



Getting it right — reverification of occupancy

Implementing effective processes and procedures during loan origination and quality control (QC) can help lenders proactively and intentionally originate high-quality loans while minimizing risk. With a strong QC environment in place, lenders can increase their chances of detecting red flags and uncovering discrepancies during the reverification of occupancy post-closing QC process. Additionally, lenders can validate that the data used to determine the borrower's eligibility was accurate and gain insights regarding potential gaps across their internal control environment.

Ask yourself:

- Are you aware of the risks associated with making loans with inaccurate occupancy status?
- Do you have proven origination and underwriting processes in place to spot occupancy red flags?
- Is your QC team well-versed on how to investigate occupancy red flags?

Occupancy type — why it matters:

Because of the different levels of risk, there are different eligibility rules based on the occupancy type. Lower-risk transactions often allow for higher loan-to-value ratios and lower interest rates for the borrower. This cost differential could potentially incentivize borrowers to misrepresent an investment property as a primary residence so they can

borrow more at a lower cost. Additionally, occupancy risk is one of the variables that mortgage investors, such as Fannie Mae, consider when pricing loans. For example, when a primary residence is discovered to be in fact an investment property, the higher risk profile can result in financial losses for the stakeholders.

Reverse occupancy is a type of occupancy misrepresentation in which the borrower purchases a home as an investment property, claiming rental income to qualify for the mortgage. Instead of renting the home out, the borrower occupies it as a primary residence, thereby not receiving the rental income that was used to qualify for the mortgage.

The Fannie Mae *Selling Guide* [B2-1.1-01](#) describes three types of occupancy and each poses a different level of risk:

- **Principal residence:** The subject property will be occupied by the borrower(s) as their primary residence. This occupancy type represents the least amount of risk, as borrowers are less likely to default on the mortgage for the home that they occupy.
- **Second home:** The subject property will be occupied by the borrower(s) for some portion of the year, such as a summer or vacation home. This occupancy type represents a higher risk than a principal residence.
- **Investment:** An investment property is owned but not occupied by the borrower(s) and is rented out to others. This occupancy represents the highest level of risk.

Identifying red flags

A vital step to validating occupancy of the subject property is identifying inconsistencies in the loan file that raise questions about the authenticity of the occupancy as disclosed. It is critical to research and resolve red flags to ensure the occupancy status is accurate. The presence of one or more red flags in a file does not necessarily mean the occupancy is inaccurate, but it should warrant further investigation.

Table: Lists examples of occupancy red flags and additional considerations when a particular red flag has been identified.

Red Flag	Purchase	Refinance	Additional Considerations
Subject property disclosed as owner-occupied			
Property insurance policy is inconsistent with occupancy type	X	X	<ul style="list-style-type: none"> Property insurance policy does not include personal property Subject property address is different from insured mailing address Property insurance policy includes rental coverage
Loan file documentation indicates the borrower is not currently occupying the subject property		X	<ul style="list-style-type: none"> Borrower's mailing address is a PO box Credit report, bank statement, or other documentation reflect a different address Occupancy affidavits show the borrower does not intend to occupy
Borrower purchased or refinanced properties around the same time as purchasing owner-occupied properties	X	X	<ul style="list-style-type: none"> Desktop Underwriter® message indicates multiple owner-occupied loans within the last 60-days Undisclosed mortgage(s)
Borrower is downgrading to a notably smaller or less expensive home	X		<ul style="list-style-type: none"> Borrower intends to lease current residence Borrower owns other properties near the subject property
Significant or unrealistic commuting distance	X	X	<ul style="list-style-type: none"> Type of employment is inconsistent with the commuting distance
Occupant field on appraisal reflects tenant or vacant	X	X	<ul style="list-style-type: none"> Photos indicate the subject property is vacant (refinance) The rent comparable schedule is included on a single-family residence Appraiser comments reference a tenant or rental income Can the owner legally occupy the property to meet the terms of the note? (Validation of lease expiration date is listed for tenant-occupied properties)
Schedule E of the borrower tax return or transcript reflects the subject property as a rental property		X	<ul style="list-style-type: none"> The filing address does not match the subject property
Borrower currently resides in a single-family residence and is moving to a 2- to 4-unit property	X		<ul style="list-style-type: none"> The appraisal reflects all units are currently rented
Sales contract includes furniture, recreational equipment, etc.	X		<ul style="list-style-type: none"> The sales contract indicates an existing lease is being assumed The Final Closing Disclosure shows a rental credit for the subject property

[table continued]

Table: Lists examples of occupancy red flags and additional considerations when a particular red flag has been identified.

