Fannie Mae

Lender Letter (LL-2021-01)

Jan. 06, 2021

To: All Fannie Mae Single-Family Sellers
Appraisal Risk Management Policy Reminders and Resources

In recent months, low interest rates and other market factors have triggered record numbers of loan originations. Housing demand is high, supply is limited, and home prices have been accelerating – in some markets, dramatically. While market conditions come and go, the current environment highlights the importance of vigilance in managing appraisal risk.
This Lender Letter covers the following information:

- Lenders' responsibilities for appraisal review: reviews lenders' responsibilities for appraisal review
- Top appraisal findings and defects: provides examples of appraisal defects and shows how Collateral Underwriter® (CU®) messages can help to identify them
- Lenders' responsibilities for compliance with Appraiser Independence Requirements: provides clarity for lenders' on how to comply with AIR
- Appraisal underwriting best practices: suggests best practices for lenders' appraisal underwriting processes
- QC best practices: suggests best practices for lenders' QC processes related to appraisals
- Resources: points out resources to help lenders manage appraisal risk efficiently and effectively

Lenders' responsibilities for appraisal review

The appraisal review process is an essential part of originating a loan for sale to Fannie Mae. As stated in the *Selling Guide:*

> "The lender is responsible for ensuring that the subject property provides adequate collateral for the mortgage." (Appraisal Requirements B4-1.1-02, Lender Responsibilities)

Unless an appraisal waiver is offered and accepted, confirming the adequacy of the collateral means the lender must obtain and review an appraisal to confirm that it accurately reflects the market value, condition, and marketability of the property. The *Selling Guide* further states:

> "A lender must continually evaluate the quality of the appraiser's work through the normal review process of *all* appraisal reports." (Appraisal Requirements B4-1.3-12, Quality Assurance, emphasis added)

Collateral Underwriter provides feedback on appraisals submitted to us, assigning a risk score from 1 to 5, with 1 indicating lower risk and 5 indicating higher risk. Lenders can use the CU feedback – risk score, flags, and messages – to segment appraisals by risk profile for effective workflow management and resource allocation. Furthermore, an appraisal with a CU risk score of 2.5 or lower on the final submission is eligible for representation and warranty relief on property value.

While dealing with high origination volumes, lenders may lose sight of their obligation to review every appraisal, not just those with a high CU risk score. The representation and warranty relief on property value that comes with a low CU risk score should never be a reason to skip the appraisal review.

As a reminder, with a CU risk score of 2.5 or lower, the lender is **not responsible** for the following requirements in *Selling Guide* B4-1, Appraisal Requirements:

- underwriting the appraisal report to determine whether the subject property presents adequate collateral for the mortgage;
- ensuring the appraisal accurately reflects the market value of the property;
- ensuring the appraiser used sound reasoning and provided evidence to support the methodology chosen to develop the opinion of value; and
- analyzing the comparable sales used in the appraisal report, including the description, selection, adjustments, and reconciliation of the comparables.

Importantly, the lender **remains responsible** for:

- the description of the subject property,
- ensuring the subject property meets property eligibility requirements, and
- the accuracy and completeness of all data on the appraisal that pertains to the property and project (if applicable), other than the appraised value. This includes the subject property's condition and quality ratings (*Selling Guide* B4-1.3-06, Property Condition and Quality of Construction of the Improvements).

CU can help drive review process efficiency for lower-risk appraisals by providing tools and information that empower the user to quickly validate those aspects of the appraisal for which they are responsible.

Every lender must have a process in place to ensure the appraisal content is reviewed for accuracy and not just for value. Common examples of inaccurate data include the dwelling size, dwelling condition, unobserved encroachments, and undisclosed external influences. Inaccurate data leads to misinformed analysis that can cause the lender to make faulty underwriting decisions impacting the sustainability and the eligibility of the loan. One objective of the lender QC process should be detection of inaccurate appraisal data, empowering lenders to improve analysis and loan decisioning, and mitigating defects that may result in repurchase requests.

Top appraisal findings and defects

Our random and targeted post-purchase review process identifies significant defects, which can result in a repurchase request, and findings, which may suggest patterns that should be addressed to avoid more serious issues.

