgage transactions.[127] Total accuracy cannot be expected because an appraisal is a subjective opinion of value.[128] In addition, appraisers are still subject to external pressures exerted by self-interested parties.[129] These parties

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119. *See* CONSUMER FIN. PROTECTION BUREAU, *supra* note 30, at 1 (noting that compliance requirements include the following: creditor must deliver a written appraisal to the applicant within (3) business days before loan consummation, or within (30) days if the loan will not be consummated by the creditor, and the creditor must also deliver to the applicant a written statutory disclosure within three days of when the creditor determines that the loan is an HPML).

120. Hobson-Brown, Greco, & Savoie, *supra* note 114.

121. *Id.*

122. *See* Patricia A. McCoy & Susan M. Wachter, *Has The Mortgage Pendulum Swung Too Far? Reviving Access To Mortgage Credit: Why Cyclicality Matters to Access to Mortgage Credit*, 37 B.C.J.LLI. & SOC. JUST. 361, 361 (2017).

123. Johnson, Ramirez, & Shelby, *supra* note 89, at 1803.

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. Murray, *supra* note 3, at 1307.

129. *Id.*

include loan originators and real estate brokers who pressure appraisers to deliver inflated opinions of value in exchange for business referrals.[130] As a result, appraisers tend to overvalue homes, putting key mortgage industry participants at risk.[131]

If borrowers are unable or unwilling to repay these excessive mortgages, then lenders, secondary market investors, and federal mortgage insurers suffer substantial financial losses when actual home values cannot cover outstanding mortgage balances.[132] For example, improper influence exerted on appraisers resulted in many fraudulent appraisals that contributed to the 2007-2009 housing crash.[133] The Appraisal Institute claims "instances of client pressure doubled between 2005 and 2007, despite two decades of regulatory efforts aimed at promoting appraisal accuracy."[134]

Because loan originators can exert pressure in very subtle ways, there is a fine line between legitimate communications and improper attempts to influence appraisals.[135] For example, lenders and brokers can apply pressure by suggesting that an appraiser consider different comparables that would yield higher-value estimates, or by implying that future work is contingent on the outcome of pending appraisals.[136] Such hints and implications may be nothing more than casual comments or even legitimate communications aimed at ensuring the quality of appraisals.[137] But other times, the pressure can be forceful and direct.[138]

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130. *Id.* at 1307.
131. *Id.*
132. *Id.*
133. McCoy & Wachter, *supra* note 122, at 373.
134. Murray, *supra* note 3*,* at 1316.
135. *Id.*
136. *Id.* at 1317.
137. *Id.* at 1316.
138. *See id.* (stating, "when appraisers submit honest appraisal values that are insufficient to support mortgages, lenders often inform appraisers of the values needed to complete the transactions. If appraisers refuse to revise their appraisals to hit the numbers, lenders may refuse to pay them.") However, some appraiser communications are permitted. *See* John Brenan, *The Appraisal Foundation- Hot Topics*, APPRAISALBUZZ.COM (Jan. 1, 2018) www. appraisalbuzz.com/appraisal-foundation-hot-topics.

> However, to preserve customer service relations, an appraiser should be able to answer some basic questions about the process without being intimidated. This concept is consistent with the provisions of the Dodd-Frank Act of 2010, which prohibited inappropriate contact with an appraiser, but specifically identified the following as acceptable areas of communication: (1) consider additional, appropriate property information, including the consideration of additional comparable properties to make or support an appraisal, (2) provide further detail, substantiation, or explanation for the appraiser's value conclusion, and (3) correct errors in the appraisal report. We believe that appraisers should be able to respond to such requests in a courteous, professional manner, without impairing appraiser independence in any way.

Id.

To address the problem of illegitimate appraiser communications following the Great Recession,[139] the federal banking agencies in 2010 amended[140] the *Interagency Appraisal and Evaluation Guidelines.*[141] The guidelines added a new "independency standard," which prohibits appraisers and persons performing evaluations from engaging in any types of coercive communications.[142] This standard applies to anyone who orders, performs, or reviews appraisal reports.[143]

New guidelines also require that all banking and appraisal institutions adopt sufficient policies and procedures to safeguard against inappropriate actions that may compromise the independence standard.[144] Nevertheless, improper influence

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139. Murray, *supra* note 3, at 1319 (explaining that "in 2008 Congress responded with Regulation Z of the 2008 Amendments to the Truth in Lending Act – "Regulation Z" and the Home Valuation Code of Conduct, which include provisions that expressly prohibit lenders and brokers from pressuring appraisers to deliver predetermined values").

140. *See* Weissman, *supra* note 13, at 1 (explaining that the updated guidelines supplement existing guidance and rescind the following: a statement intended to supplement existing guidance and rescind the following: (a) 1994 Interagency Appraisal and Evaluation Guidelines, FIL-74-94; (b) statement on Appraisal Standards, FIL-20-2001;(c) Interagency Statement on Independent Appraisal and Evaluation Functions, FIL-84-2003; and (d) 2006 Revisions to Uniform Standards of Professional Appraisal Practice, FIL-53-2006).

141. *See id.* at 9 (defining Section V, Independence of the Appraisal and Evaluation Program, has been expanded substantially to clarify some points and also to address the communication process between a lending institution and its fee appraisers). The guidelines state that independence applies to those persons who order, perform, and review appraisals and evaluations. *Id*. The standards of independence apply to both appraisals and evaluations). *Id.*

142. *Id.*

> "Guidelines" contain 18 sections and 4 appendices. Section V, Independence of the Appraisal and Evaluation Program, has been expanded substantially to clarify some points and also to address the communication process between a lending institution and its fee appraisers. The guidelines state that independence applies to those persons who order, perform, and review appraisals and evaluations. The standards of independence apply to both appraisals and evaluations. This section also gives examples of the types of communications that would not be construed as coercion or undue influence on appraisers and persons performing evaluations, as well as examples of actions that would compromise independence. Id. For example, a permitted form of contact is to request the appraiser to correct factual issues, provide additional information in support of basis for evaluation. Some of the prohibited communication includes: conditioning a person's compensation on a loan, communicating a predetermined value or expected value, procedures that compromise the independence of appraisal, implying future retention of a person's series.

Id.

143. *Id.* at 10-13.

144. *See id.* (including but not limited to; communicating a predetermined value, specifying a minimum value requirement, conditioning a person's compensation on loan consummation, failing to compensate a person or excluding such person because of a low opinion of value).

exerted on appraisers is a serious problem that is difficult to enforce.[145] Existing regulatory efforts, which require the appraisal independence standard or otherwise prohibit pressuring of the appraisers, are not only impractical but also difficult to invoke.[146]

3. Lack of Legal Liability and Weak Disciplinary Avenues

Aside from disciplinary sanctions and monetary fines, there is very little accountability for appraiser misconduct in the legal system. The Appraisal Foundation is not an enforcement agency and it does not have authority to process complaints for appraiser misconduct.[147] Accordingly, state agencies are in charge of enforcing disciplinary actions against appraisers who do not comply with state law or the USPAP.[148] Each state maintains its own agency that establishes licensing, education, and experience requirements that, at a minimum, must satisfy the AQB criteria.[149]

For example, in Illinois, the Illinois Department of Financial Professional Regulation ("IDFPR") and its Division of Real Estate is in charge of licensing, and it regulates all professionals involved in "buying and selling property, including real estate brokers, appraisers, auctioneers, community association managers, home inspectors, and timeshare/land sale developers and agents."[150] According to the IDFPR's Professional Regulation report issued in 2015, only five complaints against individual appraisers were investigated and prosecuted.[151] All of these complaints resulted in monetary fines and license suspension.[152]

Allegations of appraiser misconduct are investigated by state agencies that impose disciplinary sanctions for any action not in

145. Murray, *supra* note 3, at 1319.

146. *Id.*

147. USPAP, *supra* note 28, at 1. Rather, it's a not-for-profit organization dedicated to the advancement of professional standards required by the appraisal profession. *Id.*; *see also* Federal Financial Institutions Examination Council, *supra* note 69, at 1 (describing the limited powers of the Appraisal Foundation).

148. USPAP, *supra* note 28, at 1.

149. *Id.*

150. Real Estate Appraisal, ILLINOIS DEPARTMENT OF FINANCIAL PROFESSIONAL REGULATION, www.idfpr.com/profs/appraisal.asp (last visited on Apr. 22, 2019).

151. *See id.* (describing incidents of appraiser misconduct).

152. *Id.* All of these complaints resulted in monetary fines and license suspension. Once incident involved a Naperville appraiser who was suspended for a minimum of five years and fined $5,000 for "developing and communicating a series of misleading appraisals that contained a series of errors or omissions and exceeded the scope of Respondent's license. *Id.* Another incident involved a misconduct case where a licensed appraiser from Greenfield, Illinois was reprimanded and fined $3,000 for acting outside the scope of his license and appraising three properties that require a Certified General Real Estate Appraiser license. *Id.* The IDFPR determined that he lacked credibility and his appraisal report contained significant errors and omissions. *Id.*

compliance with state regulations and the USPAP.[153] But there is very little recourse in the court of law for those who rely on fraudulent appraisals, because fraud is a difficult standard to prove.[154] Similarly, suits against appraisers for negligence rarely succeed, as the "opinion defense" has often been successfully asserted.[155] In recent years, it has become painfully apparent that the legal system serves as a bar to recovery for those who relied on fraudulent appraisal values.[156]

4. Lack of Federal Enforcement of Appraiser Regulations

There is a lack of federal enforcement of appraisal regulations on the state level. First, under authority granted by Title XI, federal regulators have adopted laws that exempt federal mortgage transactions valued at $250,000 or less from the appraisal requirement.[157] This exemption is referred to as the *de minimis*

153. *Id.*

154. Murray, *supra* note 3, at 1318. Allegations of fraud require proof of an intentional misrepresentation of a material fact, so unless there is clear and convincing evidence that an appraiser intentionally deviated from his independent judgment, a cause of action for fraud will be unsuccessful. *Id.*; *see e.g., Tsereteli v. Res. Asset Sect. Trust 2006-A8,* 692 F. Supp. 3d 387, 393 (S.D.N.Y 2010) (holding that fraud claims based on appraisals have been dismissed on the ground that an appraisal is a subjective opinion and is not actionable absent an allegation that the appraiser did not believe the appraisal at the time it was issued); *see also* In re IndyMac Mtge.-Backed Secs. Litig., 718 F. Supp. 2d 511 (S.D.N.Y 2010) (holding that fraud claims involving appraisals have also been dismissed where the complaint pleaded only general allegations that the appraisers were subject to pressure from the banking industry to inflate their appraisals, and not that the appraisers of the loans at issue succumbed to such pressure; *see e.g.* Plumber's Union Local No. 12 Pension Fund v. Nomura Asset Accept. Corp., 632 F.3d 762 (1st Cir. 2011) (discussing specificity requirements to plead a claim for undue appraiser pressure). An appraisal is an opinion of value and thus some margin of error is expected. Murray, *supra* note 3, at 1318; *see also* Peter J. Hartmann Co. v. Capital Bank & Trust Co., 296 Ill. App. 3d 593, 601 (1998) (acknowledging that an expression of opinion will not support an action for fraud). As a result, it is exceptionally difficult to prove that an inflated appraisal is the product of an improper influence as opposed to an erroneous, but good faith opinion of value that is still within the allowed margin of error. Murray, *supra* note 3, at 1318.

