



Keys to Appraisal Review in Distressed or Declining Markets

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Appraisal Review Process	Pg 3
Appraiser's Responsibilities	Pg 2
AUS Messages	Pg 2
Comparable Sales	Pg 3
Inconsistent/Questionable Information	Pg 6
Neighborhood Characteristics	Pg 5
Neighborhood Section	Pg 4
Property Location	Pg 3
Resources/Websites	Pg 6
Underwriter's Responsibilities	Pg 2
Unit Housing Trends	Pg 5

It is critical to review and analyze the appraisal for every loan to ensure that the property value is supported. This review should be completed regardless of any AUS, collateral assessment model, or other messaging received. A poor, inaccurate, or incorrect appraisal report is not corrected by a reduction in the LTV.

We have provided this information to give guidance on how to identify distressed/declining markets, in the event such information may not be indicated on the appraisal report or when the AUS messaging does indicate a distressed/declining market. It is important to recognize that the AUS messaging and the information provided in the appraisal can be helpful in determining when a more careful review of the appraised value is required.

With the current volatility in the housing market and restrictions being implemented to reduce or limit the maximum loan-to-value (LTV) ratio for properties located in markets where prices are falling, this information assists in the review of the appraisal report to determine if the subject property is located in a distressed/declining market. Although, there is no standard industry definition of what constitutes a distressed/declining market, generally this is a specific geographic area with property values that have been influenced by foreclosure, unemployment, and other factors affecting the property values in those areas or specific geographic areas with property values that have been declining or are likely to decline.

From a lending perspective, the greatest credit risk occurs when a property is overvalued. The overvaluing of a property results in the understatement of the (LTV) ratio and/or insufficient collateral. The possibility of overvaluation increases in a declining market. With recent trends indicating that home prices are falling in many areas across the country, it is important to thoroughly review the appraisal report to ensure that it accurately reflects the current market value of the subject property.

There are a number of factors found on the appraisal report that can be used to determine if a property is located in an area where prices are falling. These factors include the property's location, comparable sales, neighborhood characteristics, and current market trends. The degree to which these factors influence the subject property's value should be fully disclosed and supported by the appraiser on the appraisal report.

APPRAISER'S RESPONSIBILITIES

It is the responsibility of the appraiser to use industry data and market trend information to determine if property values are declining in a particular area. The appraiser's analysis should demonstrate an understanding of the subject property's location, neighborhood characteristics, and current market conditions in order to accurately assess the value of the subject property in a specific geographic area. In short, the appraisal needs to support the value given by the appraiser.

UNDERWRITER'S RESPONSIBILITIES

It is the underwriter's responsibility to complete a thorough evaluation of the appraisal to ensure that the report is complete, accurate, and consistent with appraisal and investor standards, and that it provides a reasonable determination of the property value. The underwriter should be able to determine from the information provided on the appraisal report whether or not the property value constitutes sufficient security for the mortgage. Identifying inconsistencies within the appraisal report as they relate to the property value is a critical part of the appraisal review.

Underwriters are required to review the appraisal in its entirety for completeness, accuracy, and consistency to ensure that it provides an adequate determination of property value, regardless of what message is received from any Automated Underwriting System (AUS) or other collateral assessment models.

AUS MESSAGES

When loans are reviewed by an AUS, the underwriter is expected to:

- Review the appraisal to ensure consistency with appraisal standards and evaluate the property's acceptability as security for the loan as it relates to its value and marketability.
- Ensure that the appraiser analyzes current listings and contract sales, along with the most recent closed sales. If the appraisal report does not accurately reflect the current market conditions, additional clarification, justification, and comparables should be requested from the appraiser.

There are several key phrases or messages that may be received regarding the appraisal, which can be used as indicators of the property value:

- ...returned the following standardized address and census tract for... This is the address that will be used in its property valuation and fieldwork...
- ...collateral assessment model indicates that the submitted value estimate for this...transaction may be excessive.
- ...collateral assessment model indicates that the...appears to have an excessive rate of appreciation...
- The subject property has been identified as being located in either an area of declining home prices or in an area where it may be difficult to assess home values...
- Review for accuracy: The estimated value of property or net purchase price submitted for this transaction may have a higher rate of appreciation than the local market...
- Form (2055, 2065, 2075) is the minimum assessment required ...

