

Lender Letter LL-2015-02

February 04, 2015

To: All Fannie Mae Single-Family Sellers

Appraisal Tools, Processes, and Policies

The purpose of this Lender Letter is to provide clarifications and additional information regarding Fannie Mae's valuation-related tools and policy updates announced within the past 12 to 18 months. These include Collateral Underwriter™ (CU™), Appraiser Quality Monitoring (AQM), and updates to the Property Eligibility and Appraisal Requirements section of the *Selling Guide*. With such a significant body of changes, it is inevitable that there would be some misconceptions and misinformation among lenders and appraisers. This communication is intended to provide facts, context, and clarifications.

Collateral Underwriter

CU is a proprietary model-driven tool developed by Fannie Mae that provides an automated appraisal risk assessment to support proactive management of appraisal quality. As previously announced, Fannie Mae is making CU available to Fannie Mae-approved lenders in 2015 to provide transparency and to help lenders more effectively and efficiently identify potential issues with appraisals.

A significant amount of CU information and training is provided on Fannie Mae's [CU web page](#), including a fact sheet, FAQs, and On-Demand eLearning courses that are available 24/7. Fannie Mae highly recommends that industry stakeholders – in particular, lenders and real estate appraisers – take advantage of the information provided on the website to become familiar with CU.

There has been much discussion and anticipation in the industry since the October 2014 announcement regarding the 2015 release of CU to Fannie Mae lenders. As a result, Fannie Mae believes it is important to provide some facts related to CU in an effort to clarify some of the misstatements and misconceptions that exist.

- The use of CU is voluntary and at no cost to the lender.
- CU is a Fannie Mae-only risk management tool.
- CU does not make a credit decision and the lender may not use CU to make a credit decision.
- CU does not accept or reject appraisal reports or characterize an appraisal as “good” or “bad.” The CU risk score and messages pertain to risk and identify potential defects in the appraisal report. The lender is not obligated to “clear” or “override” the CU messages. The messages are meant to be used as red flag messages that lenders should use to assist with their appraisal analysis and inform their decisions based on a complete analysis and understanding of the appraisal report.
- CU does not provide an estimate of value to the lender.
- CU provides a numerical risk score from 1.0 to 5.0, with 1 indicating the lowest risk and 5 indicating the highest risk. Risk flags and messages identify risk factors and specific aspects of the appraisal that may require further attention.