155. *See* Wooley, *supra* note 15, at 363 (acknowledging that where no negligence is proven, courts generally recognize the likelihood of differing opinions of value). Courts have determined that the use of the word "estimate" on the appraisal report is synonymous with "opinion" and thus, the appraisal report could not support an actionable, negligent misrepresentation. *See* Sampen v. Dabrowski, 222 Ill. App. 3d 918, 924 (1991) (holding that appraisal is an opinion of value and thus is not a negligent misrepresentation actionable in court). Consequently, claims based on fraudulent appraisals rarely succeed. Wooley, *supra* note 15, at 363. Rather, the legal system serves as a bar to recovery to appraisal misrepresentation. *Id.*

156. Wooley, *supra* note 15, at 363.

157. Russell, *supra* note 25, at 10.

threshold.[158] For example, if the purchase price of real property is $250,000 or less, an appraisal performed by a licensed appraiser is not required.[159] The *de minimis* threshold creates a huge regulatory gap. This gap removes a substantial amount of mortgage transactions from any appraiser-related federal regulation. Essentially, every consumer buying a house with a fair market value below $250,000 is without protection against fraudulent mortgage lending practices by big banks.[160] Second, the Dodd-Frank Act is too far removed from transactions on the state level. It does not apply to non-federal mortgage loans, and it only requires an independent and written appraisal for higher-risk mortgage loans.[161] Since, the Dodd-Frank Act only regulates federal mortgage-loans, many states still lack mandatory licensing requirements for appraisers.[162] To illustrate, a borrower who is working with a local lender (who is not federally-regulated) in a state where appraiser licensing is not required is not afforded any of the consumer protections provided by the Dodd-Frank Act.[163]

E. Freddie Mac and the Use of Automatic Collateral Evaluation Products ("ACEs")

There is also disagreement over the required degree of accuracy in valuing real property in residential mortgage transactions.[164] The traditional view on lending, values the use of licensed real estate appraisers for their training, experience, and expertise necessary to provide a credible opinion of value.[165] In recent years, particularly in the residential sector, there has been a lot of proliferation of products and processes attempting to provide alternatives to traditional appraisals.[166] The development of new loan products accustomed to today's real estate encourages the use of alternative valuation products ("AVPs") in order to decrease borrower's loan origination costs and improve the timeline for mortgage approval process.[167]

158. *Id.*
159. *Id.*
160. *Accessory Dwelling Units May Have Higher Values when Using Income Approach: The Appraisal Journal*, *supra* note 49.
161. *See* Boyack, *supra* note 2, at 971 (explaining that the Dodd-Frank Act does not apply to non-federal mortgage transactions).
162. Federal Financial Institutions Examination Council, *supra* note 69, at 1.
163. Murray, *supra* note 3, at 1306.
164. Wooley, *supra* note 15, at 362.
165. Brenan, *supra* note 138, at 29-32.
166. *Id.*
167. *Id.*

1. *Freddie Mac & Fannie Mae*

Freddie Mac and Fannie Mae are two of the largest, for-profit, and privately owned mortgage finance companies in the United States.[168] After the Great Depression, Congress found a way to provide local banks with federal money to stabilize the U.S. housing market.[169] It created these institutions "to develop a liquid national market for residential mortgages in order to encourage homeownership."[170] Initially, ownership of their stock was limited to other financial institutions, but later, the stock was converted so that it could be owned and traded by all investors.[171] Today, Freddie Mac and Fannie Mac make up the modern secondary mortgage market, and recently have become the biggest proponents of using ACEs in a vast majority of residential mortgage transactions.[172]

2. *The Great Recession*

Fannie Mae and Freddie Mac were placed into conservatorship in 2008 and had received approximately $169 billion in bailout funds from the U.S. Treasury.[173] Accounting scandals and mismanagement led to a recent investigation by the Justice Department and the Securities Exchange Commission ("SEC").[174] The investigation revealed accounting errors in the amount of 4.5 to 4.7 billion dollars, which resulted in a termination of three of the company's top executives.[175] Ongoing investigations by Congress[176]

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168. *Id*. Measured by the size of their assets, Freddie Mac's and Fannie Mae's shares are traded on the New York Stock Exchange. *Id.*; *see also* FORBES, *The Forbes Special Report of 2000,* (Mar. 30, 2006), www.forbes.com/lists/2006/18/06f2000_The-Forbes-2000_Assets.html (showing Fannie Mae ranked at thirty-seven and Freddie Mac ranked at two hundred); *see* FANNIE MAE, www.fanniemae.com/faq/faq8.jhtml? p=FAQ (last visited Apr. 22, 2019) (describing Fannie Mae as a private company); *see also* FREDDIE MAC, www.freddiemac.com (last visited on Apr. 22, 2019) (announcing that Freddie Mac common stock will continue to be listed on the New York Stock Exchange."); *see also* Reiss on Federal Government, *supra* note 4, at 1019 (discussing Fannie Mae and Freddie Mac as private companies).

169. Graham, *supra* note 86, at 2.

170. Reiss on Federal Government, *supra* note 4, at 1019.

171. Graham, *supra* note 86, at 2. "The business models and mortgage loan-related activities for Fannie Mae and Freddie Mac changed over time, beginning with Fannie Mae's original focus on creating a secondary mortgage market, and later, standardized conventional residential mortgage loans." *Id*.

172. *New Program to Help Buyers Bypass Appraisals,* REALTOR.ORG, (Aug. 8, 2017) www.realtormag.realtor.org/daily-news/2017/08/21/new-program-help-buyers-bypass-appraisals (proposing that Freddie Mac and Fannie Mae are both proponents of the automated collateral evaluations).

173. *Id.* at 3.

174. *Id.* at 3.

175. *Id.*

176. *See* SEC v. Fed. Home Loan Mortg. Corp., Et Al., 07-CV-1728 (U.S.D.C, D.D.C 2007) (noting that on September 27, 2007, the Securities Exchange

and the House Finance Services subcommittee[177] will determine the future role of Fannie Mae and Freddie Mac and the secondary mortgage market that they dominate.[178] There is still significant uncertainty as to whether Freddie Mac will ever emerge from conservatorship.[179]

Freddie Mac and Fannie Mae are privately owned financial institutions.[180] Currently, they control about ninety percent of the nation's secondary mortgage market.[181] Collectively, these two entities guarantee roughly sixty percent of mortgages in the United States.[182] Freddie Mac and Fannie Mae help mortgage originators package their mortgages into residential mortgage-backed securities ("RMBS") by providing credit guarantees for those securities.[183] They raise capital by issuing debt securities through the world's financial markets and use those funds to purchase mortgages and related securities.[184] In short, Freddie and Fannie Mae do not make mortgages, but buy them from lenders, wrap them into securities and make guarantees to investors if the loans default.[185] Those two activities have driven the rapid growth and high profitability of these two companies in recent years.[186]

Commission filed a settled enforcement action charging Freddie Mac with securities fraud in connection with improper earnings management).

> The SEC's Complaint alleges that Freddie Mac engaged in a fraudulent scheme that deceived investors about its true performance, profitability, and growth trends, and that in 2000, 2001 and 2002 the Company misreported its net income in each of those years by 30.5%, 23.9% and 42.9%. In its settlement with the Commission, Freddie Mac agreed, without admitting or denying the allegations, to the entry of a final judgment that permanently enjoins the Company from violations of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, and Section 17(a) of the Securities Act, which are anti-fraud provisions of the federal securities laws. Freddie Mac also agreed to pay a $50 million civil penalty.

Id.

177. *See id.* (noting that the House Finance Services Subcommittee oversees the activity of GSEs).

178. Graham, *supra* note 86, at 3.

179. Brian Taylor Goldman, *The Indefinite Conservatorship of Fannie Mae and Freddie Mac is a State-Action*, 17 J. BUS. & SEC. L. 11, 12 (2017).

180. *Id.*

181. *Id.*

182. Goldman, *supra* note 179, at 3.

183. *See id.* (discussing residential mortgage backed securities "RMBSs.")

184. *Id.*

185. Joe Light, *The Next Job Humans Lose to Robots; Real Estate Appraiser,* BLOOMBERG (July 11, 2017), www.bloomberg.com/news/articles/2017-07-11/the-next-job-humans-lose-to-robots-real-estate-appraiser.

186. Reiss on Federal Government, *supra* note 4, at 1022.

3. *Freddie Mac and Fannie Mae Are Not Subject to Appraisal Regulations*

With the exceptions of HIMLs, "loans backed by government agencies and government sponsored enterprises are exempt from the appraisal requirements, which means that loans insured by the FHA[187] have their own appraisal requirements, and loans bought by Fannie Mae and Freddie Mac are determined by the agencies themselves."[188] Since Freddie Mac is exempt from federal statutory requirements regarding appraisals, it generally only requires them to evaluate the risk in the purchase of RSMBs.[189] Since the most recent financial crisis, Freddie Mac adheres to the underlying appraisal requirement.[190]

Freddie Mac, the proponent of the Automated Collateral Evaluations ("ACEs"), took the lead and initiated a new program to help borrowers bypass the traditional appraisal, which became effective on September 1, 2017.[191] This program allows for certain federal loans backed by Freddie Mac to use the ACEs[192] to determine the real property's collateral value and evaluate the lending risk.[193] The ACE uses data generated from various computer models such as the multiple listing service ("MLS"), public records, and wealth of historical home values published online.[194] They use a mathematical modeling, drawing on a huge database of

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187. *See Accessory Dwelling Units May Have Higher Values when Using Income Approach: The Appraisal Journal, supra* note 49 (explaining that by statute, FHA maintains an appraisal requirement for all federal loans because the risk associated with the FHA insurance fund).

188. *Id.*

189. *Id.*

190. *Id.*

191. *New Program to Help Buyers Bypass Appraisals,* REALTOR.ORG (Aug. 8, 2017) www.realtormag.realtor.org/daily-news/2017/08/21/new-program-help-buyers-bypass-appraisals.

192. *Freddie Mac Introduced Innovative Appraisal Alternative,* FREDDIE MAC (Aug. 18, 2017) www.freddiemac.mwnewsroom.com/press-releases/freddie-mac-introduces-innovative-appraisal-altern-otcqb-fmcc-1318582.

> To find out if a property is eligible for ACE, lenders must submit loan data through Loan Product Advisor®, the cornerstone of Loan Advisor Suite®. Loan Advisor Suite is Freddie Mac's smart end-to-end technology solution that assesses credit, capacity and collateral to help lenders validate the quality of the loans they originate. Lenders receive real-time risk assessment feedback and information about the loans.

Id.

193. *See* USPAP, *supra* note 28, at 1 (discussing reasons why Freddie Mac is opting for the automatic collateral evaluations).

194. Lisa Tibbitts, *Freddie Mac Introduces Innovative Appraisal Alternative for Home Purchases and Refinances,* FREDDIE MAC, (Aug. 18, 2017). www.freddiemac.mwnewsroom.com/press-releases/freddie-mac-introduces-innovative-appraisal-altern-otcqb-fmcc-1318582.

recent transactions, complete with property characteristics, to generate an estimates sales price.[195] Freddie claims ACEs are cost effective because they can reduce borrowers loan origination costs up to $500, and they provide immediate collateral valuations, which allow the lender to close up to ten days sooner.[196] Although a traditional appraisal may still be needed for some home purchase transactions, the use of ACEs gives Freddie substantial control over lender's requirements for approving the loan.[197]

III. ANALYSIS

This section will compare and contrast the two competing views regarding the use of appraisals in residential mortgage transactions: the traditional approach with the modern approach, which uses the automated collateral evaluation products ("ACEs"). Section "A" will present the traditional view, which emphasizes the importance of using an accurate and independent appraisal in residential mortgage transactions. Section "B" presents arguments in favor of the modern view—based on the use of ACEs. Section "C" presents risks associated with the use of ACEs. Finally, this section concludes with a comparison of these two approaches and how they affect residential mortgage transactions.

A. Traditional View – Accurate Appraisals Are Critical to the Health of Mortgage Industry

1. Assurance for Lender

Advocates of the traditional approach argue that a conventional (i.e. traditional) appraisal is not only essential but also critical to the health of mortgage industry.[198] Appraisal acts as an assurance for the lender, who relies upon the value of real property to ensure repayment of the loan if the borrower defaults.[199] The combined loan-to-value ("CLTV")[200] ratio is the single most important predictor of default.[201] The use of an appraisal enables lenders to compute the CLTV ratio and determine whether an

195. Laurie Goodman & Jun Zhu, *A Significantly Improved Appraisal Process Has Reduced The Riskiness of Refinanced Mortgage*, URBAN INST., (Mar. 7, 2019) (available at www.urban.org/urban-wire/significantly-improved-appraisal-process-has-reduced-riskiness-refinance-mortgages).

196. USPAP, *supra* note 28, at 4.

197. Tibbitts, *supra* note 194, at 1.

198. Wooley, *supra* note 15, at 360.

199. *Id.*

200. *See* McCoy & Wachter, *supra* note 122, at 373 (explaining that combined loan-to-value (CLTV) are ratios that are computed based on the appraised value of the property).

201. *Id.*

applicant's down payment or home equity will be sufficient to contain default risk.[202]

Proponents of the traditional view argue that removing a conventional appraisal and substituting it with other valuation products will not only loosen the underwriting procedures but will ultimately lead to another housing crash.[203] This proposition stems from the fact that during the mid-2000s credit boom, key mortgage lending standards substantially deteriorated.[204] The single most important determinant of default risk – the average combined loan-to-value ratio – went up while another crucial loan quality indicator – the percentage of full documentation underwriting – went down.[205] Supporters of the traditional view say that ACEs will diminish underwriting procedures by relying on computer-generated data that may not be reliable at the time of valuation.[206]

Although an appraisal is not the central factor taken into consideration when banks evaluate borrowers creditworthiness, it is nonetheless essential to determine the proper loan amount.[207] Despite the dissenting view that traditional appraisals no longer play a central role in credit approval process, lenders still consider the value of collateral to be as important, as borrower's ability to pay due to the increasing use of nonrecourse mortgages.[208] Although a traditional appraisal is still at risk for being inaccurate due to human error, solely relying on automated valuations generated from various computer sources carries a more substantial risk of grossly disproportionate inflation.[209]

2. *Safeguard to Keep Big Banks at Bay*

a. Appraisal Cyclicality and Subprime Lending

There are two competing views concerning the role of an appraisal in residential mortgage transactions. On one hand, advocates of the traditional approach argue that it protects consumers from exploitation by big banks, such as Freddie Mac.[210] Banks are inherently fragile and prone to cyclicality due to the term mismatch between their short-term liabilities and their long-term

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202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

206. USPAP, *supra* note 28, at 4.

207. McCoy &Wachter, *supra* note 122, at 363.

208. *See* Wooley, *supra* note 15, at 360 (explaining that a nonrecourse mortgage is one in which the borrower is not personally liable for repayment in the event of default.)