The five most common appraisal significant defects with a CU risk score of 2.6 or higher are:

- Inappropriate Comparable Sale(s) Selection Due to Location
- Inappropriate Comparable Sale Adjustment(s)
- Use of Physically Dissimilar Comparable Sale(s) – Gross Living Area
- Use of Dissimilar Comparable Sale(s) – Site Characteristics
- Failure to Adjust Comparables

Here are some examples of significant defects on appraisals and sample CU messages that might be red flags to these types of defects.

Appraisal defect type	Example	Sample CU message
Comparable selection (location)	Comp 2 considered inappropriate as it was 10 miles away from the subject and in a different city, without explanation. Similar, more appropriate comps were available.	"The appraiser-provided comparables are materially different than the model-selected comparables."
Inadequate comparable adjustments	The appraiser made a $10K adjustment for a basement to comp 1; but the adjustment was incorrectly applied – it should have been negative, not positive.	"The appraiser's net adjustments for the comparable sales are materially different from the model net adjustments."
Comparable selection (dissimilar Condition/ Quality of Construction)	The appraiser inaccurately represented the condition and/or quality of construction as C2 when evidence indicated it was a C3.	"The condition rating for Comparable #4 is significantly different than what has been reported by other appraisers."

Five common appraisal findings with CU risk scores of 2.5 or lower that lenders remain responsible for (not covered by value rep and warrant relief) are:

- Subject Physical Features Reported Inaccurately – Condition / Quality of Construction
- Subject View or Location Reported Inaccurately
- Failure to Report or Analyze the Subject Sales History
- Wrong Form for the Property or Transaction Type
- Subject Physical Features Reported Inaccurately – gross living area

Inaccurate reporting of subject property characteristics including the condition or quality of the subject can invalidate the lender's relief from representations and warranties on property value.

A sound appraisal review process will contribute to delivery of quality appraisals. Having a robust and holistic appraisal review program in place, in both originations and prefunding or post-closing QC, can better position your company to effectively manage appraisal quality risk regardless of market conditions.

For tips on minimizing your appraisal risk, review the best practices for underwriting appraisals and QC and other resources below.

Lenders' responsibilities for compliance with Appraiser Independence Requirements

The purpose of Appraiser Independence Requirements (AIR) is to ensure that lenders do not interfere in the professional judgement of the appraiser. Appraisers are *not* responsible for AIR compliance – in fact, *lenders are the responsible party* for AIR compliance. AIR should protect the appraiser from pressure from the lender.

Lenders must have the appropriate guardrails in place to foster appraiser independence and prohibit influence in the development, reporting, result, or review of an appraisal, not just the ordering of an appraisal. Lender policies and procedures must ensure that people who are directly compensated or motivated by the outcome of the appraisal are not involved in the fulfillment process. As a reminder, we may cite lenders for being out of compliance with AIR in our periodic Mortgage Origination

Risk Assessment (MORA) reviews, requiring the lender to remediate their processes. During 2020, 25% of the lenders reviewed were cited for non-compliance.

Some lenders misinterpret AIR regarding appraisal fulfillment, particularly around the selection of an appraiser or appraisal management company. We are clarifying the requirements for requesting and ordering appraisals.
AIR states “Certain parties are prohibited from: (a) Selecting, retaining, recommending, or influencing the selection of any appraiser for a particular appraisal assignment or for inclusion on a list or panel of appraisers approved or forbidden to perform appraisals for the Seller; and (b) Having any substantive communications with an appraiser or appraisal management company relating to or having an impact on valuation, including ordering or managing an appraisal assignment.” It goes further to clarify that “These parties are: (i) All members of the Seller’s Mortgage production staff; (ii) Any person who is compensated on a commission basis upon the successful completion of a Mortgage; and (iii) Any person whose immediate supervisor is not independent of the Mortgage production staff and process.”

Retail or correspondent mortgage production staff or wholesale mortgage brokers are allowed under AIR to r*equest an appraisal* from a lender-designated appraiser or appraisal management company provided they have no opportunity to choose from a list of multiple appraisers or appraisal management companies. This is permitted because they are not responsible for selecting, retaining, or providing for payment of compensation to the appraiser.