- CU's selection of comparable sales considers the relevance of each potential comparable sale based on physical similarity, time, and distance. The selection process is not based on the relative "risk" or sale price of a comparable sale nor is there a "lower is best" approach. In fact, CU may assign a high risk score to an appraisal when the model identifies alternative sales that are potentially more relevant than the comparable sales used by the appraiser, regardless of whether the alternative sales are higher or lower in price.
- CU considers under-valuation and over-valuation risk, based in part on factors such as the relevance of the comparable sales chosen, and whether or not the appraiser made appropriate adjustments when warranted.
- CU takes location into account using Census Block Group levels, which are subsets of Census Tracts. This is the most viable proxy for location in the absence of standardized neighborhood definitions, and more effective than use of arbitrary distance guidelines. Fannie Mae is not suggesting that appraisers use Census Block Groups to define comparable search areas, but appraisers remain responsible for indicating when comparables are from outside of the subject neighborhood and for addressing any differences.
- The risk analysis performed by CU is for exclusive use by the lender in their analysis of the appraisal report. After completing a thorough review, a lender should be able to have constructive dialogue with the appraiser to resolve specific appraisal questions or concerns. Although the lender may use output from Collateral Underwriter to inform its dialogue with appraisal management companies and appraisers regarding appraisals they supplied, the CU license terms prohibit providing these entities with copies or displays of Fannie Mae reports that contain CU findings, including without limitation the CU Print Report, the UCDP Submission Summary Report, or any other CU report. The lender must not make demands or provide instructions to the appraiser based solely on automated feedback. Also the CU license terms prohibit using it "in a manner that interferes with the independent judgment of an appraiser." Fannie Mae expects the lender to use human due diligence in combination with the CU feedback, and will actively follow up with lenders who are reported to be asking appraisers to change their reports based on CU feedback without any further due diligence.
- Fannie Mae does not instruct or suggest to lenders that they ask the appraiser to address all or any of the 20 comparables that are provided by CU for most appraisals. It is also not Fannie Mae's expectation that appraisals should contain only CU's top-ranked comparable sales. In the majority of cases, there may be no material difference between comparable sales utilized by the appraiser and those identified by CU. Before asking the appraiser to consider any alternative sales, it is imperative that the lender analyze the relevance of the sale and determine if the use of such sale would result in any material change to the appraisal report. If the lender determines that there would be no material change, then they should not ask the appraiser to make revisions. Fannie Mae expects CU to enable lenders to accept appraisals "as is" with greater confidence.
- CU is available only to approved Fannie Mae lenders, and is not available to other industry participants such as appraisers for several reasons, including:
 - Fannie Mae's contractual relationship is with approved lenders. Based on the lender's representations and warranties in accordance with the *Selling Guide*, it is up to the lender to determine which appraisals they submit to the Uniform Collateral Data Portal (UCDP) and ultimately whether to sell a particular loan to Fannie Mae. Additionally, it is their responsibility to underwrite the appraisal to determine acceptability with respect to property eligibility and other Fannie Mae requirements.
 - CU requires an appraisal submission to UCDP in order to run; it is not based on entering an address and retrieving market data.

CU is an appraisal risk management tool. It is not the first product of its kind and is not the first automated technology that lenders have used to assist with their quality control processes. Lenders have long been using

automated products, checklists, and overlays, which may have led to unnecessary correction requests to the appraiser.

Appraisers who make a good faith effort to provide accurate data, select appropriate comparables, make market-based adjustments, and give weight to the most relevant comparables should feel no significant negative impact as a result of the use of CU. CU can identify issues with appraisal reports, and it can also validate the many appraisal reports that are very well-supported. The net result should be that lenders, AMCs, and appraisers should not expect any significant increase in correction requests or need for rework.

