



BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

DONALD L. KOHN  
VICE CHAIRMAN

July 25, 2008

The Honorable Elizabeth Dole  
United States Senate  
Washington, D.C. 20510

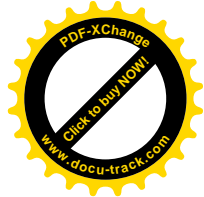
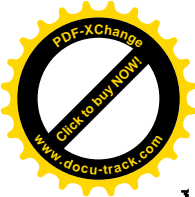
Dear Senator:

Enclosed are my responses to the questions you submitted following the hearing on "The State of the Banking Industry: Part II" before the Senate Banking Committee on June 5, 2008. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure



Vice Chairman Donald Kohn subsequently submitted the following in response to written questions received from Senator Dole in connection with the June 5, 2008, hearing before the Committee on Banking, Housing, and Urban Affairs:

- 1. In March, the Attorney General of New York, OFHEO, and the GSE's entered into an agreement creating new appraiser requirements that are inconsistent with existing practices. Last month, I introduced an amendment to the Federal Housing Finance Regulatory Reform Act of 2008 that would require the Director of OFHEO to issue a regulation establishing appraisal standards for mortgages purchased or guaranteed by Fannie and Freddie. It would establish a common set of appraisal standards governing mortgage lenders that are federally supervised and regulated. In your opinion, would this amendment strengthen the appraisal standards of federally regulated mortgages?**

The Federal Reserve is supportive of promoting sound appraisal practices in residential mortgage lending that ensure lenders use independent, quality appraisals and that protect appraisers from inappropriate influence by the loan production staff, borrowers, or other third parties. In fact, these important principles are embodied in the existing appraisal regulations and guidance of the Board and other federal financial regulatory agencies, which have been in place since the early 1990s.

Your proposed amendment would acknowledge that federally regulated institutions and their affiliates are already subject to an appraisal regulatory framework and would address potential confusion on the part of those entities as to the appraisal standards for which they will be held accountable.

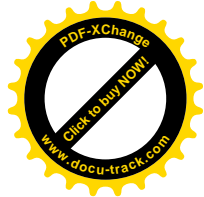
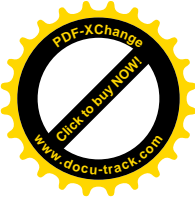
- 2. Vice Chairman Kohn, would you review this technical issue with the other Members at the Federal Reserve Board? Could the Board please get back to us in writing with a detailed letter articulating all the inconsistencies and conflicts of this agreement with current banking law, and the corresponding risks associated therein? I would ask that this letter not only articulate the inconsistencies and conflicts with current banking law, but also the potential risks to safety and soundness, as well as the expected impact on consumers as it relates to the costs and availability of mortgage credit.**

The Federal Reserve has reviewed the agreement and the accompanying Home Valuation Code of Conduct and provided written comment to the Office of Federal Housing Enterprise Oversight.<sup>1</sup> Our letter to OFHEO should provide sufficient information to respond to your request for explanation on the inconsistencies and conflicts of the agreement with current banking laws and regulations. Further, the letter outlines our most significant concerns with the agreement and code, and explains how the agencies' existing appraisal regulatory framework promotes appraiser independence and reliable valuations of real estate collateral in mortgage lending by federally regulated institutions.

Attachment

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<sup>1</sup> See the attached letter dated June 19, 2008, from Randall S. Kroszner, Governor, Board of Governors of the Federal Reserve; John C. Dugan, Comptroller of the Currency; John M. Reich, Director, Office of Thrift Supervision; and JoAnn M. Johnson, Chairman, National Credit Union Administration, to James B. Lockhart, Director, OFHEO.



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Office of the Comptroller of the Currency  
Board of Governors of the Federal Reserve System  
Office of Thrift Supervision  
National Credit Union Administration

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June 19, 2008

Mr. James B. Lockhart, III  
Director  
Office of Federal Housing Enterprise Oversight  
1700 G Street, N.W.  
Washington, D.C. 20552

Dear Director Lockhart:

The Federal Reserve Board ("Board"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), and the National Credit Union Administration (collectively, the "Agencies") appreciate the opportunity to convey our concerns about the Home Valuation Protection Program and Cooperation Agreements ("Agreements") between your agency, the New York State Attorney General, and the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the "GSEs").<sup>1</sup> The Agreements require mortgage lenders, including federally regulated financial institutions and organizations ("federally regulated lenders"), seeking to sell single-family mortgage loans to the GSEs to adopt the Home Valuation Code of Conduct ("Code") attached to the Agreements and to comply with certain practices imposed by the Code.

