

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Parts 25 and 203

[Docket No. FR-4722-P-01]

RIN 2502-AH78

FHA Single Family Mortgage Insurance; Lender Accountability for Appraisals

AGENCY: Office of the Secretary, HUD.

ACTION: Proposed rule.

SUMMARY: This proposed rule clarifies and strengthens HUD's regulations concerning the responsibilities of lenders approved by the Federal Housing Administration (FHA) in the selection of appraisers to perform appraisals on properties that will be the security for FHA insured mortgages. First, the proposed rule provides that lenders are to be held strictly accountable for the quality of appraisals on properties securing FHA insured mortgages. Further, the proposed rule specifically provides that lenders who submit appraisals to HUD that do not meet FHA requirements are subject to the imposition of sanctions by the HUD Mortgagee Review Board. The proposed rule would apply to both sponsor lenders, who underwrite loans, and loan correspondent lenders, who originate loans on behalf of their sponsors. HUD believes these proposed changes will help protect the FHA Insurance Fund, ensure better compliance with appraisal standards, and help to ensure that homebuyers receive an accurate statement of appraised value.

DATES: *Comments Due Date:* March 14, 2003.

ADDRESSES: Interested persons are invited to submit comments regarding this proposed rule to the office of the Department's Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410-0500. Communications should refer to the above docket number and title. Facsimile (FAX) comments are not acceptable. A copy of each communication submitted will be available for public inspection and copying between 7:30 a.m. and 5:30 p.m. weekdays at the above address.

FOR FURTHER INFORMATION CONTACT: Vance T. Morris, Director, Office of Single Family Program Development, Office of Insured Single Family Housing, Room 9266, U.S. Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410-8000; telephone (202) 708-

2121 (this is not a toll-free number). Hearing-or speech-impaired individuals may access this number via TTY by calling the toll-free Federal Information Relay Service at (800) 877-8339.

SUPPLEMENTARY INFORMATION:

I. Background

A. FHA Appraisals

The success of the Federal Housing Administration (FHA) single family mortgage insurance program, and HUD's ability to protect the FHA Insurance Fund, begins with the quality of appraisals on properties that secure FHA mortgages. Section 203(b)(1) of the National Housing Act (12 U.S.C. 1709(b)(10)) provides the method for calculating the maximum mortgage amount that FHA can insure. The calculations required by the statute are based on the appraised value of the property that is security for the mortgage. If a mortgagor defaults and the lender¹ conveys property title to HUD in exchange for payment of mortgage insurance benefits, FHA then must manage and sell the property in order to recoup its insurance loss. If the appraisal was accurate, FHA's loss will be minimal. However, if the appraisal was inaccurate or the appraiser neglected to report readily observable defects, FHA's losses could be increased.

HUD has implemented several policies to help ensure the accuracy and completeness of appraisals on properties securing FHA insured mortgages. For example, HUD has established the FHA Appraiser Roster (Appraiser Roster), which lists those appraisers who are eligible to perform FHA single family appraisals. To be eligible for placement on the Appraiser Roster, an appraiser must be state licensed or certified and pass a test on FHA appraisal methods. Further, the appraiser must not be listed on the General Services Administration's Suspension and Debarment List, HUD's Limited Denial of Participation List, or HUD's Credit Alert Interactive Voice Response System. HUD maintains the Appraiser Roster to provide a means by which HUD can ensure the competency of appraisers performing FHA appraisals. Placement on the Appraiser Roster means that an appraiser is qualified to perform FHA appraisals; it does not mean that the appraiser is approved by FHA, nor does it provide a guarantee or warranty that the appraiser's work will meet FHA standards. The FHA Appraiser Roster

¹ This proposed rule uses the terms "lender" and "mortgagee" interchangeably.

regulations are located at 24 CFR part 200, subpart G.

The FHA single family mortgage insurance regulations at 24 CFR 203.5(e)(1) provide that "[a] mortgagee shall have the property appraised in accordance with such standards as the Secretary may prescribe." These standards are contained in HUD Handbook 4150.2, entitled "Valuation Analysis for Home Mortgage Insurance," which each appraiser receives upon applying to be placed on the FHA Appraiser Roster. All appraisers on the Appraiser Roster are required to read and comply with the handbook in performing appraisals of properties that will be security for FHA insured mortgage loans (*see* § 200.206 of the Appraiser Roster regulations). A copy of Handbook 4150.2 may be downloaded from HUD's Client Information and Policy System (HUDCLIPS) internet homepage at <http://www.hudclips.org>.

