PennyMac®

<u>Via Electronic Submission</u>

February 26, 2021

The Honorable Mark Calabria
Federal Housing Finance Agency
400 7th Street SW
Washington, D.C. 20219

Re: Request for Information on Appraisal-Related Policies, Practices and Processes

Director Calabria:

PennyMac[1] appreciates the opportunity to provide feedback on the Federal Housing Finance Agency's (FHFA) request for information on appraisal-related policies, practices, and processes. We agree with the FHFA that proper modernization of the appraisal process can create significant operational efficiencies in the mortgage origination process and address appraiser shortage issues, while maintaining the integrity of the valuation. More importantly, the lower cost and convenience of the origination process along with increased coverage of appraisal products can directly benefit consumers. We also acknowledge that such an endeavor comes with challenges and risks. We are encouraged by the FHFA's commitment to engage with industry participants, such as PennyMac, to better understand the benefits, challenges and risks that we have identified through our own use of hybrid appraisal products.

While the request for information raises a number of important issues that require serious consideration by the FHFA and the mortgage finance industry at large, our response primarily focuses on the utility of appraisal alternatives, including appraisal waivers as we feel our expertise adds the greatest value in this area. Our general views can be summarized as follows:

- Consumers can benefit from reduced borrowing costs due to lower closing costs and lender costs, as a result of more efficient and expedient valuation methods;

[1] "PennyMac" refers to PennyMac Financial Services, Inc. (NYSE: PFSI) and PennyMac Mortgage Investment Trust (NYSE: PMT). PFSI is a publicly-listed specialty financial services firm with a comprehensive mortgage platform that is primarily focused on the production and servicing of U.S. residential mortgage loans and the management of investments related to the U.S. mortgage market. As of December 31, 2020, PFSI was the second largest producer and the seventh largest servicer in the U.S. according to Inside Mortgage Finance. PFSI also has $2.3 billion in assets under management. PMT is a publicly-listed mortgage REIT that specializes in residential mortgage strategies enabled by the operational and investment management capabilities of its manager and service provider, PFSI. PMT's investments focus on mortgage-related assets that are generated through its leading correspondent production business.

- Additional benefits may be presented through added convenience for consumers, as well as potential disparate impact benefits through reduced unconscious racial bias;

- Appraisal alternatives are necessary to address capacity concerns within the real estate appraisal workforce;

- Extensive repositories of data available to the Enterprises can be used to prudently expand the types of non-traditional[2] appraisals, while adding little incremental risk;

- Risks can be mitigated through more conservative valuations, mitigation of confirmation bias, and risk monitoring methods; and,

- Sufficient consideration should be given to key implementation details to ensure certainty for lenders across all transaction and property types.

One of the guiding principles of PennyMac's industry-leading enterprise risk management framework is to ensure there is appropriate oversight of our business processes through timely and comprehensive monitoring. As such, we maintain robust reporting that has informed our observations and recommendations offered herein. Specifically, we will detail the benefits, risks, and implementation challenges associated with appraisal alternatives.

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Real Estate Appraisal Workforce

Over the years the real estate appraisal workforce has experienced a shortage of appraisers in addition to challenges with attracting new appraisers to the profession. According to data from an Appraisal Institute report[3] published in 2019, there were approximately 78,000 active appraisers in the United States at the end of 2018. The report also shows that between 2014 and 2018, the number of active appraisers has decreased at an average rate of 2.6% per year, while, according to a report recently released by Clear Capital[4], the number of appraisals completed have increased from 2012 to 2020 by about 50%. Indeed, the combination of these factors may be a contributing factor to the rise of appraisal costs by 24% since 2016 and the 65% increase in average turn times from 2018 that are noted in the same report. Appraisers leaving the profession

[2] For the purposes of this response, a "traditional" appraisal refers to a valuation completed on Form 1004/70

[3] Appraisal Institute. (2019). U.S. Valuation Profession Fact Sheet Q1 2019. https://www.appraisalinstitute.org/file.aspx?DocumentId=2342

[4] Clear Capital. (2021). Why We're Heading Into a Golden Age for Appraisal Modernization. https://www.clearcapital.com/resources/whitepapers/white-paper-why-were-heading-into-a-golden-age-for-appraisal-modernization/

due to retirement and fewer appraisers entering the profession has limited the growth of the workforce. In fact, over half of the workforce was between the ages of 51 and 65 at the end of 2018.

