Arch Capital Group, Ltd.
David Gansberg
CEO Global Mortgage Group
230 N. Elm Street
Greensboro, NC 27401
Direct: 336-217-2111
Email: dgansberg@archmi.com
www.archmi.com

February 26, 2021

Federal Housing Finance Agency
400 7th Street, S.W.
9th Floor
Washington, D.C., 20219

Re: Arch MI's Response to FHFA's Request for Input on Appraisal-Related Policies, Practices and Processes

Ladies and Gentlemen:

Arch Capital Group Ltd., on behalf of itself and its subsidiaries ("Arch"), submits this letter in response to the Federal Housing Finance Agency's ("FHFA"), Appraisal-Related Policies, Practices, and Processes Request for Input (the "RFI"). Arch, through its insurance subsidiaries, provides commercial, institutional, and individual customers with mortgage, property-casualty, and reinsurance offerings on a worldwide basis.

Arch's subsidiaries, Arch Mortgage Insurance Company and United Guaranty Residential Insurance Company, (together "Arch MI") is a leading mortgage insurance provider in the United States, having $280.6 billion of insurance in force as of December 31, 2020. Arch's reinsurance subsidiaries are also leading investors in Fannie Mae and Freddie Mac's (together, the "GSEs" or "Enterprises") credit risk transfer ("CRT") programs. Arch has made a long-term strategic commitment to the U.S. mortgage market, investing in, managing, and distributing credit risk in a variety of single family and multifamily executions. Arch has developed its own internal credit risk and econometric models and invests heavily in the intellectual capital required to support underwriting decisions and risk management. Thus, Arch is well-positioned to provide input on the RFI.

Arch supports FHFA's, and the GSEs' efforts to modernize the appraisal process and agrees that balancing process efficiencies against the need for quality valuations that foster prudent risk management is of paramount importance. Arch appreciates the opportunity to provide comments on this important initiative.

Arch's general comments focus on two primary recommendations. First, the GSEs should limit the use of non-traditional appraisal methods and appraisal waivers to loans with loan-to-values ("LTV") below 80%. Second, the GSEs should limit the use of non-traditional appraisal methods and appraisal waivers in metropolitan statistical areas ("MSAs") with declining values or overly inflated values. The remainder of our comments respond to a few of FHFA's specific queries.

Section I. General Comments

A. Default Risk. As a risk-taker in first loss position, Arch firmly believes the integrity of underwriting processes, including an accurate assessment of value, is critically important to the long-term stability of the GSEs and the housing finance system more broadly. An accurate assessment of value is necessary for a precise LTV calculation and for a true assessment of a borrower's equity in the home.

A borrower's equity in the property is one of the most important parameters to assess in determining the ultimate risk of default and loss. The risk associated with appraisal waivers or other non-traditional appraisal practices is that the value of the property used to determine the LTV will be overstated. By extension, the overstated value will also result in an overstatement of the borrower's equity in the property. The borrower's equity position is particularly important for determining the risk of loss for a high-LTV loan where the borrower has invested less initial equity as compared to a loan with a low-LTV.

The table below reflects Arch's analysis of predicted default rates with respect to a low-LTV loan with a stated LTV of 65% compared to a high-LTV loan with a stated LTV of 90%, and the impact to the default rate from overstated property values.

	Stated LTV = 90%		Stated LTV = 65%	
Value Inflation	True LTV	Relative Increase in Default Risk	True LTV	Relative Increase in Default Risk
0%	90%	0	65%	0
5%	95%	1.3x	68%	1.2x
10%	99%	2.4x	72%	1.5x
15%	104%	5.3x	75%	1.8x

When comparing a loan that has a stated LTV of 90% versus one with a stated LTV of 65%, the high-LTV loan's default rate increases by a factor of 2.4x - 5.3x if the property value was found to be inflated 10 - 15%; the increase is only 1.5x - 1.8x for the low-LTV loan. The default risk is exacerbated when value inflation occurs, and exponentially so on a high-LTV loan, which intuitively aligns with expectations given the lower equity stake of high-LTV borrowers.

FHFA correctly identifies this key risk in its RFI, noting that appraisal waivers expose "…mortgage insurance companies to potentially higher claims if the collateral is overvalued versus a traditional appraisal."[1] FHFA also recognizes that borrowers are harmed by value

[1] FHFA's Request for Information on Appraisal Related Policies, Practices, and Procedures, at pg. 17.

inflation, which leads borrowers to have higher LTVs than anticipated and with less or no equity in the property. Take a borrower with a 90% LTV mortgage, for example, in which the value has been inflated by 15% due to an erroneous evaluation of the value. The true LTV of the mortgage is 103.5% LTV, meaning that the borrower owes more on their mortgage than the property is worth. The borrower is underwater and will have to pay 3.5% above the true value of the property to satisfy the promissory note. The average loan size of high-LTV loans is approximately $275,000, which implies that a borrower would have to use $9,625 of savings to avoid the negative credit consequences of defaulting.

