

June 17, 2008

Mr. Wayne Pugh  
President  
Appraisal Institute  
550 W. Van Buren Street, Suite 1000  
Chicago, IL 60607

Dear Mr. Pugh:

The Puerto Rico and Caribbean Chapter of the Appraisal Institute is in receipt of a letter from HUD to Mr. José Gómez, President of the Puerto Rico Mortgage Bankers Association (PRMBA), dated April 25, 2008 (EXHIBIT A). Copies of this letter were distributed to attendees (lenders, appraisers and others) of a HUD training program held in Puerto Rico during the week of May 5-9, 2008.

We would like to make you aware of the following consequences that HUD's communication is having in the Puerto Rico market.

- **Promoting situations of appraiser pressure, in direct conflict with existing appraisal independence guidelines and proposed appraiser independence legislation pending in Congress.**
- **Promoting inflated appraisals.**
- **Increasing the potential of default risk in residential loans.**

#### Why promoting appraiser pressure?

To provide you an idea of the interpretation given to this letter, we are including a translation of the first portion of the press article (EXHIBIT B) that accompanied the letter's release:

*Like a grant, and not like a sales incentive, the U.S. Department of Housing and Urban Development (HUD) recently defined the Program of Tax Credits (Law 197) approved several months ago in Puerto Rico to spur the sale of new and existing housing on the Island. The communication, signed by Charles Gardner, Director of HUD's Atlanta Homeownership Center, reiterates that the tax credits will be considered as a grant and not as a sales incentive as affirmed at one time by the appraisers' guild. Said definition contrasts with the opinion stated several days ago by Carlos Xavier Velez, SRA from RE Advisors, who in the appraisers' name indicated that the tax credit negatively affected their execution and that the same required adjustments in the appraisals. About this matter, José Gómez, president of the Mortgage Bankers Association (MBA), indicated that said clarification from HUD was the result to a joint effort carried out by the MBA and its peer from the Puerto Rico Bankers Association, Arturo Carrión, who during a visit to Washington, D.C. "took quick action by clarifying to the Federal Authorities the true meaning of Law 197". Gómez said that "this declaration from HUD dissipates any doubt by clarifying that the same is a grant directed not only to benefit the industry, but more so the consumer". "The proper intervention by Carrión, as well as by Gilberto Monzón, Past President of the MBA, was crucial in giving this definition the importance it merited" expressed Gómez.*

As will be demonstrated in the following pages, there is ample market evidence that proves that Law 197 is having an impact in the market, and that adjustments for this condition are required in many comparable sales in which the tax credit was ultimately a part of the transaction.

Yet some appraisers have related situations in which after referencing the HUD letter, a client has asked them not to adjust sales with Law 197 tax credits even if they believe market evidence demonstrates that such an adjustment is required. Reportedly, these clients have in some instances ordered a new appraisal if the original appraiser did not agree to eliminate the adjustments. Other appraisers have related how after the letter was published, they received calls from clients instructing them not to adjust sales with the tax credit "as per HUD's memo".

#### Why promoting inflated appraisals?

Ignoring or failing to consider market-based adjustments for the impact of tax credits in transactions that closed with these credits results in inflated appraisals. In those situations where HUD's letter is used or asked to be used as justification for not considering or eliminating such an adjustment, the letter is promoting inflated appraisals.

#### Why increasing the potential of default risk in residential loans?

Future refinancing would be impossible for many owners seeking to raise cash or jettison toxic loans. Foreclosure levels could increase because fewer borrowers would be able to sell or refinance for prices that would cover current loans, especially if they were based on inflated appraisals.

It is interesting to note that HUD has an inconsistent position regarding Law 197 and the practice in the United States where a third party, typically a charity, provides down payment assistance to buyers. FHA has recently reopened a public-comment period in their second effort to ban such a practice, where the third party provides the down payment for the buyer and is then reimbursed by the home seller. FHA commissioner Brian Montgomery has said that these loans go into foreclosure at three times the rate of loans in which borrowers pay for their down payment. The tax credits under Law 197 are in many instances used to cover the down payment, and we can expect the same impact in foreclosure rates. It should not matter if the down payment assistance to the buyer is reimbursed to the seller or not, the fact is that the home buyer does not contribute towards the down payment and this increases the risk of foreclosure.