A message that simply indicates the form number required for the appraisal is not an assurance that the value of the property is accurate. The absence of any of the above messages does not indicate that the submitted value is appropriate as the appraised value for the property. The appraisal would still require a thorough review for completeness and accuracy.

APPRAISAL REVIEW PROCESS

PMI believes that the following suggestions and processes are examples of sound business practices. Implementing such practices is recommended to ensure that the true value of the subject property has been determined. A thorough review of the appraisal report for completeness, accuracy, and consistency will ensure that the value of the subject property is adequately supported by the appraiser.

Property Location – A good starting point is to determine where the subject property is located by referring to the location map.

- Determine if the location map has been reduced in size or “zoomed-out” in order to fit all of the comparables and the subject property on the same map; check to see if the street names are visible. The location map should clearly identify the location of the subject property. Cross-check the property location through mapping websites. Compare streets on the location map to the neighborhood boundaries provided on page one of the appraisal.
- The neighborhood description should be compared to the location map to determine if there are any barriers, such as a freeway, major thoroughfare, creek/river, hills/mountains, park/golf course or large designated open space that determines the subject property’s neighborhood boundaries.
- Refer to the location map to determine if the same types of barriers separate the subject property from the comparable sales. This could reveal that the comparable sales are in a different neighborhood from the subject property. In such instances, additional comparables should be requested.

Comparable Sales - The comparable sales should be as similar as possible to the subject property. Inconsistencies among the comparables decrease the accuracy of the appraised value. In using the sales comparison approach, the following guidelines will help ensure that the comparables support the value of the subject property.

- *Number of Comparables* – A minimum of three closed comparables should be provided that are similar to the subject property in location, age, condition, room count, lot size, and square footage, etc.
- *Proximity to Subject* – As a general rule, the comparables should be within one mile of the subject property. The appraiser should provide an explanation for any sale that is considered to be outside the neighborhood boundaries (i.e., separated from the subject property by a barrier or boundary referenced by the appraiser on page one.)
- *Date of Sale/Time* – The marketing time of the subject property and the comparables do not have to be the same, but there should be a correlation between the two. Although the comparables’ dates of sale are required to have closed within the last 12 months of the effective appraisal date, using the most recent comparables available helps ensure that current market conditions are reflected.
 - Comparable sales over six months old should be explained by the appraiser. For example, if the comparables are not recent (i.e., 6-12 months old) they may not reflect the most current price trends in the area. The comparables’ sales prices may in fact be inflated, if prices have declined in the area.
 - If the appraisal indicates that the subject property has a marketing time of less than three months in the Neighborhood section, but the comparables are 12 months old, the appraiser should provide a detailed explanation as to why there is such a large difference in the marketing times of “similar” properties.
 - For example, the appraiser’s explanation might be “the neighborhood is very stable, limited sales have occurred, and they sell quickly when they come on the market.” An unacceptable response would be “comparables less than 12 months old are not available.” While this may be a true statement, it does not explain why the appraiser indicates the marketing time as less than 3 months.

