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The CFPB Seeks Comments on its Proposed Rules on the Use of AVMs

INTRODUCTION

Automated valuation models (AVMs) are software tools used to estimate residential and commercial property values. These models determine the value of a particular property using data such as the property's features, sales history, and tax assessor value, along with data on similar properties. The use of AVMs for underwriting mortgages and loans has increased dramatically as databases have increased in size, accuracy, and availability and software capabilities have improved.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[1] added section 1125 to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) which requires quality control standards for AVMs. FIRREA section 1125 covers the collateral worth of a mortgage. The Act 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"[2] and directs several agencies, including the Consumer Financial Protection Bureau (CFPB), to create regulations requiring AVM quality control standards 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 (listed) agencies determine to be appropriate."[3]

The Consumer Financial Protection Bureau (CFPB) has recently published the proposals it is considering implementing as part of its regulatory responsibility. The agency includes, in each section, a series of questions directed at small entities that might be affected by the proposed rules. The agency is concerned with many issues relating to the rulemaking, from compliance costs and regulatory overlap to biased data and potential fair lending risk and seeks to "encourage

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[1] Public Law 111-203, 124 Stat. 1376 (2010).
[2] 12 U.S.C. 3354(d).
[3] 12 U.S.C. 3354(a) and (b).

institutions to implement robust compliance management systems that prevent, identify, and correct violations of nondiscrimination laws.[4]

Vega Economics offers expert support on AVM issues and has prepared this summary of the CFPB proposals and discussion. This summary addresses only some of the issues presented in the CFPB outline and we recommend reading of the outline in full to obtain a complete understanding of the agency's viewpoints and the information it currently is seeking. To the extent that we discuss a specific proposal point, Vega Economics has left the section numbers the same as those used in the CFPB proposals.

CFPB FRAMES ITS CONCERNS

The CFPB is one of several agencies working together to develop rulemaking for FIRREA section 1125. The agency is required, under the Regulatory Flexibility Act (RFA),[5] to obtain advice and recommendations from small entities[6] or their representatives to assess and minimize any negative effects rulemaking might have on members of this group.[7]

Obtaining a mortgage is one of the most significant financial commitments a consumer can make. An overvalued property can increase a consumer's debt load while an undervalued property can block an otherwise qualified consumer's access to credit.[8]

The use of AVMs can lower costs and reduce the time needed to obtain property valuations.[9] This can help consumers seeking to obtain mortgages. But unlike an appraisal, which involves the inspection of the actual property and direct comparison with comparable properties to estimate value, AVMs rely on databases and algorithms and can introduce risks such as accuracy and data integrity issues, as well as biases that can harm or even exclude groups of consumers.[10] In its proposals, the CFPB focused on these concerns.

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[4] "Small Business Advisory Review Panel for Automated Valuation Model (AVM) Rulemaking Outline of Proposals and Alternatives Under Consideration" at 2. *Consumer Financial Protection Bureau* (February 23, 2022). <https://files.consumerfinance.gov/f/documents/cfpb_avm_outline-of-proposals_2022-02.pdf> (accessed Mar. 16, 2022).

[5] *Id.* at 3 (citing Public Law 104-121, 110 Stat. 857 (1996) (5 U.S.C. 609) (amended by Dodd-Frank Act section 1100G)).

[6] The Small Business Administration defines what constitutes a small entity. See "Table of Small Business Standards Matched to North American Industry Classification System Codes." *U.S. Small Bus. Admin.*, <https://www.sba.gov/sites/default/files/2019-08/SBA%20Table%20of%20Size%20Standards_Effective%20Aug%2019%2C%202019_Rev.pdf> (accessed March 20, 2022).

[7] "Small Business Advisory Review Panel for Automated Valuation Model (AVM) Rulemaking Outline of Proposals and Alternatives Under Consideration" at 3. *Consumer Financial Protection Bureau* (February 23, 2022). <https://files.consumerfinance.gov/f/documents/cfpb_avm_outline-of-proposals_2022-02.pdf> (accessed Mar. 16, 2022).

[8] *Id.* at 3.

[9] *Id.* at 2.

[10] *Id.*

CFPB PROPOSAL ISSUES

In its outline, the CFPB presents specific questions in Section III relating to the issues its proposals raise and invites comment from small entities in the time leading up to proposed rules being presented. Comments can be sent to the CFPB at *2022-SBREFA-AVM@cfpb.gov*. The CFPB, with other agencies, will take these comments into account in the next step in the process—issuing a proposed rule. The presented questions are detailed and invite businesses to describe their own processes and potential impacts the proposals might have.

The CFPB proposals address the entire array of issues contemplated by FIRREA section 1125. On many issues, the agency looks to definitions used in other consumer financial laws, such as the Truth in Lending Act (TILA)[11] and Regulation Z.[12] The agency is concerned that other laws may "duplicate, overlap, or conflict"[13] with the options it is considering.

