

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580



Office of Policy Planning
Bureau of Economics

April 30, 2008

Home Valuation Code of Conduct Response
Attn: Senior Vice President, Credit Risk Oversight
Freddie Mac
1551 Park Run Drive, Mail Stop D2Z
McLean, VA 22102-3110

Re: Home Valuation Code of Conduct

Dear Senior Vice President, Credit Risk Oversight:

On March 14, 2008, Federal Home Loan Mortgage Corporation (“Freddie Mac”) announced that it is seeking comments on the Home Valuation Code of Conduct (“Code of Conduct”) that Freddie Mac proposes to adopt pursuant to a settlement agreement with the New York Attorney General (“NY AG”).¹ Staff of the Federal Trade Commission’s Office of Policy Planning and Bureau of Economics appreciates the opportunity to file this comment on the potential effects on competition and consumers of the Code of Conduct.²

Given the recent problems in the mortgage lending marketplace, the FTC staff generally supports efforts to improve the lending process for consumers and, in particular, supports proposals such as those contained in the Code of Conduct to protect the independence of appraisals. The following comments on the proposed Code of Conduct are based on the staff’s consumer protection experience in the mortgage market and its research on consumer mortgage

¹ Press Release, Freddie Mac, Freddie Mac Seeks Mortgage Industry Comments on New Appraisal Code of Conduct (Mar. 14, 2008), *available at* http://www.freddiemac.com/news/archives/corporate/2008/20080314_appraisal-comment.html. The Code of Conduct is available at http://www.freddiemac.com/singlefamily/docs/030308_valuationcodeofconduct.pdf.

² These comments represent the views of the staff of the Office of Policy Planning and the Bureau of Economics of the Federal Trade Commission (“FTC” or “Commission”). They do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner. The Commission has, however, voted to authorize the staff to submit these comments.

disclosures, as well as its competition experience in the real estate and other industries. Section I summarizes FTC law enforcement and other activities addressing unfair or deceptive practices in the mortgage lending market. Section II provides a brief discussion of the role of appraisals in the mortgage lending process. Section III identifies the relevant provisions in the proposed Code of Conduct on which this comment focuses. Section IV explains how these provisions raise potential concerns regarding their ultimate impact on competition and consumers in the mortgage lending market.

I. FTC Law Enforcement and Other Activities in Response to Unfair or Deceptive Practices in the Mortgage Lending Market

As the primary federal agency that enforces consumer credit laws with respect to non-depository institutions, the Commission has wide-ranging responsibility regarding consumer financial issues in the mortgage market, including those involving mortgage lenders, brokers, and servicers. The FTC, along with other agencies, enforces a number of federal laws governing mortgage lending, including the Truth in Lending Act (“TILA”)³ and the Home Ownership and Equity Protection Act (“HOEPA”).⁴ The Commission also enforces Section 5 of the Federal Trade Commission Act (“FTC Act”), which more generally prohibits unfair or deceptive acts and practices in the marketplace.⁵ In addition, the Commission conducts research on mortgage lending and related topics, develops consumer and business education materials,⁶ responds to inquiries about these matters from consumers, industry and the media, and works with other federal and state law enforcement entities to protect consumers from unfair or deceptive mortgage lending and servicing practices.

The Commission’s law enforcement actions have targeted deception and other illegal practices in the mortgage market, focusing in particular on the subprime market. In recent years, the agency has brought 22 actions against companies and principals in the mortgage lending industry, involving companies large and small in various regions of the country.⁷ Several of

³ 15 U.S.C. §§ 1601-1666j (requiring disclosures and establishing other requirements in connection with consumer credit transactions).

⁴ 15 U.S.C. § 1639 (amending TILA to provide additional protections for consumers who enter into certain high-cost refinance mortgage loans).

⁵ 15 U.S.C. § 45(a).

⁶ Materials on mortgage issues are available at the Commission’s For Consumers Credit web page, at <http://www.ftc.gov/bcp/menus/consumer/credit.shtm>, under the category Mortgages/Real Estate. The web page includes consumer education materials such as “Mortgage Payments Sending You Reeling? Here’s What to Do,” “High-Rate, High-Fee Loans (HOEPA/Section 32 Mortgages),” and “Reverse Mortgages: Get the Facts Before Cashing In On Your Home’s Equity.”

