QC sampling —Know your choices

Effective quality control (QC) sampling is fundamental to ensuring your organization maintains actionable insight into the effectiveness of your operational controls.

Efficient QC programs include thoughtful and intentional QC sampling strategies that consider your organization's unique risks. Leveraging all available sources of data to make well informed QC sampling decisions is critical to identifying and mitigating risk as well as strengthening your loan manufacturing controls.

Ask yourself:

- When was the last time you reviewed your organization's rationale for selecting your prefunding and post-closing QC samples?

- Does your QC sampling strategy include trigger points to respond to shifts in production volume and market conditions, and procedures for implementing necessary changes?

- Are your internal staff and/or vendor resources sufficient to support the demands of QC sampling, and are they allocated to produce the highest and best controls to successfully mitigate risk?

Fannie Mae requires random and discretionary sampling selections to help organizations apply intentional strategies to gain insights into their QC risk.

Random and discretionary sampling differ from one another as each method brings a distinct view of risk into your loan population. The review results provide valuable insights that can drive loan manufacturing process improvements and instill confidence that QC leaders have insight into the risks facing the organization.

- **Random sampling** is intended to provide a holistic view into the loan quality of your overall book of business.

- **Discretionary sampling** returns loan quality results from a subset of loans within the total population of mortgages to test suspected high-risk loans, adverse characteristics, or to test that a process is working as intended.

Monitor your quality control and loss-prevention initiatives **at least quarterly** to avoid the tendency to "set it and forget it."

Prefunding QC sampling

Intelligent prefunding QC sampling enables your organization to identify loan quality issues earlier in the loan origination cycle and allows sufficient time to correct them prior to the loan closing. We do not have a minimum required sample size for prefunding QC, nor do we require random selections for loans sampled in the prefunding QC review. We do require that your sample size be relevant to your loan volume to provide insight into your manufacturing quality.

Evaluating the most effective prefunding QC file review scope and sampling methodology should be an ongoing process and agile enough to evolve as high-risk factors develop in your loan population. We consider it a best practice to analyze your prefunding QC file selections and review scope on a quarterly basis. Lenders can maximize their prefunding sample size without sacrificing resources or loan turn times while ensuring more high-risk loans are reviewed with discretionary selections.

Discretionary selections fall into two separate sampling strategies:

Discretionary full-file sampling strategies

We require that some portion of your prefunding selections be full-file reviews; this is key when multiple risk factors are present within a population of loans. Your organization benefits from a higher degree of certainty on the overall loan quality when a full-file review is performed:

- Consider selecting loans requiring the use of unique underwriting guidelines or documentation requirements.

- Leverage resources by selecting loans for newly hired loan officers, processors, underwriters, or new third-party originators.

- Focus on loans with multiple layers of credit risk, such as high loan-to-value (LTV) ratios, low credit scores, and high debt-to-income (DTI) ratios.

Discretionary component file sampling strategies

Component reviews focus on a particular element(s) of the loan file that have the potential for elevated risk or have loan characteristics that have been identified with defects in the post-closing QC review:

- Target loans with a higher risk profile and focus your review on those areas likely to impact eligibility (e.g., higher DTIs where an undisclosed liability could impact eligibility).

- Consider including loans with process failures identified in your post-closing random sample (e.g., **Form 4506-C** execution rates).

- Validate your internal exception policies and procedures and confirm all requirements are consistently followed.

- Leverage government-sponsored enterprise data, including Fannie Mae's Collateral Underwriter ® (CU®) risk scores and eligibility/overvaluation flags, to target loans with potential appraisal quality issues. Refer to Fannie Mae Form 1033.

- Select loans to validate the accuracy of loan quality tools used by your organization (e.g., fraud monitoring tool, undisclosed debt monitoring).

- Select loans with top trending defects identified in your post-closing random sample (e.g., gift funds, excessive interested party contributions) and test internal controls around each defect as well as the effectiveness of your corrective action plans and remediation efforts.

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Post-closing QC sampling

Post-closing QC affords the lender the opportunity to view the entire loan transaction holistically, including closing and legal documents, that are not available during the prefunding reviews. Lenders have the option of implementing either a **random 10% sampling** or **statistical sampling** method for the post-closing QC selection process.