A. Defining AVMs used to "determine" the collateral worth

For purposes of FIRREA section 1125, an AVM is "any computerized model used by mortgage originators and secondary market issuers to determine the collateral worth of mortgage secured by a consumer's principal dwelling."[14] What does "determine" mean? The CFPB is looking for input on very basic but critical questions like this.[15]

[11] 15 U.S.C. 1601 *et seq.*
[12] 12 CFR 1026.1 *et seq.*
[13] "Small Business Advisory Review Panel for Automated Valuation Model (AVM) Rulemaking Outline of Proposals and Alternatives Under Consideration" at 5, Question 1. *Consumer Financial Protection Bureau* (February 23, 2022). <https://files.consumerfinance.gov/f/documents/cfpb_avm_outline-of-proposals_2022-02.pdf> (accessed Mar. 16, 2022).
[14] 12 U.S.C. 3354(d).
[15] *Id.* at 6.

The discussion on determining collateral worth extends to AVMs used for making underwriting decisions,[16] reviews of already completed determinations,[17] developing an appraisal by a certified or licensed appraiser,[18] post-origination,[19] and AVM use related to appraisal waiver loans.[20]

B. Defining "mortgage originators"

FIRREA section 1125 does not define "mortgage originators." The CFPB proposes a general definition of mortgage originator and discusses additional considerations relating to the term. The agency is considering relying heavily on definitions used in TILA[21] and Regulation Z[22] to ensure consistency and clarity for small entities participating in the mortgage lending market.[23]

C. Defining "secondary market issuers"

The CFPB is considering defining "secondary market issuers" to include entities that issue RMBS. Alternatively, the CFPB could broadly include issuers, guarantors, insurers, or RMBS underwriters. Ultimately, the definition will depend, at least in part, on whether the eventual rule will cover AVMs used in securitization. The agency believes a broad definition of "secondary market issuers" would provide greater consistency among participants as well as among various statutes and regulations currently in effect.[24]

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[16] *Id.* at 6-7. The CFPB is considering applying the rules to AVMs used for making underwriting decisions regarding collateral value rather than for *any* AVM valuation estimate. The reasoning is that their focus is on AVMs used for making decisions affecting consumer credit terms and conditions and underwriting decisions are more official valuations than estimates used for other activities such as marketing or portfolio monitoring.

[17] *Id.* at 7-8. The CFPB is considering excluding from its rules those AVMs used to review already-completed appraisals or other determinations of collateral value for transactions that do not require a licensed or certified appraiser. The agency distinguishes between a creditor relying on the already-completed determination "to determine the collateral worth" versus a quality control review.

[18] *Id.* at 8-9. The CFPB believes that federal and state quality control standards imposed on certified and licensed appraisers should suffice to ensure quality control. The agency is therefore considering exempting these appraisers from certain quality control standards.

[19] *Id.* at 9-13 (discussing loan modifications and other changes to existing loans, credit line reductions or suspensions, and securitization).

[20] *Id.* at 13-14 (considering defining "secondary market issuer" to include guarantors, insurers, RMBS underwriters (that might not be RMBS issuers) and others and making the secondary market issuer, rather than the mortgage originator, responsible for AVM quality control compliance).

[21] 15 U.S.C. 1601 *et seq.*

[22] 12 CFR 1026.1 *et seq.*

[23] "Small Business Advisory Review Panel for Automated Valuation Model (AVM) Rulemaking Outline of Proposals and Alternatives Under Consideration" at 14. *Consumer Financial Protection Bureau* (February 23, 2022). <https://files.consumerfinance.gov/f/documents/cfpb_avm_outline-of-proposals_2022-02.pdf> (accessed Mar. 16, 2022).

[24] *Id.* at 15-16.

D. Defining "mortgage"

Section 1125(d) limits coverage to AVMs used "to determine the collateral worth of a mortgage secured by a consumer's principal dwelling."[25] but does not define the term, "mortgage." The CFPB is considering two possible definitions of "mortgage." One possibility is to define the term as the extension of credit secured by a dwelling. The other proposal is to define it as "a transaction in which a mortgage, deed of trust, purchase money security interest arising under an installment sales contract, or equivalent consensual security interest is created or retained in a dwelling."[26] This definition would include various security interests that might not otherwise be covered and, if implemented this way, could impact the definition of other terms, like "mortgage originator."

E. Defining "consumer's principal dwelling"

FIRREA section 1125 does not define "consumer's principal dwelling" and the CFPB is looking to existing regulatory definitions to minimize the potential impact on small entities while achieving section 1125 objectives. The CFPB provisions on valuation independence can be found in Regulation Z § 1026.42. The regulation applies to certain credit transactions secured by a "consumer's principal dwelling," but the phrase is not defined in that regulation either.

