By Anna DeSimone

Quality Assurance Requires Executive Accountability

A year after Fannie Mae put its Loan Quality Initiative (LQI) into effect and just months until Freddie Mac does the same with its new Quality Control rules (effective Dec. 1), it's clear the industry has gotten serious about producing loans that can endure new market demands and greater regulatory scrutiny.

Indeed, the government-sponsored enterprises (GSEs), which reflect the administration's intentions when it comes to housing industry direction, now expect more intense involvement and accountability from lenders.

This is evident in a host of pre-funding verification and validation requirements embedded in Fannie's LQI, including:

- confirmation of borrower identity prior to the extension of credit;
- verification of the validity of borrower's Social Security or tax identification numbers;
- verification that a borrower intends to occupy the property;
- determination that all borrower debts are evaluated and included in the loan qualification; and
- expanded requirements for property identification and appraisal.

These new steps aimed at improving quality assurance are fairly consistent with previous directives by the agencies regarding the re-underwriting of the credit file; re-verification of asset and income documents; and ordering of new credit reports and review appraisals.

The agencies always have understood the need for quality control (QC). The Department of Housing and Urban Development (HUD), Fannie Mae and Freddie Mac have had germane requirements in place for 20 years, typically requiring that one in every 10 files had to be independently audited with a re-verification of the loans.

However, what is different now is that the agencies expect more involvement and accountability. Both agencies, as well as HUD, mandate that quality-control functions be completed in an area outside of loan production.

From a practical standpoint, this makes sense because the process should be independent and avoid conflicts of interest. So, the development and monitoring of a quality-assurance program is an executive responsibility that requires full accountability. If senior managers are too far removed from the QC process, their level of accountability is diminished. It is in the boardroom where urgent business decisions are based upon the outcome of QC.

In the past when they were correcting deficiencies in QC, lenders were taking a loan-by-loan approach; however, the scope really must be corporate-wide.

Fannie Mae expects lenders to ascertain a "loan quality standard" through the formation of a corporate-wide "target defect rate." To accomplish this, lenders must realistically project the number of errors likely to be found during the quality-control process. After QC reports are submitted to senior management, the actual defect rates are measured against the target rate.

Freddie Mac also advises lenders to develop and implement a system to collect indicators of performance (IOP) to monitor wholesale lending activities.

Freddie's "Discover Gold Through Quality" initiative states the following: "The design of an IOP system should be based on the way a 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."

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Vigilance in individual QC operations

What Fannie Mae and Freddie Mac are saying is supported by HUD and Ginnie Mae—as well as private institutional investors, including Bank of America, GMAC and Wells Fargo Home Mortgage, to name a few. Agencies and wholesalers expect their seller/servicers and correspondent lenders to be vigilant about developing and overseeing their individual quality-control operations. A comprehensive written plan is expected to match the lender's business model and be consistent with the deployment of QC tasks.

Two critical areas requiring management attention on an on-going basis are management response and discretionary or targeted samplings, the latter consisting of loans that are selected in addition to the base agency requirement of 10 percent of a lender's closed loan production.

Freddie Mac advises lenders to conduct discretionary QC to review the work of a new branch office, employee

or third-party originator (TPO), to validate a new product or offering. As part of a lender's TPO approval and monitoring process, Fannie Mae requires the discretionary selection of the third-party originator's production to be based on factors such as property location and the TPO's past performance.

Both GSEs require "targeted" QC for loans with certain features, such as condominium properties, co-ops, investment properties, cash-out refinances, marginal credit score or high loan-to-value (LTV) ratio. Another example of a targeted sample is the Freddie Mac requirement for lenders to conduct QC on all loans that go into default within 60 days.

In the past, lenders were completing the QC steps but not really embracing the corporate-wide follow-through necessary to build on that momentum. In essence, they treated QC as another audit report, but failed to deal with the results of their findings (what's that saying about doing the same thing wrong repeatedly, hoping for a different and positive result?).

This additional layer of QC file selection is best handled by the department managers responsible for making the decisions on product or geographic expansion, broker approval and service providers, as well as monitoring employee performance.

It's a new era of quality for residential mortgage loans, and the result will benefit all parties in the process.

Lenders' follow-through efforts

Another critical area is referred to as management response, which are follow-through efforts made by the lender after receiving the QC report.

The federal housing agencies have long published "levels of risk" on a scale of 1 to 5, where the lowest number assignment is considered a minor error or omission. The scale includes "moderate" risk loans where underwriting guidelines were unmet. "Significant" QC findings often include Real Estate Settlement Procedure Act (RESPA) or Truth in Lending Act (TILA) violations, for example.

A "prohibitive" risk rating (5) generally is associated with fraud or misrepresentation and, if the occurrence involves an employee, TPO or service provider, it may warrant disciplinary action.

Recent housing missteps motivated the GSEs to start asking for QC when they began auditing defaulted loans or early payment defaults (EPDs) where they had uncovered underwriting weaknesses in the form of occupancy and borrower fraud and misrepresentation—discrepancies that could have been detected at the pre-funding stage.

Effective management response first requires a bit of "slicing and dicing." Deficiency curing is administered on a loan-by-loan basis. Generally, a minor defect does not require corrective action. There are other forms of remediation where "missing" documents are located or "improperly executed forms" are re-signed. These examples of QC defects fall into the category of "curable deficiencies" and management response reports are updated to reflect the corrective action.

Other types of QC findings relate to underwriter weaknesses. In some cases, the investor's underwriting guidelines are met but there may be other fairly significant errors.

The concern is about prohibitive risks—e.g., compromising the loan's investment quality.

Most lenders require their underwriters to respond to QC findings. Unfortunately, this process is often misunderstood by some who view QC as a report card of one's performance. It is not. There is a distinction between curable document deficiencies and process improvement. Underwriting errors frequently fall into the latter, where they must address an error made during the course of the file review.

When a QC finding is viewed as a criticism, it can diminish productivity and deplete office morale. To argue about calculation of overtime, for example, is not the best use of one's time. When a lender sees a pattern or practice of errors made during the application interview, processing, underwriting or closing, these errors are addressed through communication and training. When senior managers are involved in the follow-through, they are prepared to discuss quality control with their investor's account executive.

At the Mortgage Banker Association's (MBA's) Quality Assurance and Residential Underwriting Conference in New Orleans in September 2011, Fannie Mae representatives provided feedback on the GSE's Loan Quality Initiative. Two takeaways were that when a QC report shows defects, at least there is something on which to begin a dialogue to address corrective action. Second, quality-control reports must be "actionable" and lenders are expected to have an action plan that demonstrates responsiveness.

Quality-control discussions have evolved from "Yup, here's my latest report" to "Here's the Excel™ spreadsheet that illustrates the trend patterns of our target defect rate, gross defect and net defect rate." (Gross vs. net represent the total number of defects compared to post-curing defects.)

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