#### **What can be done?**

The Appraisal Institute believes that in order to protect the public, the soundness of lending institutions, and ultimately the Government since many of these appraisals are for FHA insured mortgages, HUD should:

1. Acknowledge that the market's reaction to Law 197 cannot be determined by a rule; the market will simply act independently and it is the appraiser's job to analyze and report on the market's reaction.

2. Issue a public statement to end the controversy created by the April 25, 2008 letter, clarifying that it is the appraiser's responsibility to independently analyze the market, and adjust for all appropriate issues that impact the price in a particular transaction, including Law 197 if necessary.

### **Where is the evidence?**

The Appraisal Institute's position on this matter is that the impact of the tax credits in the market is something that must be analyzed case by case, and that the impact of this condition in the marketplace has to be measured and adjusted after an appropriate analysis of the market. This position, and the procedural guidelines that accompanied it, were developed and later ratified after an analysis of the following documentation:

- 1- Email communication from HUD's senior underwriting Iván Tirado, referred the PRCAL to Mortgagee Letter 2005-02, dealing with "Seller Concessions and Verification of Sales", as the one that would apply to Law 197 (EXHIBIT C).
- 2- Email communication from Fannie Mae (EXHIBIT D), indicated that the tax credit is something noteworthy that should be discussed when analyzing and commenting on the contract of the property, if the sale is expected to include the credit. Fannie Mae also referenced their guidelines dealing with market value and sales or financing concessions when addressing the use of sales having the tax credit.
- 3- Email communication from the US Department of Veterans Affairs (EXHIBIT E), indicating that they the view the tax credit as a concession, and that all comparable sales that benefit from the credit must be adjusted accordingly.
- 4- Email communication from Barrett A. Slade, PhD, Associate Professor of Finance from Brigham Young University (EXHIBIT F).
- 5- Email communication from David C. John, Senior Research Fellow at The Heritage Foundation (EXHIBIT G).
- 6- Inquiries with Appraisal Institute staff and members.
- 7- Articles about a tax credit program proposed for the U.S., which includes a credit for vacant houses, in addition to the ones being proposed for owners in default, and for foreclosed properties. (EXHIBITS H, I, J and K).

Law 197 is already six (6) months old, and practicing appraisers, real estate brokers and others have begun collecting market evidence showing that law has impacted the market in several areas and in several ways.

In an article appearing in the weekly business periodical Caribbean Business on April 10, 2008, Gisela Castro, President of TIRI Real Estate, the largest residential real estate company in Puerto Rico, stated that "Another way the tax incentives are affecting the market is by making newly built homes more attractive pricewise than existing homes, therefore halting sales of the latter". She also stated that "If you have existing homes close to a new project, homebuyers will naturally gravitate toward the new homes to take advantage of the \$25,000 tax incentive, so existing homes are being left behind". Ms. Castro's statement that the law has negatively affected the existing home market, in spite of the law including a limited amount of units (first 1,500 originally, 2,000 additional ones added with the law's recent extension), is a similar situation observed by appraisers in some markets.

The following are actual examples where the law has had a negative impact in the prices of existing homes for which the tax credits were not available.

Item	Property 1	Property 2	Property 3
Address	Confidential	1560 Modena	1578 Sorento
Project	Fuentebella	Fuentebella	Fuentebella
Municipality	Toa Baja	Toa Baja	Toa Baja
Seller	Private Individual	Private Individual	Developer
Room Count	8/4/2.5	8/4/2.6	8/4/2.5
GLA (Sq. Feet)	1,822	1,822	1,877
Lot Size (Sq. Meters)	405	405	405
Date of Sale	Under Contract	2/1/2008	2/25/2008
Government Tax Credits	No	No	Yes
Amount of Credit	\$0	\$0	\$25,000
Price	\$239,500	\$237,000	\$264,900
Developer Concessions	\$0	\$0	(\$10,000)
Price net of Concessions	\$239,500	\$237,000	\$254,900
Difference attributable to Tax Credit	\$15,400	\$17,900	N/A