⁷ *FTC v. Safe Harbour Found. of Fla., Inc.*, No. 08-1185 (N.D. Ill. 2008); *FTC v. Mortgages Para Hispanos.Com Corp.*, No. 06-00019 (E.D. Tex. 2006); *FTC v. Ranney*, No. 04-1065 (D.

these cases have resulted in large monetary judgments, collectively returning more than \$320 million to consumers. These enforcement actions have targeted deceptive or unfair practices in all stages of mortgage lending – from advertising and marketing through loan servicing – by mortgage lenders, brokers, and loan servicers.

In addition to pursuing numerous law enforcement actions in the mortgage lending market, Commission staff also has conducted research on mortgage lending issues, including two recent studies of consumer mortgage disclosures.⁸ The studies were conducted, in part, because the Commission’s law enforcement experience has demonstrated that current mortgage disclosures are often ineffective in preventing deception. This research builds on the FTC staff’s substantial experience evaluating the role of consumer information and disclosures in a wide variety of markets. The insights from the Commission’s law enforcement experience and research informs the FTC staff’s view of the proposed Code of Conduct.

II. Appraisals in the Mortgage Lending Process

Retail mortgage lenders, correspondent lenders, and brokers compete with each other to

Colo. 2004); *FTC v. Chase Fin. Funding, Inc.*, No. 04-549 (C.D. Cal. 2004); *United States v. Fairbanks Capital Corp.*, No. 03-12219 (D. Mass. 2003); *FTC v. Diamond*, No. 02-5078 (N.D. Ill. 2002); *United States v. Mercantile Mortgage Co.*, No. 02-5079 (N.D. Ill. 2002); *FTC v. Associates First Capital Corp.*, No. 01-00606 (N.D. Ga. 2001); *FTC v. First Alliance Mortgage Co.*, No. 00-964 (C.D. Cal. 2000); *United States v. Action Loan Co.*, No. 00-511 (W.D. Ky. 2000); *FTC v. NuWest, Inc.*, No. 00-1197 (W.D. Wash. 2000); *United States v. Delta Funding Corp.*, No. 00-1872 (E.D.N.Y. 2000); *FTC v. Cooper Props.*, No. 99-07782 (C.D. Cal. 1999); *FTC v. Capitol Mortgage Corp.*, No. 99-580 (D. Utah 1999); *FTC v. CLS Fin. Serv., Inc.*, No. 99-1215 (W.D. Wash. 1999); *FTC v. Granite Mortgage, LLC*, No. 99-289 (E.D. Ky. 1999); *FTC v. Interstate Res. Corp.*, No. 99-5988 (S.D.N.Y. 1999); *FTC v. LAP Fin. Serv., Inc.*, No. 99-496 (W.D. Ky. 1999); *FTC v. Wasatch Credit Corp.*, No. 99-579 (D. Utah 1999); *In re FirstPlus Fin. Group, Inc.*, FTC Docket No. C-3984 (2000); *In re Fleet Fin., Inc.*, FTC Docket No. C-3899 (1999); *FTC v. Capital City Mortgage Corp.*, No. 98-00237 (D.D.C. 1998).

⁸ FTC BUREAU OF ECONOMICS STAFF, JAMES M. LACKO & JANIS K. PAPPALARDO, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS (2007), available at <http://www.ftc.gov/os/2007/06/P025505mortgagedisclosurereport.pdf> (finding that, with current disclosures, both prime and subprime borrowers misunderstood key loan terms and that both groups benefitted significantly from a prototype version of improved disclosures developed for the study); FTC BUREAU OF ECONOMICS STAFF, JAMES M. LACKO & JANIS K. PAPPALARDO, THE EFFECT OF MORTGAGE BROKER COMPENSATION DISCLOSURES ON CONSUMERS AND COMPETITION: A CONTROLLED EXPERIMENT (2004), available at <http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf> (finding that proposed yield spread premium disclosures confused consumers, leading many to choose loans that were more expensive than an alternative loan option, and created a substantial consumer bias against broker loans, even when the broker loans cost the same or less than direct lender loans).

offer loan products to consumers.⁹ In recent years, mortgage brokers have become an important part of the mortgage market, originating approximately 58-70% of mortgage loans.¹⁰ Regardless of which entity the consumer initially contacts, at some point in the mortgage loan shopping process one of the parties seeks an appraisal¹¹ to obtain an estimate of the market value of a specific property.¹² Lenders (retail and correspondent) rely on the appraisal to evaluate the collateral that will secure the loan. Brokers obtain an appraisal to shop a complete loan package (including the appraisal) to multiple lenders. Accurate appraisals therefore are important to the integrity of the mortgage lending process.

