FIRREA: A Study in Compliance

by Brad Carter, MAI, and Dori D'Esposito Bower

Sixteen years and multiple revisions later, there are varying opinions as to how well the objectives of the Financial Institutions Reform, Recovery and Enforcement Act, more commonly known as FIRREA, are being met.

In an attempt to gain a better understanding of the general level of compliance in the lending and appraisal communities, we surveyed several lenders to solicit their opinions regarding their own institutions as well as their competitors.

Background

In 1989 the President of the United States signed FIRREA into law. The Act's Title XI created fundamental changes to the way appraisals are ordered by and performed for federally regulated institutions. One of Title XI's key objectives is to ensure that appraisals conducted for federally related transactions are done in accordance with uniform standards by individuals whose competence has been demonstrated. Another critical point is to ensure that the ordering and reviewing of appraisals within a bank takes place away from the hands, eyes and control of those in loan production.

Awareness of FIRREA in the lending community seems to be at an all-time high, as federal regulators seek to actively enforce regulations focused in part on further separating those who order appraisals from those in loan production. This has been done mainly via two subsequent publications: the Interagency Appraisal and Evaluation Guidelines, published in October 1994, and the October 2003 guidelines, Independent Appraisal and Evaluation Functions. Therefore, it follows that compliance is also at an all-time high. Or does it?

For a three-week period in June 2005, we contacted approximately 90 bank review appraisers and credit officers via e-mail and telephone. The sample was nationwide, although the response ratio was greatest in the Southeast. Although this endeavor was less than scientific, it did provide some interesting results. Moreover, while the sample size was too small to be considered statistically valid, the shocking similarity in responses we got on many questions from a wide variety of lenders does suggest that the results are meaningful.

This is a snapshot of what they said.

How common are violations?

Although opinions varied on this particular question, the majority of respondents seemed to think that violations were quite common but not at their bank. At first blush, this may seem to suggest an unwillingness to air dirty laundry; and maybe that's a part of it. Another possibility is that review appraisers and credit officers at banks who play by the rules may simply have been more willing to participate in this study than their counterparts at less "compliance-conscious" institutions. Either way, the number of specific examples shared with us regarding serious violations is compelling evidence to suggest that violations are ongoing.

Why would compliance be an issue at the height of regulatory scrutiny? Isn't the current emphasis by regulators making an impact? "Based on changes in community banking and the lack of experienced loan officers, I believe that FIRREA exceptions are becoming more common," reports Brad Day, Senior Credit Officer with Quantum National Bank. Along

similar lines, a high-level review appraiser at a large national bank who did not want to be identified, added, "FIRREA is a broad act subject to much interpretation. The OCC, OTC, FDIC and other agencies try to provide clarity from time to time. In some cases, interpretations are allowed to develop by default at the local bank level in the absence of OCC guidance." This review appraiser may be on to something. Some of the "violations" shared with us during this study were things that did not in fact violate FIRREA, at least not according to our interpretation.

What are the most common violations?

A high ratio of respondents cited these violations as most common:

- Use of outdated appraisals
- Business loans to be repaid with income from real estate/abundance of caution abuses
- Loan production people ordering the appraisal
- Borrowers choosing the appraiser/ appraisals being "readdressed" to make it look like the appraisal had actually been ordered by the bank
- No "as is" value estimate provided in the appraisal

That last one seemed a bit surprising to us, since requiring an "as is" value is not only one of the more well-known requirements (so we thought), it would also seem to be one the most easily detectable points of noncompliance. Upon following up, we found that appraisals not addressing the property in its "as is" condition at all is not very common; however, "as is" can apparently be interpreted in different ways. For example, some credit officers contend that reporting a value "as is, subject to rezoning" (and with no reporting of a value subject to current zoning) is nearly as common now as it was pre-FIRREA.

A point of contention that has recently come into the spotlight in many markets is the "as is" value of an apartment property to be converted to condominiums. Many lenders require the appraiser to value the property as apartments in addition to the proposed condominium use. According to bankers responding to our survey, however, some lenders look to significantly slash appraisal costs by instructing the appraiser to define the "as is" value as the value as proposed less the cost of conversion.

What are the most serious violations?

According to Dwayne Myrick, vice president of risk management at Flag Bank and former OCC Examiner, the most serious violation at banks with which his competes is "The lack of an appraisal at all…and you would not believe how common this is." Many of Myrick's colleagues agreed with this observation, and some

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went on to speculate that the practice of waiving the appraisal requirement was even more common at smaller banks. Each of the lenders that expressed this opinion was from a larger bank; we could not capture a consensus of opinions from smaller lenders on this issue since very few representatives of smaller banks were willing to participate in this survey. In defense of smaller institutions, our research did indicate that in recent months many smaller banks have hired chief appraisers and begun to implement and enforce compliance procedures found at larger institutions.

Other serious violations where there was strong consensus are listed below, some of which are similar to the above-listed most common violations, since they are also perceived to be the most serious.

- Real estate loans being made without appraisals
- Appraisers "hitting their numbers" in order to gain repeat business
- Borrowers choosing the appraiser/ appraisals being "readdressed" to make it look like the appraisal had actually been ordered by the bank
- No "as is" value estimate provided in the appraisal
- Subdivision appraisals reflecting the aggregate retail price of the lots with no discounting to reflect a bulk value

An example of a particularly striking violation shared with us by a high-level credit officer at a regional bank is that written letters of engagement by loan officers were found to contain the loan amount, the loan-to-value ratio – and even the required appraisal amount. These engagement letters were in writing and even included in the addenda of the appraisal reports themselves.

The business side of compliance

We posed the question, "Do you believe that other banks in your market that do not enforce FIRREA have a competitive advantage in this regard"? The answer: a resounding "Yes!" Whether that's true or not is uncertain, but that certainly does seem to be the perception. We were inundated with stories of loan officers reporting to credit officers that the competition is lowering the cost to the borrower by not requiring appraisals. However, since our survey did not include loan officers, these reports were third-hand at best. Moreover, no specific incidences were cited, suggesting at least the possibility that some of these incidents could have been more anecdotal than factual. Still, while we did not uncover specific examples, the consistency with which respondents reported that their bank loses business to competitors that illegally waive appraisal requirements should not be ignored.

Outlook

The future is uncertain, but there are reasons for optimism. Mitch Smith, MAI, vice president at Wachovia Corporation, shared with us that many of the appraisal staffs at larger institutions have begun communicating with each other in an effort to raise the industry's overall level of understanding and compliance. Others reported that those violators that are turned in to regulatory authorities are being dealt with seriously. Some smaller banks, which were identified as frequent violators by many of their big bank counterparts, are beginning to implement and enforce many of the compliance procedures found at larger institutions. One observation that reflects this trend is that while the general response level to our survey was low at smaller banks, the credit officers from smaller banks that did participate were clearly among the most informed on this topic. Another reason for cautious optimism is that numerous banks of all sizes have recently installed "firewalls" between appraisal review and loan-production functions. ■

Bradley R. Carter, MAI, CRE, CCIM, and Dori D'Esposito Bower are principals in Greystone Valuation Services, Inc., an Atlanta-based real estate appraisal and counseling firm.