Selling Guide Policy Updates

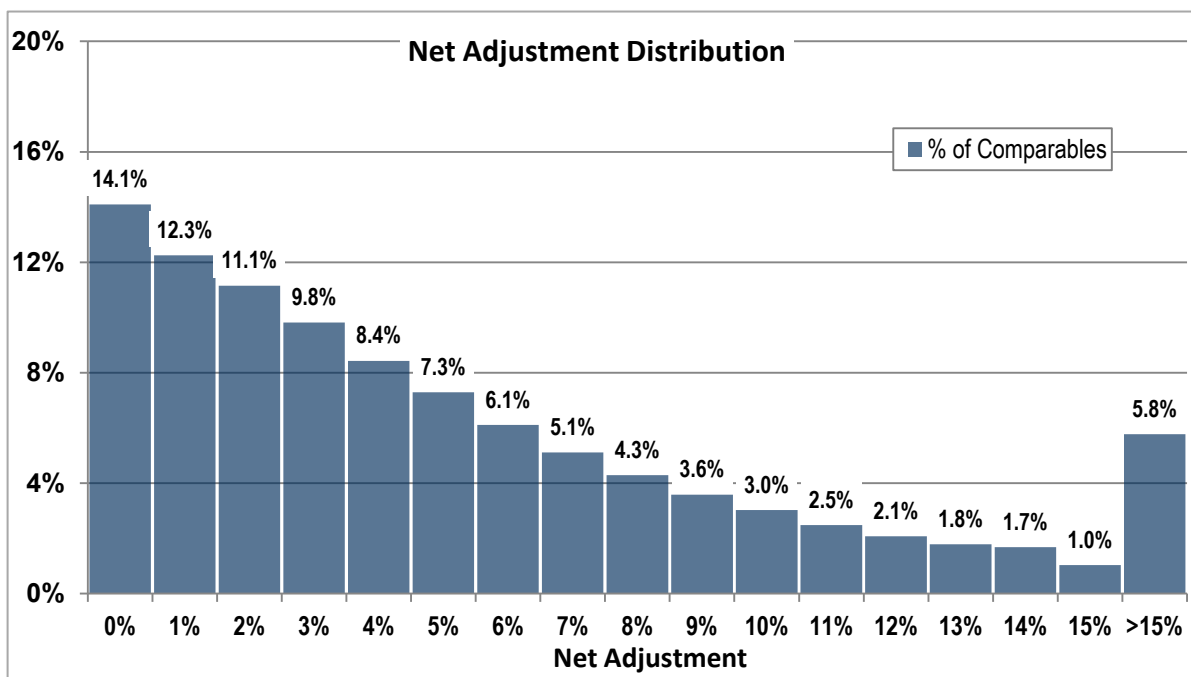
Adjustments to Comparable Sales

In the December, 2014 *Selling Guide* update, Fannie Mae removed a long-standing guideline that when adjustments to the comparable sales exceeded 15% net and 25% gross, the appraiser was required to provide an explanation as to why the comparable was chosen for use in the appraisal report. This requirement for commentary was based on the premise that the best comparable would require the fewest adjustments.

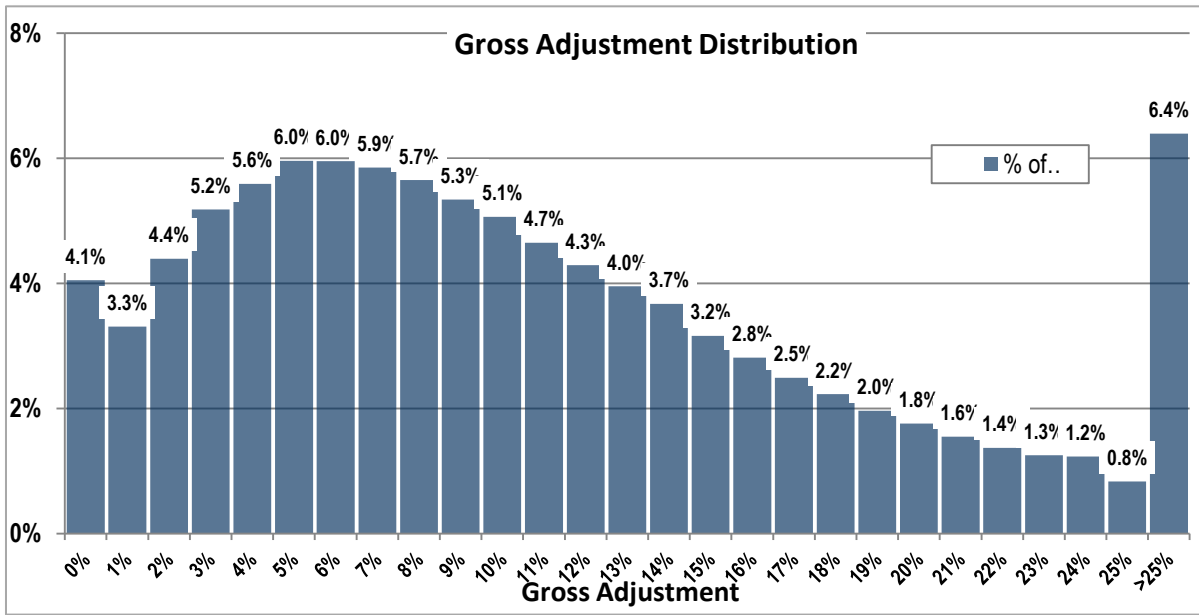
While this premise remains true in theory, the guideline for 15% net and 25% adjustments was widely implemented as an eligibility “hard stop” due to many rules-based automated review systems. Analysis of appraisals submitted to UCDP made it clear that many appraisal reports never exceeded the 15% or 25% guideline – the focus of many appraisers had become keeping the amount of the adjustments within the guidelines instead of reflecting actual market reaction for specific characteristic(s).

