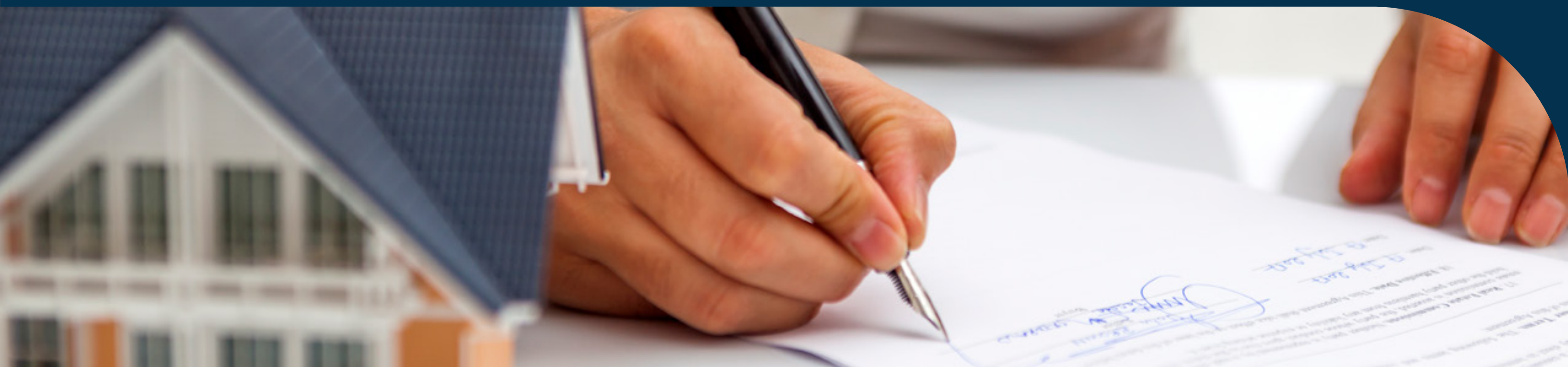

Undisclosed liabilities – attacking this common defect

Evaluating a borrower's ability to repay their mortgage is crucial for lenders to accurately assess the risk of each mortgage originated and to ensure Fannie Mae *Selling Guide* underwriting requirements are met.

When a borrower doesn't disclose of all their existing obligations, including any new debts, the calculated debt-to-income (DTI) ratio is inaccurate and a lender is unable to evaluate a borrower's ability to repay the loan. This could also increase the likelihood that the loan fails to meet Fannie Mae *Selling Guide* eligibility requirements.

Undisclosed debt is defined as any loan or liability (e.g., auto, revolving, installment, mortgage, or lease) that exists at the time the borrower closes on the subject loan and is not disclosed by the borrower during origination. Borrowers often incur new debts after the initial loan application is submitted and the origination credit report is pulled but prior to the loan closing.

70% of undisclosed new debt is opened more than 14 days before closing.

Research from our post-acquisition quality control (QC) reviews reveals common characteristics of undisclosed debts. *The data below is based on Fannie Mae's 2020 random and discretionary file selection reviews for all lenders.*

- 47% of Fannie Mae defects associated with undisclosed debt are for new auto loans; 37% are for installment loans; and 14% are for mortgage loans.
- On average, undisclosed auto loans are opened 39 days prior to closing and have an average high credit amount of $34,300 with an average monthly payment of $594.
- 70% of undisclosed new debt is opened more than 14 days before closing.
- 81% of the undisclosed debt is reported by all three credit bureaus.
- An inquiry that can be associated with the new debt obligation is often present on the origination credit report.

While "undisclosed liabilities" is a top defect cited in Fannie Mae's post-purchase loan reviews, it is typically not a top defect identified by lenders in their internal QC results.

Ask yourself:

- Have you considered evaluating your QC process to increase the likelihood of identifying undisclosed liabilities in your reviews?
- Have you deployed an undisclosed debt monitoring tool?

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Best practices to prevent and detect undisclosed liabilities

Continuously engage borrowers throughout the origination process:

