AXIS Appraisal Management Solutions, Inc.

Industry best practice guidelines

Appraisal Quality Control

Consistency, accuracy, efficiency, and compliance

UPDATED: Now includes Fannie Mae's new requirements

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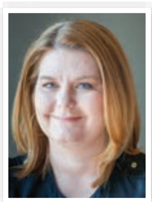
About the authors



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As co-founder and EVP of one of the nation's largest and most reputable AMCs, Kim Perotti is responsible for the appraisal management services for AXIS' lengthy roster of national clients. She's an expert on a wide variety of appraisal issues, with a specific focus on the consistent, effective quality control that solidified AXIS' position as a market leader.

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INTRODUCTION

All the mortgage industry experts agree on very few things

But since the 2008 financial crisis and the resultant HVCC the following year, it seems every article about appraisal management or compliance has begun with a sentence similar to this:

> **"The appraisal industry has changed dramatically."**

In fact, rapid and continual change are the only constants in our industry and it's a common complaint for most lenders. But, now smart institutions can easily adapt and perform far more competitively than their competitors and do so less expensively than they might think.

When managing appraisal QC, many lenders and appraisal management companies (AMCs) try to solve the wrong problem. Instead of desperately trying to keep up with new guidelines and requirements your organization can work smarter by implementing a PROCESS which allows you to be agile and flexible. Your ability to quickly adapt to change can become a competitive advantage. To do that effectively, it's the SYSTEM you have in place that matters. You need a consistent and efficient infrastructure that enables you to thread the needle of effective, well-documented, quality control, while also maintaining strict legal compliance.

Is your appraisal QC system broken? Do you have a QC system at all?

If you're reading this, you've probably been stung by an inefficient appraisal QC system. Our objective here is to give a brief regulatory overview concerning appraisal quality control and why it matters to your organization, but then we'll focus on ten critical warning signs that your organization might be carrying unnecessary risk that you can easily and quickly eliminate. We conclude with a checklist of important considerations when building your own QC process.

After decades providing solutions used by the largest lenders and AMCs in the nation, best practices have emerged that we can share to help you prevent the most common, most costly, and most preventable pitfalls and compliance violations.

By "pitfalls", we mean buybacks, non-compliance fines and penalties, reputational risk, closing delays, and worse.

REGULATORY OVERVIEW

After this white paper was first published, Fannie Mae issued new QC requirements that directly affect your appraisal operations. Pre-funding, investors and regulators want every appraisal to undergo a documented, consistent QC process.

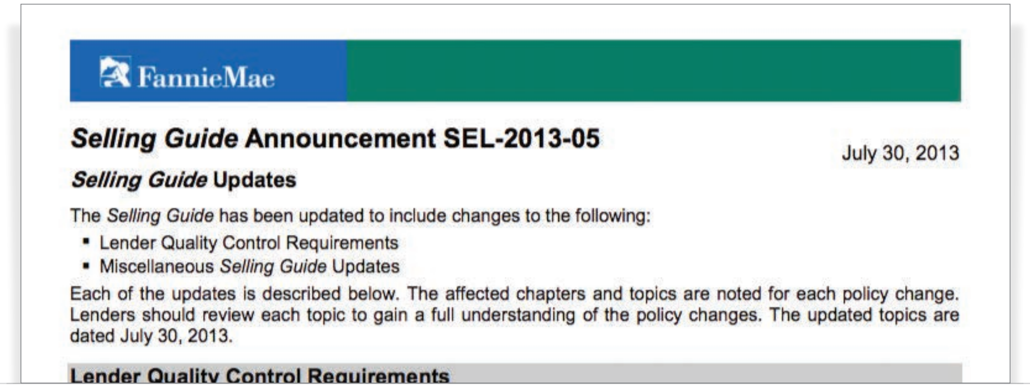
Announced in July, Fannie Mae adds pre-funding QC process and documentation requirements

The Selling Guide Announcement issued July 30 focuses on quality control requirements to reduce repurchases. The full list is long, but we've isolated a few of the specific requirements that many lenders and AMCs don't have in place yet:

The new Fannie Mae Selling Guide requirements

- Your QC program must be documented and **incorporate systems and processes** for achieving your QC standards.
- Your program must **specify the location of QC findings** and all related QC documentation. This requirement eliminates the mental checklist or spreadsheets that many use. In repurchase requests or exams, they're looking for a documented QC audit trail.
- You must **develop severity levels to categorize defects.** They're requiring this type of scoring, but it's a good idea to implement anyway. QC scoring with severity levels is useful to streamline your internal operations since you can more effectively triage files to the appropriately experienced underwriters for each score range.
- You must **report on QC findings monthly to senior management.** Without a consistent QC process and system, meaningful reporting will be very difficult. Trends and overall findings of all your QC staff can't be determined without a standard process that eliminates as much subjectivity as possible.
- Your QC process **has to include stated data and documents,** so you can ensure the data relied upon in making the underwriting decision is accurate. This last requirement makes clear that these new standards apply to a review of the appraisal.