To support the decision-making process to remove this guideline, Fannie Mae analyzed 700,000 appraisals submitted to Fannie Mae in Q1 2014, including analysis of more than 2.5 million comparable sales. The charts below reflect the results of the analysis.

Nearly 95% of comps analyzed had net adjustments less than 15%, suggesting that appraisers strictly adhered to the net adjustments guideline. Fannie Mae’s concern is that the adjustments might be artificially low.



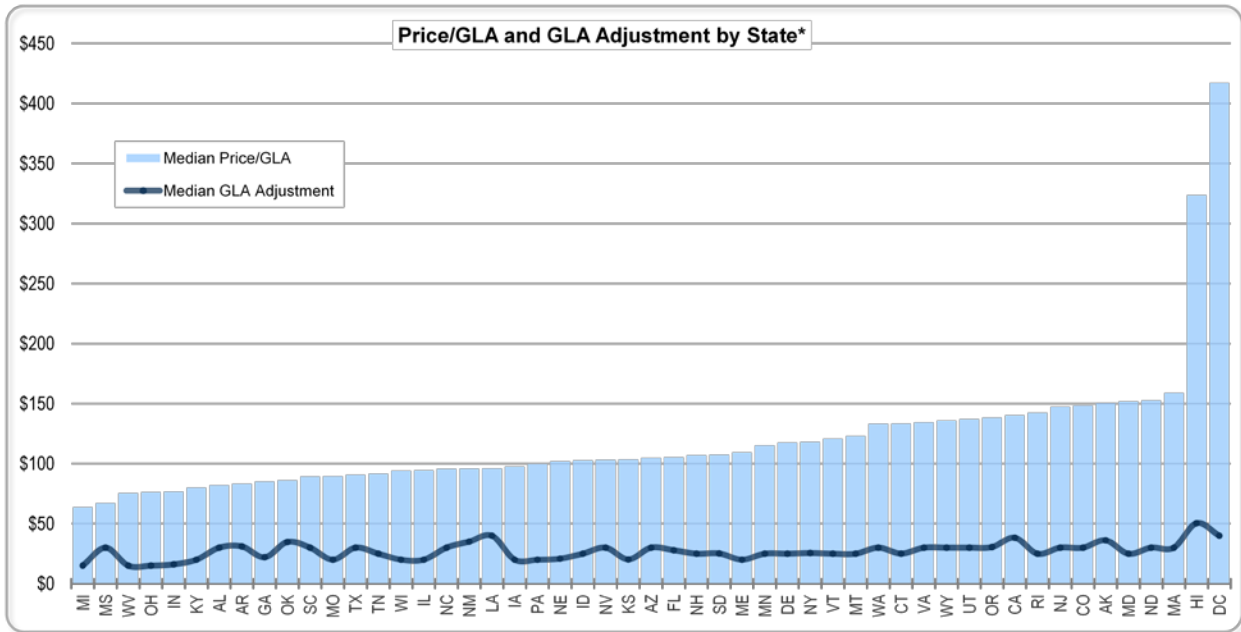
Appraisers also appear to adhere to the 25% gross adjustment guideline, with nearly 94% of comps having gross adjustments less than 25%. Again, this raised concerns with the accuracy of these adjustments.



In addition to the data suggesting that adjustments are being forced to remain within the 15% and 25% parameters, analysis of the same data supports the notion that comparable adjustments are not necessarily market-based. Analysis of appraisals submitted to the UCDP showed that the median adjustments made for gross living area (GLA) are fairly consistent across the country, regardless of characteristics such as price tier and size – which defies the reality and logic of market-based differences.