  

Item	Property 1	Property 2
Address	Confidential	Unit 2902
Project	Alturas del Bosque Condominium	Alturas del Bosque Condominium
Municipality	San Juan	San Juan
Seller	Private Individual	Developer
Room Count	6/3/2	6/3/2
GLA (Sq. Feet)	1,597	1,597
Date of Sale	Under Contract	2/20/2008
Government Tax Credits	No	Yes
Amount of Credit	\$0	\$25,000
Price	\$228,000	\$253,000
Developer Concessions	\$0	(\$5,000)
Price net of Concessions	\$228,000	\$248,000
Difference attributable to Tax Credit	\$20,000	N/A

The first example illustrates the list price of the property sold by the developer with the tax credits is approximately \$25,000 to \$28,000 higher than for the properties sold by private individuals without the tax credit. Of this amount, \$10,000 is a function of the developer's seller concessions, and the remaining \$15,000 to \$18,000 is attributable to the tax credits. The seller in Transaction 1 also reported that he marketed the property for several months at \$260,000 but ultimately had to decrease the price to be able to compete with houses being sold with the developers, which had the tax credit available. In the second example, the \$25,000 tax credit had an impact of \$20,000 after accounting for developer concessions.

The previous examples are only a few of the many situations in which the law has impacted market behavior. The way the program is structured might make it a grant from a law perspective, but the appraiser's function is to determine how the market reacts to it. The examples provided demonstrate that many instances the market views the credit as an inducement to sale or a concession. This is not surprising, since even some ads published by developers admit that the actual price of the unit is the list price minus the amount of the credit (EXHIBITS L, M, and N).

In closing, there is ample theoretical and market evidence from academia, policy foundations, real estate brokers and practicing appraisers, showing that temporary housing tax credits have an impact in prices. Unless HUD clarifies its position, there is a very serious risk that its April 25, 2008 communication will continue to promote inflated residential appraisals, with all the dire consequences that these could carry.

The fact that a similar temporary tax credit program is being proposed by Congress underscores the need for HUD's timely clarification of its position, as its actions in Puerto Rico will set a precedent nationwide.

Based on the importance of this situation, and the risks to the public, lending institutions and the government, we kindly request that the Appraisal Institute, and possibly other appraisal organizations as well, intercede with HUD and communicate to them the importance of accurate appraisals and an independent appraisal process.

Cordially,

A handwritten signature in blue ink that reads "Carlos Xavier Vélez". The signature is written in a cursive style.

Carlos Xavier Vélez, SRA  
President  
Puerto Rico & Caribbean Chapter of the Appraisal Institute

cc:

Mr. William Garber  
Director, External Affairs  
Appraisal Institute

U. S. Department of Housing and Urban Development  
Atlanta Homeownership Center  
40 Marietta Street  
Atlanta, Georgia 30303-2806  
(800) CALLEHA or (800) 225-5342



APR 25 2008

Mr. Jose Gomez  
President  
Mortgage Bankers Association of PR  
P.O. Box 192097  
San Juan, PR 00919-2097

SUBJECT: Tax Incentive Program – Law 197

Dear Mr. Gomez:

This is in response to an inquiry sent by the Appraisal Institute of Puerto Rico regarding the Tax Incentive Program, Law 197. Specifically the Department of Housing & Urban Development was asked to make a determination if Law 197 is in compliance with FHA guidelines.

HUD staff from Headquarters and the Atlanta Homeownership Center participated in a conference call with Mr. Gilberto Monzon Segura of the Puerto Rico MBA to discuss how this program works. As a result of the information disseminated, it was determined that Law 197 is considered a grant; therefore, it is not considered as a sales incentive. It is eligible to be used on loans processed with FHA insured financing. This determination was made in collaboration with the Office of General Counsel.

I trust this will clarify HUD's position on this Tax Incentive Program. If you have any additional questions or I can be of assistance, please contact Debra F. Robinson, Director, Processing and Underwriting Division at 678-732-2674.

Sincerely,

Charles E. Gardner  
Director  
Atlanta Homeownership Center