All parties to the loan transaction have some incentive to obtain an appraisal at the highest possible value. Borrowers want an appraisal valuation high enough that they can obtain a loan to purchase the property at the sales price. Lenders have a strong interest in ensuring that the property is accurately valued to assess whether it provides adequate security in the event of a foreclosure, but they also want the appraisal to meet the sales price amount so that the loan is made. Mortgage brokers have an incentive to obtain a sufficiently high appraisal because they only get paid if the loan is made, and their commissions usually are based on the loan amount.

Appraisers are paid to value property for their customers, who primarily are lenders or mortgage brokers.¹³ Lenders and mortgage brokers may have some incentive to seek inflated appraisals, and some of them may use coercion or pressure appraisers to obtain the valuations they want.¹⁴ To satisfy and retain customers, appraisers have some incentive to provide an

⁹ See Fannie Mae Single-Family MBS Prospectus, Exhibit B, n.23 (Apr. 1, 2008), available at http://www.efanniemae.com/syndicated/documents/mbs/mbspros/SF_April_1_2008.pdf (defining “retail,” “correspondent,” and “broker”).

¹⁰ Lew Sichelman, *Loan Brokers Lose Share, But Still Rule the Market*, REALTY TIMES, July 18, 2007, http://realtytimes.com/rtpages/20070718_loseshare.htm; Press Release, Wholesale Access, New Research About Mortgage Brokers Published (July 28, 2005), available at http://www.wholesaleaccess.com/7_28_mbkr.shtml.

¹¹ This comment does not address automated valuation models.

¹² See 12 C.F.R. §§ 34.42(a), 225.62(a), 323.2(a), 564.2(a), 722.2(a); Uniform Standards of Professional Appraisal Practice, Definitions, available at http://commerce.appraisalfoundation.org/html/USPAP2008/USPAP_folder/uspap_foreword/DEFINITIONS.htm.

¹³ Appraisers also are paid to value property for appraisal management companies (“AMCs”). Typically, AMCs are hired by lenders to provide appraisal and, in some cases, other settlement services. AMCs, in turn, typically develop, and purchase appraisals from, a network of independently contracted appraisers.

¹⁴ Based on publicly available information, it is not clear how extensive appraisal abuse has been – particularly given lenders’ ability to monitor the quality of appraisals with automated valuation models.

appraisal at or above the amount sought. In the face of these incentives, certain restrictions may be needed to protect the independence of appraisers and the integrity of the mortgage lending process.

III. Proposed Home Valuation Code of Conduct

On March 3, 2008, the NY AG announced settlement agreements with Freddie Mac, Federal National Mortgage Association (“Fannie Mae”), and the Office of Federal Housing Enterprise Oversight (“OFHEO”), the office within the Department of Housing and Urban Development that oversees Freddie Mac and Fannie Mae.¹⁵ The settlement agreements are the result of a larger investigation by the NY AG into conflicts of interest, fraud, and other misconduct in the mortgage industry.

Pursuant to the settlement agreements, beginning on January 1, 2009, Freddie Mac and Fannie Mae will no longer purchase single-family mortgage loans, other than government-insured loans, from mortgage originators that do not agree to adopt the Code of Conduct with respect to such loans.¹⁶

Section I of the Code of Conduct prohibits a wide range of conduct that may undermine appraiser independence and thus result in inflated or faulty appraisals. Specifically, Section I prohibits lenders, including any employees, agents, and affiliates of such lenders, from influencing or attempting to influence “the development, reporting, result, or review of an appraisal through coercion, extortion, collusion, compensation, instruction, inducement, intimidation, bribery, or in any other manner.”¹⁷ The Code of Conduct further provides several examples of conduct that would be implicated by Section I, including, among others, the withholding or threatening of withholding of timely payment for an appraisal, the termination or threatening of termination of an appraiser, and providing to an appraiser an anticipated or desired value for a subject property.¹⁸

¹⁵ The Home Value Protection Program and Cooperation Agreement among the NY AG, Freddie Mac, and OFHEO (“Freddie Mac Settlement Agreement”) is available at http://www.freddiemac.com/singlefamily/docs/030308_freddieagree.pdf, while the Home Value Protection Program and Cooperation Agreement among the NY AG, Fannie Mae, and OFHEO (“Fannie Mae Settlement Agreement”) is available at http://www.fanniemae.com/media/pdf/030308_agreement.pdf.

¹⁶ Freddie Mac Settlement Agreement ¶ 1; Fannie Mae Settlement Agreement ¶ 1.