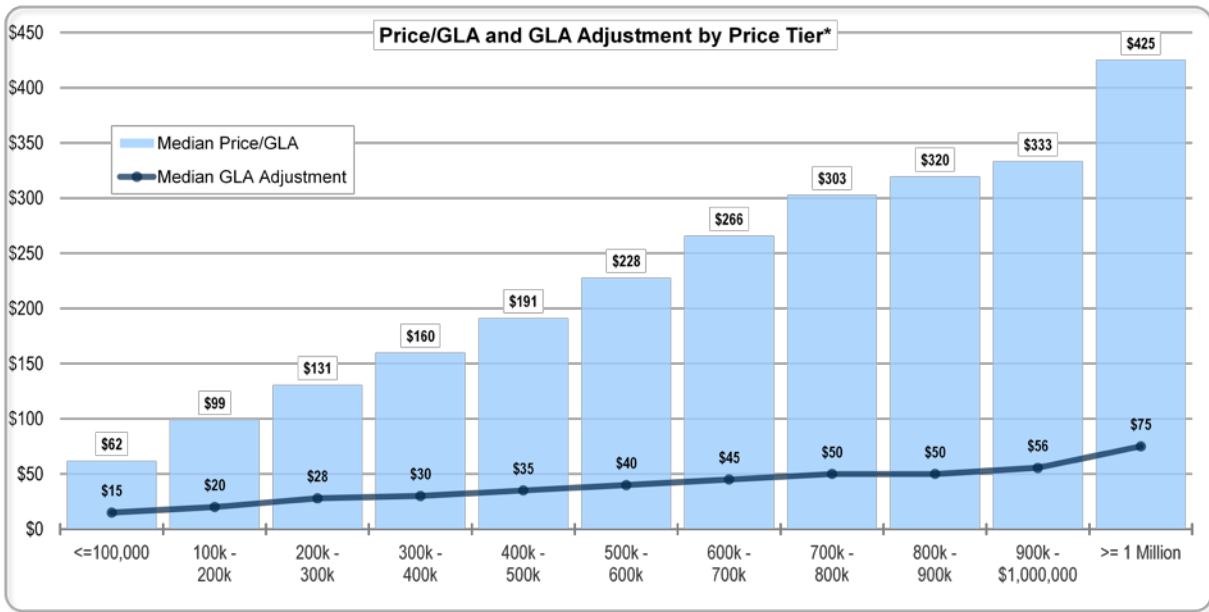
The next chart shows the median amount of an adjustment for GLA by state. Analysis shows little variation in the median GLA adjustment despite significant variation in price. Only in Hawaii does the median GLA adjustment break \$50 per square foot, even though median GLA price exceeds \$50 per square foot in all 50 states and is significantly higher in certain market areas.

NOTE: *Regardless of any state by state averages, Fannie Mae relies on appraisers to make adjustments based on the local market.*