209. *See generally* Light, *supra* note 185 (discussing implications of using computer-generated data in real estate transactions).

210. *See* Murray, *supra* note 3, at 1306 (recognizing that a traditional real estate appraisal protects consumers against big banks).

liquid assets.[211] Cyclicality fuels mortgage bubbles[212] that incorporate inflated appraisals based on recent sales comparables ("comps").[213] These recent comps are used to justify more lending, which artificially raises home appreciation values.[214] During this cycle, increasing home prices and loose credit, along with government-induced lower underwriting standards, fueled massive surge in the mortgage market participation.[215]

Ultimately, banks view high and raising prices as reducing their portfolio risk[216] because collateral of their previous loans is now higher in value.[217] After the financial "bubble" bursts,[218] appraisals artificially prolong economic downturns when property values are starting to rise by limiting extensions of mortgages based on lower, outdated comparables that erode bank's capital, causing lenders to withdraw from home lending.[219]

Although it is generally agreed that fraudulent appraisals fuel

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211. *See* McCoy & Wachter, *supra* note 122, at 363 (explaining that short-term liabilities are in a form of demand deposits, and the long-term liquid assets also include interest and loans).

212. BIG SHORT (Paramount Pictures 2015) (discussing the possibility that the market "bubble" may pop:

> Lawrence Fields: Your big mortgage bet concerns us. We have no confidence in your ability to identify macroeconomic trends.
>
> Michael Burry: You flew here to tell me that? Why? I mean, anyone can see there's a real estate bubble.
>
> Lawrence Fields: Actually, no one can see a bubble. That's what makes it a bubble.
>
> Michael Burry: That's dumb, Lawrence. There are always markers. Mortgage fraud - it's quadrupled since 2000. Average take home pay is flat yet home prices are soaring. That means homes are debts not assets.
>
> Martin Blaine: [*sarcastically*] So Mike Burry of San Jose, a guy who gets his hair cut at SuperCuts, and doesn't wear shoes, knows more than Alan Greenspan and Hank Paulson?
>
> Michael Burry: Dr. Mike Burry. And yes... he does.

Id.

213. McCoy & Wachter, *supra* note 122, at 373.

214. *Id.*

215. *See* Lux Marshall & Robert Greene, W*hat's Behind the Non-Bank Mortgage Boom*? 6 (Harvard Mossavar-Rahmani Center for Business & Government, Working Paper No. 42, 2015) (noting that loan originations increased 22 percent between 2004 and 2006).

216. McCoy & Wachter, *supra* note 122, at 373 ("The single most important determinant of default risk—the average combined loan-to-value ratio—went up during the most recent financial crash, while another crucial loan quality indicator—the percentage of full documentation underwriting—went down").

217. *Id.*

218. Marshall & Greene, *supra* note 215, at 1. For example, the total mortgage originations declined to $1.240 trillion in 2014, from $3.120 trillion in 2005. *Id.*

219. McCoy & Wachter, *supra* note 122, at 373.

cyclicality, proponents of the traditional approach maintain that an appraisal is one of the very few independent sources in a mortgage transaction.[220] When a bank is required to order a traditional appraisal,[221] it loses direct control over the collateral valuation.[222] Ultimately, an appraisal is a safeguard that protects consumers from overreaching of major financial institutions.[223]

Opponents of the traditional view agree that fraudulent appraisals played a role in the financial crisis, but they strongly believe that the secondary-mortgage market was to blame.[224] Recent innovations[225] in the mortgage market encouraged subprime

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220. Boyack, *supra* note 2, at 970.

221. Assuming that it is done in compliance with the USPAP standards. Wooley, *supra* note 15, at 385.

222. *Id.*

223. Greg Gelzinis & Joe Valenti, *Fact Sheet: The Senate's Bipartisan Dodd-Frank Rollback Bill*, CTR. FOR AM. PROGRESS, (Feb. 28, 2018) www.americanprogress.org/issues/economy/reports/2018/02/28/447264/fact-sheet-senates-bipartisan-dodd-frank-rollback-bill/.

224. Goldman, *supra* note 179, at 3.

> Although Fannie and Freddie's primary goal is to promote quality, affordable housing by: "(a) purchasing qualifying residential loans from mortgage originators to increase home finance market liquidity, and (b) providing capital support to multifamily housing projects." Fannie and Freddie, also called government sponsored entities or "GSEs," purchase mortgages from originators, creating a secondary market in mortgages (fueled by the creation of mortgage-backed securities).The secondary market sale of mortgages, by shifting risk, allows capital to be freed for the purpose of originating more mortgages, where the process then repeats itself. The GSEs were particularly vital cogs in the mortgage marketplace because they were viewed as implicitly supported by the "full faith and credit" of the United States. As a result, the GSEs could borrow at lower rates and secure strong credit ratings.

Id.

225. Reiss on Subprime, *supra* note 77, at 4. For example, before the 1980s, Americans who wanted to buy a house would visit their local savings and loan bank to meet with a loan officer in order to apply for the loan. *Id.* Since the 1980s however, due to technological, financial, and legal innovations allow global finance companies to offer a range of mortgage products. *Id.* As a result of these innovations, there has been an unbundling of the submarkets of the mortgage industry. *Id.* A mortgage now can be:

> (1) originated by a mortgage broker who makes money only from origination;
>
> (2) serviced by a mortgage banker who did not originate the loan and may have bought the right to service the loan from another mortgage banker;
>
> (3) originated with the credit risk taken by one of the secondary market institutions, perhaps along with a mortgage insurance company; and
>
> (4) funded by a mortgage -backed security (MBS) sold into the capital markets , and the MBS can be packaged as a bundle of derivative securities that separate interest rate and prepayment risk among

lending—[226] a significant and growing activity reaching nearly twenty percent of all loan originations in 2004.[227] Opponents characterize subprime lending as a "negative consequence of change in the mortgage industry, away from dominance and toward relatively unregulated specialty firms."[228] Subprime lending resulted in a great deal of abuses[229] in the secondary mortgage market, which ultimately caused the Great Recession.[230]

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different investors"

Id.

226. *Id.* at 4. Subprime lending is the extension of credit to those with lower incomes, less wealth, and riskier credit profiles than traditional, "prime" borrower" with an 80% LTV ratio. *Id.*

227. *Id.* at 5.

228. *Id.*

229. *See* BIG SHORT*, supra* note 212 (discussing big bank bailouts):

> Goldman Sachs Quant (Deeb): Why? Those bonds only fail if millions of Americans don't pay their mortgages. That's never happened in history. If you'll forgive me, Dr. Burry, it seems like a foolish investment.
>
> Michael Burry: Well, based on prevailing sentiment, the market, the banks and popular culture, yes, it's a foolish investment. But, everyone's wrong.
>
> Goldman Sachs Sales Rep (Lucy): This is Wall Street, Dr. Burry. If you offer us free money, we ARE going to take it...
>
> Michael Burry: [*interrupts her*] My one concern is that when the bonds fail I want to be certain of payment in case of solvency issues with your bank.
>
> Goldman Sachs Sales Rep (Lucy): I'm sorry, are you for real? You want to bet against the housing market and you're worried WE won't pay YOU?
>
> Goldman Sachs Quant (Deeb): [*confers, whispering with colleage, in a lengthy sidebar*] Dr. Burry, we could work out a pay-as-we-go structure that would pay out if the bonds fail. But it would also apply to your payments if the value of the mortgage bond goes up, You'd have to pay us monthly premiums.
>
> Goldman Sachs Sales Rep (Lucy): Is that acceptable, Dr. Burry?
>
> Michael Burry: Yes... yes. I have prospectuses on the six mortgage-backed securities I want to short.
>
> Goldman Sachs Quant (Deeb): [*Lengthy silence as the Goldman reps scan and review the thick booklets*] Dr. Burry, these should be fine.
>
> Goldman Sachs Sales Rep (Lucy): We're prepared to sell you five million in credit default swaps on these mortgage bonds.
>
> Michael Burry: Could we make it a hundred million?

Id.

230. See Reiss on Subprime, *supra* note 77, at 4 (describing the process of marketing subprime loans to consumers and describes the way predatory lending grew alongside the extraordinary and rapid expansion of subprime lending market); *see also* BIG SHORT*, supra* note 212 (discussing big bank

Ultimately, both of the views arrive at a similar conclusion: big financial conglomerates were responsible for insufficient underwriting procedures. On one hand, supporters of the traditional view blame the fraudulent appraisals, whereas its opponents blame subprime lending.[231]

b. Degree of Appraisal Accuracy

Big banks, such as Freddie Mac, oppose the use of a traditional appraisal because; given the extensive subjectivity and ambiguity inherent in the appraisal process, unscrupulous appraisers can manipulate this process to reach predetermined property values.[232] Loan originators often exploit the subjective nature of the appraisal process by exerting pressure on appraisers to deliver pre-determined values in order to quickly close on high-volume mortgage transactions.[233] An appraisal value insufficient to support the desired loan amount may jeopardize the deal and prevent loan officers and brokers from being paid.[234]

Because appraisers rely on loan origination parties for continuous business, it is inevitable that they will submit to third-party pressures by delivering inflated appraisals to meet business expectations and earn referrals.[235] Consequences for parties[236] who submit to such pressures are severe. [237] But it is also easy to mistake

bailouts):

> Jared Vennett: "In the years that followed, hundreds of bankers and rating-agency executives went to jail. The SEC was completely overhauled, and Congress had no choice but to break up the big banks and regulate the mortgage and derivative industries. Just kidding! Banks took the money the American people gave them, and used it to pay themselves huge bonuses, and lobby the Congress to kill big reform. And then they blamed immigrants and poor people, and this time even teaches! And when all was said and done, only one single banker went to jail this poor schmuck!"

Id.

231. *Id.* at 4.

232. Murray, *supra* note 3, at 1309. The accuracy of any appraisal is subject to number of variables, including the availability and reliability of information. *Id.* Even where adequate comparable sales data is available, the data may not be available. *Id.* For example, if the sale of a comparable is not a valid arm's length transaction. *Id.* "Consequently, where information is limited or unreliable, even appraisals prepared by the most competent and conscientious appraisers are prone to inaccuracy." *Id.*

233. *Id.* at 1313 (discussing borrowers, mortgage-brokers, and lenders as self-interested parties).

234. *Id.* at 1314.

235. *Id.* at 1313.

236. *See* Wooley, *supra* note 15, at 360 (giving an example of lenders who rely upon the value of property to ensure repayment of the loan in the event that borrower defaults on that loan).

237. *Id.* at 357 (discussing consequences of lender's reliance on inaccurate real estate appraisals).

appraisal manipulation for an erroneous, but good faith, assumption that nonetheless can be a valid opinion of value.[238]

The degree of appraisal inaccuracy is the primary weakness of its industry.[239] One way to address this weakness is to insulate appraisers from influence exerted by loan origination parties.[240] By adopting an independent appraiser assignment system, which implements a random assignment of appraisers based on their availability in a specific area, loan origination parties will not have the opportunity to employ repeat appraisers.[241] A neutral and independent appraisal system is not a new concept, and the Federal Housing Administration ("FHA") used a similar concept called the "FHA Fee Panel" back in 1994.[242]

To eliminate the opportunity for self-interested parties to influence appraisers to deliver predetermined valuations, the responsibility for selecting appraisers cannot reside with parties who have incentives to condition future work on the delivery of favorable appraisals.[243] To substantially reduce the likelihood of this pressure, appraisers must be randomly assigned to perform collateral valuations.[244]

However, supporters of automated collateral valuation

238. Murray, *supra* note 3, at 1311.
239. Wooley, *supra* note 15, at 357.
240. Murray, *supra* note 3, at 1306.
241. *Id.*
242. *Id.* at 1319.

> Under that system, homes financed with loans insured by the FHA were appraised almost exclusively by appraisers assigned from a fee panel (FHA Fee Panel). Each loan was assigned by the FHA on a rotational basis to one of approximately 6,000 appraisers on the FHA Fee Panel. Lenders paid appraisers for completed appraisals and charged the cost to borrowers. The rotational basis assured appraisers of receiving regular work. Accordingly, lenders had no power to influence appraisers with promises or denials of future work. Unfortunately, in 1994, the Department of Housing and Urban Development (HUD) implemented legislation that allowed lenders to choose appraisers in the origination of single-family home mortgages insured by the FHA. Accordingly, the FHA established a national roster (FHA Roster) from which lenders could select appraisers. To assist lenders, the FHA provided an electronic database tool with which lenders could search for appraisers in their localities. In 1996, HUD noted that lender-selected appraisers were performing the vast majority of appraisals and terminated the FHA Fee Panel. Since then, lenders have selected appraisers from the FHA Roster to perform all FHA appraisals. In 2008, the Housing and Economic Recovery Act of 2008 (HERA) revised FHA standards for placement on the FHA Roster. To be eligible for placement on the FHA Roster, appraisers must be certified in their state of practice and cannot be listed on any federal sanctions lists.