¹⁷ Code of Conduct § I. The Code of Conduct specifically allows the lender or any third party acting on behalf of the lender to request that an appraiser “(i) provide additional information or explanation about the basis for a valuation, or (ii) correct objective factual errors in an appraisal report.” *Id.*

¹⁸ *Id.* § I(1), (2) & (6).

Other provisions in the Code of Conduct relevant to the FTC staff's analysis include those that prohibit the use of appraisal reports from certain market participants, as well as those provisions that prohibit certain participants from selecting, retaining, and compensating appraisers.¹⁹ In particular, Section VI of the Code of Conduct prohibits lenders desiring to sell mortgage loans to Freddie Mac or Fannie Mae from using any appraisal report prepared by an appraiser employed by:

- (1) the lender;
- (2) an affiliate of the lender;
- (3) an entity that is owned, in whole or in part, by the lender;
- (4) an entity that owns, in whole or in part, the lender[;]
- (5) a real estate "settlement services" provider, as that term is defined in the Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 et seq.; [or]
- (6) an entity that is owned, in whole or in part, by a "settlement services" provider.²⁰

In addition, lenders are prohibited from using any appraisal obtained by or through an AMC owned by or affiliated with the lender, unless: (1) the lender has a 20% or less ownership interest in the AMC; (2) the lender has no involvement in the day-to-day operations of the AMC; (3) the AMC is operated independently; and (4) the lender plays no role in the AMC's selection of appraisers.²¹

Finally, Section III of the Code of Conduct addresses the selection and compensation of appraisers and provides: "The lender or any third-party specifically authorized by the lender (including, but not limited to, appraisal management companies and correspondent lenders) shall be responsible for selecting, retaining, and providing for payment of all compensation to the appraiser. The lender will not accept any appraisal report completed by an appraiser selected, retained, or compensated in any manner by any other third-party (including mortgage brokers and real estate agents)."²²

IV. Potential Concerns Raised by the Code of Conduct

The FTC staff is concerned about recent mortgage market turmoil and its effects on individuals, families, neighborhoods, and the overall economy. Some of the current problems in mortgage markets may be attributable to abuses in the appraisals of residential homes. In

¹⁹ FTC staff does not take any position regarding the potential impact on competition or consumers of the other provisions in the Code of Conduct.

²⁰ Code of Conduct § VI.

²¹ *Id.*

²² *Id.* § III.

comments recently filed with the Federal Reserve Board (“Board”), the FTC staff supported the Board’s proposed rule to protect appraiser independence, noting that pressuring an appraiser to misrepresent the value of a property distorts the lending process and harms consumers.²³ Section I of the Code of Conduct would provide similar protections for appraiser independence.

Prohibiting specific conduct that may undermine the independence of the appraisal process – as Section I of the Code of Conduct would do – is the most direct means of protecting such independence. In contrast, limiting the way in which participants in the mortgage lending industry can contract with each other and thus imposing potentially significant changes in the structure and functioning of that industry – as Sections III and VI of the Code of Conduct apparently would do²⁴ – is a much more indirect means of protecting appraiser independence. The use of such indirect means also creates concerns that, notwithstanding the laudable goal of appraiser independence animating the requirements and prohibitions in the proposed Code of Conduct, such provisions may have unintended adverse consequences for competition and consumers in the mortgage lending area, including, for example, higher prices for consumers without sufficient protections or other benefits to offset such costs.

Based on its experience, the FTC staff recognizes the need to consider all of the implications – including both the benefits and costs to consumers – of imposing restrictions in the mortgage lending area because of the potential for such restrictions to impair consumers’ access to mortgage credit. Thus, in considering the impact on competition and consumers of the proposed Code of Conduct’s efforts to insulate appraisers from undue influence and thereby protect the integrity of the lending process, it is important to assess whether the restrictions contained therein would impede unduly individuals’ access to mortgage credit by, for example, raising the prices consumers pay for appraisal services, increasing the costs of shopping among potential lenders for the best loan for a given consumer and property, or reducing the availability of timely, high-quality appraisals.

For example, a potential competitive concern raised by Section III of the Code of Conduct involves the apparent prohibition on mortgage brokers directly ordering appraisal reports. To the extent that such brokers rely on the ability directly to order an appraisal and then shop around a complete loan package (including the appraisal) to multiple lenders, the Code of Conduct would appear significantly to hamper the ability of mortgage brokers to compete in the lending market. Even if the Code of Conduct could be interpreted as merely requiring a lender to obtain another appraisal in addition to the broker-ordered appraisal, the cost of dual appraisals will raise the cost of such loans for consumers. If implementation of the Code of Conduct

²³ FTC STAFF, COMMENTS TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM ON PROPOSED RULE RESTRICTING CERTAIN MORTGAGE PRACTICES 9 (Apr. 8, 2008), *available at* <http://www.ftc.gov/os/2008/04/V080008frb.pdf>.

