FannieMae LENDER LETTER

Lender Letter LL-2010-03 **February 26, 2010**

To: All Fannie Mae Single-Family Sellers

An Introduction to Fannie Mae's Loan Quality Initiative

Introduction

Historically, many issues related to compliance with Fannie Mae selling policies are not detected until after loans are delinquent or through the foreclosure process. Loan repurchase requests to lenders have increased in the past three years, highlighting the need for an improved approach for working with lenders to deliver loans that meet Fannie Mae's underwriting and eligibility guidelines. Fannie Mae conducted an extensive analysis to determine the primary drivers of repurchase requests and is launching the Loan Quality Initiative (LQI) to identify and implement policy, process, and technology enhancements to improve the compliance with underwriting and eligibility guidelines and mitigate repurchase risk.

Working with its lender partners, Fannie Mae will implement the LQI enhancements to promote improved loan delivery data that is complete, accurate, and fully reflective of the terms of the mortgage. The LQI will also help ensure that the loan meets the credit and eligibility standards, pricing guidelines, and other requirements of the *Selling Guide* or negotiated variances. A primary focus is on capturing critical loan data earlier in the process and validating it before, during, and immediately after loan delivery.

This updated approach is designed to stand the test of time across market cycles and risk tolerances, thus supporting market stability and reducing investor and lender risk. Changes introduced under the LQI are intended to reduce repurchase requests through improved data integrity and consistent and early feedback on policy compliance while maintaining the current business model of relying on lenders to make appropriate decisions in accordance with Fannie Mae's guidelines.

Over the next few months, Fannie Mae will release a number of Selling and Servicing Guide announcements and release notes (Loan Delivery and Desktop Underwriter®) that will describe the specific changes that fall under the LQI. The purpose of this Lender Letter is to familiarize lenders with the changes that are coming to facilitate lender planning and allocation of resources for the implementation.

Overview

The Loan Quality Initiative focuses on several areas, including:

- policies that confirm the identity and occupancy of the borrower, validation of qualified parties to the transaction, and policies that address the borrower's credit profile;
- updated quality control requirements for lenders and an improved feedback loop;
- the delivery of additional information about the property and the appraisal;
- loan delivery enhancements, including
  - validation of loan eligibility at delivery;
  - a new capability that enables lender validation of data before, during and immediately after loan delivery; and
  - collection of additional loan data at delivery and transition to an XML format;
- reporting and validation of mortgage insurance coverage data.

Following is a description of each of the policy changes or enhancements that are planned and an indication of how and when additional information will be communicated to the lender.

Note: All references to loan delivery apply to mortgage loans delivered for whole loan purchase and to mortgage loans delivered in MBS pools. The delivery edits noted below will apply based on the date the whole loan or MBS loan data is submitted to Loan Delivery.

Confirmation of Borrower Identity and Occupancy, Validation of Qualified Parties, and Borrower Credit Profile

Borrower Identity Verification

Lenders will be required to confirm each borrower's identity prior to the extension of credit. Fannie Mae's requirements for borrower identity verification are intended to align with lenders' existing federal obligations under laws requiring information and document verification, including the Department of Treasury's Office of Foreign Assets Control (OFAC) regulations and the U.S. Patriot Act.

Future Communication: *Selling Guide* Update and Announcement - March 2, 2010

Social Security or Tax Identification Numbers

As part of the LQI, Fannie Mae will be implementing several enhancements related to Social Security numbers.

Policy Change: Fannie Mae will require all borrowers to have a valid Social Security number or Individual Taxpayer Identification Number (ITIN) (in addition to meeting existing legal residency and documentation requirements).

Desktop Underwriter (DU®): The existing "Potential Red Flag" messages pertaining to Social Security number will be changed to verification messages, which will require the lender to take steps to verify the accuracy of the Social Security number.

Delivery: Lenders will be required to provide the Social Security number or ITIN at loan delivery for up to two borrowers. Delivery of mortgage loans for borrowers without Social Security numbers or ITINs will require a variance to the *Selling Guide* (e.g., legal entity borrowers of group homes), and must be delivered under a Master Agreement for identification and tracking.

New Social Security number/ITIN edits will be implemented as follows:

Data integrity checks - format-specific, nine numeric digits, and "0" not permitted in certain positions.

- May 17, 2010 – Warnings
- July 26, 2010 – Edits will become fatal

Validation edits - Based on information from the Social Security Administration, the number has reportedly not been issued, was issued prior to date of birth, or belongs to deceased individual.

