January 8, 2012

Fannie Mae Publishes Recommendations for Quality Control

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Fannie Mae Recommendations for Quality Control

In October 2011, Fannie Mae published a new booklet named "Beyond the Guide" that provides a more comprehensive description for recommended best practices for pre- and post-funding quality control. Since launching the Loan Quality Initiative (LQI) in September of 2010, Fannie Mae has listened to feedback from both lenders and QC vendors and has spelled out ideas and concepts to enhance quality control beyond the minimum standards.

The guidebook includes illustrations, suggested report and action plans and some practical "do's and don'ts".   Summarized below are Fannie Mae's suggested Key Control points of the quality assurance program:

Control Point #1
Internal and Third-Party Data and Fraud Tools

Data and fraud tools can help ensure that loan application data is validated as early as possible in the origination process to catch errors and/or identify intentionally misrepresented information.

• By using third-party or internal tools, a lender can spot bad data beginning at the point of application.
• Lenders should compare loan application data to their origination, servicing, or other customer databases to identify issues such as multiple applications, occupancy concerns, or erroneous or fraudulent social security numbers.
• Loan officers should be trained to be a vital part of the data-gathering and validation process and encouraged to ask the borrower for additional information when appropriate.

• Proper use of data validation tools reduces a lender's exposure to adverse selection, misrepresentation, and fraud.

Control Point #2
Underwriting and Eligibility

Underwriters are not only responsible for making credit decisions on the data presented, they also play a key role in ensuring the file information is accurate and complete.

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Underwriters should be fully empowered to act on red flags and stop or delay processing if all required documents are not in the file. While underwriters can suggest valuable solutions for loan roadblocks, "no" should be an acceptable decision. It should be just as valued as a "yes" if it stops a defective loan from closing, and can help alleviate the pressure on underwriters to approve loans.

• An underwriter's role is not only to ensure the validity of individual pieces of information but also to make a decision considering all information in the file.
• The underwriter should take a big picture view of inconsistent data and ask broad questions.
• If a data element looks erroneous or inconsistent, it may need more support.
• The Desktop Underwriter or Automated Underwriting output is only one step in the underwriting process. AU recommendations are only as good as the accuracy of the underlying data.
• Consider integrating a document control with your automated underwriting system. Often, one missing document triggers a red flag or the need for more documents.
• Consider underwriters as the traffic cops for production and empower them accordingly.
• Avoid, whenever possible, collecting documentation at closing as there is little or no time to review for inconsistencies.
• When a value is questionable, there is a tendency to just ask the appraiser for another comparable that supports the value. Before doing this, the underwriter should clearly identify what about the existing comparable makes the value suspect and state why the additional comparable will overcome the issue.
• Sound underwriting requires having the right information from independent sources to validate data or statements. An explanation letter alone may not be sufficient. For example, asking the borrower for a statement that they intend to occupy a property does not necessarily resolve an occupancy question.

• Scorecards that objectively evaluate an underwriter's assessment of a file have proven to be an effective feedback and training tool.

Control Point #3
Pre-funding Quality Control

Pre-funding Quality Control (PFQC) brings QC to the forefront of the loan manufacturing process. Effective PFQC can provide a substantial return on your QC investment because it prevents closing loans with defects.

Note: Fannie Mae does not specify how lenders should conduct their PFQC activities. The following ideas for building effective PFQC are based on what we have currently observed as best practices being utilized by Fannie Mae's lenders.

• PFQC can have significant impact on quality and profitability. It usually is customized to the lender's business model.
• PFQC should evaluate all origination channels while targeting specific risk concerns such as incomplete asset documentation, income calculation errors, or manual workarounds. It also should test remediation activities.
• Lenders should guard against having PFQC performed by someone with a vested interest in a loan closing.
• Independent oversight of PFQC results is vital.
• PFQC evaluates the whole file, not just the raw data as reviewed in Control Point 1.
• Optimally, PFQC is performed after file approval, but before closing.
• There should be separate reporting for PFQC activities, which should include results from data validation tools and provide feedback to individuals and units that have a role in the origination process including underwriters, appraisers, loan officers, processors, and branches.

• PFQC allows problems to be corrected before closing, but PFQC personnel should also have authority to stop loans from closing.
• Pre-funding review methodology should mirror post-closing QC and inform post-closing QC of possible areas of investigation. There should be active sharing of information and data between the two functions.
• Post-closing QC results can drive pre-funding QC targeting.
• There should be a mix of random and discretionary selection of loans for a full file review before closing.
• PFQC should be a series of defined activities embedded into the loan process.
• Expectations should be set for production staff and the borrower that QC activities are necessary steps that may add additional time to the closing date.
• A brief sample of effective PFQC activities include: 4506 transcript before underwriting; appraisal, red flag checklist, clearing of anti-fraud alerts prior to approval and proof of liquidation of assets that are to be the source of funds for closing.

Control Point #4A
Pre-closing Document Review

Fannie Mae's research shows that many curable defects occur during the closing process, yet they have seen a noticeable lack of controls during closing. FNMA strongly suggests that lenders dedicate resources to provide an independent QC review of the closing package. Even though the Selling Guide provides a checklist for evaluating the closing documents after closing (See D1-3-07), this validation should also take place before closing. The Selling Guide's closing documents checklist can help with this.