- *Similar Unit Structures* – Compare the photographs of the comparable sales to determine if the subject property is the same type of unit structure. For example, if the subject property is a ranch-style home, but the comparables are two-story homes, then the comparables and subject property are not similar properties. Additional comparables should be requested to reflect the same type of unit structure.
- *Functionality* – The comparable sales should have the same functionality as the subject property. For example, if the subject property has a 4 bedroom/2 bath room count, then a similar property should generally have an equal room count, not a smaller one of 3 bedroom/2 baths. A value adjustment may not adequately address the differences in functionality between 3/2 and 4/2 room counts; even if they have the same or similar square footage, room count is driven by a different market influence. The appraiser must address significant differences between the subject property and the comparable sales if they raise doubts about the validity of the comparable sales as good indicators of value.
- In established subdivisions, Planned Unit Developments (PUD) or condominium (condos), the comparables should be from the same subdivision or PUD. An explanation is required from the appraiser as to why comparables are located outside the boundaries of the subdivision/PUD.
- In new subdivisions and condo projects, the appraisal should have at least one sale within the general market area and one sale within the subject subdivision or project. The third comparable sale should also be from within the same subdivision or project, as long as it is an arms length sale and the builder/developer is not involved with the sale.
- In rural areas, the value of the property must be fully supported by the appraisal. The appraisal report should provide a thorough analysis of the subject's property value if it is located in a rural area, as the comparable sales may well be located a considerable distance from the subject property. When assessing the value of a rural property, it is crucial that the appraiser is familiar with rural lending practices, as they differ greatly from suburban or urban markets.

NEIGHBORHOOD SECTION

The Neighborhood section of the appraisal report identifies several factors which may provide insight as to whether a property is located in a distressed/declining market. These factors include the property's general location, the built-up and growth rates in the area, the trend in property values, the demand for housing versus supply, and marketing time. The neighborhood boundaries, as well as a description of the neighborhood itself should be described in this section.

Generally, a detailed explanation from the appraiser is required when the following Neighborhood and/or Unit Housing Trends characteristics are indicated on the appraisal report.

- Location - *Rural*
- Built-Up - *Under 25%*
- Growth Rate - *Slow*
- Property Values - *Declining*
- Demand/Supply - *Over Supply*
- Marketing Time - *Over 6 months*

If the appraisal reflects an over supply of properties, the marketing time exceeds six months, or other comments within the appraisal report indicate that the values are declining, the appraiser must supply comments supporting the increasing or stable selection.

It would be highly unlikely that all of the above mentioned “red flags” would be marked on the same appraisal. However, the following combination of Neighborhood Characteristics and Housing Unit Trends, although not comprehensive, may point to a declining market which should prompt further investigation:

- Built-Up Under 25% / Marketing Time Under 3 Months
- Growth Slow / Marketing Time Under 3 Months
- Growth Slow / Demand/Supply Shortage
- Property Values Stable / Marketing Time Over 6 Months

NEIGHBORHOOD CHARACTERISTICS:

Location – In general, rural properties are more difficult to value than urban or suburban properties due to their mixed characteristics such as large lots, varying house designs and styles, and the agricultural influence of the surrounding area. Rural areas are typically less than 25% developed and exhibit slower growth and longer marketing times than urban or suburban neighborhoods.

Built-Up –This rate (expressed as a percentage) indicates the extent to which the neighborhood has been developed. If the neighborhood is under 25% developed, the development progress and its impact on property values should be addressed in detail by the appraiser, as this may indicate weak price appreciation. Rural areas zoned residential or with a Built-Up rate of over 75% indicates an inconsistency that warrants further investigation to ensure that the comparables and the subject property are located in the same market area. Confirmation that the property is actually located in a rural area, as opposed to a suburban or urban area where the Built-Up rates are typically higher, should be obtained from the appraiser.

Growth – This helps determine the current stage in the life cycle of the subject property as well as the neighborhood. Growth in new and developing areas is generally “Rapid.” Once all of the land is developed, growth becomes more balanced and is considered “Stable.” Growth continues in older and established neighborhoods due to changes in land use or redevelopment. If growth is indicated as “Slow,” a detailed explanation should be provided as to why, since this may indicate that prices are weakening and that the subject property is located in a distressed/declining market.

UNIT HOUSING TRENDS:

Property Values - The appraiser must identify whether the property values in the neighborhood are “Increasing,” “Stable,” or “Declining.” Maximum financing is only appropriate when property values are Stable or Increasing.

Demand/Supply – If an “Oversupply” of housing inventory is indicated, then an adequate explanation of its impact on the value as well as the marketability of the subject property should be addressed. An oversupply of housing may result in a softening of house prices. In general, when there is more than a six month supply of housing inventory, the market is considered to be a “buyer’s market.” Typically, in a buyer’s market, the supply of houses exceeds the demand, which tends to drive prices down and can lead to increased sales incentives.