The full Selling Guide Announcement can be found here:
https://www.fanniemae.com/content/announcement/sel1305.pdf



FannieMae

Selling Guide **Announcement SEL-2013-05** July 30, 2013

Selling Guide **Updates**

The *Selling Guide* has been updated to include changes to the following:

- Lender Quality Control Requirements
- Miscellaneous *Selling Guide* Updates

Each of the updates is described below. The affected chapters and topics are noted for each policy change. Lenders should review each topic to gain a full understanding of the policy changes. The updated topics are dated July 30, 2013.

Lender Quality Control Requirements

Announced in September, UCDP expands to include QC messages

Their requirements will eventually be enforced through the submission platform, Uniform Collateral Data Portal, or UCDP. The Fannie Mae UCDP Release Notes from September 24 let us know it's coming faster than most expected, and they're probably in place by the time you read this. The full Release Notes can be found here:
https://www.fanniemae.com/content/release_notes/ucdp-release-notes-11092013.pdf.

For now, these are warning messages and won't prevent a "successful" UCDP submission, but warnings will transition to errors. When you take a look at these messages, you'll quickly see the GSEs' focus is emphasizing pre-funding quality control and consistency. Here's just one example:

New UCDP warnings

> FNM0189: The appraiser indicated a condition rating for the subject property of C3 or greater. However, the age and update history of the subject property appear to support a condition rating of C1 or C2. Verify that the reported condition rating and actual age of the property are accurate.

What's coming: UCDP's future QC focus

Investors have spoken at industry conferences, frequently stating that UCDP warning messages that will go even further, and provide a comparison of data aggregated across the entire platform from various appraisers. An example of these types of warnings would look like this:

> The appraiser indicated a condition rating for the subject property of C2. 83% of appraisers have rated this property a C3. Verify that the reported condition rating is accurate.

In addition, "self discrepancies" will be noted. Examples of these types of warnings could look like this:

> The appraiser indicated a condition rating for the subject property of C2. The same appraiser used this property as a comparable in another assignment with a condition rating of C3. Verify that the reported condition rating is accurate.

The Selling Guide Announcement referenced on page 4 gives a good overview of their requirements, but seeing the actual warnings and errors they're planning to give you when you submit an appraisal gives us a really good idea of what the GSEs expect your QC process to uncover.

Regulatory overview continued on page 6.

