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Best Practices for Wholesale Lending

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On May 20, HUD stopped accepting applications from brokers for FHA approval but began allowing them to originate loans if they are sponsored by an FHA-approved lender (known as a "full Eagle"). The Federal Housing Administration's efforts to shift the burden of supervising mortgage brokers to lenders now means that lenders must take steps to strengthen their broker approval and monitoring procedures. According to FHA Commissioner David Stevens, "HUD will continue to track loan performance and broker performance. "

At this time, many lenders are waiting to see what HUD publishes as guidance for approving brokers. However, there are many existing tools and resources that may be used. Importantly, agencies and investors look favorably upon lenders who do their own research and develop their own systems and methodologies. Lenders can utilize the FHA's Neighborhood Watch system to monitor the default ratios of their third party originators. Certain data within the Neighborhood Watch are available to the public and therefore ideally used by outsourced quality control companies and consultants. Most

institutional investors have strengthened their requirements for lenders to have a written plan for broker approval, monitoring and quality control. Specific guidance has been published by Fannie Mae and Freddie Mac, summarized below.

Fannie Mae Requirements

Fannie Mae stated in its March 29, 2010 Announcement SEL-2010: "Before entering into an agreement with a third-party originator, the lender must be certain that the third-party originator is capable of producing quality mortgages. Therefore, Fannie Mae is requiring the lender to have written procedures for the approval of third-party originators, and that those procedures include the lender's review of specific documents, such as the third-party's recent financial statements and current licenses. In addition, Fannie Mae is updating its requirements related to the lender's management of third-party originations to include a requirement for lenders to perform quarterly (instead of annual) reviews of the performance of mortgage loans originated by third-party originators."

According to the FNMA Selling Guide updates of March 2010, a third-party originator is any mortgage that is completely or partially originated, processed, underwritten, packaged,

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funded, or closed by an entity other than the lender that sells the mortgage to Fannie Mae, such as a mortgage broker or correspondent. Fannie Mae does not consider a mortgage that is originated and/or funded by a lender's parent, affiliate, or subsidiary to be a third-party origination unless the parent, affiliate, or subsidiary uses the services of a mortgage broker or loan correspondent to perform some or all of the loan origination functions. The lender is responsible for ensuring that any mortgages originated and processed by third parties that it sells to Fannie Mae meet Fannie Mae's eligibility criteria and are originated in a sound manner. Special Feature Codes are required at delivery for third-party mortgage loans and lenders remain fully liable to Fannie Mae under the terms of their Contractual Obligations for any functions that are outsourced to third parties.

Before entering into an agreement with a third-party originator, the lender must satisfy itself that the third-party originator is capable of producing quality mortgages. Therefore, Fannie Mae requires the lender to have written procedures for the approval of third-party originators. Specifically, the lender's procedures must include a review of the following:

1. Most recent financial statements
2. Current licenses
3. Resumes of principal officers and underwriting personnel
4. The third party's QC procedures so that the lender can determine if the party and its originations comply with the lender's standards for quality; and
5. Results of background checks for principal officers (for example, obtaining a credit report, screening through a mortgage fraud database or investor exclusionary list, confirming business references, etc.).

Management Procedures for Third-Party Originations

Lenders must have effective procedures for management of third-party originations, given that lenders may lack firsthand knowledge about the borrowers, properties, and business practices of the individuals who originate the mortgage loans. Fannie Mae recommends that lenders document their arrangement with third-party originators by a contractual agreement that includes specific warranties related to the eligibility of mortgages and the third-party originator's responsibilities, as well as avenues of recourse that can be taken if the warranties are breached. Management procedures should include:

1. A system for evaluating and approving third-party originators
2. A method for verifying, and periodically reverifying, a third-party originator's compliance with applicable laws, licensing, and qualifications for originating mortgage loans
3. A method for confirming that a third-party originator complies not only with its contract with the lender, but also with the terms of the lender's Contractual Obligations with Fannie Mae
4. A requirement that a third-party originator have a written QC plan and a method to validate the existence of that plan
5. A process for resolving QC discrepancies and tracking corrective actions
6. A requirement for submitting periodic reports on activity and performance issues to the lender's senior management

Standards for evaluating a third-party originator's performance

1. Provisions for suspending or terminating the third-party originator's relationship
2. Annual review of the third-party originator's financial statements to determine that it is financially viable and capable of meeting its contract terms
3. Quarterly review of the performance of mortgage loans originated by the third party originator (e.g., particularly delinquencies and foreclosures)

QC Requirements for Lenders Reviewing Third-Party Originations

Fannie Mae requires a review of a representative sample of the mortgage loans received from the third party originator to ensure that those originations meet the lender's standards for loan quality. Review cycles must be structured to ensure that transactions originated by each third-party originator are reviewed at least once annually. The discretionary selection of the third-party originator's production may be based on, at a minimum:

1. property location
2. LTV ratios
3. Mortgage product types
4. Borrowers' credit scores
5. Third-party originator's past performance

Freddie Mac Requirements

Freddie Mac's 65-page guide, Discover Gold Through Quality - Wholesale Originations Best Practices is available at <http://www.freddiemac.com/dgtq>.

