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DODD-FRANK IMPACT ON MORTGAGE APPRAISAL PROCESS

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ABSTRACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) had an unanticipated effect on a portion of the mortgage industry. Mortgage Loan Originators (MLO) expressed their belief that the creation of the Appraisal Management Companies (AMC) process to oversee real estate appraisals has resulted in some negative consequences. Specifically, the real estate appraisals are more restrictive and thus more costly to the MLO and their customers. A sampling of selected MLOs demonstrates there is a significant impact to a mortgage loan officer's mortgage loan production through use of an AMC impacting the mortgage loan process.

Key Words: Dodd-Frank Act, Mortgage Loan Originators, Appraisal Management Companies, consumer protection, financial crisis, appraisal management process

The passage of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank) by the United States Congress in 2010 was to address various failings within the financial system that caused or led to the 2008 recession ("Superintendent of Documents," 2010). This legislation was enacted to promote the fiscal stability of the United States by improving accountability and transparency within the financial system. Dodd-Frank was also designed to protect the American taxpayer from undue economic burdens through the need to provide financial support to banks and other budgetary intermediaries that may encounter difficulties because of poor or fraudulent investments. Some segments and sections of Dodd-Frank are directed toward mortgage lenders. Various provisions of this legislation apply unevenly to differing types of firms engaged in mortgage lending.

Three primary sources of mortgage origination exist today in the United States. The bulk of mortgages originated through independent firms known as mortgage brokers. Mortgage bankers constitute the second source of originations, and commercial banks constitute the third source (Dennis & Pinkowish, 2004). Each of these institutions has to contend with differing applications of the provisions of Dodd-Frank in all aspects of their operations. One aspect of the legislation that is particularly problematic is the property appraisal process (Timiraos, 2010). The appraisal is an opinion of value on a specific date that is based on market research data. As the appraisal represents the opinion of the appraiser as to the value of a precise piece of real estate based on objective market analysis, the value is not guaranteed. The review and analysis contained herein will explore the potential impact on the Dodd-Frank appraisal process on the appraisal management process.

As approximately 60% of new mortgage originations in the United States today are processed through mortgage brokers/bankers (NAMB, 2008), clearly a large portion of borrowers relies on their mortgage broker/banker to obtain the best possible terms for their mortgage. A mortgage broker is an individual or entity that acts as a go-between from individual borrowers to end lenders (Dennis & Pinkowish, 2004). One portion of the mortgage origination process involves the necessity to assess the value of the proposed property to be mortgaged. This process is commonly referred to as the property appraisal. Significant portions of Dodd-Frank changed the process for appraisals such that the broker, realtor or other external parties are unable to affect the outcome of the appraisal. This was accomplished by enabling only the end lender to request the appraisal from an independent firm, an AMC, who then uses a rotating process for selection of the appraiser with no undue superficial influence from parties to a given mortgage transaction which have a vested interest in that transaction.(Superintendent of Documents, 2010). Enactment of Dodd-Frank and it encompassing provisions has created significant difficulties during the mortgage market lending process.

Purpose of the Study

This analysis explores some of the issues and causes that led to the enactment of Dodd-Frank and the ensuing issues with the property appraisal process as part of that legislation. The purpose of this study is to determine the effects, if any, of Dodd-Frank upon the appraisal process currently employed throughout the Mortgage industry. Specifically, this research examined the following question:

Research Question: How are mortgage broker's loan productions affected by the AMC in the appraisal process?

Literature Review

The following literature review examines the Mortgage Loan Officer and broker considering their roles and involvement in the financial collapse. In addition, the Dodd-Frank Act is defined, next the housing bubble collapse is considered in light of the financial collapse. Furthermore, research regarding the causes of the financial collapse is presented. Finally, Dodd-Frank's impact on the mortgage loan process is considered which then leads to the methodology of the study.