As a leading mortgage insurer, Arch MI has participated in Fannie Mae's appraisal waiver program for the past couple years during a very benign economic environment with stable and rising home prices. Freddie Mac expanded its program in March 2020 to include high-LTV loans in response to the COVID-19 pandemic. Both high-LTV appraisal waiver programs are limited to rate-term refinanced loans with LTVs at or below 90%. Arch believes that appraisal waivers are appropriate to address the unique friction in the mortgage origination process caused by the pandemic. However, given 1) the exponential increase to the risk of default from inflated values on high-LTV loans, 2) the lack of through-the-cycle performance data on loans that received waivers, and 3) the increased economic uncertainty resulting from the pandemic, Arch believes that appraisal waivers and other non-traditional appraisal alternatives (such as hybrid appraisals), should generally be limited to low-LTV loans and that the GSEs should cease using appraisal waivers on high-LTV loans when the nationwide emergency declaration for COVID-19 ends.

B. Declining and Overvalued Markets. The risk of value inflation and the resulting harm to borrowers, GSEs and MI companies is most acute in markets with declining house prices or in overvalued markets with home prices well above long-term fundamental values for that geography. Thus, Arch suggests that the use of appraisal waivers be further limited for properties located in MSAs with declining property values or with values that exceed a defined threshold over the inflation-adjusted long-term trend for that MSA.

Over the course of past housing cycles, values remained stable or increased for a long period of time before reaching an inflection point and starting to decline. In 2007, the GSEs recognized that such an inflection point had been reached and the potential for overstatement of property values in appraisal reports. In response, in July 2007, Fannie issue an announcement, Collateral Valuation Practices and Declining Markets, which reiterated that it expects appraisers to "research, analyze and report on the factors in the neighborhood that may affect the market value or marketability of the properties in the market area."[2] Given the heightened risk, Fannie Mae instructed originators and appraisers to be extra-diligent in supporting the value of properties located in declining markets. The FHFA should establish a similar approach and limit the use of non-traditional appraisal methods and appraisal waivers in declining markets.

On the opposite end of the spectrum, excessive growth in property values also exacerbates the risk of increased losses to the GSEs due to value inflation. The FHFA explicitly recognizes the

[2] https://appraisalnewsonline.typepad.com/0711_FNMA.pdf

risk of overvaluation (typically referred to as a housing bubble) to the safety and soundness of the market in the final Enterprise Capital Rule published last year.[3] To address this risk, the FHFA included a loan-level countercyclical adjustment that is assessed based on a defined set of rules and a discretionary countercyclical buffer that can be assessed at the regulator's discretion when property values become overvalued. Pursuant to the loan-level adjustment, the GSEs are required to hold additional capital for loans with mark-to-market LTVs when national house prices are 5.0 percent greater than an inflation-adjusted long-term trend.

The FHFA should consider adopting a similar methodology in the context of setting limitations on the use of non-traditional appraisal practices when a market has become overvalued. Consistent with Arch's feedback on the Enterprise Capital Rule, given the U.S. housing market heterogeneity and the local importance of market value in the context of appraisals, we also believe that appraisal waivers should vary by MSA as to not exacerbate cyclicality of housing values. For example, the FHFA could consider requiring traditional appraisals in MSAs whereby the housing values exceed a defined limit (e.g. 10%) over the inflation-adjusted long-term trend for that MSA to limit the risk of further exacerbating value inflation. Alternatively, the GSEs could implement a more holistic risk management approach to evaluating over-valued markets that includes consideration of an MSA's inflation-adjusted long-term trend in combination with other economic analysis. Culminating from this analysis, which should be refreshed on a periodic basis, the GSEs could disclose those markets whereby appraisal waivers are not permitted.

C. CRT. Finally, the FHFA and GSEs should consider the risk of value inflation on their CRT programs. Uncertainty surrounding the true LTV of loans will result in uncertainty in the weighted average life and loss expectations. The elevated conditional prepay rates ("CPR") of loans with appraisal waivers will also reduce the weighted average life if this trend continues in the future. While CRT investors are already exposed to this risk on low-LTV deals, if the proportion of loans with appraisal waivers increases, CRT investors are likely to price for this increased uncertainty in the short term. Long term value inflation and increasing uncertainty regarding the true LTV, loss expectations, and prepayment speeds could dampen investor and reinsurers' appetite to invest. As an investor in both low-LTV and high-LTV credit, Arch is comfortable with the use of appraisal waivers on low-LTV loans, given the need to balance efficiency with prudent risk management, subject to proper controls and monitoring.