The guide recommends procedures for evaluating, approving and monitoring mortgage brokers and correspondents. Summarized below are key requirements of a wholesale lending monitoring program:

1. Ensure that a wholesale home mortgage is originated by a mortgage broker or correspondent with sufficient experience and demonstrated integrity to produce an investment-quality wholesale home mortgage
2. Contain criteria and standards for evaluation and approval, including specification of the approval authority in your organization
3. Include a check of the Freddie Mac Exclusionary List
4. Verify the mortgage broker's or correspondent's current compliance with all applicable laws related to licensing, qualification or approval to originate wholesale home mortgages

Freddie Mac Exclusionary List

It is essential that written standards and procedures for evaluating and approving mortgage brokers and correspondents include checking the most current Freddie Mac Exclusionary List. Lenders may find it efficient to have their staff check the Freddie Mac Exclusionary List in conjunction with reviewing the resumes of mortgage brokers and correspondents. As part of meeting Freddie Mac's purchase requirements, lenders must represent and warrant that they have not knowingly retained as a mortgage broker or correspondent any person or entity listed on the Freddie Mac Exclusionary List, in the capacity of a principal, in connection with any mortgage sold to Freddie Mac (or in connection with any related function) after the effective

date of the list.

Quality of the Mortgages

Freddie Mac expects lenders to be specific about questions relating to the quality of the wholesale home mortgages originated by the mortgage broker or correspondent. To gather this information, lenders might ask about:

1. The percent of wholesale home mortgages submitted which are approved or rejected
2. The completeness of the information in the mortgage files submitted
3. Any major problems or recurring discrepancies found in re-underwriting, prefunding reverifications or quality control reviews
4. The overall quality of the underwriting, if performed by the correspondent
5. Prefunding and/or other quality control statistics
6. Early payment default rates
7. Secondary market acceptance, feedback letters and repurchase requests
8. Delinquency and foreclosure trends

Monitoring the Performance of Mortgage Brokers and Correspondents

Freddie Mac strongly suggests that lenders develop written performance standards for mortgage brokers and correspondents. The standards should be based on overall loan performance experience and awareness of the risks associated with delegating tasks outside the lender's organization. Freddie Mac sellers are responsible for the investment quality of the home mortgages they sell. In light of this responsibility to ensure quality, lenders should establish and vigorously enforce performance standards. Written procedures for monitoring the performance of mortgage brokers and correspondents should include:

1. Standards for evaluating acceptable performance
 2. A system for collecting Other Indicators of Performance (IOPs) and for periodic reporting of each mortgage broker and correspondent performance to your senior management
 3. Provisions for establishing greater controls over, or terminating the business relationship with, a mortgage broker or correspondent that does not meet your performance standards
 4. A process for regularly re-verifying the mortgage broker's or correspondent's current compliance with all applicable laws related to licensing, qualification or approval to originate home mortgages, and rechecking the Freddie Mac Exclusionary List
- Once standards and procedures are written and implemented, lenders should have a clear statement of performance expectations and an organized system to evaluate and make necessary management decisions about each mortgage broker and correspondent. In establishing standards of performance, lenders should determine what is acceptable performance for their business. Lenders should determine what will give them the needed confidence to warrant the investment quality of each wholesale home mortgage. Decisions should be based in part on the extent and scope of the services provided by the company's mortgage brokers and correspondents.

Establishing Indicators of Performance (IOP)

Lenders are responsible for controlling their wholesale process. Freddie Mac recommends that lenders develop and implement a system for collecting IOPs as part of its controls. The

design of an IOP system should be based on the way the lender operates its business. It is important that whatever system you choose provides meaningful information for your senior management to use in making decisions about the continued use of each mortgage broker and correspondent. Incidences of fraud should always be reported to Freddie Mac and law enforcement. To provide meaningful data, Freddie Mac suggests lenders focus on current IOPs rather than lagging IOPs. Relevant information should be isolated so that it may be used to predict future performance. Relevant information may include:

- Rejection rates and reason for rejection
- Underwriting and re-underwriting summaries (patterns of conditions)
- Results of prefunding reviews
- Quality control postfunding reviews
- Early payment defaults and delinquencies

Policy Development

Bankers Advisory Services

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