²⁴ Given the significant roles that Freddie Mac and Fannie Mae serve in the secondary mortgage market, it seems likely that the Code of Conduct will have a significant impact on the structure and functioning of the primary mortgage lending industry.

results in it being more difficult or expensive to use mortgage brokers than lenders to obtain a mortgage, then consumers may lose some of the benefits brokers may provide as a significant mortgage distribution channel. The FTC staff thus recommends that Freddie Mac and the other parties to the settlement agreements fully consider the potential impact on the lending market and, ultimately, consumers of the prohibition on mortgage brokers directly ordering appraisals.

Another potential competitive concern relates to the ability of AMCs and other settlement services providers to offer a package of appraisal and one or more other real estate closing-related services, such as title insurance, flood reports, and settlement services. Section VI of the Code of Conduct would prohibit lenders desiring to sell loans to Freddie Mac or Fannie Mae from utilizing appraisals conducted by *employees* of real estate settlement services providers.²⁵ There does not appear to be any language in the Code of Conduct that would prohibit the use of appraisals done by independently contracted appraisers on behalf of (non-lender-affiliated or otherwise qualifying) AMCs. In fact, Section III of the Code of Conduct explicitly provides for the ability of lenders to authorize AMCs to select, retain, and compensate appraisers.²⁶

Freddie Mac, however, has publicized an interpretation of the Code of Conduct that would prohibit lenders from utilizing appraisals done or perhaps even ordered by an entity that offers any services other than appraisals. In a March 3, 2008, email advisory to its sellers and servicers, Freddie Mac stated: “A lender will no longer be allowed to sell Freddie Mac a loan if the appraisal was done by an in-house appraiser, a subsidiary or affiliate of the lender (except under certain conditions . . .), ordered by a mortgage broker, or *an entity that offers any other services other than appraisals.*”²⁷ It is the FTC staff’s understanding that a significant number of AMCs – particularly those operating on a regional or national basis – offer services other than appraisals. Under one reading of Freddie Mac’s stated interpretation of the Code of Conduct,²⁸ such companies would have to choose between offering either appraisal or non-appraisal services; they could not offer lenders – and, ultimately, consumers – both. To the extent that consumers benefit from the packaging of appraisal and non-appraisal services by AMCs and

²⁵ Code of Conduct § VI(5). Section VI(6) extends this prohibition to any entity owned in whole or in part by a settlement services provider. *Id.* § VI(6).

²⁶ *Id.* § III. *See also id.* § V (requiring certain training for lender employees or, if the lender retains an AMC, employees of the AMC responsible for selecting appraisers).

²⁷ Advisory Email Message to Seller/Servicers, Freddie Mac, Important Information about Home Valuation Code of Conduct (Mar. 3, 2008) (emphasis added), *available at* http://www.freddiemac.com/singlefamily/20080303_advisory.html.

²⁸ It is unclear from the language of the email advisory whether prohibited appraisals include those “done” or “ordered” by “an entity that offers any other services other than appraisals” – or both.

other settlement services providers,²⁹ Freddie Mac’s interpretation of the Code of Conduct could have adverse implications for competition and consumers. The FTC staff therefore recommends that Freddie Mac clarify and, more importantly, consider the competitive implications of, its interpretation of those provisions in the Code of Conduct relating to settlement services providers.

V. Conclusion

The FTC staff supports initiatives to improve the mortgage lending process for consumers, including those designed to protect appraiser independence. These initiatives are particularly important in light of current problems that mortgage borrowers are experiencing. FTC staff hopes that this comment is useful to Freddie Mac, Fannie Mae, OFHEO, and the NY AG in their assessment of the impact on competition and consumers of the proposed Code of Conduct.

²⁹ See, e.g., FTC STAFF, COMMENTS TO THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT ON PROPOSED RESPA AMENDMENTS 12 (Oct. 28, 2002), *available at* <http://www.ftc.gov/be/v030001.pdf> (noting that the packaging of various loan and settlement services “should lead to lower prices in the market for settlement services, increase efficiency, and simplify the process for borrowers”).

Respectfully submitted,

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cc: Fannie Mae
OFHEO
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