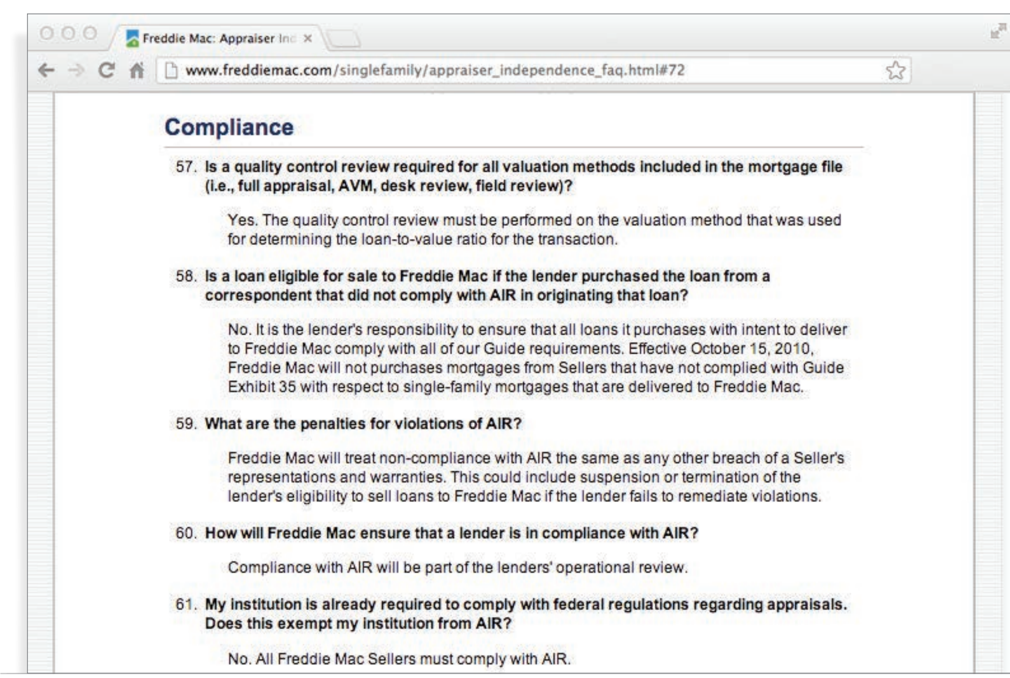
REGULATORY OVERVIEW

Several other guidelines pertain to your appraisal QC process, as well. Dodd-Frank's appraisal rules can be found in subtitle F of Title XIV of the Act, titled "Appraisal Activities". (http://www.law.cornell.edu/uscode/text/15/1639e) Section 1472, Appraisal Independence Requirements (AIR) establishes some common sense compliance guidelines designed to prevent collusion. Most of these were also required by HVCC (http://www.fhfa.gov/webfiles/2302/HVCCFinalCODE122308.pdf) so they've been well documented in the industry and should be familiar to most.

The CFPB deadline

The Consumer Financial Protection Bureau is charged with overseeing the rules and enforcement of the Dodd-Frank Act and we know they are still issuing final rules while gearing up for enforcement. **It's critical to examine your current process with enough time to make internal changes for compliance before the January 2014 effective dates.** In light of that quickly approaching date, most organizations are already short on time.

We know investors will also adopt the same quality control requirements as the regulators are, at a minimum. For one example, see Freddie Mac's Appraiser Independence FAQ, shown below, regarding the necessity for an appraisal quality control process. Freddie Mac's full AIR requirements can be found here: http://www.freddiemac.com/singlefamily/appraiser_independence_faq.html.



Freddie Mac: Appraiser Ind
www.freddiemac.com/singlefamily/appraiser_independence_faq.html#72

Compliance

57. **Is a quality control review required for all valuation methods included in the mortgage file (i.e., full appraisal, AVM, desk review, field review)?**

    Yes. The quality control review must be performed on the valuation method that was used for determining the loan-to-value ratio for the transaction.

58. **Is a loan eligible for sale to Freddie Mac if the lender purchased the loan from a correspondent that did not comply with AIR in originating that loan?**

    No. It is the lender's responsibility to ensure that all loans it purchases with intent to deliver to Freddie Mac comply with all of our Guide requirements. Effective October 15, 2010, Freddie Mac will not purchases mortgages from Sellers that have not complied with Guide Exhibit 35 with respect to single-family mortgages that are delivered to Freddie Mac.

59. **What are the penalties for violations of AIR?**

    Freddie Mac will treat non-compliance with AIR the same as any other breach of a Seller's representations and warranties. This could include suspension or termination of the lender's eligibility to sell loans to Freddie Mac if the lender fails to remediate violations.

