Top quality control defect trends – take action

During post-purchase loan reviews performed on early 2021 acquisitions, Fannie Mae observed a notable increase in eligibility violations in the key defect categories of incorrect income calculations, borrower not employed, and undisclosed liabilities.

Lenders should take immediate action to address defects, such as increasing prefunding quality control (QC) component reviews on high-risk loans (e.g., self-employed borrowers), and providing additional staff training on how to accurately assess income and liabilities.

Below are some common themes, analysis, and QC best practices to ensure your company is originating quality loans.

Ask yourself:

- Do you have an established control environment that minimizes defects in income calculations, borrowers not employed, and undisclosed liabilities?
- Have you established prefunding component reviews of loan transactions with high-risk characteristics?
- Does your QC sampling and/or review process adequately assess the risks of the top defects?

Take action

Lenders should address top defects. Increase prefunding QC reviews on high-risk loans and provide additional training.

Fannie Mae top defects

The past 12 months of random reviews indicate that more than 50% of the loans with eligibility violations had significant defects in income, employment, and liability categories.

Top 5 defects for May 2020 - April 2021 acquisitions

Income not documented (self-employed)

Borrower not employed

Undisclosed liabilities

Incorrect income calculation (self-employed)

Incorrect income calculation – rental income/loss

Note: Fannie Mae's top defects have remained unchanged for the most recent three months.

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Root cause analysis

If you have attended Fannie Mae QC Boot Camp, you may be familiar with the concept of "Root Cause Analysis." There are several approaches to performing root cause analysis, but all methods focus on understanding the cause(s) of a particular defect or problem. We have analyzed the top five significant defects to identify key drivers and provide suggestions for improvement and successful performance of your own root cause analysis.

Income not documented (self-employed)

Common traits

- **Incorrect Desktop Underwriter® (DU®) submission**: The borrower owns more than 25% of the business but the income entered in DU identifies the borrower as an employee of the business.
    - The loan data contained red flags, such as the borrower's position indicated "president," or the verbal verification of employment identified the borrower as a partner with more than 25% ownership interest in the company.
    - An internet search revealed the borrower was an owner of the business.
- **Lack of understanding of *Selling Guide* policies**: The *Selling Guide* requires two years of personal and business tax returns for borrowers (DU determines whether one or two years of tax returns are required). While we provide the flexibility to waive business returns in some circumstances, we do not permit the underwriter to use their discretion to only require one year of personal tax returns.
- **Lack of understanding of COVID-19 *Selling Guide* policies**: For loan applications after Dec. 14, 2020, the lender must obtain an audited profit and loss statement, or if the profit and loss statement is not audited, three months bank statements are required to support the income reflected on the P&L. Our post-purchase review results indicated the appropriate documentation was not obtained.
- **Inadequate documentation to support self-employment income**: Our post-purchase review results indicated not all the required documentation was obtained. For example, loan files were missing Schedule K-1s, business tax returns for an additional business entity, or an adequate written analysis of the required documentation was not performed, especially the requirements related to the COVID-19 Flexibilities:
    - The documentation was not analyzed to determine that the bank statements aligned with the profit and loss period, including business income and expenses, or did not address unemployment income.
    - The documentation was not analyzed to confirm it was dated within the required timeline.

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Borrower not employed

Common traits

- Borrower left employment shortly before loan closing.
  - In some instances, the loan file had documentation confirming that the borrower was inactive or terminated before closing.
  - Borrower retired before closing — may have applied knowing retirement plans but did not disclose them.
- Underwriter failed to analyze the borrower's income stability.

Possible actions

☑ Implement a policy to reverify the borrower's employment as close to closing as possible.

☑ Engage the borrower throughout the origination process, including having employees follow scripts to confirm continued employment and reinforce the importance of accurately disclosing financial conditions throughout the loan application process until loan closing.

☑ Contact the borrower at their place of employment as close to closing as possible to confirm there are no changes in their employment or income. Incorporate this practice into the script to confirm closing details.

☑ Incorporate income analysis training for underwriters to identify when a borrower's employment history does not represent stable continuity of income.

Undisclosed liabilities

Common traits

- In almost half of the loans with significant defects for undisclosed liabilities, the origination credit report contained an inquiry for the new creditor.
- Of the loans with inquiries from the undisclosed creditors, 80% had original debt-to-income ratios greater than 43% without the new debt.
- Of the loans where no inquiries were on the credit report for the new debt, the loan closed in an average of 42 days after the credit report was pulled. This gap increases the possibility of inquiries going undetected prior to closing.

Possible actions

☑ Continuously engage borrowers throughout the origination process and reinforce the importance of accurately disclosing financial conditions throughout the loan application process until loan closing.

☑ Consider pulling a new credit report on loans with a debt-to-income ratio greater than 43%.

☑ Consider using an undisclosed debt monitoring service.