We strongly support the goals of protecting appraisers from coercion or other undue influence by lenders, borrowers, brokers, or others involved in the mortgage lending and securitization process. Appraiser independence and reliable valuations of real estate collateral for loans in the primary and secondary residential mortgage markets are a necessary part of the foundation to protect lenders in making safe and sound residential mortgage credit decisions, consumers in their borrowing decisions, and investors in their decisions to purchase mortgage-backed securities.

We are very concerned, however, that the requirements imposed by the Agreements and Code would unnecessarily undermine the safe and sound extension of mortgage credit, reduce the availability of mortgage credit to many consumers, and ultimately lead to less reliability and accuracy in real estate appraisals. Moreover, issues regarding appraiser independence and protection from coercion are already adequately addressed by current and pending rules and guidance of the Agencies. In addition, we believe that insufficient information has been collected and inadequate analysis has been performed to permit confidence that the

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<sup>1</sup> The OCC and the OTS have previously submitted separate comment letters concerning the legal and policy issues presented by the Agreements and the Code. See letter dated April 30, 2008, from Timothy T. Ward, Deputy Director, OTS, to Senior Vice President, Credit Risk Oversight, Freddie Mac; and letter dated May 27, 2008, from John C. Dugan, Comptroller of the Currency, to James B. Lockhart, Director, OFHEO.

Code will appropriately address the issue of potential coercion and other undue influence of appraisers without causing other significantly adverse, unintended consequences. We believe, therefore, that the Agreements and Code should be withdrawn. If not withdrawn, the Agreements and Code should be revised to exempt federally regulated lenders, and the implementation of the Agreements and Code should be deferred until the significantly adverse consequences are prevented and the other material legal and policy concerns expressed in this letter and by others are satisfactorily addressed.

The Code conflicts in material ways with the rules and guidance established by the Agencies and undermines appropriate risk-management and consumer protection practices at federally regulated lenders. The Code inappropriately attempts to regulate the corporate structure and internal operations of federally regulated lenders in connection with their mortgage lending operations. In addition, the Code contravenes appropriate risk-management practices of federally regulated lenders by banning the use of appraisals prepared by in-house appraisers, appraisers employed by affiliates, or appraisers at entities that also provide loan settlement services. The Code also hinders the ability of federally regulated lenders to perform other types of quality controls necessary to ensure the accuracy and quality of appraisals used in lending decisions and, thereby, protect the safety and soundness of such institutions and organizations. For example, the Code overly restricts lenders from ordering or using a second or subsequent appraisal to ensure the reliability of the collateral valuation. Such appraisals are an important quality control tool for lenders, particularly when markets are turning and public data updates are delayed, as recently demonstrated in various declining markets.

The Agencies have significant concerns that compliance with overly restrictive requirements in the Code will materially disrupt mortgage lending processes and raise costs to consumers without enhancing protections for consumers, lenders, or the mortgage markets. Implementation of the Code will result in higher loan origination costs for federally regulated lenders and other mortgage lenders and thereby increase costs to consumers. For example, the Code's unwarranted restriction on a lender using any appraisal performed by an in-house appraiser or ordered by a broker will likely result in loan application processing delays and require the consumer frequently to pay for multiple appraisals for a loan. Higher costs and disruptions in mortgage lending processes also will result from the Code's restrictions on using appraisals from appraisal management companies that are affiliates of lenders or that provide both appraisal and settlement-related services for institutions. The unwarranted loss of the significant efficiencies these companies can provide to mortgage lenders that provide loans to consumers where the lender has few, if any, loan underwriting offices, and particularly to small financial institutions, is likely to result in loan processing delays, higher costs for consumers, and reductions in the availability of mortgage credit in many areas. We believe that the Code's draconian approach sacrifices quality, efficiency, and cost for a result that would not materially enhance protections against undue influence on appraisers.