MLO and Broker

Trust has been a missing component in the mortgage industry since before the financial collapse (Finkelstein, 2009). Lee (2011) reports that the MLO and broker have been blamed for the housing market and financial industry collapse and compromising its integrity. According to Koenig (2014), a mortgage loan originator (MLO) works at an originating organization, such as a licensed mortgage banker or registered mortgage broker. The MLO takes a residential mortgage loan application and negotiates terms for such a loan in exchange for compensation or gain. An MLO must now pass definite testing requirements to obtain a license before working within the mortgage loan industry since the passage of the Secure and Fair Enforcement Licensing Act (S.A.F.E.) and its final rule's passage in July of 2010 (Feds Now Require, 2011). Residential mortgage loan originators who are employed by banks, savings associations, credit unions, farm credit systems, and particular subsidiaries of financial institutions must record with the Nationwide Mortgage Licensing System (NMLS) and Registry, obtain a unique identifier number and keep this enrollment current (NMLS Resource Center, 2014). These individuals are not compelled to pass the same testing requirements as MLOs employed by mortgage brokers or bankers. Organizations, such as mortgage brokers or bankers, who originate loans, are also required to obtain federal registration.

Dodd-Frank Act

In addition to the SAFE Act, Dodd-Frank was passed by the United States Congress and signed into law by President Obama in July 2010 to promote the financial stability of the United States by improving accountability and transparency in the monetary system. Its intent is to terminate the too big to fail mentality and shield the American taxpayer by ending bailouts and protecting consumers from unscrupulous financial service's practices. Its aim is to prevent future economic recessions in the United States economy that nearly sank the economy by providing a compliance foundation and implementing the regulations (Jackson, 2011).

Even today, the Dodd-Frank Act impacts the industry and mortgage appraisals. According to Richard Cordray, Director of the Bureau of Consumer Financial Protection (BCFP) (2015), in November 2013, pursuant to sections 1098 and 1100A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Bureau of Financial Protection issued the Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z) (2013 TILA-RESPA Final Rule),1 combining certain disclosures that consumers receive in connection with applying for and closing on a mortgage loan. This rule amends the 2013 Loan Originator Final Rule (LOFR) to provide for placement of the Nationwide Mortgage Licensing System and Registry ID (NMLSR ID) on the integrated disclosures. BCFP is making corrections to assist with better disclosure for consumers regarding the mortgage loan origination to closing. This final rule revises Regulation B to implement an ECOA amendment concerning appraisals and other valuations that was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). This rule is effective August 1, 2015 and applies to transactions for which the creditor or mortgage broker receives an application on or after that date.

Housing Bubble Collapse

According to Shiller (2008), the housing bubble was a major cause of the subprime crisis and the broader economic crisis. The speculative housing market bubble burst in the United States in 2006 and created ruptures across the globe in the form of financial failures and a tight credit market. Johnston (2009) argues that mercantilism and marketplace forces led to the mortgage meltdown. His research determined marketers and market institutions each had roles in the proper functioning of the mortgage market along with the government to frame fairness and transparency in order to allow investors to make informed decisions to avoid credit crisis or market failures.

Johnston (2009) summarized the marketing practices leading to the credit crisis. He argued that

greedy lenders preyed on vulnerable and unsophisticated borrowers while aggressive lenders steered good credit borrowers into profitable but risky subprime loans, and that lenders and borrowers committed fraud. In addition, the United States government failed to protect borrowers and encouraged loose lending standards and requirements. This process eventually contributed to the destabilizing of the housing market.

Johnston (2009) also posits his argument as regards the market forces that led to the mortgage market collapse. He contends that there is a difference in subprime lending versus the predacious lending. The subprime business practices offered individuals with weak credit scores the opportunity to buy a home with affordable rates and terms and enabled them the opportunity to rebuild credit scores, while the loan term loans appearing rapacious were only a small portion of the market.