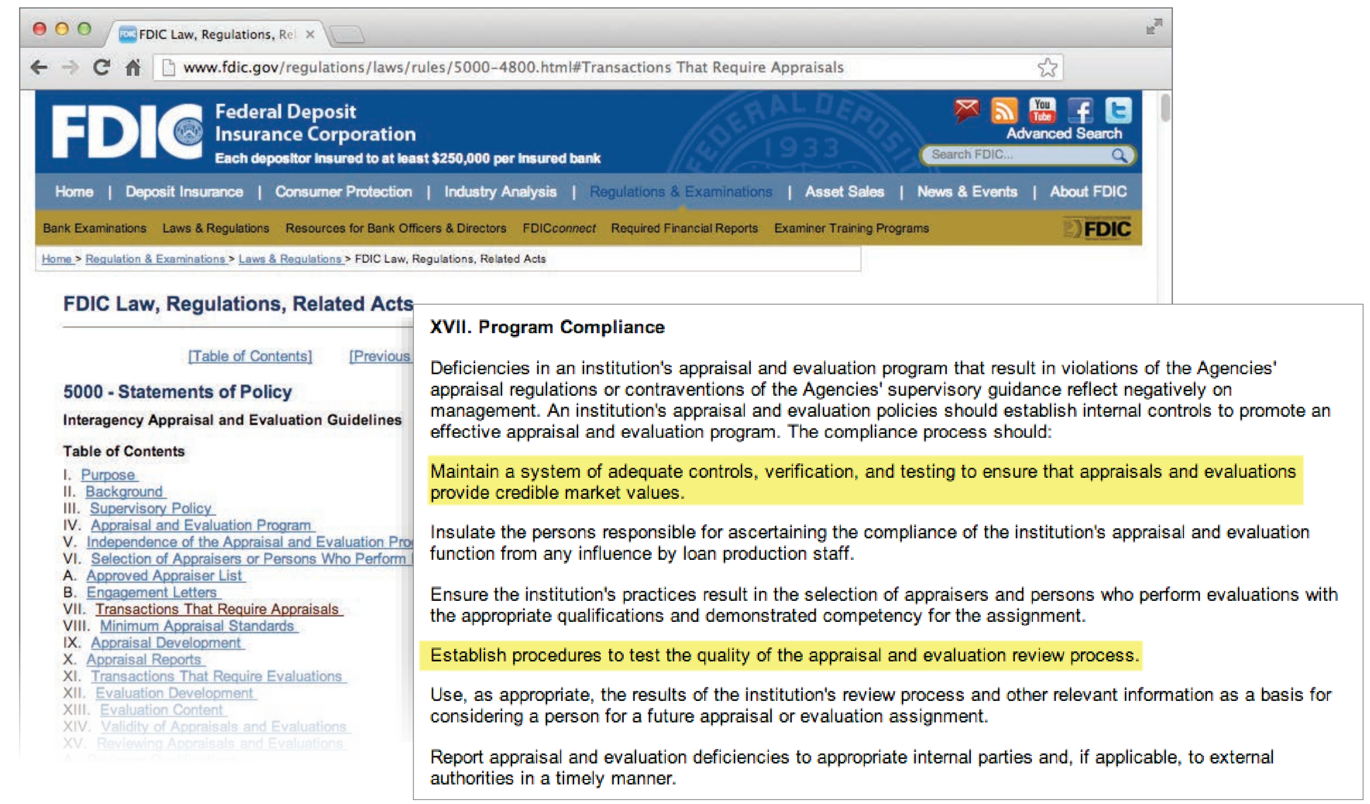
60. **How will Freddie Mac ensure that a lender is in compliance with AIR?**

    Compliance with AIR will be part of the lenders' operational review.

61. **My institution is already required to comply with federal regulations regarding appraisals. Does this exempt my institution from AIR?**

    No. All Freddie Mac Sellers must comply with AIR.

The FDIC also requires consistent quality control procedures for appraisals. See their Statements of Policy, section XVII. Program Compliance, shown below. The FDIC Statements of Policy can be found here: http://www.fdic.gov/regulations/laws/rules/5000-4800.html.



XVII. Program Compliance

Deficiencies in an institution's appraisal and evaluation program that result in violations of the Agencies' appraisal regulations or contraventions of the Agencies' supervisory guidance reflect negatively on management. An institution's appraisal and evaluation policies should establish internal controls to promote an effective appraisal and evaluation program. The compliance process should:

Maintain a system of adequate controls, verification, and testing to ensure that appraisals and evaluations provide credible market values.

Insulate the persons responsible for ascertaining the compliance of the institution's appraisal and evaluation function from any influence by loan production staff.

Ensure the institution's practices result in the selection of appraisers and persons who perform evaluations with the appropriate qualifications and demonstrated competency for the assignment.

Establish procedures to test the quality of the appraisal and evaluation review process.

Use, as appropriate, the results of the institution's review process and other relevant information as a basis for considering a person for a future appraisal or evaluation assignment.

Report appraisal and evaluation deficiencies to appropriate internal parties and, if applicable, to external authorities in a timely manner.

Additional resource

Dodd-Frank and Appraisals: The Compliance Strategy
Get an in depth look at appraisals under the Dodd-Frank Act, as featured in the October issue of Mortgage Bankers Association's Mortgage Banking magazine.

Download the PDF:
http://www.mercuryvmp.com/dfa/
(No subscription required)

INSTITUTIONAL RISKS

"Why you need a QC system at all"

You've already read the scary headlines about the penalties for non-compliance. They range based on the violation, but they're all calculated on a per-violation, per-day basis, and punitive and civil damages are added to the top. It's not a pretty picture.

Compliance issues aside, the lack of a consistent, transparent appraisal QC process results in unnecessary institutional expenses, significant reputational risk, dead deals, and poor lending decisions. An inadequate appraisal QC system dramatically affects underwriting too, stretching already understaffed departments too thin.