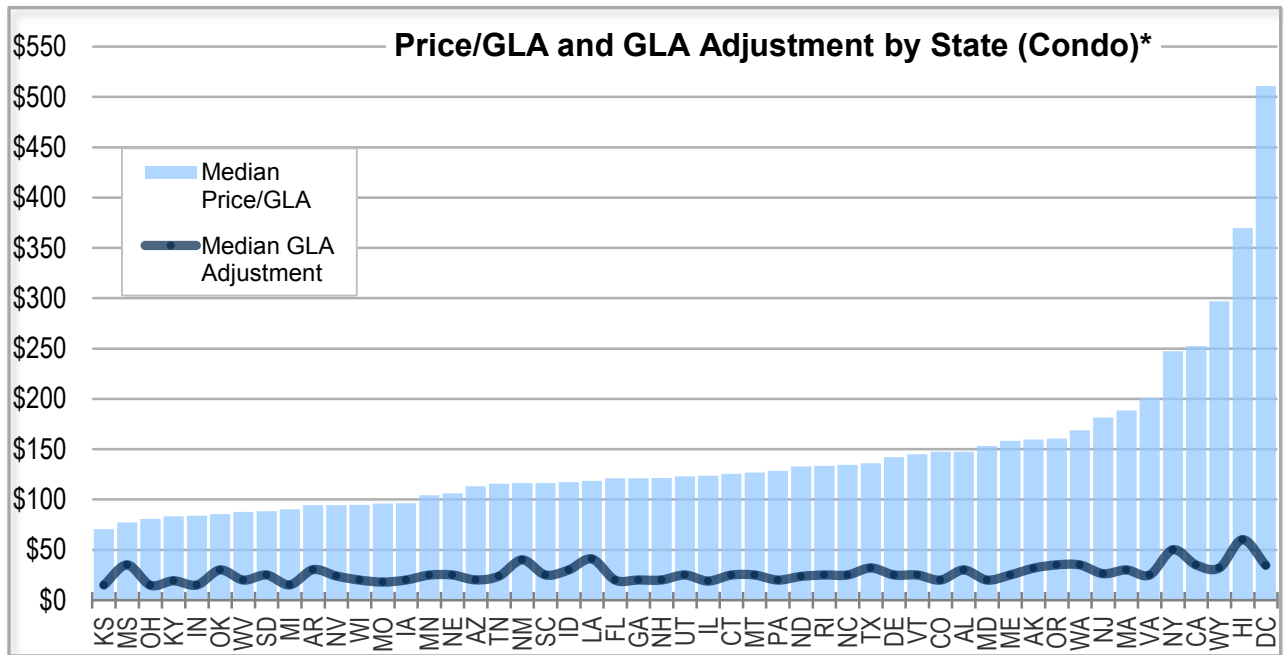
* Analysis based on over 700,000 appraisal submissions to UCDP in 2014 Q1

Not surprisingly, there is a strong correlation between price per square foot and price tier, but GLA adjustments remain much the same. Only at the price level of \$900,000 does the median adjustment exceed \$50 per sq ft.