Short-Term Thinking

Many believe that myopic or short-term thinking is primarily to blame for market volatility and instability that contributed to the financial crisis. According to Dallas (2012), short-termism or short term leadership vision are both defined as an excessive focus of managers on short-term results, regardless of long-term value creation and the value of the firm. It may involve increasing the current stock value of a firm or profits, or decreasing discretionary expenses or under investing in long-term assets, or taking on excessive risk in order to maximize short-term earnings and many refer to this as earnings management or managerial myopia. This was considered a problem prior to the crisis and during it. Many believe that short-termism is still a problem pervasive to business decisions in the U.S. and world economy.

Regulatory responses and firm culture are also important considerations regarding the focus on short-term incentives. The reward structures of firms that impact individual incentives drives behavior of employees to behave in their best interests whether that is in short-term or long-term thinking. When a substantial portion of the compensation of managers is based on the long-term health of their firms, then they will act accordingly and think in a more sustainable manner. Board structure and the centralization of CEO power in organizations is important to long-term sustainable thinking. Developing a board that is more informed, that contains a diversity of perspectives, and is accountable will lead to the creation of an environment where organizations support and encourage managers to conduct business in ways to improve long-term value of their terms and avoid the short term actions that contributed to the financial crisis of 2007-2009 (Dallas, 2012).

According to Mizik (2010), financial markets do not differentiate well between firms that engage in short thinking and those who do not. However, these myopic or short-term thinking firms are not valued properly when they are engaged in myopic spending cuts, especially in the year that they operate in this fashion. They will have stock returns comparable to non-myopic firms with positive earnings and realize substantial return premiums. This short-term management might have short-lived benefits that lead to higher current-term earnings and stock price, but damage the long-term financial performance of the organization because the initial gains are followed greater negative abnormal returns. Firms may cut their investment in marketing and R & D to increase profitability and lower their stock market valuation. Myopic management led to inefficient decision making and lowering of future organizational firm value. Shareholders must consider how to motivate managerial behavior that focuses on long-term outcomes in a manager's compensation package.

Financial Failure Factors Explored

Elliot and Baily (2009) posit three major narratives regarding the causes of the financial crisis, and they are as follows:

Narrative 1: The crisis was the fault with the government, which encouraged a massive housing bubble and mishandled the ensuing crisis.

Narrative 2: The crisis was Wall Street's fault, stemming from greed, arrogance, stupidity and misaligned incentives, especially in compensation structures.

Narrative 3: Everyone was at fault: Wall Street, the government and our wider society. People in all types of institutions and as individuals became blasé about risk-taking and leverage, creating a bubble across a wide range of investments and countries.

Elliot and Bailey (2009) argue that Narrative 3 is the one which comes closest to the truth, and it matters whether that story line becomes accepted by the public. A well-designed program of regulative reforms would fix the wide-spread problems in both the markets and in government regulation, or at least greatly assist in solving the problems in both areas. In contrast, public acceptance of Narrative 1 would lead to too little regulative change or change of the wrong kind, while Narrative 2 would likely encourage a stifling of markets without fixing the problems inherent in our regulatory structure. The Elliot and Bailey (2009) preferred narrative encouraged a balanced and comprehensive set of changes. They believe ultimately there were many factors that led to the financial crisis that help explain its intensity and the causes reflect mistakes, bad incentives and flawed structures across the board: in the financial markets, among regulators and government officials, and in our larger society.

Congress created the Financial Crisis Inquiry Commission pursuant to Public Law 111-21 to investigate causes of the pecuniary crisis and explain them to the American people. These findings were presented in the *Financial Crisis Inquiry Report* completed January 2011 (United States Government, 2011). The six commissioners supported the second narrative from the Brookings Institute that blames Wall Street and its influence in Washington. According to this, narrative, greedy bankers knowingly manipulated the budgetary system and politicians in Washington to take advantage of homeowners and mortgage investors alike, intentionally jeopardizing the monetary system while enjoying huge personal gains. That is the view of the six majority commissioners. However, three commissioners who served upon the commission were unable to support the majority's conclusions and presented a dissenting statement.