1. Coverage of "consumers"

The CFPB is considering defining a 'consumer' as a natural person to whom credit is offered or extended.[27] The scope of FIRREA section 1125 is broader than TILA and Regulation Z and the agency believes that if it uses a TILA-based definition of "consumer's principal dwelling," it would have to make it clear that the definition would include mortgages secured by a consumer's principal dwelling, even if the proceeds are used for another purpose.[28]

2. Coverage of "dwelling"

FIRREA section 1125(c)(2) grants several agencies,[29] including the CFPB, enforcement authority over "participants in the market for appraisals of 1- to 4-unit single-family residential real estate."[30] The CFPB seeks a broad concept of the term, consistent with TILA's definition of "dwelling," as implemented in Regulation Z.[31] The agency is considering defining "consumer's principal dwelling" to include one to four units, inclusive of condominiums, cooperative units, manufactured homes,

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[25] 12 U.S.C. 3354(d).
[26] "Small Business Advisory Review Panel for Automated Valuation Model (AVM) Rulemaking Outline of Proposals and Alternatives Under Consideration" at 17. *Consumer Financial Protection Bureau* (February 23, 2022). <https://files.consumerfinance.gov/f/documents/cfpb_avm_outline-of-proposals_2022-02.pdf> (accessed Mar. 16, 2022).
[27] *Id.*
[28] *Id.* at 18.
[29] *Id.* at 37, n.1 (listing the other agencies).
[30] 12 U.S.C. 3354(c)(2).
[31] Regulation Z § 1026.2(a)(19).

and "any other structure used as a residence, regardless of whether the structure is classified as personalty under State law."[32]

As an alternative, the CFPB could limit "dwelling" to those transactions using real property to secure the dwelling. This would be consistent with other CFPB mortgage-related authorizations.[33]

3. Limiting coverage to "principal" dwelling

i. "Principal" dwelling

The CFPB is considering defining "consumer's principal dwelling" to include one principal dwelling at a time. Vacation homes, second homes, and secondary residences would not be included in the definition.[34]

ii. Treatment of new construction

The CFPB is considering including, under "consumer's principal dwelling," certain new construction. Specifically, the agency is considering including a transaction secured by a new dwelling as one secured by a principal dwelling, even before occupancy, where that home is under construction or will be constructed and will become the consumer's principal dwelling within a year of completion.[35]

F. Scope of eventual rule requirements

1. Quality control standards generally

Given the goals of FIRREA section 1125(a), the CFPB is considering two possible alternatives for compliance. The first option is to require regulated institutions to create their own systems that ensure AVM quality control requirements are met. Alternatively, the agency is considering issuing specific requirements for meeting the section's goals.[36]

The CFPB reviewed the first four (section 1125) statutory quality control factors in the context of other agencies' guidance on AVMs and believes that flexibility may be appropriate in this regard. Different institutions have different risk profiles and business models so their policies, practices, procedures, and control systems might not suit a 'one size fits all' rule. The agency also notes that the rate at which technology is advancing could render a prescriptive rule obsolete in a short amount of time. A prescriptive rule could also present a significant burden to small entities that could cause them to reduce their use of AVMs. Further, several agencies already have AVM guidelines in place.[37]

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[32] "Small Business Advisory Review Panel for Automated Valuation Model (AVM) Rulemaking Outline of Proposals and Alternatives Under Consideration" at 18. *Consumer Financial Protection Bureau* (February 23, 2022). <https://files.consumerfinance.gov/f/documents/cfpb_avm_outline-of-proposals_2022-02.pdf> (accessed Mar. 16, 2022).
[33] *Id.* at 19.
[34] *Id.*
[35] *Id.* at 19-20.
[36] *Id.* at 20.
[37] *Id.* at 20-21.

Accordingly, the agency appears to be leaning toward a principles-based rule requiring institutions "to develop and maintain their own policies, practices, procedures, and control systems designed to satisfy the statutory factors" rather than issue a hard prescriptive rule.[38] It has not ruled out the possibility of a prescriptive rule, however, with limitations and possible further parameters.[39]

The agency addresses the quality control factors individually. For the first factor—ensuring a high level of confidence in AVM estimates—the agency is considering specific requirements regarding the risk of errors or inaccurate outputs as well as the potential inappropriate or incorrect usage of the results.[40] The agency is considering addressing the second factor—protecting against data manipulation with AVMs—with specific requirements of management oversight.[41]

For the third factor—avoiding conflicts of interest—the agency is considering specific requirements that the persons who "develop, select, validate, or monitor an AVM are all independent of the loan origination or securitization process."[42] For the fourth factor—random sample testing and reviews of AVMs—the CFPB is leaning toward issuing specific requirements that institutions employ random sample testing and reviews to validate the AVM on an ongoing basis, including rules for whether particular AVMs are appropriate for certain transactions or lending activities.[43]

2. Specifying a nondiscrimination quality control factor

The fifth factor of section 1125 covers agency discretion regarding "any other such factor that the agencies determine to be appropriate."[44] The CFPB is considering including under this section a requirement that quality control criteria be nondiscriminatory. The Equal Credit Opportunity Act (ECOA)[45] and Fair Housing Act (FHAct)[46] are subject to federal nondiscrimination laws regarding AVMs. The ECOA's Regulation B prohibits discrimination in credit transaction practices, including the design and use of AVMs, and the CFPB recognizes specific methods for proving such discrimination in this context.