B. Lender Responsibilities Concerning FHA Appraisals

Almost all FHA insured mortgage loans are originated under the Direct Endorsement process. Under this process, a lender selects an appraiser from the Appraiser Roster. The appraiser appraises the property and then submits an appraisal report and accompanying documentation to the lender. The lender's Direct Endorsement underwriter (or, in the case of a loan correspondent, its sponsor's Direct Endorsement underwriter) reviews the appraisal documentation. Under § 203.255(b)(5), when a mortgage is submitted to FHA under the Direct Endorsement process, the application must contain, among other things, "[a]n underwriter certification, on a form prescribed by the Secretary, stating that the underwriter has personally reviewed the appraisal report ... and that the proposed mortgage complies with HUD underwriting requirements." Consequently, a lender is required, through its underwriter, to review the appraisal documentation to assure that the documentation meets the FHA requirements contained in HUD Handbook 4150.2 and amendatory issuances.

HUD's regulation at § 203.255(b) explicitly authorizes the Secretary to determine if there is any information indicating that any required certification (including the appraisal certification) "is false, misleading or constitutes fraud or misrepresentation on the part of any party, or that the mortgage fails to meet any statutory or regulatory requirement." Further, the Mortgagee Review Board regulations at 24 CFR 25.9 authorize the imposition of

administrative sanctions against a lender who submits such a false certification in connection with any FHA insured mortgage transaction. The responsibilities of a lender in ensuring the quality of FHA appraisals are also emphasized in the guidance issued by HUD through Mortgagee Letters. For example, Mortgagee Letter 94–54, issued on November 7, 1994, provides that “mortgagees that select their own appraisers must accept responsibility, equally with the appraisers, for the integrity, accuracy, and thoroughness of the appraisals, and will be held accountable by HUD” (this guidance was reiterated by FHA Mortgagee Letter 97–45, issued on November 25, 1997). Further, Mortgagee Letter 97–22, issued on May 20, 1997, reminds lenders “that if the appraiser they selected provides a poor or even fraudulent appraisal which leads the Department to insure a mortgage at an inflated amount, the lender is held equally responsible with the appraiser for the violation.” Copies of these Mortgagee Letters may be downloaded from HUD’s Client Information and Policy System (HUDCLIPS) internet website at <http://www.hudclips.org>.

II. This Proposed Rule

A. Need for Proposed Rule

FHA has found that most appraisers perform appraisals in accordance with FHA standards. There are some instances, however, in which some lenders tacitly require appraisers to make the appraisal computations match the sales price to ensure that a home sale and mortgage loan closes for the appraiser to obtain additional business. Other instances have occurred, including recent episodes of predatory lending activity in several areas of the country, whereby lenders, realtors, investors, and others have participated in so-called property “flipping” schemes to inflate home prices and perpetuate sales that generate fees and charges to participants in the transaction. There are additional examples of fraudulent activity that could have been prevented if the underwriters had properly reviewed the appraisal reports.

This proposed rule would clarify and strengthen HUD’s regulations concerning the responsibilities of lenders in assuring the quality of FHA appraisals. The proposed rule will ensure accountability of lenders for poor appraisals and thereby protect the FHA Insurance Fund, ensure better compliance with appraisal standards, and help to ensure that homebuyers receive an accurate statement of

appraised value. The proposed changes would apply to both sponsor lenders, who underwrite loans, and loan correspondent lenders, who originate loans on behalf of their sponsors.

There are numerous tools that lenders may use to determine whether an appraisal satisfies FHA requirements. Reviewing appraisal documentation and performing quality assurance reviews are two such methods. New technology is available, such as Automated Valuation Model (AVM), which can be used to determine whether the value derived by an appraiser is within reason. A lender may wish to do business only with appraisers who carry errors and omissions (E&O) insurance. Such coverage may help in reducing possible schemes that result in fraud. There are numerous other steps that lenders can take to ensure that an appraisal package satisfies FHA requirements. The purpose of this proposed rule is not to mandate that lenders must follow a specific course of action to ensure compliance with FHA appraisal requirements. Each lender has the discretion to choose the means by which it will ensure such compliance. The purpose of the proposed rule is to require that a lender act to ensure appraisal quality and to emphasize that the lender will bear responsibility if an appraisal does not satisfy FHA requirements.

