Response to FHFA's Appraisal Waiver RFI

As highlighted in the Office of Inspector General (OIG) report[1], there are undisputed advantages to having appraisal waivers including: reduction in closing time, cost savings to borrowers, reduction in rep and warranty risk to lenders, and mitigating delays resulting from appraiser shortages. The OIG report concluded that the then modest size of the appraisal waiver program, because of the stringent eligibility requirements, posed little risk to the GSEs. However, broad based use of appraisal waivers like we have seen in 2020, with greater than 40% of the loans guaranteed by the GSEs in Q4 2020 having appraisal waivers, could lead to unintended consequences some of which are:

- **Exaggerates the Impact of Temporary Strength in Housing on GSE Portfolios**

Appraisal waivers could exaggerate the impact of appraisal biases by quickly percolating the appraisal biases through the GSEs' portfolio. For example, the housing market in 2020 has done surprisingly well despite the unprecedented high unemployment rate. One can possibly attribute this strength to low rates, WFH and low inventory level (resulting from quarantine in place requirements and foreclosure moratoriums). However, the long-term effects on housing are still uncertain especially as some of these favorable tailwinds retreat. Consequently, using appraisals in 2020 to provide appraisal waivers does reset a good portion of the GSEs' portfolio value with the home price appreciation (HPA) seen in 2020 especially given the significant uncertainty regarding the immediate future of the housing market.

- **Undervaluing Loan Putbacks related to Appraisals**

Automated valuation model (AVM) used for appraisal waiver are mostly backward looking and its predictive capability is only as good as the data being used to calibrate it. Consequently, Automated valuation models for home prices do very well in slowly changing home price environments. Hence appraisal waivers granted based on AVMs could result in GSEs grossly undervaluing loan putbacks related to appraisals during periods of sharp changes in home prices.

One metric that could help assess the value of loan putbacks is the appraisal waiver "acceptance rate" across loan products (i.e. purchase, refinance and cashout). An unusually high or low appraisal waiver "acceptance rate" (especially for purchase and cashout transactions relative to refinance transactions) along with large differences between AVM estimates and appraisals should portend possible frothiness in home prices. Consequently, putbacks related to appraisals following periods like this could be more valuable to the GSEs and fewer appraisal waivers should be offered.

- **Unintended Disparity in Mortgage Availability**

One of the main advantages of the use of appraisal waivers is to free up appraiser capacity to help focus appraisal efforts on the more difficult to appraise properties. However, given the lower cost of origination, shorter closing lags and reduced rep and warranty risk to the lenders, loans with appraisal waivers are becoming more desirable to lenders. As a result, lenders are increasingly trying to reverse engineer the methodology used for appraisal waivers to be able to identify and solicit borrowers with loans that are eligible for appraisal waivers. This is likely to result in better execution for a selected set of borrowers versus others.

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[1] An Overview of Enterprise Appraisal Waivers, OIG White Paper published on September 14, 2018

- **Risk Transfer not as Effective with Appraisal Waivers**

Reduced appraisal requirements are not uncommon and have been around in government loans for a long time. For FHA/VA/USDA loans, appraisal requirement is typically waived for existing loans looking to do a non-cashout refinancing, while all purchase and cashout refinancing require a full appraisal. The reason being that refinancing a borrower into a lower payment typically helps improve borrower's potential to service the debt thereby reducing the existing credit risk to the guaranteeing agency. On the other hand, purchase and cashout transactions add new credit risk to the agency's guarantee portfolio and so should require full underwriting including an appraisal.

In the case of the GSEs the credit risk associated with the guaranteed loan has been sold to the private market through credit risk transfer (CRT) transactions. Consequently, refinancing an existing loan is adding new risk to their portfolio and hence should require full underwriting with abundant caution on home price values.

- **Race to the Bottom on Loan Quality?**

Given that lenders prefer to originate loans with appraisal waivers, lenders also try to find the GSE that is most likely to provide appraisal waiver for the loan. Given the large share of appraisal waivers being provided by the GSEs, FHFA will have to ensure that GSEs do not continue to relax their appraisal waiver requirements to grab market share.

In conclusion, we do believe that there are significant advantages to using appraisal waivers; however, their use should be limited in years where there are sharp moves in home prices in relatively short periods of time. Also, the GSEs should ensure that appraisal waiver "acceptance rates" across purchase, cashout and refinance transactions are somewhat similar. This will ensure the continued predictive power of the AVMs used for appraisal waivers and new risk being added to the GSEs portfolio, through refinance or purchase transactions, is done so with similar caution. In addition, we believe that keeping the share of appraisal waivers relatively small would also help address issues around unintended disparity in mortgage availability to borrowers and possible race to the bottom on loan quality.