In summary, Arch respectfully suggests that the GSEs limit the use of non-traditional appraisal methods and appraisal waivers to low-LTV loans in MSAs with stable market values.

Section II. General Questions on Appraisal Policy and Process Improvements

Further to the general comments made herein, Arch submits the following responses to a few of the specific queries in the RFI for the FHFA's consideration:

---

[3] https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/Enterprise%20Capital%20Final%20Rule%20for%20Website.pdf

Question A1.3: Do appraisal waivers have a place in Enterprise appraisal policy and process, and if so, for what segment of loans? What are the current risks to Enterprise safety and soundness in how appraisal waivers are offered? Would caps or other limits on their usage be appropriate?

Response: As detailed in Section I, Arch suggests that the GSEs limit the use of non-traditional appraisal methods and appraisal waivers to loans with LTVs below 80% ("low-LTV loans") in MSAs with stable market values. Further, Arch recommends that the GSEs cease using appraisal waivers on high-LTV loans when the nationwide emergency declaration for COVID-19 ends.

Question A1.5: Is there a need for additional policies and controls to balance potential risks with efficiency benefit from appraisal modernization? If yes, please provide your recommendations.

Response: The use of non-traditional appraisal practices and waivers is a recent development, which means there is insufficient performance data available to understand whether the loss experience differs compared to loans underwritten using traditional appraisal methods. To fully evaluate the impact of appraisal waivers and non-traditional appraisal methods, the GSEs and the industry at large need to evaluate data across economic environments. Arch suggests that the GSEs conduct the following types of analyses:

1) Credit neutral performance comparisons of loans with waivers to those without, looking for confirmation that there are no performance differences.
2) For those loans that did default, a comparison of the severity of the loss between loans that had appraisal waivers and those that did not. Certain variables would have to be accounted for: location (states with judicial foreclosure/ states with non-judicial foreclosure), house price appreciation, and other critical severity factors.
3) Simple comparison of loan characteristics between populations: location, credit score, property type, debt-to-income ratios, perhaps HMDA data, etc. to see if there are any credit-related correlations or certain populations that are more or less likely to be offered a waiver.
4) Comparison of populations by prepayment speed to assess whether there is (all else equal) an increased probability to prepay.
5) A comparison of distributions between sales price and AVM values to understand the 'spread' and 'confidence' between the appraisal waiver population and the non-appraisal waiver population.

Gathering sufficient data to understand the accuracy of non-traditional appraisal methods and the resulting impact on losses will take time. Thus, Arch suggests that the GSEs limit non-traditional appraisal methods and appraisal waivers to a subset of low-LTV loans until such practices can be fully analyzed, refined, and determined fit for broader use.

Section III. Questions on Risk Management

Question B2.6: Is there any data or evidence you could share regarding the performance of alternative appraisal solutions versus traditional appraisals?

Response: Arch has seen elevated prepayment rates on loans with appraisal waivers. In the past year, the CPR of appraisal waiver loans have been 1.5x to 2x higher than the CPR of loans with traditional appraisals. However, Arch is unclear as to the causation and the durability of this difference. To reiterate the point above, it takes time to gather and analyze the data needed to fully understand this differential. To that end, Arch recommend that the GSEs conduct more analysis into what is driving the higher CPR rate for loans with appraisal waivers, and share their findings with the industry.

Question B2.7: Should Enterprise type COVID-19 appraisal flexibilities be part of an updated appraisal process to address disasters and other events to lessen market impacts?

