Agencies Propose Quality Control Standards for AVMs

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Mortgage originators and secondary market issuers use automated valuation models (AVMs) in determining the worth of collateral securing mortgages on consumers' principal dwellings. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which added section 1125 to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Congress directed the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Federal Housing Finance Agency (FHFA), and the Consumer Financial Protection Bureau (CFPB) (hereinafter, the Agencies) to develop regulations for quality control standards for AVMs.

Section 1125 of FIRREA requires that AVMs meet quality control standards designed to:

1. ensure a high level of confidence in the estimates produced by automated valuation models;
2. protect against the manipulation of data;
3. seek to avoid conflicts of interest;
4. require random sample testing and reviews; and
5. account for any other such factor that the Agencies determine to be appropriate.

On June 21, 2023, the Agencies published a proposed rule (hereinafter the Proposal) in the Federal Register to implement the required quality control standards. Under the Proposal, the Agencies would require institutions that engage in certain credit decisions or securitization determinations to adopt policies, practices, procedures, and control systems to: (i) ensure that AVMs used in transactions to determine the value of mortgage collateral adhere to quality control standards designed to ensure a high level of confidence in the estimates produced by AVMs; (ii) protect against the manipulation of data; (iii) seek to avoid conflicts of interest; (iv) require random sample testing and reviews; and, (v) comply with applicable nondiscrimination laws.

Comments must be received by August 21, 2023.

What Is an AVM?

As described in the Proposal, the term ''automated valuation model'' is "commonly used to describe computerized real estate valuation models used for a variety of purposes, including loan underwriting and portfolio monitoring." Section 1125 of FIRREA defines an AVM as ''any computerized model used by mortgage originators and secondary market issuers to determine the collateral worth of a mortgage secured by a consumer's principal dwelling.'' The Proposal defines an AVM as any computerized model used by mortgage originators and secondary market issuers to determine the value of a consumer's principal dwelling collateralizing a mortgage.

Which Transactions Would Be Covered?

The quality control standards in the Proposal would be applicable only to AVMs used in connection with making credit decisions or covered securitization determinations regarding a mortgage (covered AVMs), as defined in the Proposal.

Other uses of AVMs, such as for portfolio monitoring, do not involve making a determination of collateral value and thus are not within the scope of the Proposal. The Proposal further would not cover the use of AVMs in the development of an appraisal by a certified or licensed appraiser, nor in the review of the quality of already completed determinations of collateral value (completed determinations).

The Proposal would, however, cover the use of AVMs in preparing evaluations required for certain real estate transactions that are exempt from the appraisal requirements under the appraisal regulations issued by the OCC, Board, FDIC, and NCUA, such as transactions that have a value below the exemption thresholds in the appraisal regulations. In this regard, the Proposal would not incorporate a transaction-based exemption threshold, such as loans under $400,000.

Credit decisions are defined in the Proposal to mean a decision regarding whether and under what terms to originate, modify, terminate, or make other changes to a mortgage. The proposed definition of credit decision would include a decision regarding whether to extend new or additional credit or change the credit limit on a line of credit. Monitoring the value of the underlying real estate collateral in the mortgage originators' loan portfolios would not be a credit decision for the purposes of the Proposal.

The OCC, Board, FDIC, NCUA, and FHFA would define dwelling to mean a residential structure that contains one to four units, whether or not that structure is attached to real property. The term would include an individual condominium unit, cooperative unit, factory-built housing, or manufactured home, if any of these are used as a residence. The proposed definition of dwelling also would provide that a consumer can have only one principal dwelling at a time. Thus, a vacation or other second home would not be a principal dwelling. However, if a consumer buys or builds a new dwelling that will become the consumer's principal dwelling within a year or upon the completion of construction, the new dwelling would be considered the principal dwelling.