Marketing Time – If a marketing time of “over 6 months” is indicated, then the appraiser should provide an adequate description of the property’s marketability. Longer marketing times are often an indication of declining home prices.

Price Range – The sales price of the comparable sales and the price of the appraised value of the subject property should be close to the predominate value in the neighborhood. Otherwise, the appraiser may have used overpriced comparables to determine the value of the subject property.

Neighborhood Boundaries - Comments made in the Neighborhood Boundaries section should clearly outline the neighborhood in which the subject property is located. Generally neighborhoods do not encompass an entire city, town, township, borough, etc. Specific boundaries, natural or otherwise, such as a freeway, a major thoroughfare, creek/river, large open space, railroad tracks, hill/mountain range, park/golf course, etc., typically mark the borders of a neighborhood. The identification of boundaries ensures that the comparables are located in the same neighborhood as the subject property. Comparable sales located outside the neighborhood boundaries are not acceptable.

Neighborhood Description – Comments in this section provide information regarding neighborhood characteristics, identification, and marketability. This may include comments on the proximity to employment centers, amenities, and adverse environmental influences.

Market Conditions - This section is where the appraiser provides adequate support for the neighborhood characteristics. Comments regarding the trend in property values, demand and supply, marketing times, and data on comparable properties in the neighborhood should be supported in detail. Any indication of weak or falling home prices warrant further investigation, as this may indicate the subject property is located in a distressed/declining market.

INCONSISTENT/QUESTIONABLE INFORMATION:

If inconsistent or questionable data appears on the appraisal report, or if such information points toward distressed/declining home prices, the following is recommended:

- Request written explanations from the appraiser regarding inconsistencies and/or questionable data.
- Require detailed explanations to support the use of questionable data/information such as large price adjustments, marketing times over six months, and/or comparables sales older than six months.
- Request additional comparables or listings to confirm the value of the subject property, if those provided appear to be located outside the subject property's neighborhood, far exceed the predominate price in the area, or are a different unit structure.

RESOURCES/WEBSITES:

PMI strongly encourages its customers to use supplemental sources and tools to independently assess current housing trends and implement processes, and tools to validate current housing trends. Lenders should not rely solely on the information reflected in the appraisal report. There are several resources and websites that can be used by lenders, appraisers, and underwriters to assess current housing trends, including, but not limited to the following:

- OFHEO House Price Index <http://www.ofheo.gov/hpi.aspx>
- PMI's Economic Real Estate Trends (ERET) http://www.pmi-us.com/products_services/eret.html
- PMI's Appraisal Review Techniques modules for all property types.
- Fannie Mae Announcement 07-11, July 13, 2007: Collateral Valuation Practices and Declining Markets. <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2007/0712.pdf>
- Fannie Mae Customer Education Group, September 2007: Focus On-Valuing Property in a Declining Market. <https://www.efanniemae.com/lc/newsletters/sfnews/1007value.jsp>
- Fannie Mae Announcement 07-22, December 5, 2007: Maximum Financing in Declining Markets. <https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2007/0720.pdf>
- Freddie Mac Bulletin: New and Revised Postsettlement Delivery Fees and Other Changes to the Single-Family Seller/Service Guide. November 15, 2007. <http://www.freddiemac.com/sell/guide/bulletins/pdf/bl111507.pdf>

Basic property price estimates:

www.zillow.com
www.realtor.com
www.domania.com (fee charged)

Determining property location:

www.mapquest.com
www.googleearth.com
www.maps.yahoo.com

PMI does not endorse any of the websites. The websites listed above are suggestions only and may or may not be limited in scope by the amount of available public information.

For more information, visit our website at www.pmi-us.com. If you have any questions, please contact your PMI sales representative.

To access this document online:

- Go to www.pmi-us.com
- Select "Resource Center" and scroll to the middle
- Select "Underwriting Guidelines" and scroll to the middle
- Click on "Keys to Appraisal Review in Distressed or Declining Markets,"
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