Id.
243. *Id.*
244. *See id.* (discussing methods to reduce external pressures exerted on appraisers).

products believe that appraisal accuracy can be better achieved with new computer technology. Instead of implementing costly independent assignment systems, the issue of external pressure can be resolved by eliminating the middleman (i.e. the appraiser), and utilizing digital tools to automate the process in discrete and logical steps.[245]

For example, Freddie Mac uses its Loan Product Advisor Suite® Software to assess whether a specific property can be eligible for an appraisal waiver.[246] Freddie's software underwriting tools screen, identify, validate, confirm, and track loans that are eligible to receive the automatic collateral evaluation waiver option.[247] Freddie says it has sufficient tools in place to ensure that real property estimates are accurate and without the risk of compromising integrity of the financial system.[248]

c. The 2010 Dodd-Frank Act

Despite criticism that the Dodd-Frank Act ("Dodd-Frank") only regulates federally insured mortgage transactions, it is nonetheless the most significant piece of legislation signed into law since the Great Depression.[249] Dodd-Frank brought substantial changes to the financial sector that affect all federal regulatory agencies, including real estate appraisers.[250] Proponents of Dodd-Frank argue that its provisions add an additional layer of consumer protection by incorporating the appraisal independence standard required by Title XI of FIRREA.[251]

For example, Dodd-Frank prohibits lenders from making higher-risk mortgage loans without the support of an independent real estate appraisal.[252] It also provides for civil penalties for violations of the appraisal independence standard.[253] Dodd-Frank advocates argue that strict financial regulations enhance the

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245. Marshall & Greene, *supra* note 215, at 1.
246. FREDDIE MAC on ACEs, *supra* note 8, at 1.
247. *Id.*
248. *See id.* (noting –

> Zach Dawson, Fannie Mae director of collateral policy, listed several eligibility criteria for Fannie's Property Inspection Waiver program. Some requirements include the purchase loan having 80% or lower loan-to-value ratio, being single-family and condo properties, primary occupancy and second homes and only when Fannie already has a prior appraisal in electronic format that has been analyzed by Collateral Underwriter.

Id.
249. Federal Financial Institutions Examination Council, *supra* note 69 at 1.
250. *Id.*
251. *See id. (*discussing generally provisions of Title XI of FIRREA).
252. Boyack, *supra* note 2, at 971.
253. *Id.*

integrity[254] of the appraisal process while making the traditional collateral evaluations more reliable.[255] Of course, Dodd-Frank alone does not warrant against appraiser misconduct, but it is a step in the right direction.[256] It not only protects consumers from mortgage fraud, but it also keeps big financial conglomerates at bay.[257]

On the other hand, opponents say that Dodd-Frank regulates too much.[258] Its passage encouraged consolidation of the financial sector by ensuring that big financial conglomerates survived the crisis, while it did very little to help community banks.[259] Opponents also criticize Dodd-Frank for its costly regulatory burdens that threaten community banks, which provide essential services to small businesses, consumers, and local economies.[260]

Republican critics say "the 2010 Dodd-Frank law went too far and curbs banks' ability to lend, while many Democrats say it provides critical protections for consumers and taxpayers."[261] Although Dodd-Frank has only been in place for nine years, big banks and their political allies have succeeded to weaken its regulations.[262] They did so by lobbying regulators and suing to overturn rules, and by pushing the legislature to freeze agency budgets and repeal Dodd-Frank's key mandates.[263] In 2017, te

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254. *See* USPAP, *supra* note 28, at 1 (noting that appraisers who perform appraisals in compliance with USPAP should be able to refute any claims that their appraisals lack transparence).

> The Uniform Standards of Professional Appraisal Practice ("USPAP") requires an appraisal report to contain enough information for the intended users to properly understand the appraisal report. […] Further, the Conduct section of the ETHICS RULE in USPAP requires an appraiser to be independent, impartial, and objective, and to perform assignments without bias.

Id.

255. *Id.* at 13.

256. *Id.* at 10.

257. *Id.*

258. *See* Arthur E. Wilmarth, Jr., *A Two-Tiered System of Regulation is Needed to Preserve the Viability of Community Banks and Reduce the Risk of Megabanks*, 2015 MICH. ST. L. REV. 249, 252 (2015) (discussing criticism of Dodd-Frank).

259. *Id*. Federal regulators allowed only one large depository institution (Washington Mutual) to fail, but they stood by while more than 450 community banks failed between 2008 and 2012." *Id.* Community banks received very little assistance from the government during the financial crisis. *Id.*

260. *Id*.

261. Pete Schroeder & Michelle Price, *Senate to Consider Bill Next Week Easing Banking Regulations*, REUTERS, (Mar. 1, 2018) www.reuters.com/article/us-usa-senate-banks/senate-to-consider-bill-next-week-easing-bank-rules-idUSKCN1GD667.

262. Mike Konczal, *Why Are Democrats Helping Trump Dismantle Dodd-Frank?* N.Y. TIMES (Mar. 6, 2018) www.nytimes.com/2018/03/06/opinion/democrats-trump-dodd-frank.html.

263. Wilmarth, *supra* note 258, at 1288.

> In addition to trade group's vigorous lawsuit, the industry's aggressive

Senate began considering a bill that would roll back some of the key provisions of the Dodd-Frank Act.[264]

d. The Economic Growth, Regulatory Relief, and Consumer Protection Act ("The Crapo Bill")

In May 2018, President Trump signed into law a bipartisan bill known as "The Economic Growth, Regulatory Relief, and Consumer Protection Act," (S.2155)[265] which rolls back many post-financial-crisis banking rules that Congress enacted as part of the 2010 Dodd-Frank law.[266] The bill provides a major boost for some of the largest U.S. banks, and it releases small and medium-sized banks from tighter regulation by raising the threshold for closer federal oversight from $50 billion to $250 billion in assets.[267] Banks below the new threshold will no longer be automatically subject to annual federal stress test requirements aimed at measuring their ability to withstand a severe economic downturn.[268] By rolling back essential protections[269] of Dodd-Frank, some democrats believe that the Crapo Bill will open the door to discriminatory lending practices.[270]

More importantly, the Crapo Bill rolls back certain appraisal

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> lobbying efforts have persuaded regulatory agencies to delay or water down regulation mandated by Dodd-Frank. The industry helped to elect a Republican majority in the House of Representatives in 2010, and again in 2012, and Republican leaders have introduced numerous bills to repeal the Dodd-Frank Act.

Id.

264. Victoria Guida, *Crapo Bill State of Play*, POLITICO (Mar. 8, 2018), www.politico.com/newsletters/morning-money/2018/03/08/crapo-bill-state-of-play-125477.

265. Schroeder & Price, *supra* note 261. The Crapo bill is unusual in today's hyperpartisan environment: It has over 10 Democratic co-sponsors, many from swing or red states and up for re-election this year. *Id.*

266. Sylvan Lane, *Trump Signs Dodd-Frank Rollback*, HILL (May 24, 2018), www.thehill.com/policy/finance/389212-trump-signs-dodd-frank-rollback.

267. *Id.*

268. Alan Rappeport & Emily Flitter, *Congress Approves First Bib Dodd-Frank Rollback*, N.Y. TIMES (May 22, 2019), www.nytimes.com/2018/05/22/business/congress-passes-dodd-frank-rollback-for-smaller-banks.html. The bill also exempts some loan originators (including small lenders) from certain disclosure requirements under the Home Mortgage Disclosure Act. *Id.* Democrats say this will open the door to discriminatory lending practices because the rules required collection of credit scores, loan amounts and interest rates in an effort to expose redlining and lending discrimination. *Id.*

269. *See* Gelzinis & Valenti, *supra* note 223, at 1 (discussing how the bill also eliminates escrow requirements for higher-cost mortgages made by banks and credit unions with assets of up to $10 billion, up from $2 billion currently). Escrow is an essential borrower protection; an arrangement that prominently identifies the full cost of a mortgage loan for a prospective homebuyer. *Id.* It also prevents the likelihood of losing a home due to an unpaid tax lien or subjection to expensive force-placed insurance. *Id.*

270. *Id.*

requirements for higher-risk mortgages in rural areas.[271] It allows lenders "to bypass appraisals for any property with a transaction value of $400,000 or less" (increasing the *de minimus* threshold) if the lender is "unable to find an available appraiser to complete an appraisal within a reasonable amount of time."[272]

Opponents[273] of the Crapo Bill argue that it threatens the future profession of rural appraisers, and that banks will inappropriately use the law's provisions to avoid fundamental risk management functions.[274] The bill also ignores causes of the 2010

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271. *House Passes Dodd-Frank Reform Bill Complete With Appraisal Revisions,* APPRAISAL INSTITUTE (May 28, 2018) www.appraisalinstitute.org/ano/house-passes-dodd-frank-reform-bill-complete-with-appraisal-revisions-/; *see also* 12 C.F.R. § 1026.35(b)(2)(iii)(A) (2019) (noting the requirements for higher-priced mortgage loans and defining "rural as follows:

> (A) An area is "rural" during a calendar year if it is:
>
> (1) A county that is neither in a metropolitan statistical area nor in a micropolitan statistical area that is adjacent to a metropolitan statistical area, as those terms are defined by the U.S. Office of Management and Budget and as they are applied under currently applicable Urban Influence Codes (UICs), established by the United States Department of Agriculture's Economic Research Service (USDA-ERS);
>
> (2) A census block that is not in an urban area, as defined by the U.S. Census Bureau using the latest decennial census of the United States; or
>
> (3) A county or a census block that has been designated as rural by the Bureau pursuant to the application process established under section 89002 of the Helping Expand Lending Practices in Rural Communities Act, Public Law 114-94, title LXXXIX (2015). The provisions of this paragraph (b)(2)(iv)(A)(*3*) shall cease to have any force or effect on December 4, 2017.

Id.

272. Dave Towne, *Dangerous Pending Bill in US Senate*, APPRAISER BLOGS (Feb. 9, 2018), www.appraiserblogs.com/pending-bill-threatening-rural-areas-appraisers.

273. Caroline Basile, *House Passes Dodd-Frank Reform Bill, Approval Now Pending From President Trump*, HOUSING WIRE (May 22, 2018), www.housingwire.com/articles/43443-house-passes-dodd-frank-reform-bill-approval-now-pending-from-president-trump. Opponents of the bill strongly cautioned against the bill's passage prior to the vote. *Id.* Rep. Maxine Waters, D-Calif., vehemently opposed the bill and voiced her opposition to the bill on the floor of the House:

> Republicans are trying to pass this bill off as an effort solely designed to benefit small community banks. But the truth is the bill is packed with poisonous provisions that benefit megabanks like Wells Fargo and companies like Equifax. It also weakens critical mortgage protections to ensure borrowers can afford their loans, and prevent discrimination and fraud.

Id.

274. *Coalition Letter,* APPRAISAL INSTITUTE (Mar. 13, 2018), www.app

financial crisis and instead of narrowly tailoring rules to address specific concerns in the marketplace; it creates massive new risks in the housing market.[275] While opponents of the Crapo Bill argue that it is extraordinarily dangerous for the economy to loosen up financial regulations, its proponents believe that it will stimulate and promote economic growth.[276]

Republican lawmakers and the banking industry contend that the Crapo Bill will "help unshackle banks — and the economy — from regulatory burdens," put in place after the Great Recession.[277] Proponents of the bill believe that it will stimulate and promote economic growth by relieving small banks from strict financial

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raisalinstitute.org/assets/1/29/Coalition_letter_-_Final.pdf. For example, by attempting to contract with out of market appraisers, or presenting unreasonable or below market assignment conditions or requests. *Id*. Although the Bill requires compliance with the appraiser independence standard and mandates that appraisals be furnished "within a reasonable time," the risk of big banks using this to bypass risk management requirements is too great. *Id*. Opponents contend that the risk of this exemption will only foster dangerous mortgage practices because reducing appraisal requirements will only increase risks to the taxpayers, who stand behind FDIC-insured institutions. *Id*.

275. Gelzinis & Valenti, *supra* note 223, at 1. The bill is applicable to primarily residential loans held in portfolio where the loans generally are prohibited from being sold or transferred. *Id*. Nonetheless, opponents of the Crapo Bill say that it will weaken the oversight needed to monitor and discourage dangerous lending and investing the U.S. economy to its "knees a decade ago." *Id*. The bill makes the U.S. financial system – and key regional economies – more vulnerable to another financial crisis, potentially putting taxpayers back on the hook to bail out the same banks once again. *Id*.

276. *Id.;* Schroeder & Price, *supra* note 261; *see also* APPRAISAL INSTITUTE on Dodd-Frank, *supra* note 271, at 1 (noting as follows—

> The Appraisal Institute took no position on the bill, which the Senate approved in March, but endorsed changes to appraisal exemptions included in the measure. The bill clarifies that a bank must engage at least three appraisers on the bank's approved appraiser list, in the local market area and in compliance with existing appraiser independence requirements. It also establishes a reasonable timeliness standard.)

Id.; *see also* Coalition Letter, *supra* note 274, at 1 (agreeing that provisions of the Crapo Bill will ensure that banks made a good faith effort to place the appraisal with local market appraisers, consistent with the bill's intent). "However, without further clarifying provisions, we believe the provision could be used inappropriately by banks to avoid fundamental risk management requirements altogether, for example, by attempting to contract with out of market appraisers, or presenting unreasonable or below market assignment conditions or requests." *Id*.