Thomas, Hennessey, & Holtz-Eakin (2011), subscribed to a third narrative that emphasizes the global economic forces and failures in United States policy and supervision. They state that their explanation of the crisis does not fit conveniently into the political order of Washington, but that it is a far superior to the other two narratives presented. They identified 10 individual factors that contributed to the financial crisis, but they must be combined in order to provide a more complete explanation of what happened.

Factors 1 and 2 were the broad credit bubble that started in the late 1990s in the United States and Europe and the housing bubble in the United States. Factor 3 is the excess liquidity that, when combined with rising home prices and an ineffectively regulated primary mortgage market, caused an increase in nontraditional mortgages that were deceptive, confusing and beyond the ability of many to borrower's borrower's ability to repay the loan. These causes are not by themselves the reason for the crisis. Factor 4 was the failure in credit-rating and securitization that transformed bad mortgages into toxic financial assets. Factor 5 occurred when securitizers lowered the credit quality of the mortgages they securitized, while credit-rating agencies incorrectly rated these securities as safe investments. Purchasers of those securities then failed to look behind the ratings and do their own due diligence as to the quality of the debt. The managers of many sizeable and midsize financial institutions amassed substantial amounts of highly

correlated housing risk that created Factor 5. Factor 6 occurred when managers increased risk by holding too little capital as compared with the risks and funded these exposures with short-term debt. They incorrectly assumed that these funds would always be available, and this turned out to not be true (Thomas et al., 2011).

Factor 7 is the risk of contagion, which combined the risks within highly leveraged, short-funded financial firms that had created a concentrated exposure to a collapsing asset class that led to a domino of firm failures. The losses spread through firms that amassed large counterparty credit risk exposures that lead to the sudden and disorderly failure of one firm, and that exposure risked triggering losses elsewhere. The problem was a common shock in many firms that lead to Factor 8, where many firms made bad bets on housing. These unconnected firms failed for similar reasons and occurred at about the same time. Factor 9 was the rapid succession of 10 firm failures, mergers and restructuring in September 2008 that caused a fiscal shock and panic. Factor 10 was the severe contraction in the real economy caused by economic shock and panic. The confidence and trust in the financial system left, as the monetary health of almost every large and midsize financial institution in the United States and Europe was therefore, in jeopardy (Thomas, et al., 2011).

Dodd-Frank implications for AMCs and the Mortgage Loan Process

Prior to enactment of Dodd-Frank, the mortgage broker/banker would elicit the services of an appraiser to value property prior to the completion of a loan. The selection of appraiser was based mainly upon respect and trust. A fair appraisal provided both the customer and lending institution confidence in value to the property for all parties involved. However, during the early 2000's that trust was eroded in locations where banks, brokers, and appraisers were willing to tacitly collude for large profits.

Dodd-Frank, as part of the mortgage loan provisions contained therein, sought to resolve this collusion by establishing controls over who can be selected as an appraiser. The appraiser is now selected by an AMC. Regulations governing implementation of Dodd-Frank required the local AMC must pay a registration fee per appraiser each year. This will mean that it is not cost-effective to have appraisers that are seldom used. It also indicates the AMC will approve appraisers that are most cost effective. Financially, it is more profitable to the AMC to have appraisers in the more densely populated areas, and this creates the unintended consequence. AMC approved appraisers needed in rural areas are sparse. The distance traveled to view the real estate has increased. This has resulted in increased expenses and time necessary to receive a property appraisal if the property is located outside large cities, thus impacting the mortgage loan process in a negative manner. The additional costs for appraisals have been passed along to the mortgage broker who handles the loan process.

Methodology

A questionnaire was developed to gather raw data because historical information does not exist that addresses the research question. Mortgage Loan Originators (MLOs) were asked their belief as to the process of procuring appraisals. All respondents were MLOs. This survey was intended to ascertain the ability of MLOs to continue a satisfactory level of mortgage loan production in the face of significantly hindered ability to procure those appraisals. The research question to be examined through this survey is:
Research Question: How are mortgage broker's loan productions affected by the AMC in the appraisal process?