"Compliance issues aside, the lack of a consistent, transparent appraisal QC process results in unnecessary institutional expenses, significant reputational risk, dead deals, and poor lending decisions."

Many are relying upon underwriters to be appraisal experts, even when AMCs are employed to serve that role. The lack of a process or system means you can't prove compliance even if you were lucky enough to achieve it. Even if you forget about compliance for a second, the internal risks and efficiency costs are staggering just by themselves. They're reason enough to pursue a documented, consistent, and transparent appraisal QC process.

Are you armed for buyback requests?

One of the most important benefits of a software-powered, consistent QC process is the automatic compilation of end-to-end audit trails to prove your due diligence on every loan file. The thorough documentation of your QC process on a per-loan basis can protect you from those increasingly common buyback requests.

Software systems let you create automatic audit trails of every step of your QC process!

Additional resources

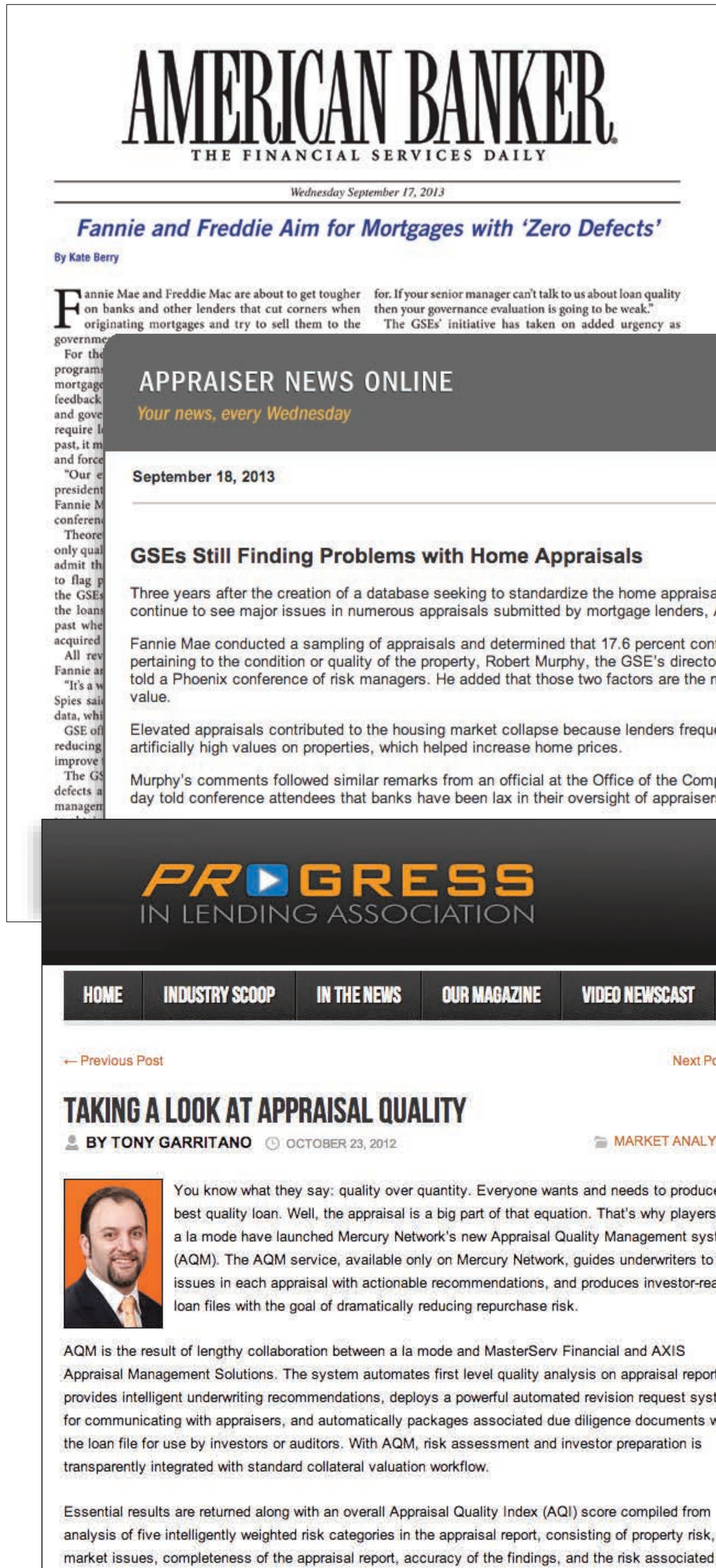
Fannie and Freddie Aim for Mortgages with 'Zero Defects'
By Kate Berry in American Banker
September 17th, 2013
Download the PDF:
http://alashort.com/1db6LaL
(No subscription required)

"Our expectation is zero defects," said Steve Spies, a vice president of loan quality and lender assessment at Fannie Mae.