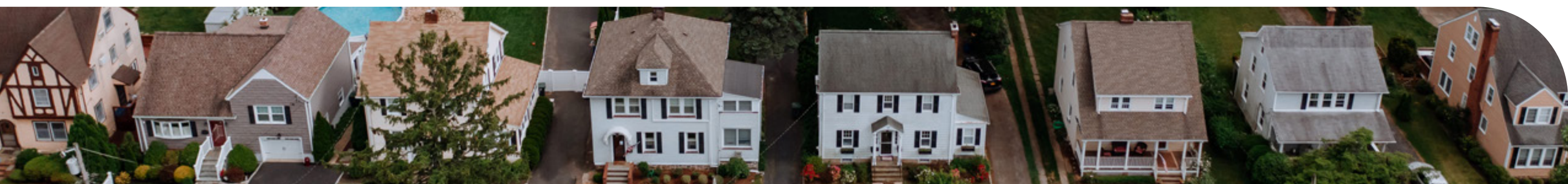
- Borrower education is your first line of defense and starts with well-trained loan officers and processors. Provide talking points to educate borrowers on the importance of properly disclosing changes in their financial condition throughout the life of the application process.
- At every borrower touchpoint, require the operations staff to ask the borrower if they have opened any new debt and inform them of the possible impact to their loan approval.
- Consider implementing a standalone borrower disclosure to be signed at the time of application that outlines the importance of not incurring any new liabilities prior to closing. The disclosure should include potential ramifications if it is discovered that the borrower did not properly disclose their complete financial position. If you do not have direct contact with the borrower, include this document with the disclosure packet and require the borrower to acknowledge and sign the disclosure.
- Rather than having the borrower sign a boilerplate credit inquiry explanation letter, have them compose one addressing each inquiry that appears on their credit report as a potential new debt.
- Educate your origination business partners on how to identify red flags that could be evidence of a borrower's new debt and stress the importance of maintaining income and debt obligation stability throughout the origination process.

Use an undisclosed debt monitoring (UDM) service:

- Employ a debt monitoring service to look for new debt as well as new inquiries throughout the loan process – from application through closing.
- Be sure the UDM service covers all three credit repositories to garner the greatest coverage and ensure the coverage includes weekend monitoring.

Fannie Mae Selling Guide requirements

- "If the borrower discloses, or the lender discovers, additional liabilities after the underwriting decision has been made, up to and concurrent with closing, the lender must recalculate the borrower's debt-to-income ratio." (B3-6-01)
- "Fannie Mae expects lenders to have in place processes to facilitate borrower disclosure of changes in financial circumstances throughout the origination process and prefunding quality control processes to increase the likelihood of discovering material undisclosed debts or reduced income." (B3-6-02)



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Take action during loan prefunding and post-closing:

- Track all undisclosed debt defects from both internal and external reviews looking for trends (i.e., Are you seeing a higher number of defects from a specific loan officer or broker from a third-party origination channel?).
- Target loans with a DTI ratio above a certain threshold, leveraging data on your average undisclosed payment amount. Focus on loans where the average payment increase could result in an ineligible loan.
- If you are not using a UDM service, consider pulling a new tri-merge credit report or three-bureau soft pull no more than three days prior to closing to identify any new debts or inquiries not on the origination credit report.
- Flag all loans with an auto loan inquiry and select the loans for a prefunding QC review. Order an updated credit report to determine whether a new auto loan or lease was established.
- Look for any automatic withdrawals on asset statements that might indicate a new debt has started repayment.
- Require the borrower to sign a certification at closing, separate from the loan application, that they have not taken on any new debt.

If an undisclosed debt is discovered during your post-closing QC process, or you were notified by an investor that an undisclosed debt was detected in their QC review, take action to minimize future instances during the loan manufacturing process:

- Ensure you have a consistent feedback loop with operations management to share your QC results, and your investor QC findings, to improve your undisclosed liability detection rate.
- Develop robust reporting of undisclosed debt defects including data from both internal and external QC reviews:
  - Perform a root cause analysis to determine if the new debt could have been discovered prior to closing.
  - Track and trend the review results, looking for commonalities in loan profiles or parties involved in the loan transaction.
  - Develop a training program to coach loan officers and processors on how to educate the borrower on the ramifications of opening new liabilities prior to closing.
- Create a scorecard easily identifying undisclosed liability trends or issues by loan officers, processors, and underwriters.
- If you have a correspondent channel, ensure lenders have a thorough and documented process to look for undisclosed debt red flags during their origination process. Consider pulling a new credit report for higher-risk loans during the pre-purchase process and create a third-party originator scorecard to track QC

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Next steps

It is imperative your organization has appropriate controls in place to reduce risks associated with undisclosed liabilities. Is your organization doing all that it can to combat this risk?

Ask yourself:

1. Is our staff properly trained on how to detect undisclosed debts; do they know how and when to speak to borrowers about the importance of not opening any new debt prior to closing?

2. Does our current origination process have the tools to properly detect undisclosed debt (e.g., Are we using a UDM service?).

3. Has our organization assessed the risk and potential financial impact of repurchases tied to the failure to detect an undisclosed debt?

4. Are our controls effective in mitigating defects related to undisclosed liabilities? Are there additional controls we can put in place to reduce our risk?

5. Have we identified ramifications for borrowers who don't accurately disclose their financial position, resulting in a repurchase or our accepting the costs of a repurchase alternative?

Resources:

Selling Guide B3-6-01, General Information on Liabilities

Selling Guide B3-6-02, Debt-to-Income Ratio

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