For support of this research question, the following hypotheses were tested.

H0: There is no significant impact to a mortgage loan officer's mortgage loan production through use of an appraisal management company.

H1: There is a significant impact to a mortgage loan officer's mortgage loan production by through use of an appraisal management company.

Survey Instrument

The survey consisted of ten questions. Nine related directly to the research question, and one was demographic. The researchers were of the belief that the normal demographics of age, gender, educational level, and income would not be a factor influencing this research question.

A pilot study was completed using 25 individuals who fairly represented the population of MLOs. These individuals were sent the sample surveys along with a list of questions concerning recommended changes in the instrument. Word confusion and additional information were elicited. Nine of those contacted responded with suggestions for improvements. Subsequent adjustments were made according to the responses from those surveyed. Additionally, the time to complete the instrument was reported as five minutes.

The broker's names and email addresses were secured through state agencies nationwide. An attempt was made to collect data from all states. Seventeen states responded with broker information. There were 18,667 broker's names and email addresses received.

Survey Monkey was the medium used as the intermediary from which the questionnaire was distributed. The survey was emailed with a two-week follow-up notice. The only response motivation was a request for the MLOs to voice their beliefs. The total responses received were 1,213 individuals or 6 ½ % of those contacted.

Validity. Face validity is the degree to which the questionnaire appears to address what it is intended to measure (Alreck & Settle, 1985). The instrument is merely ten questions of which nine deals directly address the question of mortgage transaction appraisals. The length of the instruments was intentionally limited to addressing purely the null hypothesis.

Content validity assessed if the instrument measures accurately that which it purports to quantify within the domain (Alreck, 1985). The domain was MLOs with a vast knowledge about the industry. It is inferred that these professionals would be forthcoming with responses that represented their true beliefs.

Construct validity, "the degree to which survey instruments conforms to the underlying concepts or makes sense based on what it represents" (Alreck, 1985, p.?). This questionnaire pertains to the appraisal process as changed by Dodd-Frank. The construct of this law has potentially affected the MLOs financially as well as the quality of appraisals.

External validity is demonstrated using samples from many different states across the country. Additionally, the large number of respondents supports the belief that the conclusions from this study would apply to MLOs nationwide.

Reliability. Cronbach's alpha was used to measure internal consistency of the survey questions. The authors believed the compiled questions addressed the research question; therefore, all questions were used for the comparison. A score of .989 led the authors to conclude reliability exists.

Results

The majority of the questions resulted in Strongly Disagreed. Mortgage transactions can be lost due to the inability to transfer an appraisal from one investor to another. Over 87% either agreed or strongly agreed to that statement. The authors believe Dodd-Frank necessitating a re-evaluation should the probable mortgagee change lenders will delay the transaction resulting in a likely loss for the client.

When asked if the respondents (brokers) were monetarily affected by the inability to requirement

will also affect the income to the broker negatively. A similar question was asked if the brokers believed their customers were monetarily affected by the lack of appraisal portability. At least 86% were in agreement to this statement. This demonstrated the respondents' belief that their customers would also be resistant to expending additional funds is a lender with better terms was subsequently located.

The next question addressed if appraisers from outside the subject property market area were having a gloomy impact on the mortgage transaction. More than 86% believed those appraisers not familiar in the area of the subject property would have a pessimistic impact upon the appraisal outcome. The authors contend that unfamiliarity with the local market by foreign appraisers resulted in fewer accurate valuations.

To determine if the appraisers that had to travel a large distance were providing a equitable market value assessment, an opinion was requested. At least 78% held the belief that the appraisers were not providing a fair market price. The majority of respondents sensed that the valuation process had suffered due to the change in appraisers caused by the addition of the AMC process.