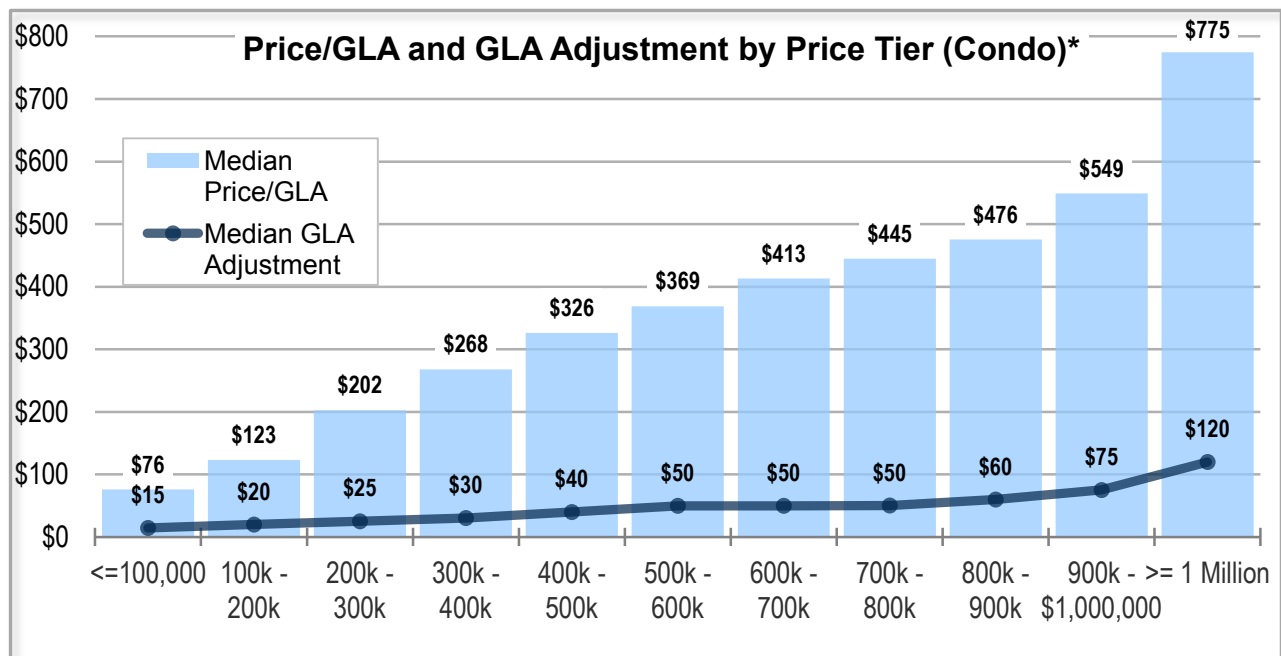


* Analysis based on over 700,000 appraisal submissions to UCDP in 2014 Q1

Appraiser behavior appears to be the same when the analysis is limited to condominiums. For example, the median adjustment in California is the same as in Mississippi, even though \$/GLA is nearly four times higher for California. Additionally, the \$/GLA is nearly seven times higher for the District of Columbia when compared to Mississippi.



This trend is even more pronounced in an analysis of condominiums by price tier. Median adjustments for GLA are a fraction of the \$/GLA and do not scale with price.



The analysis results reflected in the charts provide strong evidence that adjustments have been made to fit within guidelines that were not intended to be rules, but instead a trigger for commentary and rationale. While the best comps remain those that warrant lower adjustments – if those adjustments are based on market reaction and well-supported – the removal of the net and gross adjustment guidelines appropriately shifts focus to supporting market-based adjustments regardless of the amount of the adjustment either as a single line item or in total.

As stated in B4-1.3-09, Adjustments to Comparable Values, in the *Selling Guide*:

“Fannie Mae does not have specific limitations or guidelines associated with net or gross adjustments. The number and/or amount of the dollar adjustments must not be the sole determinant in the acceptability of a comparable. Ideally, the best and most appropriate comparable would require no adjustment; however this is rarely the case as typically no two properties or transaction details are identical. The appraiser’s adjustments must reflect the market’s reaction (that is, market-based adjustments) to the difference in the properties. For example, it would be inappropriate for an appraiser to provide a \$20 per square foot adjustment for the difference in the gross living area based on a rule-of-thumb when market analysis indicates the adjustment should be \$100 per square foot. The expectation is for the appraiser to analyze the market for competitive properties and provide appropriate market-based adjustments without regard to arbitrary limits on the size of the adjustment.”

Another point of clarification is that Fannie Mae currently does not have, and has never had, a limitation on a single-line item adjustment.

Photographs

In 2010, Fannie Mae added a requirement for appraisals to include interior photographs of specific rooms and examples of deterioration or updating if present within the property. This was in addition to the previous requirements for clear and descriptive photographs of the front, rear, and street scene of the subject property as well as photographs of the front of the comparable sales.

As a clarification, Fannie Mae requires the lender to ensure that all photographs in the appraisal report are clear and descriptive. Photographs that are out of focus or taken with improper light, rendering them not clear and descriptive, are not acceptable. Lenders should remind appraisers to use a flash in dark areas and review images to ensure they are not blurry. The purpose of this requirement is to enable all parties relying on the report to be able to clearly identify the property’s condition and quality.

Condition Ratings

The Uniform Appraisal Dataset (UAD) includes definitions for Condition Ratings C1 – C6. Fannie Mae will accept loans secured by properties with any condition rating (provided all other requirements are met), except that a C6 rating must be “subject to” and subsequently reflect the condition rating of the repaired property.