Allowing the retail or correspondent mortgage production staff or wholesale mortgage brokers to select an individual appraiser from a list of appraisers, or an appraisal management company from a list of appraisal management companies, constitutes participation in the appraiser engagement process and is not allowed under AIR. The appraisal process must be developed, controlled, and monitored (process and quality) by independent lines of business in the lender’s organization – such as, risk, vendor management, or an appraisal department. Those lines of business cannot directly report to or be influenced by the lines of production. Independence is key to preserving process integrity.

Appraiser independence has many components, not just fulfillment. Influencing the appraiser to misidentify, remove, or modify anything in their report to conceal facts dealing with eligibility is also out of compliance with AIR (for example, misidentifying a condotel or changing a condition rating). Lenders must ensure that appropriate firewalls are in place for the appraiser to report what they know and find, without feeling any overt or subtle pressure in the process. Lenders make better decisions when they are accurately informed and must not abuse the appraisal process to obscure uncomfortable facts.

Appraisal underwriting best practices

CU is our proprietary model-driven tool that provides an automated appraisal risk assessment to support proactive management of appraisal quality. With more than 50 million appraisals in its database, CU is powered by the most advanced analytics in the industry. Since 2015, we have given our approved lenders free access to CU. Understanding how to use CU helps lenders most effectively and efficiently identify potential issues with appraisals.

Using the CU web application to support the appraisal review process is highly recommended. Although CU provides message feedback in the Uniform Collateral Data Portal® after appraisals are uploaded, accessing CU directly provides even more information to assist in appraisal reviews. For example, it allows users to look at a property’s value in the context of its market. Additionally, although not required, these highly recommended underwriting practices will help lenders manage appraisal quality risk:

- Evaluate your appraisal underwriting process to be sure you are aligning your review resources with risks.
- Remember that we require lender review of all appraisals, even those that qualify for representation and warranty relief on value based on a CU risk score of 2.5 or less.
- Consider a bifurcated review process that assigns review of appraisals with indicators of poor quality (based on CU scores and messages) to more experienced staff appraisers or well-trained senior underwriters.
- Gain operational efficiency by focusing the underwriting of appraisals with representation and warranty relief on those aspects that lenders remain responsible for.

- Require a more in-depth review, additional sign-off, or management review of appraisals with higher CU risk scores or certain CU flags (such as CU risk scores of 4 or 5 or an Overvaluation flag).
- Think about how you remediate indicators of poor appraisal quality in your process, or how you quantify your increased risk and potentially reserve for heightened losses if poor quality is not addressed.

While CU can be a tremendous asset to lenders in reviewing appraisals, users should understand the limitations of automated analysis. Fannie Mae expects lenders to use the CU feedback in combination with human due diligence, and consideration of other validation data sources may also be prudent in some cases.

QC best practices

Although not required, these highly recommended QC practices help lenders manage appraisal quality risk:

- Review your Fannie Mae appraisal quality findings and defects. Calibrate them to your own review process and understand what creates disparate results.
- Develop an appraisal quality scorecard based on appraisal quality feedback from us (defects, findings) and your own findings to help identify specific trends or gaps and develop training opportunities or process improvements.
- Use our appraisal quality feedback to target loans with potential appraisal quality concerns, such as those with high CU risk scores (2.6–5). Feedback sources include Submission Summary Reports on appraisal uploads to the Uniform Collateral Data Portal; reports in Fannie Mae Connect™; and the workflow function in CU. You can target your reviews through:
  - prefunding QC selections,
  - the required 10% field review selection as part of the random post-closing sample, and
  - targeted discretionary selections.
- Target loans with higher LTV ratios in prefunding selections because potential defects could cause a negative impact to the property value and are more likely to result in an ineligible loan.
- For the 90% of loans in the random post-closing sample requiring a Desk Review, use a checklist to ensure a consistent and comprehensive review (example).

Resources

Appraiser Independence Requirements
Collateral Underwriter
Seller/Servicer Risk Self-Assessment: Appraisal Management and Appraiser Independence
Boot Camp Webcast: Managing Appraisal Risk (recording)

Lenders may also contact their Fannie Mae Account Team if they have questions about this Lender Letter.
Have guide questions? Get answers to all your policy questions, straight from the source. Ask Poli.