

# Discrimination in the Valuation Process: New Developments

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Three recent developments have all focused on what has become a key issue for regulators of financial institutions and other mortgage lenders: discrimination in the appraisal and valuation process.

On June 24, 2024, the Consumer Financial Protection Bureau (“CFPB”), Office of the Comptroller of the Currency (“OCC”), Board of Governors of the Federal Reserve System (“Board”), Federal Deposit Insurance Corporation (“FDIC”), National Credit Union Administration (“NCUA”), and Federal Housing Finance Agency adopted the [Quality Control Standards for Automated Valuation Models](#) (the “Rule”), a new rule addressing the use of algorithms and artificial intelligence (“AI”) for home appraisals and valuations.

Shortly thereafter, on July 15, 2024, the Department of Housing and Urban Development (“HUD”) [charged](#) a lender, appraisal company, appraisal management company, and appraiser with racial discrimination and violating the Fair Housing Act in the home appraisal process, highlighting the increased scrutiny on appraisal bias and the valuation process generally.

Most recently, on July 18, 2024, the FDIC, Board, NCUA, OCC, and CFPB issued final [Interagency Guidance on Reconsiderations of Value \(“ROV”\) of Residential Real Estate Valuations in the Federal Register](#) (the “Interagency Guidance”). The Interagency Guidance addresses the risks associated with deficient residential real estate valuations, particularly those that contain inaccuracies due to errors, omissions, or discrimination that affect the value conclusion.

The Rule, HUD’s charge of discrimination, and the Interagency Guidance all highlight the current heightened oversight on appraisals and the valuation process in the mortgage lending industry. Each of these developments is discussed below.

## **I. CFPB’s Quality Control Standards for Automated Valuation Models**

For many years, computer models have been used by participants in the mortgage and real estate industries to determine the value of a property. These models can resemble what many people refer to as AI as they become more complicated and incorporate more factors. Based on the data they are fed and the algorithms they use, regulators have stated that automated valuation models (“AVMs”) can embed the very human bias they are meant to correct, and the design and development of the models and algorithms can reflect the biases and blind spots of the developers. In fact, regulators believe that AVMs can make bias harder to eradicate in home valuations

because the algorithms used cloak the biased inputs and design in a false mantle of objectivity.

Due to these concerns, the Rule requires companies that use these algorithmic appraisal tools for mortgages secured by a consumer's principal dwelling to adopt and maintain policies, practices, procedures, and control systems to ensure that automated valuation models used in these transactions adhere to quality control standards designed to:

- Ensure a high level of confidence in the estimates produced;
- Protect against the manipulation of data;
- Seek to avoid conflicts of interest;
- Require random sample testing and reviews; and
- Comply with applicable discrimination laws.

The preamble to the Rule explains that a "flexible approach" to implementing the quality control standards allows the implementation of the standards to evolve along with AVM technology and reduce compliance costs. As a result, different policies, practices, procedures, and control systems may be appropriate for institutions of different sizes with different business models and risk profiles, and a more prescriptive rule could unduly restrict institutions' efforts to set their risk management practices accordingly.

The Rule does not apply to the use of AVMs in the following scenarios:

- Monitoring of the quality or performance of mortgages or mortgage-backed securities;
- Reviews of the quality of already completed determinations of the value of collateral; or
- The development of an appraisal by a certified or licensed appraiser.

The Rule is effective 12 months from publication in the Federal Register which has not occurred as of this post.

## **II. HUD Charges Appraiser, Appraisal Company, Appraisal Management Company, and Lender with Race Discrimination**

HUD's charge against a lender, appraiser, appraisal company, and appraisal management company alleges that the appraiser issued a discriminatory appraisal that undervalued a Black homeowner's property on the basis of her race. The charge further alleges that, when the homeowner complained to the lender, the lender would only proceed with her refinance loan application based on the appraised value that she alleged was discriminatory.

The Fair Housing Act prohibits entities and individuals involved in real estate-related transactions, including appraisals, from discriminating in the terms and conditions of the transactions because of race. It also prohibits anyone from retaliating against individuals who are exercising their fair housing rights, including by reporting discrimination.