The closer should be inquisitive, asking questions like:
• Do you have the right property?
• Do you have the right parties?
• Does the title information align with the loan information?
• Is cash back to the borrower excessive for the transaction? Are other parties getting money disbursed to them who should not be?
• Will the borrowers pay more money at closing than verified or disclosed?
• Has the sales contract changed since completion of underwriting? If so, the loan should be stopped and sent back for underwriting.
• Occupancy, Occupancy, Occupancy - make sure it is right.
• Are insurance elements correct? Do you have MI? Does the homeowner's policy match the transaction? Is flood insurance required and adequate coverage provided?
Other important considerations include:
• Many things can occur just before closing that result in changes in the loan amount, such as payoff differences or a change in the down payment. These require redrawing the closing documents or possibly re-underwriting the loan.
• Sometimes payoff amounts on refinances are larger than estimated. Does the borrower need to bring funds to closing, and were those funds verified?
• Review the HUD-1 thoroughly. Review the seller side of the HUD-1 just as thoroughly as the buyer's.
• Changes may occur at many points during processing of a loan that might alter the terms of the transaction. Never assume underwriting is aware of a change. Always inform and secure the necessary approvals.
• Closing is time-sensitive and pressure-filled. Provide the closer with sufficient time to make an accurate assessment as well as the authority to stop or delay closing to get it right.
• Limiting items to be collected at closing may help reduce errors.

Control Point #4B
Post-Closing Document Review

The post-closing Quality Control process answers the question, "Is the loan you closed, the loan you thought you closed?" If the loan is not exactly as expected, (i.e., if any errors are detected), the lender has a responsibility to remediate the loan and take action to eliminate errors on future production. Management should first make sure the company and the staff knows why QC is necessary. Quality control is essential not just to comply with Fannie Mae's Selling Guide, but because QC is one of the lender's most valuable loss-prevention controls. Don't make the mistake of underfunding and understaffing quality control. It is wise to put some of your most experienced people in QC because of their ability to identify issues. Effective QC:

• Tells you whether you correctly originated a specific loan.
• Ensures all mistakes are captured. Severity and accountability should not be debated at this stage.
• Is embraced by the lender's culture because the discovery of errors is a way to improve quality. And the culture should not create anxiety over retribution if errors are surfaced.
• Determines if the credit decision was correct.
• Tells you the loan quality of your entire book of business and your exposure to repurchase risk.
• Will be one of the primary tools to drive improvement in your loan origination process and is vital to effective management of third-party originations.
• Alerts you to whether your policies and procedures are being followed, if your staff needs training, and if prefunding controls are working.
• Can confirm the effectiveness of any previous remediation efforts.
• Distinguishes random sampling from discretionary or targeted sampling. (Random Sampling)
• Provides statements about entire populations of loans. Discretionary or targeted sampling is used to test suspected high-risk or adverse populations. It should almost always include first and early payment defaults and will likely have higher finding rates than random samples.
• Evaluates the ability of your staff and other participants in the loan manufacturing process, including appraisers, title companies, and others.
• Is timely. Effective lenders select and review loans well within Fannie Mae's minimum requirements and address issues as soon as possible.
• Almost always finds something. If your QC is not consistently discovering errors or only reports minor findings, then your file reviews may not be thorough enough.

Control Point #5b
Reporting

Robust reporting is the mechanism for communicating with those directly involved or overseeing the loan manufacturing (origination) process. It transforms data into meaningful information useful in analysis, decision-making, and taking remedial action. When reports are effective and QC is part of the culture, the Board of Directors and senior management are as interested in QC reports as those directly involved in the QC function.

• Effective reporting leads to improved quality and loss prevention.
• Thorough loan level reviews are the foundation for reporting. However, QC reports that provide only loan-level information and do not evaluate the entire origination process, are not effective tools for management action.
• QC reports should have trending information to be of utmost value.
• Effective reporting compiles loan review data into meaningful information that can lead to continuous improvement and fewer defects.
• Effective reports measure the quality of originations, evaluate performance against requirements and goals, and confirm compliance with policy and procedures, addresses the effectiveness of controls, identifies actionable items, tracks the effectiveness of action taken, feeds individual compensation and performance and predicts risk exposure.

• Reporting is typically unique to each lender, reflecting the desired credit culture, defect rate goals, and specific risks, including those reflected in their products, origination channels, third-party partners, and geographical markets.
• Lenders that outsource their QC to contractors (vendors) should still take the lead in report design to provide meaningful information for all levels of employees up to senior management and the Board of Directors. These lenders also need to develop reports that facilitate the evaluation of the QC contractor.
• Reporting is the venue to help understand severity of findings and distinguish between compliance and credit findings. Therefore, these should be reported and assessed separately.
• Proactive lenders develop expanded reports that consider the personnel involved in the loan manufacturing process and their needs specific to quality. They identify the information that users need (content) and how often they need it (frequency).

Control Point #6
Action Plan

If no action is taken to remediate observed defects and prevent recurring defects, then repurchase and other risks will persist. Without a formal process for acting on QC results, the lender's QC program is incomplete and ineffective.

• Identify the root cause of each defect. For example, was income calculated incorrectly due to a lack of understanding of the right calculation components, or was it due to a flaw in the calculation process itself?
• With each defect, should a specific individual be part of the remedial action?
• Untrained staff or staff and third parties who intentionally misrepresent information create a significant source of defects that must be addressed.
• If a specific individual is the issue, one-on-one training may be appropriate. If the issue occurs more broadly among staff, classroom training should be a part of systematic changes to address the root cause.
• Were there indications that a specific process, policy, control, or system is flawed? Look first for the possibility of system-wide changes in controls, processes, or policy to fix the issue(s).
• Provide loan quality performance scorecards to each origination channel and origination unit (branch, region etc.).
• Provide loan quality performance scorecards to each individual in the origination process, including loan officer, processor, underwriter, appraiser, closer, and funder. These scorecards should affect both performance review and compensation for that individual.
• Include guidance on how to prevent quality issues in procedure manuals.
• Report to Quality Control on the remediation action taken.
• Quality Control should test and report on the effectiveness of remedial actions.
• Senior management should evaluate the effectiveness of the remedial actions and direct changes if the actions are not working. Management actions should be documented.