The Agencies have issued and proposed appraisal regulations and supervisory guidance, applicable to federally regulated lenders, that promote sound appraisal practices; require lenders to originate, purchase, and sell mortgage loans based on reliable appraisals; and protect appraisers from inappropriate influence by loan production staff, borrowers, or other third



parties.<sup>2</sup> The Agencies require separation of the appraisal function from the loan production, investment, and collection functions to prevent the threat of coercion or other undue influence on appraisers. This measured approach recognizes that staff appraisers can provide the lender with impartial, independent and reliable appraisals. Importantly, staff appraisers can provide effective reviews of appraisals performed by unaffiliated appraisers to verify that such appraisals are accurate, supportable, and comply with the Agencies' appraisal regulations and guidance and the lender's appraisal standards. The Agencies already require that these quality control functions be performed independently and without any influence by the lender's loan production staff. The constraints on the role of staff appraisers imposed by the Code would inhibit these quality control functions and impose increased costs for verifying and ensuring the quality and accuracy of appraisals on mortgage lenders and ultimately on consumers without any demonstrable benefit.

The appraisal regulatory framework established by the rules and guidance of the Agencies is based on balanced requirements to help ensure that federally regulated lenders use reliable appraisals that were prepared independently by competent appraisers who are separated, and protected from coercion or other undue influence, from the lender's loan production, investment, and collection functions or any third party. The Agencies' appraisal regulations and supervisory guidance reflect our belief that the reliability of appraisals is not dependent on a blanket prohibition that requires that lenders use only appraisals prepared by third parties that do not provide settlement services. The key to promoting reliable appraisals is that the appraisal function be separated from the loan production function, whether those functions reside in one organization, affiliated organizations, or unaffiliated third parties. Federally regulated lenders must couple the independence of those functions with robust credit and compliance risk-management systems to ensure appraiser impartiality, appraiser independence, and the reliability of the appraisals used in underwriting residential real estate loans.

The Agencies' appraisal regulatory framework is monitored and enforced through examinations that review the operations of the federally regulated lenders' mortgage lending functions. Such entities are instructed to establish adequate internal controls to ensure appraiser independence through separation of the appraisal ordering, preparation, and quality control processes from the institution's and organization's loan production staff and lending processes, including separation of responsibilities and reporting lines between the appraiser and the lending function. Under the Agencies' appraisal regulations and supervisory guidance, an appraisal ordered or prepared by a third party also must meet these impartiality and independence

<sup>2</sup> 12 CFR part 208, subpart E (Board); 12 CFR part 34, subpart C (OCC); 12 CFR part 564 (OTS); and 12 CFR part 722 (NCUA). See Interagency Appraisal and Evaluation Guidelines, SR letter 94-55 (Board), Comptroller's Handbook, Commercial Real Estate and Construction Lending (Appendix E) (1998) (OCC), and Thrift Bulletin 55a (OTS). See also Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions (2005), SR Letter 05-5 (Board), OCC Bulletin 2005-6 (OCC), CEO Memorandum No. 213 (OTS), and NCUA Letter to Credit Unions 05-CU-06 (NCUA); and Interagency Statement on Independent Appraisal and Evaluation Functions (2003), SR Letter 03-18 (Board), Advisory Letter 2003-9 (OCC), CEO Memorandum No. 184 (OTS), and NCUA Letter to Credit Unions 03-CU-17 (NCUA).



requirements, and lenders are instructed to review any broker-ordered appraisals thoroughly to ensure that the appraisal complies with the Agencies' regulations and guidance and the institution's appraisal policies.

A federally regulated lender must demonstrate that its appraisal process complies with our requirements to protect appraiser impartiality and independence, and requires quality, independent opinions of collateral market value through appraisals that conform to minimum regulatory appraisal standards, including the Uniform Standards of Professional Appraisal Practice (USPAP). Appraisals also must be prepared by appropriately credentialed and competent appraisers protected from coercion. The real estate appraisal and evaluation policies and procedures of federally regulated entities are reviewed by examiners, and the Agencies require corrective action when deficiencies are discovered.