277. Rappeport & Flitter, *supra* note 268, at 1. Paul D. Ryan, the House Speaker and Wisconsin Republican, said the bill's passage was a step toward "freeing our economy from overregulation." "Our smaller banks are engines of growth," he said in a statement. "By lending to small businesses and offering banking services for consumers, these institutions are and will remain vital for millions of Americans who participate in our economy." *Id*. "Republicans, and some Democrats, say that the Dodd-Frank law has unnecessarily hurt small-and-medium-sized banks that did not play a role in the financial crisis and which as a result, have cut off the flow of credit to many Americans." *Id*.

regulations and thus, encouraging credit lending.[278] But, more must be done to fix the regulatory overreach created by the crisis.[279] Because the Crapo Bill was just signed into law earlier this year, it is unclear how it will be applied to residential mortgage transaction.

B. Freddie Mac Says that Automatic Collateral Evaluation Products Make Mortgages Affordable and Efficient

Big banks such as Freddie Mac, and other financial institution oppose the use of traditional appraisals for several reasons. First, they want to utilize different or additional analytics to evaluate collateral in light of innovative technology.[280] Second, they want to eliminate the traditional appraisal to shorten the mortgage underwriting process.[281] Third, they want to reduce borrower's loan origination cost[282] by eliminating the cost of a traditional appraisal.[283] Additionally, Freddie Mac says that traditional appraisals yield unreliable estimates of value due to the subjective nature of the valuation process.[284]

Without doubt, Freddie Mac is the leading proponent of the Automated Collateral Evaluations ("ACE") and it encourages loan origination parties to utilize its innovative underwriting tools on its website.[285] These tools enable mortgage brokers to assess whether a traditional appraisal is required for a specific type[286] of real property that has a federally insured loan.[287] In fact, Freddie Mac announced a new program effective September 1, 2017 that helps residential buyers in certain states lower the loan origination fees by removing the appraisal requirement.[288]

David Lowman, Freddie Mac's executive vice president of single-family business says, "[b]y leveraging big data and advanced

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278. Schroeder & Price, *supra* note 261, at 1. Supporters of the Crapo Bill argue that it brings needed relief to small and regional banks, which they say were treated unfairly during the financial reform of 2010. *Id.*

279. *Id.*

280. *See* USPAP, *supra* note 28, at 31 (discussing reasons for Freddie Mac's increased use of automatic collateral evaluation products).

281. *Id.* at 13.

282. *See id.* (providing one example in the default mortgage-servicing sector). Clients often require valuations for each asset several times a year. *Id.* Many of these clients feel the opinion of value may not be as important as the data presented; as a result, the cost of acquiring appraisals on a property several times each year is considered cost-prohibitive. *Id.*

283. *Id.*

284. Tibbitts, *supra* note 194, at 1.

285. *Id.*

286. *See id.* (giving an example of an exception where the use of a traditional real estate appraisal may be required is new construction homes).

287. *Id.*

288. USPAP, *supra* note 28 at 4.

analytics, as well as 40-plus years of historical data, we're cutting costs and speeding up the closing process for borrowers."[289] Freddie also says that it is "reimagining" the mortgage process to create a better experience for consumers and lenders by providing immediate collateral representation and warranty relief to lenders, saving buyers loan origination fees of approximately $500, and speeding up the closing up to ten days sooner.[290]

To determine whether a loan is eligible for an automated collateral evaluation, mortgage brokers working with consumers who are buying homes or refinancing their existing Freddie Mac mortgages must submit the loan through Freddie Mac's website.[291] Freddie Mac went even a step further and designed the "Loan Advisor Suite,"[292] which it claims will enhance "the mortgage lending process by utilizing advanced analytic tools" to efficiently come up with an estimated property value and determine buyer's creditworthiness.[293] The innovative mortgage underwriting techniques encourage other big banks to save time and costs by converting to the use of ACEs and other automatic loan processing tools.[294]

Proponents of the ACEs argue that eliminating the use of traditional appraisals will make mortgage underwriting more accessible[295] (by helping buyers save on loan costs) and more efficient (by eliminating tools that prolong the credit approval process).[296] Because clients utilize ACEs for different needs with varying degree of data, Freddie believes this new trend will eliminate economic waste and preserve resources.[297] Appraisal alternatives have been on the market for decades and their use is

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289. *Id.*

290. *Id.*

291. *See* Tibbitts, *supra* note 194, at 1 (discussing Freddie's procedures for loan eligibility for automatic collateral evaluations).

292. Freddie Mac Loan Advisor Suite, FREDDIE MAC (last visited on April 22, 2019), www.freddiemac.com/loanadvisorsuite

> Freddie is building tools to help mortgage professionals cut costs in the underwriting process, by also giving them representation and warranty relief sooner in the loan manufacturing process by utilizing the use of automated collateral evaluation, automated assessments for borrowers without credit scores, immediate certainty for collateral rep and warranty relief, and coming soon automated asset and income validation.

Id.

293. *Id.*

294. *Id.*

295. *See* Harney, *infra* note 302, (stating, "Consumers definitely appreciate it," he added. There's "more cash in their pockets" and the total experience is better.")

296. *See id.* (arguing that elimination of a traditional appraisal will lower borrower's loan costs and discussing other advantages of using ACEs).

297. Light*, supra* note 185.

expected to grow in the future.[298] For example, the Broker Price Opinions ("BPOs")[299] and the Comparative Market Analysis ("CMAs")[300] are a less costly alternative to help buyers, sellers, and lenders quickly determine property values.[301] Mortgage lenders are also enthusiastic about this move because ACEs will simplify the mortgage origination process.[302]

While opponents of ACEs do not condemn the use of innovative technology in the mortgage field, they nonetheless caution against the use of ACEs to determine fair market value of real properties in

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298. *See* USPAP, *supra* note 28 at 4 (explaining, [a]lthough it may be difficult to verify, some estimate that over 12 million BPOs 182 are performed annually. […] These alternate collateral products also include Broker Price Opinions (BPOs) typically in short sales, Comparative Market Analysis (CMAs) for determining the fair market value, and Automated Valuation Products (AVPs) which are used by Freddie Mac in lieu of a traditional appraisal, Appraiser Price Opinions (APOs), Reconciliation Review, Non-Standard Desktop Valuations/Field Review, and Full Inspection Proprietary Appraisal Forms.)

Id. at 4.

299. *See id*. at 4 (noting that

> BPOs are one of the most commonly-recognized AVPs. Id. In addition, BPOs have been used for many years by real estate brokers in the ordinary course of their real estate brokerage businesses, with over 12 BPOs preformed annually. Id. The product was originally designed to assist homebuyers and sellers in real estate listing and sale transactions, but in recent years its use has been expanded for additional purposes. Id. Freddie Mac has developed sample BPO forms, and they have been used in residential sales, appraisals, internal non-lending purposes, secondary loan markets, distressed loans, and other legal purposes such as foreclosure or a divorce).

Id. at 4.

300. *Id*. at 4.

> Comparative Market Analysis "CMA" is a product, which originally was used in a very similar fashion to BPOs, but mostly real estate brokers use it. Like BPOs, CMAs may also include information regarding closed and pending sales, as well as active listings in the area to assist buyers and sellers to determine a fair market value of the subject property.

Id.

301. *Id*.

302. Kenneth Harney, *Are Home Appraisals Always Necessary*? CHI. TRIB. (June 20, 2017), www.chicagotribune.com/classified/realestate/ct-re-0625-kenneth-harney-20170621-column.html.

> For example, Dave Norris, chief revenue officer of loanDepot, one of the highest-volume retail lenders in the country, said "leveraging technology" to arrive at property valuations "gives consumers certainty" about the status of their application upfront, sharply reduces the time needed to get to closing and saves money. Roughly 12 percent of loanDepot's refinancing through Fannie Mae already is proceeding appraisal-free, Norris said.

Id.

residential mortgage transactions.[303] Although technology advancements help appraisers obtain valuations more efficiently, the use of ACEs still carries risks that undermine the integrity of the financial system.[304]

Appraisers must be able to control the valuation process by selecting and inputting information in the reports based on their personal knowledge and experience in the field.[305] If appraisers allow software or tools to control the valuation process, the output may be less credible with unreliable or misleading property valuations.[306] Instead of solely relying on technology, appraisers should control the valuation process by selecting data, engaging in parameter analysis, and interpreting the output.[307] ACE opponents believe that eliminating a traditional appraisal is a flashback to the "disastrous practices of subprime lenders during the housing boom and bust."[308]

While the use of ACEs sparks a lot of concerns in the mortgage field, big banks such as Freddie Mac and Fannie Mae will likely continue to innovate and dominate the market in this area. [309] These financial conglomerates are "very committed to driving responsible innovation in the collateral space and trying to modernize the mortgage origination process."[310] In this field, it is vital to keep up with the latest technology trends.[311] Ultimately, utilizing ACEs will not only speed up the mortgage underwriting process but it will also reduce borrowers' loan origination costs, making mortgages more accessible to residential purchasers.

303. Marty Hamilton, *Advisory Opinion 37 – Computer Assisted Valuation Tools*, DATA MASTER FOR APPRAISERS (Nov. 27, 2017), www.datamasterusa.com/advisory-opinion-37

304. *Id.* In fact, opponents argue that a valuation method that does not provide a property's market value or sufficient information and analysis to support the value conclusion is not acceptable as an evaluation. *Id.*; *see also* 4A DENNIS A. SCARDILLI, REAL ESTATE FINANCING § 2H.44 (2018) (giving an example of a valuation method that provides a sales or list price, such as a broker price opinion, cannot be used as an evaluation because, among other things, it does not provide a property's market value).

305. *Id.*

306. *Id.*

307. *Id.*

308. Harney, *supra* note 302. When interviewed about this issue, a Richmond, Va., appraiser, said: "I've walked into 5-year-old houses that are in such bad shape that they look like they haven't been maintained for 25 years." *Id.* "This is a return to no doc and low doc on steroids." *Id.*

309. Ramirez, *supra* note 10, at 1.

310. *Id.*

311. *See* USPAP, *supra* note 28 at 10 (noting that proponents of the use of automatic collateral evaluations value innovative technological trends).

C. Opposition to Automatic Collateral Evaluation Products

While Freddie's innovative appraisal alternative looks very promising; its opponents argue that it is a recipe for a disaster for three reasons. First, automated evaluation products are inaccurate and unreliable. Second, because the mortgage market is cyclical, allowing the use of ACEs will frustrate Congress' efforts to protect consumers against mortgage fraud. Third, it is likely that ACEs do not comply with USPAP standards.

1. ACEs Are Inaccurate and Unreliable

There are two competing views on the use of ACEs in residential mortgage transactions. One of the biggest drawbacks is a computer's inability to accurately evaluate the physical condition of real property, which affects its fair market value.[312] Because ACEs rely on a previously computer-generated market data, their software[313] is unable to accurately evaluate land and its improvements.[314] The valuation estimate assumes the average condition of real property based on information generated from various computer sources.[315] But without considering physical aspects of real property (i.e. evaluating its upgrades, fixtures, amenities, repairs, or damages), the valuation estimate will be at a substantial risk for inflation.[316] Inflation will ultimately fuel rapid and unsustainable growth in the housing market, yet creating another mortgage bubble.[317]

Undeniably, ACEs are typically less reliable for properties in markets that include new construction or uniquely renovated homes with custom features, varying levels of construction, rare amenities, etc., or homes in areas with relatively little market activity.[318] The uniqueness of a real estate parcel may render its fair market value

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312. *Id.*

313. 1 JEFFREY TORP, RISK-BASED COMPLIANCE AUDIT PROGRAM § 6D.10 (2018). A computer program estimates a property's market value based on market, economic, and demographic factors that were previously generated by other sources and published online. *Id.*

314. Light, *supra* note 185, at 1 (noting counterarguments to the use of automatic collateral evaluations); *see also* USPAP, *supra* note 28, at 10 (noting that improvements include, but are not limited to: exterior amenities, total room count, condition and age of home's systems, unappealing features, improvements and condition of kitchen, baths, roof, windows, heating, electrical, plumbing, and so forth).

315. John Reilly, *Using MLS Data to Generate an AVM*, DATA ADVOCATE (May 29, 2014), www.thedataadvocate.com/using-mls-data-to-generate-an-avm/.

316. Murray, *supra* note 3, at 1305.

317. *Id.*

318. *See* USPAP, *supra* note 28, at 9 (discussing reliability of automated collateral evaluation products).

grossly disproportionate, if the lender (e.g. Freddie Mac[319]) relies on a computer-generated valuation that disregards its unique physical aspect.[320]

On the other hand, proponents argue that ACEs are especially reliable if real property is located within a homogenous marketplace.[321] But, that is not always the case. An issue arises when the MLS system utilized by real estate brokers contains outdated property information.[322] Usually, this happens if a property has been sitting on the market for a while or when the listing expires.[323] If a particular real property is later re-listed, real estate brokers often fail to update and verify its information.[324] Too often, the MLS data is simply erroneous and not up-to-date, with property addresses that do not even exist.[325]

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319. Compliance Audit Program, *supra* note 313, at 1 (discussing that opponents of ACEs argue that such,

> Institutions should establish policies and procedures that govern the use of AVMs and specify the supplemental information that is required to develop an evaluation. When the supplemental information indicates the AVM is not an acceptable valuation tool, the institution's policies and procedures should require the use of an alternative method or tool.

