BankThink Fannie and Freddie Still Encourage Biased Appraisals

By *Lynn A. David*

In the wake of the housing crisis, bank regulators published rules designed to place a wall between lenders and appraisers. But the spirit of these necessary regulations continues to be violated thanks to policies of Fannie Mae and Freddie Mac, prompting concerns that there could be another mortgage meltdown.

One of the contributing factors of the housing crisis of 2007 was the overvaluing of residential real estate by appraisers. Some appraisers would effectively adjust appraisals to meet the value needed by lenders so the loan could be approved. This would then encourage the lender to send more business to the appraiser whose income is directly related to the number of appraisal orders received.

The new regulations are intended to keep the appraisers honest. One objective was to ensure appraisers were not aware of the proposed loan amount or the sales prices that could influence their appraisal. To comply with the new rules, some lenders are using a third-party vendor to randomly select the appraiser to avoid any question of an affiliation between the lender and the appraiser. Some of those third-party appraisal ordering firms also monitor and provide feedback to the lender concerning the quality and turnaround of each appraisers' work.

Other financial institutions and mortgage companies have attempted to follow the regulatory mandate by having an employee that is not involved with residential real estate lending or the loan documentation process order the appraisal from local appraisers. That employee can use a rotating list of appraisers. To be sure, running orders through a nonmortgage employee, and the reality that lenders and appraisers still likely associate with each other in their local communities, makes conflicts of interest still possible. But this is still an improvement from how lenders and appraisers operated leading up to the crisis.

All of these new regulations were designed to create an environment where the value placed on each property is fair and balanced. However, even though the regulators did their best to promote a more level playing field, Fannie Mae and Freddie Mac did not change their regulations.

Today, appraised home values still are almost always equal to the amount of a sales price on a purchase appraisal. This would suggest there is still communication between lenders and appraisers to prompt concern. But it's no wonder the appraisal corresponds with purchase amounts. A Fannie Mae policy on appraisals requires that, "The lender must provide the appraiser with a copy of the complete, ratified contract." (Fannie and Freddie standardized their appraisal regulations in 2013 so the rules are similar for both companies.)

Appraisers are aware of this clause for secondary market loans and therefore they insist that the lender must provide the sales contract. Unfortunately, many lenders are also providing, and some appraisers are requiring, the sales contract on loans that lenders know will be retained on their balance sheet. So when an overly eager buyer pays more than the true market value for a home, guess what: The home ends up being appraised for the overvalued purchase price.

Does this sound familiar? Hello, 2007.

I understand that the appraiser needs certain details to do their job. They need to see the Sellers Disclosure to determine if adjustments need to be made to the appraisal for the heating, electric, roof, gas, water, asbestos and numerous other potential problems with the property. The appraiser also needs to know if there were any personal property concessions included in the sales contract. This information can be included on the Appraisal Request form sent to the appraiser. However, there is absolutely no need for the appraiser to see the sales contract.

Fannie and Freddie should immediately change their regulations so lenders will hopefully receive unbiased appraisals. None of us want to relive 2007