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HUD Clarifies Quality Control Requirements for Directed Endorsement Lenders

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Key Points to HUD's Quality Control Requirements

On January 5, 2011, HUD issued Mortgage Letter 2011-02 "Quality Control Requirements for Direct Endorsed Lenders." This Mortgagee Letter clarifies FHA's Quality Control requirements in light of recent changes to the lender eligibility criteria for participation in FHA programs and also clarifies Quality Control requirements for servicing transfers and loan sales, reporting of fraud and material deficiencies, and the required timeframes for mortgagees to review rejected applications. Listed below are the key points regarding quality control:

1. The basic requirements, sampling size, steps and procedures for retail loan production has remained the same and explained in Chapter 7 of HUD Handbook 4060.1, Rev-2. 2.
2. The new requirements have been established because HUD is no longer reviewing broker applications and approving mortgagees under their correspondent program, formerly known as the "Mini Eagle"
3. The new requirements specifically address wholesale business channels, referred to as TPO (Third Party Originators) and the rules state that sponsors are responsible for Quality Control
4. The QC sampling must cover 10% from each TPO over a review period, such as week, month or quarter, under a methodology established by the sponsor. A statistical sampling is acceptable.
5. The steps and procedures are the same as the sponsor would complete on their retail loans
6. ALL lenders (retailers and wholesalers) must perform QC on their early payment defaults
7. ALL lenders must perform a QC sampling on denied loans to comply with HUD's rules for self assessment of Fair Lending regulations
8. Lenders must report fraud and material deficiencies to their HOC immediately

Further details from HUD's announcement are summarized below:

continued on next page

Effective Date

All requirements contained in HUD's Mortgagee Letter are effective immediately. HUD Handbook 4060.1, REV-2 will be revised at a later date to reflect the program changes outlined.

Changes to Basic Quality Control Requirements

The adoption and implementation of a Quality Control Plan is a required element of a lender's application for approval to participate in FHA programs. Beginning January 1, 2011, FHA will neither approve applications for approval as a loan correspondent, nor monitor lenders acting in such capacity for the purpose of the origination of loans submitted for FHA insurance. All lending entities performing in the capacity of a loan correspondent will thereafter be referred to as Sponsored Third Party Originators. Consequently, all FHA-approved mortgagees will be responsible for performing quality control reviews of their Sponsored Third Party Originators. The procedures used to review and monitor Sponsored Third Party Originators must be included in a mortgagee's FHA-approved Quality Control Plan. At a minimum, these procedures must include the requirements outlined in Paragraph 7-6 of HUD Handbook 4060.1, Rev-2.

Review and Documentation

All FHA-approved mortgagees, including those in sponsored relationships must have a Quality Control Plan that requires the review of loans that are originated or underwritten. For those mortgagees that have Sponsored Third Party Originators, the Quality Control Plan must require the review of loans

originated and sold to the mortgagee by each of its Sponsored Third Party Originators. Mortgagees must determine the appropriate sample amount of each Sponsored Third Party Originator's loans to review based on volume, past experience, and other factors specified by the Department in Paragraph 6-7(c) of HUD Handbook 4060.1, REV-2. In addition, Sponsors must document the methodology used to review Sponsored Third Party Originators, the results of each review, and any corrective actions taken as a result of their review findings. A report of the Quality Control review and follow-up that includes the review findings and actions taken, and the procedural information (such as the percentage of loans reviewed, basis for selecting loans, and who performed the review), must be retained by the mortgagee for a period of two years. Quality Control review records must be made available to HUD upon request.

Early Payment Defaults

In addition to the loans selected for routine quality control reviews, mortgagees must review all loans that are originated or underwritten by their company and that are originated by their Sponsored Third Party Originators that go into default within the first six payments (referred to as early payment defaults). Handbook 4060.1, REV-2 defines early payment defaults as loans that become 60 days past due within the first six payments. Mortgagees must perform reviews of early payment defaults within 45 days from the end of the month the loan is reported as 60 days past due. The Early Payment Default review report and follow-up, including review findings and any actions taken, along with procedural information (as specified in

HUD Handbook 4060.1 Rev.-2, Paragraph 7-6 (E)), must be retained by the mortgagee for a period of two years.

Reporting of Fraud and Material Deficiencies

If a mortgagee discovers potential fraud or other serious material deficiencies, it must be immediately reported to the Department via the Neighborhood Watch Early Warning system, as required in Handbook 4060.1 Rev.-2, Paragraph 7-3 (J). Management is expected to review and respond accordingly to each instance of fraud or other serious material deficiency, indicating what steps if any have been taken to cure and/or resolve these violations. All corrective actions taken in response to instances of fraud or other serious material deficiencies should be reported to the Department via the Neighborhood Watch Early Warning System. Mortgagees must monitor all loans they originate, underwrite or service for potential fraud or serious material deficiencies throughout the lifecycle of the loans.

Rejected Applications

In order to ensure that mortgagees' operations are in compliance with fair lending regulations, the Department requires that rejected applications must be reviewed within 90 days from the end of the month in which the decision was made, following the requirements set forth in Handbook 4060.1, REV-2, Paragraph 7-8(A).