Id.

320. *See* USPAP, *supra* note 28, at 10 (presenting opponents' view on the use of automatic collateral evaluation products).

321. *Id.* The computer system analyzes hundreds of sales of very similar properties that render a reliable estimate of value. *Id.*

322. *See* Jeanne Sager, *Expired Listing vs. Withdrawn Listing: What is the Difference?* REALTOR.COM (Sept. 28, 2017), www.realtor.com/advice/sell/what-is-the-difference-between-a-withdrawn-listing-and-an-expired-one/.

323. *See id.* (defining expired listing as a property that has not sold by the end of the period stipulated in the listing contract between the seller and the listing agent).

324. *Id.* For example, MLS listing sheets operated by real estate brokers often contains information with outdated property taxes, homeowner's assessment dues, amenities, or even square footage. *Id.* Consequently, online syndication websites such as Zillow.com, or Trulia.com obtain property information from a variety of unreliable sources, which are used too quickly to determine a property's fair market value; *see also Zillow Talk: What You Might Not Know About Online Syndicators*, MODBOULDER (Sept. 18, 2015), www.modboulder.com/blogs/2015/9/17/zillow-talk-what-you-might-not-know-about-online-real-estate-syndicators (describing Zillow as a syndicator and explaining that it grabs information from a variety of online sources, not just your local Multi Listing Service (MLS), which may not be accurate or up to date); *see also* Illinois Bar Journal, *Class Action: Zillow "Zestimate" an Unlicensed Appraisal*? ILLINOIS STATE BAR ASSOCIATION (July 2017), www.isba.org/ibj/2017/07. Zillow.com is a website that allows users to search for properties listed for sale and look up the estimated value of a property (even if it is not for sale). This value is Zillow's "Zestimate," a number generated by a computer algorithm. Zestimates are often used to quickly determine a home's approximate value. *Id.* Too often this data is simply erroneous and not-up-to-date, with property addresses that don't exist. *Id.*

325. *See* MODBOULDER, *supra* note 324 (discussing common issues with estimates generated by Zillow.Com and Trulia.Com).

But with proper internal validation procedures, proponents believe ACEs can yield reliable and accurate results.[326] For example, a financial institution can establish internal procedures to monitor automatic valuations.[327] "Validation can be performed internally or with the assistance of a third party, as long as the validation is "conducted by qualified individuals that are independent of the model development or sales functions."[328] Ultimately, the goal is to make the mortgage origination process more efficient and reliable.[329] Proponents believe that ACEs can achieve this goal without compromising the integrity of the financial system.[330]

But opponents condemn the use of ACEs in residential mortgage transactions because they believe ACEs violate the USPAP standards.[331] To illustrate, many unlicensed appraises already perform a number of ACEs assignments for mortgage transactions without the necessary education or experience.[332] Even internal validation procedures will not make up for an appraiser's knowledge and experience, or his physical inspection of real property.[333] While ACEs may prove to be cost effective and time efficient, their use raises serious implications about consumer protection.[334]

2. *ACEs Disrupt Consumer Protections*

Consumer protection groups oppose the use of ACEs in mortgage transactions because the real estate market is cyclical.[335] Housing markets are prone to booms accompanied by bubbles in mortgage credit.[336] Mortgage bubbles are created when lenders cut underwriting standards, producing a surfeit of bad loans, which

326. 1-11 Mortgage Procedure Guide to Federal and State Compliance § 11.41 (2017).

327. *Id.* A financial institution must demonstrate that the "depth and extent of its validation processes are consistent with the materiality of the risk and the complexity of the transaction." *Id.*

328. *Id.*

329. *Id.*

330. *See* McCoy & Wachter, *supra* note 122, at 373 (noting that ACEs undermine integrity of the mortgage process).

331. *See* Russell, *supra* note 25, at 14-15 (discussing complications of using ACEs in residential mortgage transactions).

332. *See* USPAP, *supra* note 28, at 13 (discussing non-licensed individuals preforming real property evaluations).

333. Mortgage Procedure Guide, *supra* note 326, at 1. An institution should not rely solely on validation representations provided by an AVM vendor. *Id.*

334. *See generally* Wooley, *supra* note 15, at 1118 (discussing risks associated with the use of ACEs).

335. *See* McCoy & Wachter, *supra* note 122, at 361 (defining cyclicality as the propensity of housing markets to undergo bubbles in which real estate values soar, then crash, wiping out home equity).

336. *Id.*

lead to elevated loan defaults.[337] The mortgage origination market understands that bad underwriting procedures and appraisal inflation were among the leading causes of the 2007-2009 financial collapse.[338]

Appraisals are essential to mortgage lending but they are also cyclical in nature (i.e. they are based on comparable sales that are market-dependent).[339] This is true for both ACEs and traditional appraisals, because they rely on comps derived from recent sales in a particular neighborhood. [340] Because the real estate market is cyclical, opponents say that ACEs frustrate procedural safeguards put in place after the Great Recession, which are keeping big banks at bay.[341]

3. ACEs Do Not Comply With USPAP Standards

Lastly, opponents believe that ACEs do not comply with USPAP standards implemented after the Great Recession.[342] For example, ACEs lack the traditional development and reporting requirements under USPAP.[343] The Appraisal Standards Board ("ASB") does not deem *any* automated valuation product as USPAP-compliant because, this responsibility rests with the appraiser.[344] Many states require their licensed appraisers to comply with USPAP for all opinions of value, not just those required by Title XI of FIRREA.[345] In fact, they allow appraisers to perform an "alternate valuation product" only if the result is USPAP-compliant.[346] But do to the inherent risk of inflation ACEs should not be used in residential mortgage transactions.[347]

4. Compare and Contrast ACEs with the Traditional Residential Appraisal

One of the most significant differences between these two approaches is the *method* by which the property valuation is

337. *Id.*
338. *Id.* at 372.
339. *Id.* at 373.
340. *See* USPAP, *supra* note 28, at 9 (defining recent as typically within the last six months).
341. McCoy & Wachter, *supra* note 122, at 373. In addition, opponents of ACEs argue that their use will also undermine the integrity of mortgage lending process by producing grossly inaccurate property values. *Id.*
342. USPAP, *supra* note 28, at 9.
343. *Id.*
344. *Id.* To be in compliance, a residential appraisal report must use a Summary Appraisal Report, or a Restricted Appraisal Report. *Id.* (discussing differences between these two appraisal reports).
345. *Id.*
346. *Id.*
347. *Id.*

procured.[348] Freddie Mac and its supporters argue that using ACEs will make housing more accessible and affordable.[349] Lowering borrowers' loan origination costs will also speed up the closing (up to ten days sooner) making the homeownership dream a reality.[350] Proponents argue that increased scrutiny after the Great Recession has "improved the industry's risk assessment and management abilities overall and, accordingly, have decreased the expected default rate on all mortgages."[351]

But lessening underwriting standards and eliminating the use of a traditional appraisal may have devastating impacts on the housing market in the near future.[352] A traditional appraisal is essential to home mortgage lending because it serves as the most important predictor of default, and it utilizes an appraiser's education and experience in generating the fair market value of real property.[353] If lenders rely on inaccurate or inflated appraisals to provide loans, which insufficiently secure the actual collateral values, the real estate market is heading towards another crash.[354]

Nevertheless, both systems (ACEs and traditional appraisals) are at risk of producing inaccurate property valuations, either due to a human error or a computer error.[355] The problem of valuation disparities is problematic because the real estate market is cyclical and it is prone to frequent "market booms."[356] When the real estate market is booming, lenders quickly expand credit without a regard for many underwriting requirements.[357] "Subsequently, when property values slump and loan defaults spike, the ensuing losses jeopardize the solvency of banks, "leaving bank failures in their wake."[358] It does not matter which appraisal technique the lender

348. *See* Tibbitts, *supra* note 194, at 1 (discussing different methods of procuring property valuations).

349. *See id.* (proposing arguments in favor of ACEs because they remove outdated and unnecessary procedures that prolong the mortgage underwriting process).

350. *Id.*

351. Goodman & Zhu, *supra* note 195, at 1. In fact, ACEs "have enabled Fannie Mae and Freddie Mac to share concerns with lenders about an appraisal prior to execution of a mortgage, allowing the lender to take corrective action. *Id.* It was predicted that these developments would decrease the expected default rate on all refinanced mortgages, which were particularly susceptible to appraisal fraud. *Id.* The data reveals that this has indeed been the case. *Id.*

352. McCoy & Wachter, *supra* note 122, at 372.

353. *Id.* at 373.

354. Murray, *supra* note 3, at 1303. In 1985, the portfolios of more than eight hundred federally insured the portfolios of more than eight hundred federally insured lending institutions contained under-secured loans supported by real estate appraisals that overvalued collateral properties by an aggregate of $3 billion. *Id.*

355. *See* McCoy & Wachter, *supra* note 122, at 364 (discussing risks of procuring unreliable appraisals).

356. *See id.* at 365 (noting that the real estate market is cyclical).

357. *Id.* at 373.

358. *Id.* at 365.

used, so long as it resulted in an inflated appraisals that did not adequately secure the actual collateral value.[359] The end result will be the same: the economy will suffer from the consequences of carless mortgage lending.

IV. PROPOSAL

While there is no easy fix to the procyclical effect of mortgage appraisals, current regulatory gaps require significant reform.[360] Undisputedly, consumer protection advocates regard Congress' efforts to encourage transparency in the financial sector as a step in right direction. But current protections of the Dodd-Frank Act are simply not enough for four reasons. First, Dodd-Frank is too far removed from the transactions on the state level. Second, until the legislature substantially reduces the opportunity for self-interested parties to exert pressures on appraisers in residential transactions, the integrity of the process will be compromised. Third, Congress has been inactive in the appraisal field for almost nine years and it is now the time to set clear appraisal standards. Fourth, Congress should repeal the Crapo Bill as it invites lenders to engage in dangerous mortgage lending practices.

A. Congress Should Extend Provisions of the Dodd-Frank Act to All Residential Mortgage Transactions

Because provisions of Dodd-Frank inadequately address the underlying asset valuation problem,[361] Congress should respond by amending provisions of the Act to require lenders to adhere to the independent appraisal standard in every residential mortgage transaction. As it stands, Dodd-Frank is too remote with respect to governing state transactions because it does not apply to non-federal loans.[362] It only affords a system of federal regulatory control over very large financial institutions.[363] Lenders who are not federally regulated are not required to adhere to statutory appraisal regulations.[364]

This regulatory oversight allows smaller lenders, such as community banks or secondary market lenders (i.e. Freddie Mac and Fannie Mae) to engage in deceptive lending practices, which may rely on the use fraudulent appraisals. Congress should incorporate the independent appraisal standard to every residential mortgage transaction to preserve the integrity of the financial

359. Murray, *supra* note 3, at 1303.
360. McCoy & Wachter, *supra* note 122, at 387.
361. Boyack, supra note 2, at 962.
362. *Id.* at 968.
363. *Id.*
364. USPAP , *supra* note 28, at 6.

system. It can do so by either amending provisions of the Dodd-Frank act or passing new legislation.

1. *Congress Should Incorporate the Independent Appraisal Standard to All Residential Mortgage Transactions.*

The independent appraisal standard should be incorporated into every residential mortgage transaction (whether the loan is federally insured or not). That is, every lender or banking institution should explicitly prohibit appraisers from engaging in any types of coercive communication.

Currently, Dodd-Frank only requires lenders to adhere to this standard when they are funding higher-risk federal mortgage loans.[365] But it is not enough to regulate the use of only highly risky loan products, such as higher-priced mortgage loans ("HPMLs").[366] To fill the regulatory gap, the appraisal independence standard must be utilized in every mortgage transaction, including, but not limited to, home purchases, refinances, or home equity loans. This step is critical to the health of the mortgage industry because it is essential in calculating lender's risk if the borrower defaults on a mortgage loan.[367] It is not enough to impose the statutory independence requirement only on highly risky loan products. Without extending provisions of Dodd-Frank to *all* mortgage transactions, the regulatory oversight gap on the state and federal level will never be properly addressed. It should be noted that this proposal does not violate the anti-commandeering[368] doctrine

365. Boyack, *supra* note 2*,* at 967.

366. *See generally,* CONSUMER FIN. PROTECTION BUREAU, *supra* note 30 (discussing HPMLs as risky mortgages).

367. *See generally*, Boyack, *supra* note 2, at 967 (outlining critical steps to ensure healthy mortgage market).