- July 26, 2010 – Warnings
- January 3, 2011 – Edits will become fatal

Lender Validation: For loans that do not pass the delivery edits and for loans that receive Social Security number verification messages from DU, the lender must validate the accuracy of the Social Security number with the Social Security Administration using Form SSA-89. Upon verification, these loans must be delivered with Special Feature Code 162, indicating the lender's compliance with this verification requirement.

Additional Information: DU Release Notes – February 17, 2010

Future Communication:

- *Selling Guide* Update and Announcement – March 2, 2010
- Loan Delivery Release Notes – March 2010 and May 2010

Borrower Occupancy

In DU, the existing "Potential Red Flag" messages pertaining to borrower occupancy will be changed to verification messages, which will require the lender to obtain documentation that confirms the borrower's intent to occupy the subject property as his or her principal residence. The lender must determine the type of documentation that is most appropriate for the particular loan scenario. For example, if the transaction is a refinance of a principal residence but the loan application contains a different current address for the borrower, the lender must obtain additional documentation from the borrower to justify the conflicting address information (e.g., a letter of explanation and/or other documentation to support the discrepancy). If the transaction is the purchase of a principal residence but a recent previous mortgage transaction was also the purchase of a principal residence, the borrower must provide some reasonable documentation to justify the new transaction.

Additional Information: DU Release Notes – February 17, 2010

Validation of Qualified Parties to the Transaction

Fannie Mae will be implementing a new policy that prohibits lenders from delivering loans that have been originated, underwritten, or serviced by individuals or companies that are listed on the federal General Services Administration (GSA) Excluded Party list or HUD's Limited Denial of Participation list. Such individuals and companies include an individual with management or supervisory responsibilities within the seller or servicer's organization, an individual or entity with critical influence on or substantive control over the origination or servicing of a mortgage or any function related to the origination or servicing of a mortgage.

Future Communication: *Selling Guide* Update and Announcement - March 2, 2010

Borrower Credit - Undisclosed Liabilities

Lenders are responsible for determining that all debts incurred or closed by the borrower, up to and concurrent with settlement on the subject mortgage loan, are disclosed on the final loan application that is signed by the borrower at closing. These debts must be evaluated and included in the qualification for the subject mortgage loan. Lenders must have adequate internal controls and processes to support this requirement.

Future Communication:

- *Selling Guide* Update and Announcement - March 2, 2010

Quality Control

Fannie Mae will be substantially rewriting Part D of the *Selling Guide* to include new and updated quality control policies, and reorganizing the topics to help lenders locate specific policies more efficiently. The policy changes will address prefunding quality control, sampling methodologies, reporting, and auditing.

The changes to the quality control requirements will provide a higher level of specificity to existing lender requirements, update outdated policies, and align with recent *Selling Guide* changes.

In addition, Fannie Mae will be implementing an internal feedback loop that will validate the effectiveness of the existing and new policy requirements and will identify new quality control policies to be implemented in the future. Fannie Mae will also be expanding the monitoring and assessment of the effectiveness of lender quality control plans to provide consistent feedback to lenders on ways to improve loan quality.

Future Communication: *Selling Guide* Update and Announcement – Late March 2010

Property and Appraisal Data

Identification of Property Unit Number

If the subject property is a condo or other property type that is identified by a unit number, Fannie Mae will require the unit number to be reflected in the property address on the note. As a reminder, unit number is currently required to be provided at delivery in the “property address” field in the 2000-character file format.

Future Communication: *Selling Guide* Update and Announcement - March 2, 2010

Collateral Data Delivery

As a follow-up to Announcement 09-14, *Electronic Appraisal Report, Enhancements to the Loan Delivery File Format, and Mortgage Fraud Reporting*, Fannie Mae will be announcing the specific policies and requirements for lenders to submit electronic appraisal reports to Fannie Mae’s appraisal report submission and analysis system, Collateral Data Delivery (CDD).

For all conventional mortgage loans, Fannie Mae will require submission of the complete appraisal report data in an acceptable XML format with an embedded PDF. Lenders will be required to submit the appraisal report data prior to loan delivery. CDD will assign a unique Appraisal Document File Identifier that the lender will then submit in the loan delivery file to Fannie Mae.

Lenders may designate appraisal providers or correspondent lenders as agents to submit appraisal reports to CDD on its behalf. Lenders, designated agents, and correspondent lenders must register for access to CDD and execute the appropriate licensing agreements.