Within the existing array of non-traditional valuation products, each is distinguished by the degree to which the resulting determination of value relies on data that was not collected by an appraiser, as well as the results of the physical inspection, if any. Expanding the use of valuation products that leverage existing data as well as the use of non-appraiser inspectors may release the burden that is currently placed on appraisers for the collection of data, alleviating some of the capacity constraints in the workforce and allowing a greater number of valuations to be completed.

There is some risk that appraisal alternatives may be perceived as a potential threat to the appraisal profession, discouraging entry into the field, thus exacerbating the appraiser shortage issue. While the easing of capacity constraints may partially mitigate the impact of this effect, the Enterprises should ensure they are continuing to engage with the appraiser community to develop hybrid appraisal products with the intent to complement rather than supplant the expertise of licensed appraisers.

Consumer Benefits

If given the opportunity to bypass a traditional appraisal, consumers can save both time and money. The average cost of an interior appraisal is about 25% higher than that of an exterior appraisal and over double that of an automated valuation model (AVM) with a property inspection. Appraisal alternatives can support faster closing times as well. The Enterprises' existing data, and/or data collected by a non-appraiser, may be utilized by an appraiser to make a determination of value without visiting the property. Or, in an ideal scenario, the data may be sufficient to render an immediate decision on value. Either result compresses the total origination timeline.

Depending on the type of appraisal alternative for which the property qualifies, the borrower may avoid the inconvenience of scheduling the appointment and attending the inspection, which frequently requires taking time off work. In high volume areas, borrowers can also face significant scheduling delays due to the aforementioned capacity restraints within the appraiser workforce. If completion of the appraisal delays the closing date, there may be other monetary consequences for the borrower. Given the expectation that the introduction of appraisal alternatives will alleviate the capacity restraints within the appraisal industry, even a borrower who does not qualify for an appraisal alternative will benefit from a shorter time to close. Further, the reduced origination costs and extra lender capacity could expand access to credit.

Another potential benefit of the use of data-driven appraisal alternatives is the strict control of the inputs used to determine value. For example, valuations done by models can be designed to eliminate the use of potentially discriminatory characteristics. Greater control over valuation inputs and methodologies, in conjunction with the elimination of certain biases may even provide the additional benefit of incrementally advancing fair housing objectives.

Implementation

Availability of Data

It is critical that careful, data-driven consideration be given to the risks associated with making changes to such an influential element of the credit decisioning process. While the bases for our recommendations are rooted in the analysis of data, we have aggregated through our monitoring regime, the Enterprises have access to larger repositories of data with which to inform the responsible expansion of non-traditional appraisals. We encourage the Enterprises to leverage this data when determining the parameters that will be used to dictate which valuation product(s) can be used on a given loan. Such an approach is also in line with FHFA's commitment to data-driven policy making.[5]

Potential Risks

The benefits to be earned through the introduction of appraisal alternatives do not come without the potential for additional risk. We believe such risks can be adequately mitigated by more conservative valuations, elimination of confirmation bias, and the appropriate use of risk monitoring measures. We have identified the following potential risks:

Risk	Description
Model Risk	The use of models invariably presents risk associated with the potential for flawed methodologies, inconsistencies in underlying data, and inaccuracy of model assumptions. All models have some degree of uncertainty and inaccuracy. Additional risk could arise if models are incorrectly developed, implemented, or used. In the case of property estimates, a small anomaly in the property data or model design can have a significant impact on the determination of value. Although model risk cannot be eliminated, it can be mitigated with proper controls and governance.
Product Risk	Certain appraisal alternatives, like AVMs or exterior appraisals, provide limited insight into the actual condition of the property and may result in a less accurate determination of the property value.