The CFPB proposes to codify the AVM requirements in Regulation Z. The definition of dwelling proposed by the other agencies is consistent with the CFPB's existing Regulation Z. Unlike the Truth in Lending Act (TILA), however, title XI generally does not limit its coverage to credit transactions that are primarily for personal, family, or household purposes. Because this rulemaking is conducted pursuant to title XI rather than TILA, the CFPB proposes to revise Regulation Z and related commentary to clarify that this rule would apply when a mortgage is secured by a consumer's principal dwelling, even if the mortgage is primarily for business, commercial, agricultural, or organizational purposes.

The Proposal would define mortgage as fully as the statute appears to envision, in the language of section 1125(d). Consequently, for this purpose, the Agencies would adopt in part the Regulation Z definition of ''residential mortgage transaction.''

The Proposal would also cover instances where an appraisal waiver is granted by an investor (such as a government-sponsored enterprise like Fannie Mae or Freddie Mac) and the investor uses an AVM.

Prior Guidance and Which Entities Would Be Covered By Which Agencies Under the Proposal

Since 2010, the OCC, Board, FDIC, and NCUA have provided supervisory guidance on the use of AVMs by their regulated institutions in Appendix B to the Interagency Appraisal and Evaluation Guidelines (hereinafter Guidelines).

The Guidelines recognize that an institution may use a variety of analytical methods and technological tools in developing real estate valuations, provided the institution can demonstrate that the valuation method is consistent with safe and sound banking practices. The Guidelines recognize that the establishment of policies and procedures governing the selection, use, and validation of AVMs, including steps to ensure the accuracy, reliability, and independence of an AVM, is a sound banking practice. In addition to Appendix B of the Guidelines, the OCC, Board, and FDIC have issued guidance on model risk management practices (hereinafter Model Risk Management Guidance) that provides supervisory guidance on validation and testing of models.

The NCUA is not a party to the Model Risk Management Guidance. The NCUA monitors the model risk efforts of federally insured credit unions through its supervisory approach by confirming that the governance and controls for an AVM are appropriate based on the size and complexity of the transaction; the risk the transaction poses to the credit union; and the capabilities and resources of the credit union. The CFPB and FHFA are also not parties to the Guidelines or the Model Risk Management Guidance. The FHFA has separately issued model risk management guidance that provides the FHFA's supervisory expectations for its regulated entities in the development, validation, and use of models.

Section 1125(c)(1) of FIRREA provides that compliance with regulations issued under section 1125 shall be enforced by, "with respect to a financial institution, or subsidiary owned and controlled by a financial institution and regulated by a Federal financial institution regulatory agency, the Federal financial institution regulatory agency that acts as the primary Federal supervisor of such financial institution or subsidiary.''

Section 1125(c)(1) applies to a subsidiary of a financial institution only if the subsidiary is (1) owned and controlled by a financial institution and (2) regulated by a federal financial institution regulatory agency. Section 1125(c)(2) provides that, with respect to other participants in the market for appraisals of one-to-four-unit single-family residential real estate, compliance with regulations issued under section 1125 shall be enforced by the Federal Trade Commission, the CFPB, and a state attorney general.

The NCUA has long acknowledged that subsidiaries of federally insured credit unions—also referred to as credit union service organizations (CUSOs)—and their employees are not subject to regulation by the NCUA as contemplated by Congress under statutory provisions similar to section 1125(c). Unlike the Federal banking agencies that do have supervisory and regulatory authority over subsidiaries of their regulated institutions, the NCUA does not have authority to supervise or examine subsidiaries owned and controlled by federally insured credit unions. Rather, the NCUA's regulations only indirectly affect CUSOs. For example, NCUA's regulations permit federally insured credit unions to invest only in CUSOs that conform to certain specified requirements.

The Proposal would not alter that position. If the Proposal is made final, given that in the context of federally insured credit unions the authority under section 1125(c)(1) applies to subsidiaries owned and controlled by a federally insured credit union and regulated by the NCUA, the NCUA would not take action to enforce the requirements of this rule under section 1125(c)(1) with respect to CUSOs. Rather, under section 1125(c)(2), the Federal Trade Commission, the CFPB, and state attorneys general would have enforcement authority over CUSOs—whether owned by a state or federally chartered credit union—in connection with a final AVM rule. Accordingly, the Proposal would provide that the NCUA's regulations apply to credit unions insured by the NCUA that are mortgage originators or secondary market issuers.