Additional Information: Lenders may access the Collateral Data Delivery page on eFannieMae.com for additional information about CDD including Frequently Asked Questions.

Future Communication: *Selling Guide* Update and Announcement – Date to be determined

Loan Delivery Enhancements - Validation of Loan Eligibility at Delivery

Many repurchase requests are driven by the fact that the delivered loan does not meet Fannie Mae's eligibility requirements. Fannie Mae will be implementing several changes to its delivery requirements to proactively identify ineligible loans at delivery. These changes will be phased in over the course of the next year:

- certain optional delivery fields will become mandatory;
- implementation of edits that will return warning messages to the lender if the data is not provided or if the data does not meet certain requirements;
- conversion of many of the warning edits to "fatal" edits, which will cause loans to be rejected at delivery; and
- requirements for additional data to be delivered.

Note: Fannie Mae wants to ensure a smooth transition as the delivery process includes more fatal edits. Fannie Mae will work with lenders to identify potential issues, and will provide optional tools and reports for lenders to use in assessing each loan before, during, and after delivery.

Required Delivery Data

Fannie Mae is changing requirements pertaining to the mandatory delivery of certain data elements. The data elements listed below will be key components in the edit process that will identify eligibility violations at the time of loan delivery.

The following "Housing Goals" data elements are currently required at loan delivery; however, Fannie Mae has given lenders the option to submit missing (or corrected) data after loan delivery using a supplemental process. Fannie Mae will be enforcing the policy to require lenders to deliver these fields at the time of loan delivery.

Field Name	Edits
Monthly income Monthly debt expense Date of mortgage note Appraisal amount Purchase price	• May 17, 2010 – Warnings if data is not delivered • July 26, 2010 – Edits will become fatal

Borrower/Co-borrower birth date	• January 3, 2011 – Fatal edit if data is not delivered
Debt-to-income ratio (DTI) Loan Delivery will calculate the DTI based on monthly income and monthly debt expense	• July 26, 2010 – Fatal edit if the calculated DTI exceeds Fannie Mae's maximum published limits
Borrower and Co-Borrower Credit Score	• July 26, 2010 – Fatal edit if credit score is less than 620 (with some exceptions) Note: The minimum credit score requirements that apply based on the transaction are not changing; the edit is based only on the absolute credit score floor.

Future Communication: Loan Delivery Release Notes – March, April, May, and June 2010

LTV Ratio Rules

The rounding rules that determine the LTV ratio will be updated in the *Selling Guide* and standardized in Fannie Mae's Loan Delivery system and in DU. The new policy will require the result of the LTV ratio calculation to be truncated to two decimal places. The truncated result must then be rounded up to the next whole percent, e.g., 96.01 → 97%, 80.001 → 80%. Lenders must ensure that the LTV ratio provided at delivery uses this methodology or one that will result in a higher LTV ratio. For example, if the lender's system begins the rounding process at four decimal places, it may result in a LTV ratio that is 1% higher than the rounding methodology that Fannie Mae requires.

Loan Delivery will calculate the LTV ratio based on the appraised value and/or purchase price (as applicable) and will compare the result to the delivered LTV ratio.

Note: These rounding rules also apply to the CLTV and HCLTV.

Future Communication:
- *Selling Guide* Update and Announcement – March 2, 2010
- Loan Delivery Release Notes – May 2010 and June 2010
  - July 26, 2010 – Warnings based on differences between the calculated LTV ratio and delivered LTV (outside of tolerance)
  - January 3, 2011 – Edits will become fatal
- DU Release Notes – LTV rounding logic will be implemented in a new version of DU later this year

DU Loan Casefiles with Refer with Caution/IV Recommendations (RWC/IV)

Fannie Mae will be updating the policy regarding the underwriting and delivery of loan casefiles with RWC/IV recommendations to include:

- Any loan casefile that receives a RWC/IV recommendation from DU may be manually underwritten pursuant to the *Selling Guide* and delivered as a manually underwritten loan.

- Special Feature Code 343 will continue to be required if the RWC/IV recommendation was the result of erroneous credit and the lender chooses to manually underwrite and deliver the loan.
- Beginning in March 2010, Loan Delivery will return warnings if DU loans with RWC/IV recommendations are delivered (i.e., delivered as a DU loan with a valid DU casefile ID and not as a manually underwritten). A fatal edit will be implemented in July that will prevent delivery of DU loans with RWC/IV recommendations.