Knowing which sampling method is best for your company is essential to obtaining reliable loan quality results, and it ensures that your QC resources are efficiently allocated.

Random sampling — 10% versus statistical method

The **random 10% sampling method** is generally used by lenders with annual production of 3,500 or fewer loans.

- Simple implementation without the need to manage a statistical calculation process.

- Does not require a periodic evaluation to ensure the sample size is valid.

The **statistical sampling method** is generally advantageous for lenders with annual production more than 3,500 loans.

- Produces statistically valid results that can be used to extrapolate loan quality conclusions.

- For lenders with a consistent defect rate, it produces a predictable monthly sample that does not vary due to large swings in production volume.

Evaluating the most effective selection method that suits your organization should be an ongoing process that takes into consideration the organization's overall risk framework. We suggest that you monitor your QC and loss-prevention initiatives at least quarterly to avoid the tendency to "set it and forget it."

Random full-file review requirements

Whether you choose the 10% or statistical sampling sampling method, your random sampling provides an unbiased representation of your overall origination population. A full-file review must be completed on all loans selected for the post-closing QC process, with reverifications on all the data relied upon to qualify the borrower. In addition, all selections require a comprehensive collateral risk assessment of the appraisal used to support the value of the subject property.

Discretionary review requirements

Discretionary selections allow you to optimize your reviews and target high-risk loan characteristics identified in your prefunding and post-closing random selections. Reviewing and revising your selection criteria on a regular basis ensures you are effectively managing risk and your QC resources. The risk factors used in your selection criteria should be current and relevant.

Discretionary reviews may be full-file reviews or targeted component reviews, which provide the flexibility to increase the overall number of reviews or allow the ability to be laser-focused on the risks being evaluated.

- **Full-file reviews** require reverification of all components, whereas targeted reviews allow for reverification of only those elements being tested.

- **Targeted, or component, reviews** are an effective way to narrow in on a particular risk element, product, or process within the manufacturing of the loan without having to complete a full-file review.

Full-file sampling strategies

- This is appropriate when selecting loans to review new hires, new products, and/or newly implemented processes. Use discretionary reviews to ensure at least one loan from each third-party originator is pulled for a review annually.

- Selections are based on risk attributes identified as top trending defects from prefunding and investor review results.

- Analyze the root causes when developing action plans to prevent future defects from occurring, or to test the effectiveness of an implemented corrective action.

Component file sampling strategies

- Optimize the number of reviews that can be completed with limited staffing.

- This approach provides additional opportunity to sample loans with known risks.

- Allows the ability to a test particular risks of the loan file. For example:

  - Ensure the borrower(s) was employed at the time of closing.

  - Validate if the income used to qualify was accurately calculated.

  - Confirm if a new calculation tool is completed and working properly.

  - Determine if the borrower(s)' assets were adequately documented, per the *Selling Guide* requirements.

  - Ensure property eligibility and validation of data used to support the appraised value.

- Validate whether an action plan solution was successful, or not.

- Identify the need for additional full-file review selections.

Continued digital advancements in the loan manufacturing process along with enhanced reporting capabilities provide opportunities to target selections on a variety of data points to assist in your discretionary selections.

- Automated underwriting system findings can be targeted to determine if the loan met the underwriting recommendations.

- Income validation sources can identify calculation discrepancies.

- Undisclosed debt monitoring tools can help target loans with higher DTI concerns.

- Closing disclosure data elements can identify if excessive interested party contributions are present.

- CU risk scores and messaging can assist in the comprehensive collateral assessment of the appraisal.

- EarlyCheck™ helps to identify potential issues prior to loan delivery.

Next steps

What can you do to ensure your organization is realizing the highest rate of return on investment from your QC sampling strategies?

- Review your existing process to validate the effectiveness of your overall QC sampling strategies.

- Assess your QC resource allocations to ensure the review process consistently provides actionable results.

- Empower your QC department to drive loan manufacturing improvements and reduce your company's overall risk exposure.

Resources

- **QC sampling — A strategy worth exploring**

- **Post-Closing QC Collateral Risk Assessment Analysis (Form 1033)**

- **Loan Quality page**

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