It is important to note that loans secured by properties with C5 condition ratings are deliverable to Fannie Mae with “as-is” reports, provided the property meets the following C5 definition:

“The improvements feature obvious deferred maintenance and are in need of some significant repairs. Some building components need repairs, rehabilitation, or updating. The functional utility and overall livability are somewhat diminished due to condition, but the dwelling remains useable and functional as a residence.”

NOTE: *Some significant repairs are needed to the improvements due to the lack of adequate maintenance. It reflects a property in which many of its short-lived building components are at the end of or have exceeded their physical life expectancy, but remain functional.*

Selection of Comparable Sales

Fannie Mae no longer requires specific comments from an appraiser if a comparable sale is older than 6 months; however, a comment is still required when a comparable sale is older than 12 months. The expectation is for comparable sales to have closed within the past 12 months and be the best and most appropriate. However, there are times when the best and most appropriate comparable sales are not the most recent sales. It may be appropriate for the appraiser to use a 9-month-old sale with a time adjustment rather than a 1-month-old sale that requires multiple adjustments. Older sales may be more appropriate in situations

when market conditions have impacted the availability of recent sales, as long as the appraisal reflects the changing market conditions.

Older comparable sales (including sales older than 12 months) that are the best indicator of value for the subject property can be used if appropriate. For example, if the subject property is located in a rural area that has minimal sales activity, the appraiser may not be able to locate 3 truly comparable sales that sold in the past 12 months. In this case, the appraiser may use older comparable sales as long as he or she explains why they are being used.

UCDP Appraisal Submissions

Lenders are reminded that the appraisal used to underwrite the loan must be delivered to UCDP prior to delivery of the loan to Fannie Mae. If necessary, lenders should contact any applicable vendor that manages their appraisal process (such as an appraisal management company) to reiterate this requirement. It is imperative that this occurs so that if the loan is selected for post-purchase review, Fannie Mae has access to the correct appraisal for review. This will avoid potential delays in the review process. Furthermore, lenders that use CU for appraisal review will want to submit the appraisal to UCDP prior to their appraisal review in order to be able to take advantage of the CU analysis.

Appraiser Quality Monitoring


Fannie Mae's AQM process identifies appraisers whose appraisal reports exhibit a pattern of minor inconsistencies, inaccuracies, or data anomalies. The intent and expectation of communicating these issues to appraisers is for training and educational purposes, and to provide them with an opportunity to improve their work. Future appraisal reports from those appraisers are then monitored to assess improvement.

The AQM process can also identify appraisers whose appraisal reports exhibit more egregious issues. In those cases, Fannie Mae will contact the appraiser and the lender that delivered the loan(s), informing them that either 100% of the loans submitted with appraisals from the identified appraiser will be reviewed in the post-purchase file review process, or that Fannie Mae will no longer accept loans with appraisals completed by the specific appraiser.

There is a misconception in the industry that the AQM process is a fully automated process with no human intervention, which is incorrect. The AQM process leverages data and technology like CU to identify (with an emphasis on "identify") consistent patterns or particularly egregious potential issues with appraisals, which in turn is used to flag them for review. However, Fannie Mae does not simply use the results from an automated system to determine if 100% file reviews are required or that the appraiser's work is no longer acceptable to Fannie Mae. Prior to issuing any communication to an appraiser, Fannie Mae conducts a significant level of human due diligence.

Although information from CU is one tool that Fannie Mae uses in the AQM process, there is no direct connection between the CU risk score and AQM. High CU risk scores do not automatically trigger AQM reviews, and lenders using CU should not consider its feedback as necessarily reflective of an individual appraiser's work.

Through the AQM process, Fannie Mae continues to identify appraisers whose work product indicates a pattern of either minor or more egregious issues. More information on each of the topics covered in this Lender Letter can be found on the Collateral Underwriter page of [Fannie Mae's website](#).



Lenders who have questions about this Lender Letter should contact their Account Team.

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