HUD's charge of discrimination alleges that the appraiser and his appraisal company issued an insupportably low appraisal of a duplex owned by a Black woman in a predominantly white area of Denver, Colorado. Other recent appraisals of the same property had shown an increase in value, yet this appraisal resulted in a dramatic drop,

despite the Denver market generally experiencing substantial growth in home values at that time. To reach that low number, HUD claims, the appraisal was rife with inaccuracies and unsupportable methodological choices (such as relying on comparable properties in neighborhoods with greater Black populations and excluding potential comparable properties in neighborhoods with greater White populations) that not only artificially lowered the appraised value but deviated from the appraiser's own methodology and findings about the relevant neighborhood in appraising similar, nearby properties with White owners. According to HUD, both the appraisal management company and the lender reviewed the appraisal report but failed to correct it despite several red flags. When the homeowner complained about this to the lender, she was told she could only proceed with her loan application based on the appraisal that she alleged was discriminatory; ultimately, her application was denied.

A United States Administrative Law Judge will now hear HUD's charge unless any of the companies involved request to move the case to federal district court. If the judge finds housing discrimination occurred, the court can award damages to the homeowner and civil penalties to the companies involved. If a federal court hears the case, the judge may also award punitive damages to the homeowner.

### **III. Interagency Guidance on Reconsiderations of Value for Residential Real Estate Valuations**

The Interagency Guidance states that credible collateral valuations, including appraisals, are essential to the integrity of the residential real estate lending process. Deficient valuations, including those that are deficient due to prohibited discrimination, can keep individuals, families, and neighborhoods from building wealth through homeownership, and may pose risks to an institution's financial condition and operations.

An ROV request made by a financial institution to an appraiser or other preparer of a valuation report encompasses a request to reassess the report based upon deficiencies or information that may affect the value conclusion. A financial institution may initiate a request for an ROV because of the financial institution's valuation review activities or after consideration of information received from a consumer through a complaint, or a request to the loan officer or other lender representative.

In general, the Interagency Guidance:

- Describes the risks of deficient residential real estate collateral valuations that remain uncorrected.
- Highlights how financial institutions may create or enhance existing ROV processes that are consistent with safety and soundness standards, comply with applicable laws and regulations (including nondiscrimination requirements), preserve appraiser independence, and remain responsive to consumers.
- Provides examples of policies, procedures, control systems, and complaint resolution processes that may help financial institutions identify, address, and mitigate risks of deficient valuations, including those that may have involved discrimination.
- Describes actions that financial institutions may take to resolve valuation deficiencies, including resolving the deficiencies with the appraiser or preparer of the valuation report; requesting a review of the valuation by an independent, qualified, and competent state certified or licensed appraiser; or obtaining a second appraisal or evaluation.
- Reminds financial institutions that the use of third parties in the appraisal review process does not diminish their responsibility to oversee those activities in the same manner as if they were conducted by the institution itself.

## **IV. Conclusion**

The Rule, HUD's charge of discrimination, and the Interagency Guidance demonstrate the heightened scrutiny that regulators are giving to mortgage appraisals and the property valuation process, especially to concerns of discrimination. As a result, participants in the mortgage lending industry should ensure that their policies, procedures and practices address the concerns raised by the agencies and HUD.

This advisory is a general overview of developments in the law and is not intended as legal advice. If you have any questions about this advisory, please feel free to contact Joseph D. Simon at (516) 357-3710 or via email at [jtsimon@cullenllp.com](mailto:jtsimon@cullenllp.com), Elizabeth A. Murphy at (516) 296-9154, or via email at [emurphy@cullenllp.com](mailto:emurphy@cullenllp.com), or Gabriela Morales at (516) 357-3850 or via email at [gmorales@cullenllp.com](mailto:gmorales@cullenllp.com).

## **Practices**

- Banking and Financial Services

## **Attorneys**

- Joseph D. Simon
- Elizabeth A. Murphy
- Gabriela Morales