[5] Prioritizing Fannie's and Freddie's Capital Over America's Homeowners and Renters? A review of the Federal Financing Agency's Response to the COVID Pandemic, 116th Cong (2020) (testimony of Mark A. Calabria).

Risk	Description
Geographic Competency	Appraisal alternatives that do not require physical data collection by an appraiser are more likely to be completed by appraisers outside of the immediate area, thus losing the benefit of familiarity with the local market.

PennyMac's Risk Mitigation Recommendations

Many of the risks above can be sufficiently mitigated by establishing a standard of care for measuring and monitoring risk composed of the following:

Risk Mitigation Measure	PennyMac Conclusions
Comparison of the Variance Between Different Appraisal Alternative Values and a Benchmark AVM	When comparing the results of data-driven alternative valuation methods to a benchmark AVM, our results have shown that an alternative valuation method, more often than not, produces a more conservative value. As such, this measure can serve to mitigate both model and geographic competency risks.
Correlation Between Loan Performance and Valuation Type	When analyzing the correlation between loan performance across valuation types, our data shows no statistically significant difference in the delinquency of loans originated with traditional interior appraisals as compared to data-driven alternatives. This type analysis can be used as a measure to mitigate model and product risks.
Metrics to Measure the Impact of the Potential Shift in Geographic Competency	Our data indicates that appraisal alternatives are significantly more likely to be completed by appraisers who live more than fifty miles from the subject property. When scored in an Enterprise valuation scoring tool, our data indicates that appraisals which are completed by an appraiser who works more than fifty miles from the subject property typically receive a valuation score that indicates a lower confidence in the determination of value than that provided by an appraiser who works within his or her local area. Developing metrics to measure appraiser competence in a geographic area can be used to mitigate geographic competency risks.

Risk Mitigation Measure	PennyMac Conclusions
Loss Severity Analysis by Valuation Type	While favorable market conditions have precluded us from collecting enough data to conduct an in-depth analysis for the impact of valuation type on loss severity, the Enterprises should evaluate and track this metric through a variety of economic cycles. That said, we believe loss severity will be lower for loans originated with appraisal alternatives due to our observation that such products tend to return more conservative values. Analyzing loss severity by valuation would be useful in mitigating model, product and geographic competency risks.

In addition to incorporating the above measures for monitoring risk, the Enterprises may want to add additional requirements for appraisal alternatives based on the findings from the analyses above. For example, hybrid or desktop appraisals must be performed by appraisers that live or work within fifty miles of the subject property.

Lender Implementation Considerations

Over the last decade, the Enterprises have been at the center of innovation in the loan manufacturing process. A key objective of many of these advancements has been providing lenders with certainty. We believe that lender certainty is a critical component of the successful implementation of a robust offering of appraisal alternatives.

Representation and Warranty Certainty

Today, the Enterprises have a representation and warranty framework that provides a standard and certainty within the origination process. The current framework leverages data and analytics to provide representation and warranty relief on collateral value to lenders for appraisal waivers, on a limited basis. Part of the success of the implementation of appraisal waivers can be attributable to the enhanced representation and warranty relief that lenders receive when such waivers are utilized. In order to encourage the broad adoption of appraisal alternatives, we strongly recommend using this framework as a model for implementing such alternatives. We also recommend expanding the scope of the Enterprises' valuation scoring tools[6] to incorporate appraisal alternatives and allow for a consistent approach to the representation and warranty relief framework across all valuation methods.

It is likely that lack of representation and warranty relief contributed to the limited uptake of the COVID-19 appraisal flexibilities. Barring an appraisal waiver, a lender could only earn relief from representations and warranty on a rate and term refinance transaction by delivering a traditional

[6] "Valuation scoring tools" refers to Fannie Mae's Collateral Underwriter (CU) and Freddie Mac's Loan Collateral Advisor (LCA)

appraisal.[7] It is imperative that the Enterprises maintain a consistent framework for representation and warranty relief across all valuation products so as not to disincentivize lenders from utilizing the products.