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Incorrect income calculation (self-employed)

Common traits

- An IRS W-2 was used, along with year-to-date wages, to qualify borrowers, in lieu of analyzing tax returns.
- Failure to analyze income tax returns to assess positive cash flows, borrower's access to net income (not eligible if less than 100% ownership when the business is a corporation), and distribution of profits to the borrower for S corporation and similar business structures.
- Inclusion of nonrecurring income sources without support of continuance.
- Failure to confirm that the revenues in the business account supported the income on the year-to-date profit and loss statement in accordance with LL 2021-03.

Possible actions

☑ **Prefunding QC reviews** – Incorporate component reviews of loans with self-employment income to ensure loans are documented and income is calculated correctly. Review the percentage of loans with self-employment income that are included in your sample, and either increase the percentage or start intentionally selecting these loans.

☑ **Training** – Conduct self-employment income training with test cases to ensure staff understand the requirements and have sufficient skills to perform financial analysis of the income stream. Leverage Fannie Mae's online training, Assessing Income from Self-Employment.

☑ **Post-closing QC reviews** – Incorporate component reviews of loans with self-employment income to confirm that loans are documented and income is calculated correctly.

☑ **Second-look process** – Have underwriting managers review their staff's loan production to confirm understanding of self-employment documentation requirements and analysis.

☑ **Process improvement** – Require underwriters to document their income analysis by consistently using income calculators (such as Fannie Mae Form 1084).

Incorrect income calculation – rental income/loss

Common traits

- Using a rental lease without documenting any circumstances that are permitted in the *Selling Guide*.
- Not reconciling the correct monthly principal, interest, taxes, insurance, and other assessments (PITIA) in the calculation, or omitting the payment altogether.

Possible actions

☑ **Training** – Incorporate test cases to ensure understanding of the requirements as well as sufficient skills to perform financial analysis of the cash flow. (View Fannie Mae's online learning course, Evaluating Rental Income.)

☑ **Prefunding QC reviews** – Incorporate component reviews of loans with rental income to confirm loans are documented and income is calculated correctly. Review the percentage of loans with rental income that are included in your sample and either increase the percentage or start intentionally selecting these loans.

☑ **Post-closing QC reviews** – Incorporate component reviews of loans with rental income to confirm loans are documented and income is calculated correctly.

☑ **Second look process** – Have underwriting managers review their staff's production to confirm understanding of rental income documentation requirements and analysis.

☑ **Process improvement** – Consider requiring underwriters to document their income analysis by consistently using Fannie Mae's Rental Income Worksheet Forms 1037, 1038, 1038A, or 1039. In addition to consistent income calculation processes, require underwriters to explain the analysis and include their work in the file submitted to Fannie Mae.

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Action planning

Once you have identified the root cause of the defects, you can take several steps to correct the issue and identify processes and procedures to prevent them in the future. Below are suggestions you might incorporate into your action planning tool kit:

1. Customize training to address the deficiencies identified by your reviews or those of your investors.
2. Target prefunding QC reviews to assess deficiencies, prevent loans with deficiencies from closing, and confirm the effectiveness of training.
3. Target post-closing QC reviews to address issues that are not easily identified before closing, such as borrower employment termination or undisclosed debts.
4. Identify outliers such as underwriters, regions, branches, or third-party originators with the highest number of defects and ensure they receive appropriate training and targeted reviews.
5. Incorporate a second-look process for top defects and the outliers.
6. Establish a process for testing protocols when policy changes (See November 2020 issue of *Quality Insider* – **How to Adapt QC for *Selling Guide* policy changes**).
7. Issue alerts and/or reminders to ensure your staff understands the policies and procedures.
8. After you have taken one or more of the steps listed above, be sure to "test" your remediation plan by performing additional reviews in prefunding or post-closing to confirm the effectiveness of your newly implemented plan.

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Next steps – take action

Customize your prefunding QC reviews and second-look processes to focus on your top identified defects. Perform component reviews on those specific defects to ensure your origination staff is executing to your organization's policies and underwriting guidelines. Consider integrating your QC testing and training together to ensure effectiveness. Develop training and test cases to focus on analyzing income cash flows and required documentation. Leverage Fannie Mae's online learning, "Assessing Income from Self-Employment" and "Evaluating Rental Income."

If you do not see these defects in your results, challenge yourself to understand why. Do you already have specific controls in place to address these defects? If not, consider the following:

- What percentage of loans do we review that are self-employed in prefunding QC and how does that compare to originations?
- What controls do we have in place to ensure accurate analysis is conducted in relation to COVID-19 Flexibilities, and are those controls being utilized on all the loans we test?
- What percentage of loans do we review in which rental income is used?

Resources

- **Assessing Income from Self-Employment** (online learning)
- **Evaluating Rental Income** (online learning)
- **How to Adapt QC for *Selling Guide* Policy Changes** (*Quality Insider*)
- **Undisclosed Liabilities – Attacking This Common Defect** (*Quality Insider*)
- **Form 1084**

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