In addition, the Board is currently considering revisions to its Regulation Z to enhance further the protection of consumers from improperly influenced real estate appraisals.<sup>3</sup> The Regulation Z proposal prohibits all creditors and mortgage brokers from pressuring an appraiser to misrepresent a dwelling's value and prohibits all creditors from extending credit if the creditor knows or has reason to know that an appraiser has been coerced to misstate a dwelling's value. The proposed amendment to Regulation Z would cover all mortgage lenders (both federally and non-federally regulated lenders) and would apply to all consumer credit transactions secured by the consumer's principal dwelling, whether the mortgage is guaranteed by the GSEs or not.

The GSEs recently invited interested persons to submit their concerns regarding the Agreements and the Code. The new requirements to be imposed by OFHEO and the GSEs through the Agreements and the Code, with their far-reaching and burdensome effects on federally regulated lenders and other mortgage lenders across the nation, are the type of federally-imposed requirements that should be subject to the full panoply of laws designed to protect the procedural and other rights of citizens and corporate entities from improper governmental action. The comment process employed, however, does not confer the protections or rigor required by the Administrative Procedures Act and other applicable laws. Use of requirements set by the GSEs to impose obligations on the entire mortgage lending industry and on consumers is tantamount to government agency action and strongly implies that the GSEs are acting as governmental agencies that should be subject to all the procedural and other laws applicable to agency action.

OFHEO requested comment from the Agencies on the implementation timetable for the Agreements and the Code to ensure that no disruption in the marketplace would occur. We believe that the time available for carefully considering the extensive number of comments and obtaining concurrence on changes needed to the Code to address the many serious concerns identified by the Agencies and the commenters will require substantial delay and revision to the content and process for the implementation of the Code, if the Agreements and Code are not

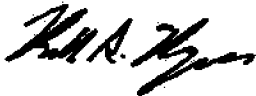
<sup>3</sup> Regulation Z—Truth in Lending, 73 Fed. Reg. 1672, 1726 (proposed January 9, 2008) (to be codified at 12 CFR pt. 226). The proposal was released for comment on January 9, 2008. The proposal's comment period ended on April 2, 2008, and Board staff is analyzing the more than 4,000 comment letters received on the proposal to determine what modifications, if any, to make to the draft regulation.



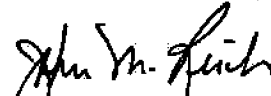
withdrawn. Under the Agreements, the new requirements will apply to all single-family mortgage loans (except government-insured loans) that are originated on or after January 1, 2009, and delivered to a GSE. The actual effective date of the restrictions, however, will of necessity precede that date by a number of months due to the length of time for completion of the origination process, particularly with the new requirements. We expect that the significant number of concerns and adverse consequences identified by the Agencies and commenters will, in fact, result in further disruption of the residential mortgage lending market.

We strongly encourage that the Agreements and the Code be withdrawn. If not withdrawn, the Agreements and Code should be revised to exempt federally regulated lenders, and the implementation of the Agreements and Code should be deferred until the significantly adverse consequences are prevented and the other material legal and policy concerns expressed in this letter and by others are satisfactorily addressed. The Agreements' and Code's overly burdensome restrictions and mandates on such a significant segment of the mortgage market would constrain the ability of our regulated institutions and organizations to provide mortgage credit to creditworthy consumers on a safe and sound and timely basis, without increased costs. The Agencies are committed to addressing any weaknesses and deficiencies in mortgage lending practices, including appraisal practices, at any of our regulated lenders through our regulatory and supervisory processes, as necessary. Moreover, the Agencies would be willing to work with OFHEO and the GSEs to identify and address any unresolved issues regarding appraiser coercion.

Sincerely,



Randall S. Kroszner  
Governor  
Board of Governors of the  
Federal Reserve System



John M. Reich  
Director  
Office of Thrift Supervision



John C. Dugan  
Comptroller  
Office of the Comptroller  
of the Currency



JoAnn M. Johnson  
Chairman  
National Credit Union Administration

cc: Federal National Mortgage Association  
Federal Home Loan Mortgage Corporation