The NCUA is also proposing to amend its regulations to clearly include the proposed AVM regulations in the NCUA's list of regulatory provisions applicable to federally insured, state-chartered credit unions. Accordingly, the Proposal would provide that insured credit unions must adhere to these NCUA requirements.

Required Procedures and Prohibition on Discrimination

The Proposal would require adopting and maintain policies, practices, procedures, and control systems to ensure that AVMs used in relevant transactions adhere to quality control standards addressing the first four factors laid out in Section 1125 of FIRREA. This would allow mortgage originators and secondary market issuers flexibility to set quality control standards for covered AVMs "based on the size of their institution and the risk and complexity of transactions for which they will use covered AVMs."

These quality control factors are consistent with practices that many participants in the mortgage lending market already follow and with the Guidance described above.

The Agencies considered whether to propose more prescriptive requirements for the use of AVMs and decided not to do so. The Agencies concluded that the statute does not require the Agencies to set prescriptive standards for AVMs. Further, because section 1125 provides the Agencies with the authority to ''account for any other such factor'' that the Agencies ''determine to be appropriate," the Agencies also propose to include a fifth factor that would require mortgage originators and secondary market issuers to adopt policies, practices, procedures, and control systems to ensure that AVMs used in connection with making credit decisions or covered securitization determinations adhere to quality control standards designed to comply with applicable nondiscrimination laws.

The Proposal notes that existing nondiscrimination laws apply to appraisals, and AVMs and institutions have a preexisting obligation to comply with all federal laws, including federal nondiscrimination laws. For example, the Equal Credit Opportunity Act (ECOA) and its implementing Regulation B bar discrimination on a prohibited basis in any aspect of a credit transaction. The Agencies have long recognized that this prohibition extends to using different standards to evaluate collateral, which would include the design or use of an AVM in any aspect of a credit transaction in a way that would treat an applicant differently on a prohibited basis or result in unlawful discrimination against an applicant on a prohibited basis. Similarly, the Fair Housing Act prohibits unlawful discrimination in all aspects of transactions related to residential real estate transactions, including appraisals of residential real estate.

The Agencies note that, as with models more generally, there are increasing concerns about the potential for AVMs to produce property estimates that reflect discriminatory bias, such as by replicating systemic inaccuracies and historical patterns of discrimination. Models could discriminate because of the data used or other aspects of a model's development, design, implementation, or use. Attention to data is particularly important to ensure that AVMs do not rely on data that incorporate potential bias and create discrimination risks.

Because AVMs arguably involve less human discretion than appraisals, AVMs have the potential to reduce human biases. Yet without adequate attention to ensuring compliance with federal nondiscrimination laws, AVMs also have the potential to introduce discrimination risks. Moreover, if models such as AVMs are biased, the resulting harm could be widespread because of the high volume of valuations that even a single AVM can process.

While existing nondiscrimination law applies to an institution's use of AVMs, the Agencies propose to include a fifth quality control factor relating to nondiscrimination to heighten awareness among lenders of the applicability of nondiscrimination laws to AVMs. Specifying a fifth factor on nondiscrimination would create an independent requirement for institutions to establish policies, practices, procedures, and control systems to specifically address nondiscrimination, thereby further mitigating discrimination risk in use of AVMs. Specifying a nondiscrimination factor may also increase confidence in AVM estimates and support well-functioning AVMs. In addition, specifying a nondiscrimination factor could help protect against potential safety and soundness risks, such as operational, legal, and compliance risks, associated with failure to comply with nondiscrimination laws.

The Agencies propose that institutions would have the flexibility to design fair lending policies, procedures, practices, and control systems that are in compliance with fair lending laws and take into account their business models regarding the first four quality control factors listed above.

Proposed Implementation Period

The Agencies propose an effective date of the first day of a calendar quarter following the twelve months after publication in the Federal Register of any final rule based on the Proposal.

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