GSEs Still Finding Problems With Home Appraisals
Appraisal Institute, Appraiser News Online
September 18th, 2013
Digital version:
http://progressinlending.com/blog/2012/10/23/taking-a-look-at-appraisal-quality/#
(No subscription required)

"The Federal Housing Administration, which oversees the GSEs, estimated that approximately 35% of repurchases that require lenders to buy back a loan are tied to faulty appraisals."

Taking a Look At Appraisal Quality
PROGRESS in Lending Association
October 23rd, 2012
Digital version:
http://www.appraisalinstitute.org/ano/DisplayArticle/Default.aspx?volume=14&numbr=17/18&id=20617
(No subscription required)



TEN CRITICAL WARNING SIGNS

How's your QC process?

In our experience with numerous lenders and AMCs, quality control is typically one extreme or the other: too manual or too automated — both leading to inconsistent or ineffective results. If any of these ten warning signs sound familiar, it's time to implement a procedural change for compliance and a defensible position that provides efficient and reasonable decision making.

10 **You use multiple AMCs.** Many lenders use multiple AMCs, but every AMC has a different QC process. When you use more than one AMC and an examiner asks for your QC process, how will you respond? You can still have the benefits of using multiple AMCs as long as you have a standard QC process across all the AMCs you use. In addition, a side benefit of your standardized QC process is much faster boarding with new AMCs as your growth dictates, or as you try different vendors.

9 **Different divisions of your company have different appraisal processes.** Do your retail and your wholesale divisions use the same valuation experts? Do branches use different solutions? Do you have consistent underwriting standards? Without transparent QC consistency, you're obviously risking quality but you're also risking your organization's compliance and reputational standing.

8 **You have no documented proof that each appraisal has been QC'd and they've been QC'd consistently.** Your appraisal QC process could be excellent. But without documentation, you can't prove it. An end-to-end audit trail for the QC process on each appraisal should be standard operating procedure to minimize risk.

7 **You order extra valuation products on every appraisal just to cover yourself.** This practice is fairly common, but it can be a significant and unnecessary expense. The idea is just to add an AVM or analytics on every appraisal, whether the supplemental information warrants the extra work or not. The problem is that these reports don't really QC anything, but instead just provide additional data. When ordered on every report whether you need it or not, the expense adds up. This strategy impacts your two most valuable resources: time and money.

6 **You send too many reports back to your AMC with questions or revisions.** Often, underwriters and processors aren't sure what the AMC has already done or what they've missed, so they're wasting time asking questions of the AMC and the appraisal vendors. Institute a process so that your AMCs or your QC staff can easily document what they've done and so they can proactively isolate the issues that your underwriters need to pay focused attention to. You'll save valuable time.

5 **Each of your underwriters or processors QCs a little differently.** Without consistent appraisal QC standards across all of your staff, you'll have confusion amongst LOs, appraisers, AMCs, examiners, and borrowers about your organization's valuation requirements. There are inherent reputational and compliance risks in this situation, and it makes growth very difficult.

4 **You're asking underwriters to be appraisal experts when you employ AMCs as your appraisal experts.** Experienced underwriters are now much harder to come by and departments continue to shrink, yet many underwriters are wasting time going back and forth with your AMCs. If your underwriter is reviewing the entire report instead of just the incurable issues isolated by your AMC, he/she is processing files much slower and less effectively than they could be. Without a consistent way for your AMC to report the QC work they've already done and the ability to quickly isolate the issues that need underwriting review, your organization is at a disadvantage.

3 **You're asking AMCs for too many revisions, and you don't have a documented audit trail to prevent the same revision requests repeatedly in the future.** If you're looking at the QC of each appraisal independently and not leveraging solutions for common issues across your entire process to limit future revision requests, it will be difficult to grow. Your process can't improve quickly as a whole, and your only growth solution is to pile on employees and payroll expenses to handle your tasks. As we all know, throwing more people at a problem can result in more inconsistency and additional compliance risks.

2 **Deals are dying because of valuation issues, but you have no idea how to manage it or identify it when the loan is originated.** Valuation problems are consistently cited as one of the largest risks, and a consistent QC process can significantly reduce risk and keep you compliant with regulatory and investor requirements.

Scary, but it still happens.