Operational Certainty

Another key implementation consideration is operational certainty around origination processes and workflows. Appraisal alternatives should be fully integrated into the Enterprises' automated underwriting systems in order to provide lenders with certainty of applicability and a streamlined integration into origination workflows. This includes maintaining certainty in the applicability of the valuation method through each transaction to ensure that lenders are not forced to change the valuation method once selected. To that end, appraisal alternatives should support all property types to eliminate friction caused by ineligible property types, which may not be easily identifiable by an originator up front.

We have gained insight into the potential complications of implementing hybrid appraisal solutions, as we piloted such a program for a 12-month period. The program allowed for different valuation options based on the risk profile of the loan and property. However, a minor change to the loan amount, for example, could trigger a requirement for a physical inspection late in the origination process and result in delays as well as additional costs for the consumer and lender. Further, depending on the timeframe, credit documentation could expire before the property inspection can be scheduled and completed, requiring the borrower to provide refreshed documentation which can further delay closing and cause additional friction. For this reason, we stress the importance of basing the qualification for appraisal alternatives on the availability of data sufficient to produce an accurate valuation to ensure the valuation requirement is not subject to change throughout the origination process.

The Enterprises should automate the selection of the appropriate valuation method into the underwriting tools and technology that they offer so lenders can efficiently adopt valuation methods, and have certainty about the application of a specific valuation method. As the FHFA highlights in the request for information, take-up of the COVID-19 origination flexibilities related to appraisals was relatively low. We would like to clarify that this is not necessarily due to a lack of perceived value in the allowance of desktop and exterior-only appraisals for certain loans, but rather due, at least in part, to the lack of integration into the Enterprises' underwriting systems, the temporary nature of the COVID-19 flexibilities, and the lack of representation and warranty relief (as mentioned above). To better serve their customers, lenders frequently employ automation to improve efficiency wherever feasible. Any change to a process that has been automated requires an investment in technology resources to modify the automation parameters. Many lenders who also service loans prioritized enhancing their servicing platforms and online borrower tools during the past year to serve the unprecedented number of borrowers in need of COVID-19-related assistance. Further, the temporary nature of the flexibilities and short

[7] Fannie Mae Lender Letter 2021-04 and Freddie Mac Bulletin 2020-05

extensions made it difficult to justify investing in system modifications that could become moot in a period of weeks if the flexibilities are not extended. We believe that making the appraisal flexibilities permanent, fully integrated, and incorporated within a consistent representation and warranty framework would prompt a sizable increase in adoption among lenders, as evidenced by the widespread adoption of appraisal waivers.

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We believe that the Enterprises are uniquely positioned today to facilitate a responsible expansion of appraisal alternatives that can create significant operational efficiencies, leading to lower costs for borrowers, a more convenient process, and the potential to reduce disparate treatment. A well-thought-out appraisal modernization initiative should be informed by the Enterprises' sizeable appraisal dataset which can be used to expand the appraisal product offering and create a robust risk management framework that will protect borrowers, appraisers, the Enterprises, and lenders. Greater certainty around representation and warranties and valuation method during the origination process will enable greater adoption of appraisal alternatives. Advancements in non-traditional, data-driven appraisal products will also provide greater opportunity to create additional capacity in the real estate appraisal workforce. We would suggest that the appraisal modernization initiative be iterative and ongoing, with policies that are sufficiently flexible to leverage advancements in technology and respond quickly to unique market conditions.

To that end, we welcome the opportunity to discuss our recommendations in further detail and share some of the aforementioned analyses we have conducted. Should you have any questions or wish to discuss further, please contact Oliver Rubinstein, SVP of Product Strategy & External Relations, at (818) 746-2055 and oliver.rubinstein@pnmac.com.

Sincerely,

David Spector

David Spector
Chairman and Chief Executive Officer
PennyMac Financial Services, Inc.
PennyMac Mortgage Investment Trust