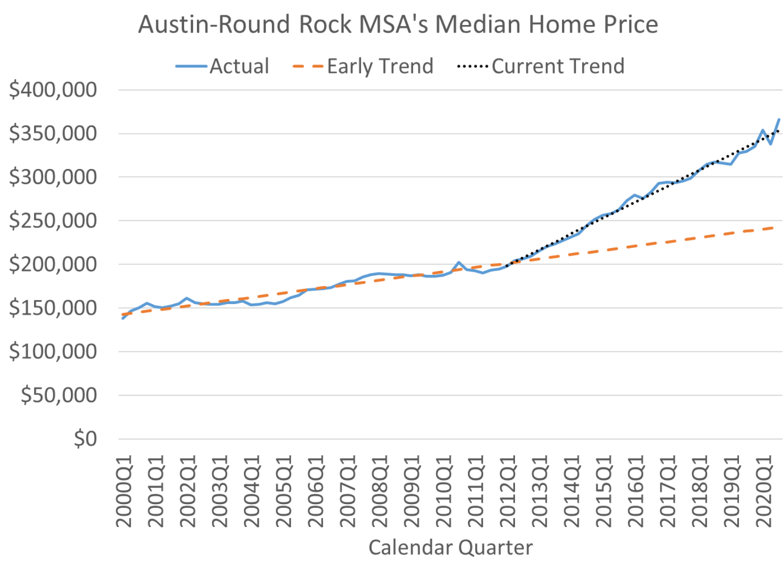
Response: As noted in Section I above, Arch recommends that the use of appraisal waivers and flexibilities be discontinued on high-LTV loans when the nationwide emergency declaration for COVID-19 ends. Regarding future disasters, the pandemic disaster is unlike any other disaster experienced to date and should be distinguished from natural catastrophe disasters such as hurricanes, tornadoes, and wildfires. Given state and local mandates to remain socially distant and concerns about virus infection, appraisers and homeowners have been reticent to conduct in-person appraisals. Furthermore, the pandemic disaster did not cause destruction to property. Natural catastrophe disasters, on the other hand, directly impact the physical condition of properties in the impacted geographies. Arguably, traditional appraisals are most important in regions impacted by a natural disaster, precisely because of the property damage experienced. Thus, Arch does not recommend that the current flexibilities be extended to natural catastrophe disasters.

Section IV. Industry Considerations

Question C1.6: Do you have any additional feedback on issues raised by this RFI?

Response: Given the GSEs' authority over the underwriting standards (including market valuation practices) applicable to the majority of loans in the U.S. housing market, Arch believes that it is in the public good to require them to provide additional transparency into their non-traditional appraisal eligibility criteria and the data supporting the same. For example, Fannie Mae currently allows appraisal waivers on rate-term refinanced loans with LTVs over 80% so long as Fannie Mae has a prior appraisal evaluating the property within a defined period of time. However, it is unclear what analysis Fannie Mae used to establish this criterion. Arch has observed significant differences in trends among MSAs across the same time horizon; thus, while deriving an accurate estimate of value from an aged appraisal in some MSAs may be possible, property values in other geographies may have undergone fundamental changes that are hard to extrapolate.

The MSA that includes Austin, TX is a good example of a housing market that has recently experienced a fundamental shift. In the last decade, Austin has experienced some of the highest population growth in the US as people move to the area for the sunny climate, tech jobs, and a large creative community. Zillow selected Austin to be the nation's hottest housing market for 2021, and it was Zillow's selection for the 2020 hottest housing market made at the end of 2019.[4] The graph below plots the median home price for the Austin, TX metropolitan area over the past 20 years and shows two potential trend lines of housing prices within that region – one based on 2000 to 2010 data and the other based on 2012 to 2020 data. There is a distinct bifurcation in the behavior of housing prices since 2012, which gives rise to concern around how an automated valuation method would handle appraisals from the "old regime" (pre-2012 in this example) and translate their value into the "new regime" (post-2012 in this example) without over-leaning into the recent uptick in home prices. This concern is especially true if, in retrospect, the "new regime" turns out to be a housing bubble where prices became inflated from their fundamental values. Thus, understanding the analysis underpinning Fannie Mae's guideline on the age of prior appraisals is needed.



To highlight another example whereby additional transparency would be helpful, Freddie Mac uses its proprietary model, Automated Collateral Evaluation (ACE), along with historical data and public records, to allow lenders to originate certain loans without an appraisal. Again, Freddie Mac has provided limited transparency into its model, eligibility criteria, and changes thereto.

Finally, the FHFA and GSEs should consider the risk that the appraisal data used in the GSEs models and industry alternative valuation models ("AVMs") will deteriorate as fewer traditional appraisals are used to generate the data necessary for the GSEs models. In other words, the more appraisal waivers are used, the less powerful the appraisal data set will be to develop and refine valuation models, particularly if it turns out that appraisal waivers exacerbate value inflation. This risk provides yet another strong rationale for using a measured approach with respect to

[4] https://www.zillow.com/research/zillow-hottest-markets-2021-28667/

appraisal waivers and non-traditional appraisal practices until the FHFA, GSEs and industry stakeholders fully understand the long-term implications.

Conclusion

Arch appreciates the opportunity to provide comments on this important initiative. As a mortgage insurer and a significant investor in CRT, assessing accurate property values is critically important to assessing the underlying risk of loss. To balance the risks created from value inflation against the need to modernize appraisal practices, Arch respectfully requests that the GSEs limit the use of non-traditional appraisal methods to low-LTV loans in MSAs with stable market values until sufficient data is available and analyzed to understand the impact of using non-traditional appraisal methods.

Thank you for the opportunity to provide this response.

Sincerely,

David Gansberg