Red Flag	Purchase	Refinance	Additional Considerations
Subject property disclosed as second home			
Close proximity between subject property and primary residence	X	X	<ul style="list-style-type: none"> Subject neighborhood has high number of rental properties
12-month lease on subject property	X	X	<ul style="list-style-type: none"> Schedule E of the tax return or transcript reflects the subject property rented for 12 months
Use of gift funds	X		<ul style="list-style-type: none"> Borrower's financial profile is inconsistent with the borrower owning a second home
Subject property disclosed as investment property			
Borrower is currently renting or living with relatives	X	X	<ul style="list-style-type: none"> Borrower does not own real estate Rental income is essential to qualifying Substantial liquid assets in relation to income
Borrower is a first-time homebuyer	X		<ul style="list-style-type: none"> Borrower has minimal or no established credit
Homeowner's insurance policy is inconsistent with occupancy type	X	X	<ul style="list-style-type: none"> Homeowners insurance includes personal property Property insurance policy does not include rental coverage



Investigating occupancy

Identifying and investigating red flags during origination and prefunding QC reviews is critical; however, some aspects of the loan file cannot be validated until after the loan has closed. The Fannie Mae *Selling Guide* [D1-3-02](#) requires the lender to reverify the accuracy of the information used to support the lending decision for any loans selected for a QC review, and specifically requires review of the property insurance policy and other documentation in the file to verify owner-occupancy of a principal residence, as disclosed.

Methods to Investigate Occupancy	Origination	Prefunding Quality Control	Post-closing Quality Control
Review the insurance policy to confirm whether the coverage includes contents, rent loss, or tenant coverage. Compare the loan occupancy to the terms of coverage.	X	X	X
Contact the insurance company and validate the terms of coverage. Has the homeowner's policy been converted to a landlord policy or vice-versa?	X	X	X
Reverify any lease agreements in the file, especially on the borrower's previous home to confirm the authenticity.	X	X	X
Use MERS ® registration to identify potential undisclosed mortgages. Is the borrower in the process of purchasing a new primary residence or investment property? Is the borrower in the process of obtaining a cash-out refinance on another property?	X	X	X
Validate the borrower's primary residence with a driver's license.			X
Confirm whether the borrower has applied for homestead exemption at the subject property.			X
Use third-party tools and/or door knockers to confirm who presently resides in the subject property.			X
Review the servicing notes to identify changes to the mailing address or indications that the occupancy is not accurate at origination.			X
Track any returned mail that was addressed to the subject property.			X

Preventing occupancy discrepancies

A corporate culture focused on loan quality is a key characteristic found in companies with effective risk management. Here are some examples of controls used by organizations with strong QC cultures to proactively identify and investigate potential occupancy discrepancies:

- Perform regular surveillance of your mortgage pipeline across all lines of business, including the servicing platform. (Do you have any loans in process for the same borrower(s)? Are you servicing any loans with the same borrower(s)?)
- Target loans with unresolved red flags at origination for post-closing occupancy validation.
- Create a review process for borrowers who change their mailing address shortly after closing or loan setup.
- Include language in occupancy certifications that outlines potential consequences if the borrower misrepresents their occupancy.
- Notify the borrower that a post-closing occupancy verification may be performed (and for loans with red flags, perform a targeted QC review).
- Establish internal procedures for escalating a suspected occupancy misrepresentation. The internal reporting process should specify who is managing the due diligence investigation and include the final approval authority to clear loans for closing. Internal reporting should outline the consequences for any employee involvement in occupancy misrepresentation.
- Provide regular staff training on red flags, fraud trends, and top QC defects.
- Hold borrowers accountable when misrepresentation of occupancy is confirmed.

Next steps

Validating occupancy ensures that loans are properly closed, priced, and delivered. To safeguard your company's financial and credit risk exposure, consider the following:

- Assess your training program and operational procedures to determine potential gaps in identifying occupancy red flags and discrepancies.
- Apply the tips referenced in this article to enhance your methods for investigating occupancy and augment your detection capabilities.

Resources:

- [Reverse Occupancy Fraud Alert](#)
- [Occupancy Defect Guidelines and Scenarios](#)

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