

“Third Party Oversight”

January 23, 2013

Peter T. Christensen
Attorney
and
General Counsel to
LIA Administrators & Insurance Services

www.liability.com

800-334-0652

peter@liability.com



LIA Administrators & Insurance Services



Third Party Oversight of AMCs

General Framework – Interagency Guidelines

XVI. Third Party Arrangements

An institution that engages a third party to perform certain collateral valuation functions on its behalf is responsible for understanding and managing the risks associated with the arrangement. An institution should use caution if it engages a third party to administer any part of its appraisal and evaluation function, including the ordering or reviewing of appraisals and evaluations, selecting an appraiser or person to perform evaluations, or providing access to analytical methods or technological tools.

An institution should have internal controls for identifying, monitoring, and managing the risks associated with using a third party arrangement for valuation services, including compliance, legal, reputational, and operational risks. While the arrangement may allow an institution to achieve specific business objectives, such as gaining access to expertise that is not available internally, the reduced operational control over outsourced activities poses additional risk. Consistent with safe and sound practices, an institution should have a written contract that clearly defines the expectations and obligations of both the financial institution and the third party, including that the third party will perform its services in compliance with the Agencies' appraisal regulations and consistent with supervisory guidance.

Third Party Oversight General Framework – OCC Bulletin Guidance



OCC 2001-47

OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Third-Party Relationships

Description: Risk Management Principles

A bank's use of third parties to achieve its strategic goals does not diminish the responsibility of the board of directors and management to ensure that the third-party activity is conducted in a safe and sound manner and in compliance with applicable laws. Many third-party relationships should be subject to the same risk management, security, privacy, and other consumer protection policies that would be expected if a national bank were conducting the activities directly.



LIA Administrators & Insurance Services



Third Party Oversight

General Framework – OCC Bulletin Guidance

Oversight of Third-Party Relationships

After entering into a contract or agreement with a third party, management should monitor the third party with respect to its activities and performance. Management should dedicate sufficient staff with the necessary expertise to oversee the third party. While the extent of a bank's oversight activities will vary depending on the nature of the activity, the oversight program should monitor the third party's financial condition, its controls, and the quality of its service and support. Performance monitoring may include, as appropriate, the following:

Monitor Financial Condition

- Evaluate the third party's financial condition at least annually, and more frequently when risk is high or moderate and increasing. This analysis should be as comprehensive as the ongoing credit analysis the bank would conduct of its borrowers. Audited financial statements should be required for significant relationships with third parties.
- If applicable, ensure that the third party's financial obligations to subcontractors are being met in a timely manner.
- Review the adequacy of the third party's insurance coverage.

Third Party Oversight – Financial Failure of AMCs and Non-Payment of Appraisers

Just in the Last 6 Weeks:

NREIS Website: “National Real Estate Information Services is winding down its operations and is consulting with its advisors regarding payment of outstanding vendor accounts. We appreciate your patience.”

Law Firm Letter to Appraisers Demanding Fees Owed by Evaluation Solutions: “Our firm has been retained to file a Chapter 7 bankruptcy proceeding for the company. Evaluation Solutions lost its major client earlier this week and was forced to shut down operations. . . . The company is not able to make payments on any outstanding invoices at this point.”

Financial Failure of AMCs

- Potential consequences to the lender from a failed AMC:
 - Thousands of panel appraisers demanding millions in unpaid fees.
 - Some appraisers will contact borrowers for payment.
 - Administrative complaints filed by unpaid appraisers to regulators.
 - Legal actions by appraisers to collect.
 - Potential for paying twice for an appraisal.
 - Loss of goodwill with appraisers at a time when appraisal fees appear to be increasing and it is challenging to retain good appraisers in some areas of the country.



Lender Liability for Unpaid Fees

A lender's outsourcing of appraisal management functions to an AMC generally (this will depend on state law) will not "outsource" the lender's liability for paying the appraiser for the appraisal.

Why? Because the AMC is the lender's legal agent – as made clear in, among other places, the Federal Interagency Appraisal and Evaluation Guidelines:

An institution or its agent must directly select and engage appraisers. The only exception to this requirement is that the Agencies' appraisal regulations allow an institution to use an appraisal prepared for another financial services institution provided certain conditions are met.

Appendix D Glossary of Terms

Agent – The Agencies' appraisal regulations do not specifically define the term "agent." However, the term is generally intended to refer to one who undertakes to transact business or to manage business affairs for another. According to the Agencies' appraisal regulations, fee

Lender Liability for Unpaid Fees

As a *general* legal matter, if the lender's agent doesn't pay the appraiser, then the lender remains liable to the appraiser.

This provision in Dodd-Frank should be an incentive for lender's to make sure the appraiser gets paid – a provision we hear a lot about in other contexts:

average services for such a transaction.