1 **Your appraisal QC checklist is all in a guy's head.** If an examiner or an investor asks about your appraisal QC process and the appraisal desk manager just gives a wink and taps their head like "it's all in here", you're probably in trouble. Get a documented, consistent, flexible process in place as soon as possible.

Overcoming resistance to change

Every organization has experts who resist change, especially considering the compliance risks today. Here's the key question to help overcome this:

"You do a tremendous amount of QC work on every file. How do we prove it?"

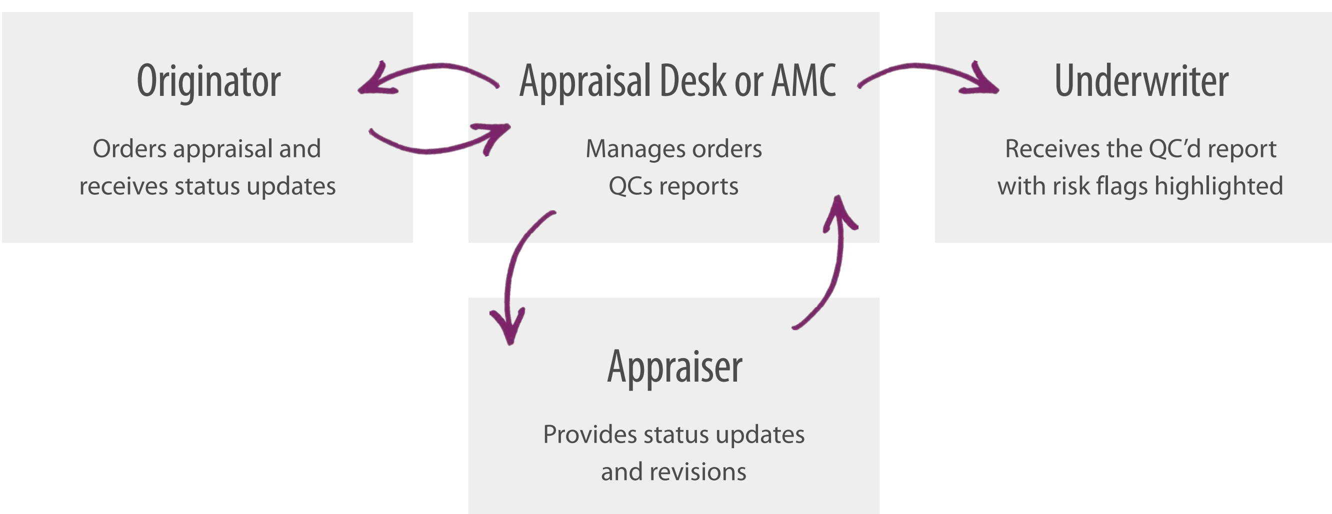
This is where a system with automatic audit trails will help. It memorializes all the QC work done and travels with the loan file.

The key is proving the value to your QC staff.

ORGANIZATIONAL WORKFLOW

Many of the largest lenders and AMCs are most efficiently deploying their appraisal QC process from the appraisal desk or with dedicated QC staff, before the appraisal arrives in underwriting. Benefits to this approach include:

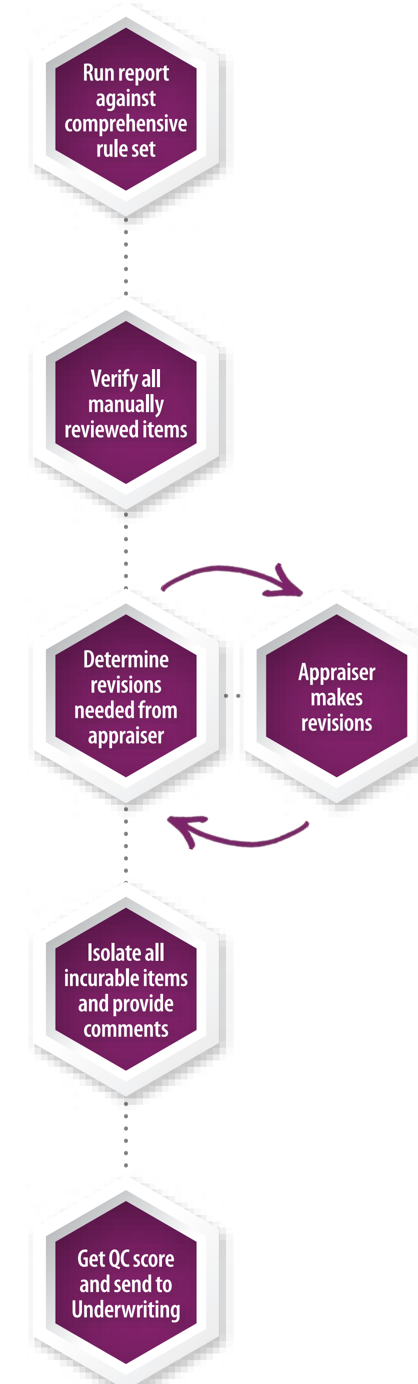
- **Enhances efficiency:** When you assign severity scores in compliance with Fannie Mae's guidelines, the QC check serves to triage reports to the appropriate levels of underwriting staff. Reports with few or no issues can go to less experienced underwriters, while reports with several risk flags are sent directly to senior staff.
- **More automation possibilities to ensure compliance and consistency:** With a QC software system, you can process QC exceptions, compliantly communicate revisions to your appraiser, and resolve all curable issues from inside your appraisal desk software. If your software includes compliance safeguards and audit trail event documentation, you lesson your risk of inconsistency and human error.