Additional Information: DU Release Notes – February 17, 2010

Future Communication:

- *Selling Guide* Update and Announcement – March 2, 2010
- Loan Delivery Release Notes – May 2010
  - July 26, 2010 – RWC/IV edit will become fatal

Delivery Data Validation – Before, During, and After Delivery

Loan Delivery to DU Compare Functionality

The DU Compare functionality within Loan Delivery compares certain DU data elements to the corresponding Loan Delivery data elements. Comparison at loan delivery currently triggers warning edits for data discrepancies that are not within allowed tolerances. Several enhancements will be made to the DU Compare functionality, including:

- Additional warning edits will be added – July 26, 2010
- Fatal edit for delivery of valid DU casefile ID – January 3, 2011
- Conversion of warning edits to fatal edits for the following comparison fields (outside of tolerance) – January 3, 2011:

LTV	Amortization type	Property inspection waiver
CLTV	Interest-only feature	Final DU recommendation
Loan purpose	DTI	Property type (co-op and manufactured home)
Credit score	Social Security number	
Occupancy	Number of units	

Future Communication: Loan Delivery Release Notes – May 2010 and June 2010

Loan Delivery Reports

New edit reporting capabilities will be available in Loan Delivery to help lenders prepare for the transition to fatal edits. Beginning in March, summary and detail level reports will be available on a monthly basis and will identify the specific loans and percentage of loans that received warning messages and information about specific required data elements that were not delivered. The reports will provide insight into the delivery edits and identify the areas that require attention in preparation for the fatal edits.

Future Communication: Loan Delivery Release Notes – March 2010

Pre-delivery Validation Capability

To help lenders identify and resolve potential data quality and eligibility issues *prior* to delivery, Fannie Mae will be making the following enhancements:

- In July 2010, the DU Compare-Only feature of Loan Delivery will be expanded to include additional pre-delivery checks.
- In September 2010, Fannie Mae will be offering a new optional capability that will enable lenders to run many of the new delivery checks prior to delivery at any point in the loan origination process.

Future Communication:
- Loan Delivery Release Notes – May 2010
- Release Notes – Date to be determined

Collection of Additional Loan Data at Delivery

In order to facilitate improved eligibility validation at the time of loan delivery, Fannie Mae will announce enhancements to the loan delivery file format that will be phased in during 2010 and 2011, including collection of additional data elements and transition to the MISMO® Version 3.0 XML format.

Future Communication: To be determined

Reporting and Validation of Mortgage Insurance Coverage

Fannie Mae's charter requires that loans with LTV ratios in excess of 80 percent have some form of mortgage insurance coverage or other credit enhancement. Several efforts are underway to improve the quality of the information that Fannie Mae has regarding loan-level mortgage insurance coverage data, and to reduce potential repurchase risk to lenders.

At loan delivery and during the servicing of mortgage loans, lenders are currently required to provide specific information regarding the origination, servicing, and coverage of insured loans owned or securitized by Fannie Mae, including:

- provider of the coverage;
- mortgage insurer company code:
- commitment/certificate number;
- coverage percentage;
- the amount of any financed mortgage insurance premium; and
- whether coverage is currently in force, and if not in force, the specific reason for the cancellation and related documentation.

To enhance the accuracy of mortgage insurance-related data, Fannie Mae will also seek to obtain and validate information concerning mortgage insurance coverage directly from mortgage insurers on a regular basis, before, at, or following loan delivery. Fannie Mae will also require servicers to direct mortgage insurers, in writing, to provide Fannie Mae with information concerning its insured loans. In the future, Fannie Mae expects to provide a service that will assist lenders in validating mortgage insurance coverage information with the insurer prior to loan delivery.

Lastly, a new policy will be implemented that requires servicers to notify Fannie Mae when mortgage insurance coverage has been rescinded. As a reminder, servicers must continue to notify Fannie Mae about automatic termination or a borrower-initiated cancellation of mortgage insurance coverage.

Future Communication: *Servicing Guide* Announcement – Date to be determined

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Fannie Mae will be offering a variety of tools and resources to help lenders implement the many aspects of the LQI, including training, Webinars, job aids, Frequently Asked Questions, and lender tips. Refer to the "Summary of Contents and Supplementary Information" document that is posted on the Loan Quality Initiative Web page on eFannieMae.com. Lenders are encouraged to refer to the Web site on a regular basis, as new and updated information will become available. Lenders may also contact their Fannie Mae Account Team for additional information.

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