368. Steven Schwinn, *Symposium: It's time to abandon anti-commandeering (But Don't Count on The Supreme Court To Do It)* SCOTUSBLOG (Aug. 17, 2017) www.scotusblog.com/2017/08/symposium-time-abandon-anti-commandeering-dont-count-supreme-court/. The anti-commandeering doctrine says that the federal government cannot require states or state officials to adopt or enforce federal law. *Id.* The Supreme Court created this doctrine out of the 10th Amendment and related federalism principles in two cases, New York v. United States (1992), and Printz v. United States (1997), 521 U.S. 898, 902 (1997) (holding that the federal government cannot force the states to act against their will by withholding funds in a coercive manner); *see also* Independent Business v. Sebelius, 567 U.S. 519, 519 (2012) (holding that the federal government cannot compel states to expand Medicaid by threatening to withhold funding for Medicaid programs already in place.); *see also* New York v. United States, 505 U.S. 144, 149 (1922) (holding that "because the Act's take title provision offers the States a 'choice' between the two unconstitutionally coercive alternatives–either accepting ownership of waste or regulating according to Congress' instructions–the provision lies outside Congress' enumerated powers and is inconsistent with the Tenth Amendment.") But the United States has a dual banking system that specifically allows Congress to regulate in the field of the financial sector. Schwinn, *supra*.

because the United States has a dual banking system that specifically allows Congress to regulate in the financial sector.[369] The banking industry has been largely removed from states' regulation by federal preemption.[370] There are very few banks in the category of state-chartered banks, because lack of federal deposit insurance is a major competitive disadvantage.[371] Although consumer protection is an essential part of states' police powers, the preemption doctrine[372] is presumed to have foreclosed the meaningful state regulation of federally chartered financial institutions.[373]

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369. Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143 (2009)

> Meaning that banks may be chartered by either the federal government or a state government. Regulatory authority over banks for consumer protection depends on whether a bank has a federal or state charter, what type of charter the bank has, whether the bank has federal deposit insurance, whether the bank is a member of the Federal Reserve system, what activity is involved (real-estate lending or non-real-estate lending, for example), and whether the consumer-protection issue arises in advertising and solicitation.

Id. at 149.
370.

> States cannot directly regulate federally chartered banks, thrifts, or credit unions, their operating subsidiaries, or even some of their agents beyond subjecting them to "state laws of general application … to the extent such laws do not conflict with the letter or the general purposes" of federal banking law. Instead, consumer-protection regulation of federally chartered financial institutions has become the preserve of a dispersed group of federal agencies. This arrangement is made more problematic by the fact that preempted state consumer-protection regulations have often not been replaced by equivalent federal protections, and federal enforcement of existing regulations has been lax. For much of the consumer financial product market, the preemption experience has effectively been a deregulation experience.

Id.

371. Levitin, *supra* note 369, at 149. "If a bank has a state charter and is neither federally insured nor a member of the Federal Reserve System, its primary regulator for consumer protection will be the state banking regulator and/or state attorney general. Non-member insured state-chartered banks are regulated by the Federal Depository Insurance Corporation." For example, State-chartered member banks are regulated by the Board of Governors of the Federal Reserve. *Id.*

372. Schwinn, *supra* note 368. The preemption doctrine, which derives from the Supremacy Clause of the Constitution, makes the Constitution and federal laws supreme over state constitutions and state laws; it also binds state judges to the Constitution and federal law. *Id.* The oath clause requires state legislators and state executive officers to swear an oath to support the federal Constitution. *Id.*

373. *Id.* However, states possess a major, untapped regulatory tool: the regulation of secondary-market purchasers of consumer debt from federally chartered financial institutions. *Id.* Preemption doctrine prevents only direct state regulation of federally chartered financial institutions. *Id.* It

2. *Congress Should Promote Responsible Lending Behavior Through Increased Federal Incentives*

Another unintended consequence of Dodd-Frank is the fact that some states do not have mandatory appraiser licensing requirements.[374] This means that in those states, a license or certification is not required to conduct a real estate appraisal.[375] For those who wish to perform an appraisal in a federally regulated transaction, the appraiser can choose to become certified/licensed and submit to the State's regulatory jurisdiction.[376] This gives lenders a lot of leverage in how they allocate their loan products, and there is no way to ensure that they comply with the independent appraisal standard.

But to encourage the appraiser licensing agencies to comply with provisions of the Dodd-Frank Act, the Appraisal Subcommittee ("ASC") allows for certain monetary incentives to participating states.[377] However, these monetary incentives are simply not enough. First, they only apply to all federally regulated mortgage transactions. Second, even with these incentives in place, some states still do not have mandatory appraiser licensing requirements.[378] Today, only a handful of states have voluntary[379] licensing requirement and only thirteen states have mandatory licensing requirements but for federally related transactions only.[380] There are two solutions to this problem.

First, Congress should increase its incentives for states to impose mandatory licensing requirements on all appraisers for all federally related transactions. In part, this will ensure that newly

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does not prevent states from regulating secondary-market purchasers of debt from federally chartered financial institutions. *Id.*

374. *See* Federal Financial Institutions Examination Council, *supra* note 69, at 1 (containing information regarding state licensing requirements).

375. *Id.*

376. *Id.*

377. Russell, *supra* note 25, at 9.

378. Federal Financial Institutions Examination Council, *supra* note 69, at 1.

379. *See id.* (stating that the following states have voluntary licensing requirements: Alaska, Wyoming, and Oklahoma).

380. *See id.* (defining "voluntary" by stating that,

> Certified/licensed appraisers are not required for any appraisal/evaluation assignments. If appraisers wish to perform appraisals in such federally related transactions and real estate related transactions, appraisers can choose to become certified/licensed and submit to the State's regulatory jurisdiction" […]. "Explaining that appraisal is required in any federally related transactions and real estate related financial transactions when Federal law requires the services of such appraisers).

Id.

licensed appraisers have sufficient knowledge and qualifications to produce a credible opinion of value.[381] The USPAP teaches new appraisers the importance of adhering to ethical performance in real estate evaluations, which is so essential to every mortgage transaction.[382] Although the risk of fraudulent appraisals will never be entirely eliminated, increasing federal grants to state participants will substantially encourage ethical performance across all states. Therefore, Congress should encourage all states to take advantage of the federal grants by amending provisions of the Dodd-Frank Act to offer better incentives to participating states.

3. Mandatory-Licensing Rules Should Apply to All States

Second, lack of consistency in state licensing requirements leaves consumers vulnerable to comparability and reliability issues.[383] Another issue associated with transparency in licensing requirements is the lack of disclosure about the components covered by appraisal fees, such as lenders fees, fees paid to the appraisal management companies ("ACMs") and appraisal fees.[384] Congress should amend provisions of Dodd-Frank to impose mandatory licensing requirements in all states. The states should be required to use a licensed appraiser for any evaluation service for which real property is used as collateral for the mortgage loan.[385] Consistency in appraisal requirements in all states would not only improve comparability but also credibility of appraisers nationwide.[386]

In addition, Dodd-Frank should contain a disclosure provision regarding a lender's failure to conform to the independence appraisal standard. This provision would not preclude such lenders from participating in the mortgage market. Rather, in those instances, regulations should foster market stability by requiring lenders who fail to conform to the independency standard to highlight that fact in their disclosure to borrowers.[387] Presumably, the disclosure requirement would steer responsible mortgage borrowers away from lenders who fail to comply with the statutory requirements.

For example, the disclosure should also contain a breakdown of how the appraisal fee is distributed to the lender, appraiser, or appraisal management companies.[388] This requirement would foster transparency in the mortgage approval process while keeping borrowers informed. Ultimately, the mandatory licensing and

381. USPAP*, supra* note 28, at 1.
382. *Id.*
383. Green et al., *supra* note 25, at 9.
384. Russell, *supra* note 25, at 10.
385. *Id.* at 11.
386. *Id.*
387. Boyack, *supra* note 2, at 971.
388. *See id.* (discussing mandated appraisal fees disclosure).

disclosure requirements across all states would eventually eliminate the lack of licensing consistency and would overall improve appraisal credibility.

4. *Congress Should Impose Regulation on the Appraisal Management Companies ("AMCs")*

Lastly, by amending provisions of Dodd-Frank, Congress should establish clear guidelines and impose strict regulation of the appraisal "middlemen" aka the Appraisal Management Companies ("AMCs.") [389] Although, Dodd-Frank heavily regulates individual appraisers, it omits any regulation of the AMCs.[390] Lenders often use AMCs to coordinate and handle the "logistics" of ordering and scheduling the appraisal. AMCs often underpay appraisers because appraisers who are willing to work with AMCs are often less experienced and less likely to accurately determine the market value.[391] Consequently, AMCs are not subject to most of the appraisal regulations, guidelines, and policies because they only perform the administrative functions of the appraisal process.[392]

Indeed, the AMCs are entirely unregulated at the federal level and are subject to appraisal regulations in only a handful of states.[393] To seal the gap between lenders who choose to work with AMCs, and AMCs themselves, the Dodd-Frank Act should require lenders to maintain adequate resources to address and monitor such third-party arrangements.[394] If lenders are to remain in charge of the lending and appraisal process, they need to have sufficient qualify control systems in place. Spending more money and resources on such systems will encourage them to look for quality appraisals done by licensed professionals, rather than relying on automatic collateral evaluations. But, this alone will not be enough.

To protect consumers and appraisers from fraud, Congress should address the lack of federal regulation of the appraisal

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389. *See* Russell, s*upra* note 25, at 18 (explaining,

> AMCs are third party arrangements, in which the lender engages a third party [an appraisal management company] to perform real property valuation-related services, such as selecting appraiser to perform an appraisal. In these situations, it is the responsibility of the lender to understand and manage the risks associated with that arrangement. However, lenders are often not doing their diligence in overseeing AMCs.

Id.

390. *Id.* at 16.

391. Murray, *supra* note 3*,* at 1326.

392. *Id.*

393. *Id.*

394. Russell, s*upra* note 25, at 18. The USPAP requires "that a third party selects an appraiser or a person to perform an evaluation who is competent and independent, has the requisite experience and training for the assignment, and thorough knowledge of the subject property's market." *Id.*

management companies immediately.[395] To ensure consumer protection, the amendment to the Dodd-Frank Act should clearly establish AMCs rights and responsibilities, as well as statutory liability for failing to comply with the statute. Without proper federal regulation of appraisal management companies, the integrity of the independency standard will remain compromised.

B. Congress Should Enact Regulation to Mandate The Use Of The Independent Appraisal Assignment System

While the independent standard requirement makes collateral evaluations more reliable, this standard alone is not enough to ensure that such valuations are sound.[396] Appraisers often violate the Ethics Rule[397] when they submit to pressures exerted by loan origination parties in hopes of receiving their continued business. So to preserve the integrity of the appraisal system, the opportunity of self-interested loan origination parties must be eliminated.[398] Congress can achieve this by enacting a statute that requires mortgage lenders and appraisers to utilize an independent and neutral appraisal assignment system, which will substantially reduce lenders' propensity for choosing the same appraisal company in every transaction.

The independent appraisal assignment system is not a new concept.[399] But the previous system in place, FHA Fee Panel System, had major flaws.[400] It allowed lenders to freely choose and employ appraisers in their specific localities.[401] A closer look at the FHA Fee Panel system revealed that lender-selected appraisers were performing the vast majority of the appraisals.[402] Ultimately, the appraiser independent standard was compromised which led to the termination of the FHA Fee Panel system.[403]

Despite its imperfections, the concept of the independent appraisal assignment system itself is not a bad idea. But it must be redesigned to incorporate innovative technology with emphasis on the neutrality function. The independent appraiser assignment system should be similar to the "desktop" software utilized by Freddie Mac, in that it should require all licensed appraisers to

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395. *Id.*
396. Boyack, *supra* note 2, at 971.
397. *See* USPAP, *supra* note 28, at 1 (explaining that the Conduct section of the Ethics Rule in USPAP requires an appraiser to be independent, impartial, and objective, and to preform assignments without bias).
398. Boyack, *supra* note 2, at 971.
399. Murray, *supra* note 3, at 1319.
400. *See id.* at 1320 (emphasizing flaws in the FHA panel).
401. *Id.*
402. Boyack, *supra* note 2, at 1320.
403. *Id.*

register with the system and provide proof of licensing. [404] When scheduling appraisals, lenders should not be allowed to choose freely, but rather, the system should randomly assign an appraiser from the pool of available appraisers in that specific area. The random assignment function would substantially reduce the likelihood of loan origination parties to employ repeat appraisers.

Today, many appraisal-scheduling systems are already in place,[405] but most of them do not have a function that allows for random assignment of appraisers. Lenders should utilize the appraisal scheduling systems because they offer a great deal of benefits,[406] but the lack of "random assignment function" provides an opportunity to incentivize repeat appraisers to deliver predetermined property values.[407] So, lenders are still able to employ appraisers with whom they prefer to share business.

The "random assignment function" of an appraisal-scheduling system would eliminate the opportunity of self-interested parties to exert pressure on appraisers to deliver predetermined property values. Accordingly, Congress should respond by enacting sufficient appraisal regulations that will remove self-interested parties from positions of influence over appraisers.[408] It can do so, by requiring mortgage lenders and appraisers to participate in a neutral and independent appraisal assignment system with a function that provides for a random assignment of appraisal requests.