TECH BASED QC WORKFLOW

For an effective QC process, it's important to follow a consistent system. Your objective is to quickly check all the items you need to review manually, review any rule violations uncovered by your QC software, and then isolate only incurable issues for underwriting's review. Here's a brief walkthrough of an optimized, technology-based QC workflow:

- **Review all issues that require manual checks.** There are issues in every appraisal that need to be verified by a human and can't be automated effectively. Examples of these include due diligence such as checking information provided against public record sources and verifying the contents of photos. These manual checks can be performed quickly with a software system. Beware of printed checklists or spreadsheets for this function when software is transparent, more efficient, more consistent and more complete. In addition, with paper or spreadsheet checklists, there's often no automatic documentation included with the report to time stamp and verify that the manual checks necessary for effective QC on this particular report took place.
- **Determine which issues require appraiser revisions.** Your QC software system should scrub the report against all the compliance and investor requirements and return issues for your consideration. You can quickly review each and determine if an appraiser revision is necessary or if the appraiser has already addressed the issue in addenda or elsewhere. If a revision is required, request it inside your QC system so your revision cycle is also documented in your QC audit trail for your own protection as proof of compliance with AIR, Appraisal Independence Requirements (see detailed information on these requirements with links to resources on page 4).
- **Isolate incurable issues and add QC comments.** Remember, your goal in appraisal QC is not to eliminate all rule failures or to correct everything. Some issues cannot be "corrected", so we refer to those as incurable. Your goal is to address all curable issues and then isolate only those incurable items that underwriting needs to consider. Incurable items are the issues with the property that can't be cured with an appraiser's revision. They are real issues with the property that underwriting needs to review.
- **Forward appraisal report and your QC results and end-to-end audit trail to underwriting.** After the QC process, the appraisal is ready to go to underwriting, along with the QC results on that report. An efficient QC system will isolate incurable items in an easy-to-read report and present the accompanying comments from the QC staff so underwriting knows the due diligence that's already been performed.



Additional resource

Video: Watch this five minute video on how to leverage technology for consistent, transparent appraisal QC.

Watch the video:
http://www.youtube.com/watch?v=UKaThpzmoDU
(No sign up required)

CONCLUSION

We hope this paper gives you a solid foundation for your appraisal QC process, and identifies the mandatory requirements for effective QC. We have developed an off-the-shelf software to assist you (described on the next page), but it's important to explain the need for having a consistent system in place at all. In decades of appraisal industry experience, we've seen many changes to best practices and we're confident the industry will continue to change quickly. To compete in that environment, it's critical to have a powerful, flexible technology-based workflow process in place.

The list below can help you with effective implementation:

- ✓ Adopt a comprehensive, consistent QC process that goes beyond auto-checks and can easily be provided when examiners inquire.
- ✓ Deploy your QC process across all your business channels and/or across all your AMCs for consistency.
- ✓ Integrate all vendor revision requests into your overall QC cycle and make sure those transactions are documented from end to end for proof of regulatory compliance.
- ✓ Quickly isolate incurable items in all appraisal reports for human review so your underwriters aren't buried in irrelevant details.
- ✓ Maximize efficiency and speed by instituting routing procedures internally for more effective underwriting, so reports with fewer incurable items go to less experienced underwriters while reports with several issues go to your veteran staff.
- ✓ Memorialize all your QC work for every file in a full audit trail document that travels with the loan file to investors and regulators.

Questions?

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