The agency understands the benefits AVMs offer, but certain design and function biases can introduce risk in fair lending and overvalue or undervalue properties in certain neighborhoods. The agency is considering requiring institutions to ensure that AVMs used for covered transactions meet applicable nondiscrimination laws but giving these institutions the flexibility to create systems that fit their own business models, risk exposures, size, business activities, and AVM usage.[47]

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[38] *Id.* at 21.
[39] *Id.*
[40] *Id.* at 22.
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] 12 U.S.C. 3354(a)(5).
[45] 15 U.S.C. 1691 *et seq.*
[46] 42 U.S.C. 3601 *et seq.*
[47] "Small Business Advisory Review Panel for Automated Valuation Model (AVM) Rulemaking Outline of Proposals and Alternatives Under Consideration" at 24-25. *Consumer Financial Protection Bureau* (February

Another option the agency is considering is to issue a rule with specific requirements regarding fair lending. Possibilities include specifying AVM development methods, such as data sources and modeling choices, as well as AVM use cases. But the agency recognizes the possibility that the requirements in some of the other statutory quality control factors already would cover compliance with applicable nondiscrimination laws because accuracy in AVM results can lead to fair results.[48]

G. Implementation period

The CFPB is considering an implementation period of twelve months after the final rule is issued. But the agency seeks input regarding how long small entities believe they would need to conform their systems and practices to the new rules.

POTENTIAL IMPACTS ON SMALL ENTITIES

A. Overview

In addition to its proposals, the CFPB presents, in Section IV of its outline, a review of the small entities covered by the proposals and the potential impacts on these entities. Among the considerations covered are compliance processes and costs.

The CFPB acknowledges that it does not have good data on how widely AVM is used among small mortgage originators or small secondary market issuers. Similarly, it lacks sufficient information to estimate the cost small entities would face in complying with the proposed rules. The agency believes the costs would mostly occur one time but periodic updates could impose new costs on these entities.[49] The questions in this section seek to clarify these factors.

B. Small entities covered by the options under consideration

The CFPB presents a list of the types of small entities that could be subject to the eventual AVM rules.[50] The vast majority of these would qualify as 'small' industries.[51] But some small entities do not use AVMs and the CFPB does not have data that could provide an estimate of how many institutions its potential rules might affect. The agency is using this process to learn more about small non-depositories' use of AVMs.[52]

C. CFPB review of compliance processes and costs

The CFPB lacks sufficient data to estimate compliance costs and will likely have to infer typical costs from other sources.[53] Recognizing the potential for inaccuracies, the agency presents the

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23, 2022). <https://files.consumerfinance.gov/f/documents/cfpb_avm_outline-of-proposals_2022-02.pdf> (accessed Mar. 16, 2022).

[48] *Id.* at 25.

[49] *Id.* at 27.

[50] *Id.* at 28-29.

[51] *Id.* at 29.

[52] *Id.* at 30.

[53] *Id.* at 31.

costs entities are likely to incur to achieve compliance with the rules and describes the procedures it intends to use to estimate these compliance costs.[54]

The agency's cost estimates will depend on the assumptions used. From legal fees to training and compliance verification, the assumptions are critical to this estimation. Accordingly, the CFPB is seeking input from small entity representatives that can help it estimate these costs accurately. The agency seeks additional information as well.[55]

VEGA ECONOMICS CAN HELP

Vega is well positioned to assist with the preparation of comments and other input as this process moves forward. We are also available to help with achieving compliance once the final rules are issued. Further, our experts can help with matters centered on the use of AVM results in financial decisions.

Vega experts have worked with the detailed issues arising from the use of AVMs which is particularly useful for identifying the global issues that the widespread use of these models can present. Our experts are well versed in analyzing AVM results and determining whether expert conclusions based on those results are accurate.

Vega's experience with analyzing AVM results allows us to evaluate the limitations of these models and the impacts such limitations can cause. This is important whether for litigation or for rulemaking. Government agencies must have a full understanding of the real problems the use of AVMs can present, so they can tailor rulemaking to ensure fairness and accuracy while limiting compliance costs.

For additional inquiries, please contact info@vegaeconomics.com.

[54] *Id.* at 31-32.
[55] *Id.* at 32-33.