C. Congress Should Clarify Appraisal Standards

To ensure the health of the mortgage industry it is essential for Congress to pass new legislation clarifying the appraisal standards. With the real estate market slowly recovering from the most recent economic recession, the need for new legislation is urgent.[409] Otherwise, consumers will once again become victims of careless and deceptive mortgage lending practices.[410] Therefore, Congress must respond quickly with the following: first, the new legislation should prohibit the use of automated collateral evaluations in all residential mortgage transactions; second, the *de minis* threshold in all federally related transactions must be eliminated; and third, Congress should adopt a statutory provision that imposes legal

404. *See* USPAP, *supra* note 28, at 1 (discussing Freddie Mac's desktop software appraisal system).

405. *See id.* (advertising www.AppraisalFlow.Com, as an appraiser software that maintains appointments, work statutes, and contains all reports in an online platform).

406. *Id.*

407. Murray, *supra* note 3, at 1303.

408. *Id*. at 1313.

409. Chris Arnold, *How to See If Home Prices Are Rising or Failing Where You Live*, NAT'L PUB. RADIO (July 7, 2017), www.npr.org/2017/07/07/535784510/how-to-see-if-home-prices-are-rising-or-falling-where-you-live.

410. *See generally*, Reiss on Federal Government, *supra* note 4, at 8.

liability on any appraisal conduct that is not in compliance with USPAP.

1. Eliminate the use of ACEs in All Mortgage Transactions

First, Congress should pass a bill to mandate incorporation of the independent appraisal standard, which also eliminates the use of automated collateral evaluations ("ACEs") in all residential mortgage transactions. The period leading up to the Great Recession witnessed big financial conglomerates (e.g. Freddie Mac) reduce their appraisal requirements over time, gradually incorporating allowances for "drive-by" appraisals (such as BPOs) and ACEs on a high percentage of mortgage loans.[411] Opting for lower loan costs and/or quicker turn around times with ACEs will not yield consistency or reliability.[412] Lenders already tested this concept before the Great Recession. Cheaper is not always better.

The real estate market also shows a fifteen percent decline in the appraiser credential requirements in the last six years.[413] The appraisal field itself suffers from poor age attrition because new entrants are discouraged to enter the field either due to market conditions, burdensome appraisal assignments, or fear or being replaced by ACEs.[414] This decline also increased lender's usage of ACEs because in some real estate markets (e.g. rural areas) it was difficult for lenders to promptly find an appraiser.[415] Because appraisers are required to pass education requirements set by the USPAP, the use of ACEs has the potential to wipe out the appraisal profession altogether.

While it is true that strict underwriting procedures can be burdensome on the home buying process, opting for automatic desktop software (i.e. ACE products) that only consider limited computer data will not produce a reliable estimate of value.[416] In fact, it will compromise the mortgage lending process by producing property estimates that are either too high or far below the fair market value. The Appraisal Standards Board ("ASB") does not deem ACEs as USPAP-complainant[417] because they compromise integrity of the financial system. Accordingly, Congress should prohibit their use in all residential mortgage transactions.

Granted, innovation in technology and mortgage lending practices is inevitable and can reduce time and costs, but the use of

411. *Accessory Dwelling Units May Have Higher Values when Using Income Approach: The Appraisal Journal*, *supra* note 49.

412. USPAP, *supra* note 28, at 10-13.

413. *Accessory Dwelling Units May Have Higher Values when Using Income Approach: The Appraisal Journal*, *supra* note 49.

414. *Id.*

415. *Id.*

416. USPAP, *supra* note 28, at 7.

417. *Id.* at 10.

ACEs should be limited to non-mortgaged transactions.[418] Also, to reduce the harsh effect of market cyclicality, Congress should adopt a law that mirrors appraisal standards established by the USPAP. This step is essential to the health of the mortgage industry, because it will not only encourage ethical performance among real estate professionals but also equip appraisers with the necessary training to yield consistent and credible opinions of value. Congress should also mandate that all financial institutions involved in residential mortgage lending strictly adhere to the USPAP standards. Accordingly, Congress should statutorily eliminate the use of ACEs in all residential mortgage transactions.

2. *Eliminate the De Minimis Threshold*

Second, Congress' new bill should eliminate the *de minimis* threshold[419] for all federally related transactions to increase the number of residential mortgage transactions that are subject to appraisal requirements.[420] The *de minis* exemption is very troublesome. According to data taken from S&P Case-Schiller 20-City Home Price Index for the years 2009-2015, indicate that the average price for homes in surveyed markets range from $140,000 to $175,000.[421]

The above data shows that most residential real estate transactions fall below $250,000, and do not have the Dodd-Frank protections, thereby nullifying the federal requirement for a traditional appraisal.[422] Many consumers are denied the right to a professional appraisal in a significant number of mortgage transactions.[423] Such practice carries substantial risks not only for consumers but also for the mortgage industry. Without a credible appraisal, lender's calculation of default risks will be grossly impaired with negative impact on home equity values. Homeowners, who rely on their home equity for "cushion," are at an increased risk of default if their equity is grossly disproportionate

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418. *See id.* (clarifying that some examples can include an additional diligence on appraisals to monitor fraud, quality control, to act as an appraisal supplement, to monitor market changes in specific communities, and for other internal non-lending purposes such as valuation of portfolio).

419. Russell, *supra* note 25, at 12.

> A report issued in 2012 by the Government Accountability Office (GAO) to Congress stated that "Under authority granted by Title XI, the federal regulators also have adopted regulations that exempt federally related transactions of $250,000 or less from appraisal requirements" [meaning that the services of a licensed or certified appraiser are not required]. Fannie and Freddie were also deemed exempt.

Id.

420. *Id.*

421. *Id.*

422. *Id.*

423. *Id.*

to its value. Consumers already face significant financial risks[424] when they take out high interest loans, so it is essential that they receive more protections from our government.

Accordingly, Congress should eliminate the *de minis* threshold. All federally related residential mortgage transactions must be subject to a traditional real estate appraisal. This will ensure that consumers not only have access to credible property valuations, but it will also protect them from deceptive loan underwriting practices.[425] In the event that Congress is unwilling to eliminate the *de minis* threshold, it should nonetheless reduce it to $50,000, as proposed back in 1991.[426] This will ensure that most residential transactions will have the appraisal protections since banks rarely make mortgage loans for less than $50,000.

3. Congress Should Create Statutory Liability for Appraiser Misconduct

To compensate for the difficulty in obtaining legal recourse, Congress should create statutory liability for appraiser misconduct. The statutory liability should not only extend to appraisers but also to mortgage origination parties (i.e. mortgage brokers and lenders). Elements required to prove under tort law (e.g. fraud or misrepresentation) are extremely burdensome. These causes of actions are very difficult to prove, and parties who rely on fraudulent appraisals and are later injured as a result are often left without legal recourse. But, some courts have already recognized the negligent misrepresentation cause of action concerning real estate appraisals.[427] However, these cases are very rare and costly to litigate.

Accountability for poorly conceived mortgage loans should track irresponsible risk-taking behavior by various financial institutions.[428] At times, lenders may be the main perpetrators of carless lending.[429] But they often become victims of fraudulent misrepresentations of borrower credentials by anxious mortgage brokers waiting to collect their commission check.[430] Statutory liability is necessary to constrain mortgage broker's economic

424. *See* CONSUMER FIN. PROTECTION BUREAU, *supra* note 30 (noting that these high-interest loans are usually secured by a first lien on their primary residence).

425. Russell, *supra* note 25, at 12.

426. *See Accessory Dwelling Units May Have Higher Values when Using Income Approach: The Appraisal Journal, supra* note 49 (proposing that Congress, should ultimately adopt the de minis rule proposed back in 1991, to have the de minis threshold set at $50,000).

427. *See* F.D.I.C v. Masarsky, 968 F.Supp. 2d 915, 917 (N.D. Ill. 2013) (recognizing negligent misrepresentation of an appraisal).

428. Boyack, *supra* note 2, at 986.

429. *Id.*

430. *Id.*

interests in making bigger and higher-interest-rate loans that yield bigger origination fees and premiums paid by the lender.[431]

Although the Dodd-Frank Act has curtailed some of the monetary incentives paid to mortgage brokers from origination fees, many borrowers are still victims of steering toward higher-priced mortgages. It is important to note that mortgage brokers are not traditionally viewed as borrowers' agents, nor do lenders typically owe borrowers any fiduciary duties.[432] "But borrowers significantly interact with and rely upon mortgage brokers, suggesting that courts or legislature should protect borrower expectation by finding that certain legal duties exist."[433]

Until Congress clearly defines what duties lenders and mortgage brokers owe to borrowers, mortgage brokers should be required to disclose that they are agents of borrowers in every mortgage transaction. This disclosure requirement should be a condition to clear the loan from underwriting prior to closing. Because borrowers closely interact with mortgage brokers who process their loans, Congress should clearly define what duties they owe to borrowers in mortgage transactions.[434]

Ultimately, Congress' establishment of clear statutory liability for engaging in deceptive lending practices, steering, and appraisals that violate the USPAP standards, will protect borrowers against loan origination parties who make poorly conceived loans. Statutory liability will also provide the necessary legal recourse for parties who were injured by relying on fraudulent appraisals. Because Congress has the power to preempt state lending regulations because of our dual banking system,[435] it is imperative for Congress to set clear statutory liability for appraisal misconduct.

D. Congress Should Repeal the Crapo Bill As It Provides an Easy Pathway To Dangerous Mortgage Lending Practices.

The Economic Growth, Regulatory, Relief, and Consumer Protection Act ("The Crapo Bill") is a dangerous piece of legislation that ignores the causes of the most recent financial crisis.[436] By loosening up financial regulations, Congress is taking a major step backwards on consumer protection. The bill runs contrary to the goal of Dodd-Frank (i.e. consumer protection) and it may have

431. *Id.*
432. *Id.* at 987.
433. *Id.*
434. *Id.*
435. *See* Reiss on Federal Government, *supra* note 4, at 32 (discussing Congress' preemptive powers, and the dual banking system in which both states and the federal government charter and regulate banks and other savings institutions).
436. Gelzinis & Valenti, *supra* note 223, at 1.

devastating impacts on the financial sector if there is another loan crisis.[437]

This bill goes far beyond the health of community banks and credit unions. It removes protections for twenty-five of the top thirty-eight banks; weakens regulations on the biggest players and encourages them to manipulate regulations for their benefit; and saps consumer protections.[438] Crapo's consequences can be severe, with regulators being less prepared to deal with the next financial crisis.[439] Although Crapo aims to improve consumer access to mortgage credit, it encourages banks to undercut their underwriting procedures.[440]

Today, certain qualifying borrowers once again have the option to purchase a home with a low down-payment or no down-payment at all.[441] In addition, rolling back certain appraisal requirements for higher-risk mortgages in rural areas also impose serious risks that threaten consumer protection and the appraisal industry. Crapo also provides a dangerous path for banks to bypass their underwriting procedures; something that Congress was very concerned about when it passed the Dodd-Frank Act.[442]

Since Crapo was signed into early this year, one of the biggest questions is the way in which the federal government will choose to implement the bill. As it currently stands, Crapo repeals too many of the essential protections afforded by the Dodd-Frank Act. In the light of the most recent financial crisis and its devastating effect on the economy, Congress should repeal this bill. In the alternative, Congress should remove the rural appraisal exemption and keep the essential consumer protections afforded by the Dodd-Frank Act.

V. CONCLUSION

It is undisputed that both approaches, the traditional appraisal approach and the alternate valuation products, carry substantial imperfections and risks associated with using both. But proper legislation can encourage appraisers to engage in ethical

437. USPAP, *supra* note 28, at 6. For example, "the failure of Countrywide (around $200 billion in size) in 2008 caused panic and problems in the mortgage market. *Id*. "The Trump administration recently admitted that it needed the regulations in Dodd-Frank to handle the failure of financial firms and that its alternative of a new bankruptcy chapter works only with these heightened rules that will be rolled back for these 25 banks." *Id*.

438. Konczal, supra note 262, at 1.

439. *Id*.

440. Gelzinis & Valenti, *supra* note 223, at 1.

441. Dan Green, *6 Low or No Down-Payment Mortgage Options for 2019*, MORTGAGE REP., (Aug. 20, 2018) www.themortgagereports.com/11306/buy-a-home-with-a-low-downpayment-or-no-downpayment-at-all.

442. Dave Towne, *Dangerous Pending Bill in US Senate*, APPRAISER BLOGS (Feb. 9, 2018), www.appraiserblogs.com/pending-bill-threatening-rural-areas-appraisers.

performance that will yield consistent and reliable results. Perhaps it should be noted that the traditional real estate appraisal remains as the only independent source in a home mortgage transaction. When done in compliance with USPAP standards, it serves as an additional layer of consumer protection against big banks' deceptive underwriting procedures. As we have seen, those protections are essential to the health of our economy.

By allowing financial institutions, such as Freddie Mac, retain significant control over the appraisal process, the mortgage industry will be once again compromised. The use of ACEs has proved defective and should not be utilized in any mortgage transaction that requires a property value as collateral for the loan. Accordingly, Congress should respond to this problem with a statutory elimination of the use of ACEs in such transactions. This will not only eliminate the risk of fraudulent underwriting standards but will also set clear appraisal guidelines to encourage consistently and reliability in the appraisal process. Congress should do so by either extending the provisions of the Dodd-Frank Act or by passing completely new legislation pertaining to residential real estate appraisals consistent with suggestions in this Comment.