“(i) CUSTOMARY AND REASONABLE FEE.—

“(1) IN GENERAL.—Lenders and their agents shall compensate fee appraisers at a rate that is customary and reasonable for appraisal services performed in the market area of the property being appraised. Evidence for such fees may be



LIA Administrators & Insurance Services



Responses From Some Lenders to the Problem -- Vetting of AMC Financial Condition

More Careful Vetting of Financial Qualifications of AMC.

- Requesting audited or sworn financial statements of the AMC.
- Understanding the AMC's other sources of business – what share is the lender?
- In evaluating AMC creditworthiness for bonds, the biggest weaknesses we often see in AMCs are:
 - Inadequate cash reserves and capitalization.
 - Obvious telltales of slow payments to the AMC's vendors – A/P which eclipse A/R.
 - High payments and salaries to management even in the face of poor profitability.
 - Shock losses – indemnification obligations or lawsuits.



Responses From Some Lenders to the Problem -- New Service Contract Provisions

We are seeing some lenders implement new requirements in their contracts with AMCs:

- Requirements for periodic financial statements.
- Provisions implementing periodic reporting by AMC to lender of vendor payment status.
- Provisions requiring payment to appraiser or other vendor within certain number of days of lender's payment to AMC.
- Requirement that appraisal fees be segregated into a separate account and that appraisers then be paid from that account.
- More expansive indemnification sections.
- But the bottom line is the AMC must be financially stable.



One Approach to Third Party Oversight: Outsource the Oversight of the Outsourced Appraisal Services Firm

5.7 Vendor Management. In Lender's sole discretion, Lender may elect to use a third party vendor management company ("Management Company") to administer certain activities on Lender's behalf (*i.e.*, auditing, compliance with SLA, fee and invoice management, collectively "Vendor Management Services"). Vendor acknowledges that in order to supply Services to Lender it may be required to enter into an agreement with Lender's Management Company, and Vendor shall timely do so upon Lender's request. **SUCH VENDOR MANAGEMENT SERVICES AGREEMENT BETWEEN VENDOR AND MANAGEMENT COMPANY MAY INCLUDE A FEE TO BE PAID BY VENDOR TO THE MANAGEMENT COMPANY FOR THESE SERVICES.**



Did That Sound Unfair? How About This...

“In the event [AMC] incurs any fees, expenses and/or costs relating to time spent on legal and regulatory matters or proceedings arising from the services provided by or engagement with Contractor pursuant to this Agreement, including but not limited to, compliance pursuant to a subpoena, testimony, consultation involving private litigation, arbitration, government or industry regulation inquiries, whether made at Contractor’s request, the request of a third party or by subpoena or equivalent, Contractor shall immediately pay or otherwise reimburse [AMC] for such fees, expenses and costs, including but not limited to, internal costs, which shall range from \$200 to \$500 an hour, and legal fees and expenses that [AMC] may incur.”



LIA Administrators & Insurance Services



Responses From Some Lenders to the Problem -- Insuring or Bonding the AMC's Payments to Appraisers

- Bond requirements continue to be proposed as part of new AMC legislation, as well as “recovery funds” in a couple states.
- The AMC registration bonds only provide minimal safeguards.
- Because of recent failures, the underwriting for AMC bonds is getting stricter and in some cases, the bonds are becoming more expensive.
- We have been asked by two AMCs recently if we could “bond” the full amount of appraisal fees outstanding at any one given time.
- This was requested by a lender to safeguard itself from non-payment.



AMC Bond Claims

674.210 Surety bond. (1) An applicant for issuance or renewal of an appraisal management company registration shall file with the Appraiser Certification and Licensure Board a surety bond . . . in the amount of \$25,000.

(2) The surety bond or letter of credit required under subsection (1) of this section must:

(a) Be conditioned that the applicant pays:

(A) All amounts owing to persons who perform real estate appraisal activity for the appraisal management company; and

(B) All amounts adjudged against the appraisal management company by reason of negligent or improper real estate appraisal activity or appraisal management services or breach of contract in performing real estate appraisal activity or appraisal management services; and

(b) Require the surety company to provide written notice to the board by registered or certified mail:

(A) At least 30 days before the surety company cancels or revokes the bond; or

(B) When the surety company pays for a loss under the bond.



Surety Makes Payment to Appraiser

February 8, 2012

██████████
██████████ Appraisal Service
P.O. Box ██████████
██████████, ██████████ ██████████

RE: Surety: Hartford Fire Insurance Company
Principal: ██████████
Obligee: ██████████ Licensing and Certification Board
Claim No.: ██████████
Bond No: ██████████
Claimant: ██████████ Appraisal Service

Dear ██████████:

This letter acknowledges receipt of the executed Release and Assignment relative to the above-referenced claim. Pursuant to Hartford's prior correspondence, you will be receiving under separate cover Hartford's check in the amount of \$385.00 payable to ██████████ Appraisal Service.

All rights and defenses, which are or may become available to Hartford Fire Insurance Company or ██████████, are and shall remain fully and strictly reserved whether mentioned in subsequent communications or not.

Sincerely,
Hartford Fire Insurance Company