The respondents were asked their opinions about the "turn time" by AMC's. Here the acceptance by 63% said the turn time was inadequate. The general certainty was the progression involving AMC's slowed down the overall mortgage operation

Asked if those questioned believed the AMC provided experienced appraisers, the opinion was less skewed than the previous questions. The majority responded with neutral. This could be interpreted as the brokers were not claiming the appraisers were inadequate, just that they did not understand the local market.

Was the appraisal management process creating a limited competitive market since banks and credit unions are not legally required to avail themselves of the identical system? More than 66% believed they were less competitive due to the changes in the law, as Dodd-Frank did not force banks and credit unions to follow the same guidelines of using an AMC.

The final opinion question addressed the comparison of rural to urban/suburban. Was the cost greater to have appraisers travel to rural areas? Again, 66% believed it was more costly. The author's contend that the cost of travel and the cost in time are greater for the less populated area than urban/suburban. Thus, the lower appraisal values in the rural area are attracting a disproportionate expense when compared to appraisals completed closer to large cities.

The final question concerning demographics adds strength to the preceding response. Over 89% of respondents considered themselves as working in urban/suburban areas, yet the vast majority understood that the rural areas had a larger expense when it came to securing appraisals. This statistic is extremely informative. The overwhelming majority of those responding were located in urban or suburban areas. They understood and agreed with the problems brokers in rural areas are facing.

Summary and Conclusions

The purpose of this study is to determine the effects, if any, of Dodd-Frank upon the appraisal process currently employed throughout the Mortgage industry and to answer the question "How are mortgage broker's loan productions affected by the AMC in the appraisal process?" The random sample collected herein leans towards a rejection of the null hypothesis that "There is no significant impact to a mortgage loan officer's mortgage loan production through use of an appraisal management company." Dodd-Frank has served its overall purpose of building confidence in the mortgage market. As with any dramatic adjustment to an industry, there occurs collateral damage. The constraint requirement to use the AMC by mortgage brokers places them at an economic disadvantage to banks and credit unions since they are not held to the same standard.

The unintended result caused by the AMC selecting city appraisers to travel longer distances has thus increased expenses and time to complete the appraisal. The "turn time"

increases when the property being assessed is farther from the home office of the appraiser. Furthermore, the lack of knowledge of the local market may in fact decrease the accuracy of the
appraisal done by an "out of town" appraiser.

Generally, levels of valuations of property a large distance from a highly populated area is lower; as a result the revenue of the broker is decreased. Add to this the increased expenses and turn time; consequently, the broker in small towns or the countryside is less profitable and therefore, the number of mortgages available for their customers is reduced.

To create fair competition, two options are plausible. Either remove the AMC system established by Dodd-Frank or require banks and credit unions to follow the same guidelines. If Dodd-Frank were amended to include all financial institutions, the rural broker would find the market as it was prior to the change. Certified appraisers in the county could be profitable thus decreasing the need for appraisers traveling long distances.

Limitations and Future Research

There are a number of limitations to this study, and one is that it cannot be generalized to the entire mortgage industry. Further research could be extended to more geographic areas of the United States, even though the authors attempted to secure lists of all brokers from each state in the union, not all were willing to provide the information, but it may be possible to get those contacts in another manner. This means the sample is stratified according to the states that cooperated. It is believed that even with this limitation, the large sample response makes this work seminal research into the side effects caused by Dodd-Frank to the extent of the property appraisal process.

Future research of this topic should use a mixed methodology that incorporates qualitative and quantitative methods to provide more depth and richness of data to the Likert Scaled questions. A longitudinal study could also provide data as the landscape of the financial and mortgage industry and legislations is in constant flux. A future study should correlate the appropriate questions with measures of organizational outcomes to find their relationships with measureable outcomes.

In summary, this study reviewed literature regarding the various reasons for the financial collapse that are important to revisit. Most importantly, this study provided a seminal empirical work regarding Dodd-Frank's impact on the mortgage appraisal process providing new findings regarding outcomes of policy implementation. These findings are also important for those academics and practitioners in the field of business to consider how implementations of future policy may impact industries and organizations.

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