B. Proposed Changes to FHA Regulations

The proposed rule would make the following changes to the existing FHA regulations:

1. *Mortgagee Review Board (§ 25.9).* The proposed rule would clarify that a mortgagee is subject to administrative action by HUD’s Mortgagee Review Board for submitting to HUD an appraisal that does not satisfy FHA appraisal requirements in connection with an insured mortgage transaction. Specifically, a new § 25.9(ee) would be added to explicitly include the obtaining and submitting of appraisals that do not satisfy FHA appraisal requirements among the list of actions subject to administrative sanction. As provided in § 25.3, which contains the definitions applicable to Mortgagee Review Board proceedings, the term “mortgagee” includes both underwriting and loan correspondent lenders.

2. *Lender accountability for appraisal (§ 203.5).* The proposed rule also would codify HUD’s policy that lenders must ensure that the appraisals satisfy FHA appraisal requirements and are responsible, equally with appraisers, for the quality of appraisals on properties that secure FHA insured mortgage loans.

The proposed rule would amend § 203.5, which describes the Direct Endorsement process, to specify that a lender must ensure that appraisals satisfy FHA requirements and is responsible for the quality of the appraisals. A Direct Endorsement mortgagee, and any of its loan correspondent lenders, that submit, or cause to be submitted, an appraisal or related documentation that does not satisfy FHA requirements may be sanctioned by the Mortgagee Review Board. The proposed rule would also amend § 203.5 to re-emphasize that a lender must select an appraiser listed on the FHA Appraiser Roster.

III. Issue Highlighted for Public Comment

While HUD invites public comment on all aspects of this proposed rule, it is particularly interested in comments regarding the possible consequences of the rule on the majority of FHA lenders and appraisers who comply with FHA standards. HUD believes that the proposed regulatory changes are necessary to ensure the accountability of lenders for poor appraisals and thereby protect the FHA Insurance Fund, ensure better compliance with appraisal standards, and help to ensure that homebuyers receive an accurate statement of appraised value. However, HUD recognizes that the proposed changes may also have unintended negative consequences on those lenders and appraisers who already comply with applicable FHA regulations and policies. Accordingly, HUD invites interested members of the public to submit their comments on such possible unintended impacts, as well as to offer suggestions on less burdensome methods to accomplish the stated goals of the proposed rule.

IV. Small Business Concerns Related to Mortgagee Review Board Actions Against Lenders

As discussed below in this preamble, HUD has determined that this rule will not have a significant economic impact on a substantial number of small entities. However, the proposed rule may nonetheless result in HUD’s Mortgagee Review Board imposing an administrative sanction on a small lender or appraiser due to a submitted appraisal that is inconsistent with FHA requirements, or taking other appropriate enforcement action against a small lender or appraiser. With respect to such compliance efforts, HUD is cognizant that section 222 of the Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104–121) (referred to as “SBREFA”) requires the

Small Business and Agriculture Regulatory Enforcement Ombudsman to “work with each agency with regulatory authority over small businesses to ensure that small business concerns that receive or are subject to an audit, on-site inspection, compliance assistance effort or other enforcement related communication or contact by agency personnel are provided with a means to comment on the enforcement activity conducted by this personnel.” To implement this statutory provision, the Small Business Administration has requested that agencies include the following language on agency publications and notices that are provided to small businesses at the time the enforcement action is undertaken. The language is as follows:

Your Comments Are Important

The Small Business and Agriculture Regulatory Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small businesses about federal agency enforcement actions. The Ombudsman will annually evaluate the enforcement activities and rate each agency's responsiveness to small business. If you wish to comment on the enforcement actions of [insert agency name], call 1-888-REG-FAIR (1-888-734-3247).

As HUD stated in its notice describing HUD's actions on the implementation of SBREFA, which was published on May 21, 1998 (63 FR 28214), HUD intends to work with the Small Business Administration to provide small entities with information on the Fairness Boards and National Ombudsman program, at the time enforcement actions are taken, to ensure that small entities have the full means to comment on the enforcement activity conducted by HUD.

V. Findings and Certifications

Regulatory Planning and Review

The Office of Management and Budget (OMB) reviewed this rule under Executive Order 12866, *Regulatory Planning and Review*. OMB determined that this rule is a “significant regulatory action” as defined in section 3(f) of the Order (although not an economically significant regulatory action under the Order). Any changes made to this rule as a result of that review are identified in the docket file, which is available for public inspection in the office of the Department's Rules Docket Clerk, Office of General Counsel, Room 10276, 451 Seventh Street, SW., Washington, DC 20410-0500.

Environmental Impact

This proposed rule would not direct, provide for assistance or loan and mortgage insurance for, or otherwise

govern or regulate, real property acquisition, disposition, leasing, rehabilitation, alteration, demolition, or new construction, or establish, revise, or provide for standards for construction or construction materials, manufactured housing, or occupancy. Accordingly, under 24 CFR 50.19(c), this proposed rule is categorically excluded from the requirements of the National Environmental Policy Act (42 U.S.C. 4332 *et seq.*).

Regulatory Flexibility Act

The Secretary has reviewed this proposed rule before publication, and by approving it certifies, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)), that this proposed rule would not have a significant economic impact on a substantial number of small entities. The proposed rule would not establish, or substantively modify, HUD policy and procedures regarding lender accountability for FHA appraisals. Rather, the regulatory changes will clarify HUD's existing policy of holding lenders equally responsible with appraisers for the quality of such appraisals. Further, the proposed changes are designed to ensure the integrity of appraisals on properties securing FHA insured mortgages. To the extent that the regulatory amendments have an economic impact, it will be on those lenders and appraisers who submit appraisals that are inconsistent with FHA requirements. Notwithstanding HUD's determination that this rule will not have a significant economic effect on a substantial number of small entities, HUD specifically invites comments regarding any less burdensome alternatives to this rule that will meet HUD's objectives as described in this preamble.

Executive Order 13132, Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial direct compliance costs on state and local governments and is not required by statute, or the rule preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule would not have federalism implications and would not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531–1538) establishes requirements for

federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments, and on the private sector. This proposed rule would not impose any federal mandates on any state, local, or tribal governments, or on the private sector, within the meaning of the Unfunded Mandates Reform Act of 1995.

Catalog of Federal Domestic Assistance

The Catalog of Federal Domestic Assistance Numbers for the programs affected by this proposed rule are 14.117 and 14.133.

List of Subjects

24 CFR Part 25

Administrative practice and procedure, Loan programs—housing and community development, Organization and functions (government agencies).

24 CFR Part 203

Hawaiian Natives, Home improvement, Indians—lands, Loan programs—housing and community development, Mortgage insurance, Reporting and recordkeeping requirements, Solar energy.

Accordingly, for the reasons described in the preamble, HUD proposes to amend 24 CFR parts 25 and 203 to read as follows:

PART 25—MORTGAGEE REVIEW BOARD

1. The authority citation for 24 CFR part 25 continues to read as follows:

Authority: 12 U.S.C. 1708(c), 1708(d), 1709(s), 1715b and 1735(f)–14; 42 U.S.C. 3535(d).

2. Amend § 25.9 by redesignating paragraph (ee) as paragraph (ff) and adding a new paragraph (ee) to read as follows:

§ 25.9 Grounds for an administrative action.

* * * * *

(ee) Submitting, or causing to be submitted, with an application for FHA mortgage insurance an appraisal, valuation condition sheet, or any other documentation relating to an appraisal that does not satisfy FHA requirements.

* * * * *

PART 203—SINGLE FAMILY MORTGAGE INSURANCE

3. The authority citation for 24 CFR part 203 continues to read as follows:

Authority: 12 U.S.C. 1709, 1710, 1715b, and 1715u; 42 U.S.C. 3535(d).

4. Amend § 203.5 by adding a sentence at the end of paragraph (e)(1)

and adding a new paragraph (e)(3) to read as follows:

§ 203.5 Direct Endorsement process.

* * * * *

(e) * * *

(1) * * * A mortgagee must select an appraiser whose name is on the FHA Appraiser Roster, in accordance with 24 CFR part 200, subpart G.

* * * * *

(3) A mortgagee and an appraiser must ensure that an appraisal and related documentation satisfy FHA appraisal requirements and shall bear equal responsibility for the quality of the appraisal in satisfying such requirements. A Direct Endorsement Mortgagee (and any of its loan correspondent lenders) that submits, or causes to be submitted, an appraisal or

related documentation that does not satisfy FHA requirements is subject to administrative sanction by the Mortgage Review Board pursuant to § 25.9 of this title.

Dated: December 3, 2002.

Mel Martinez,

Secretary.

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