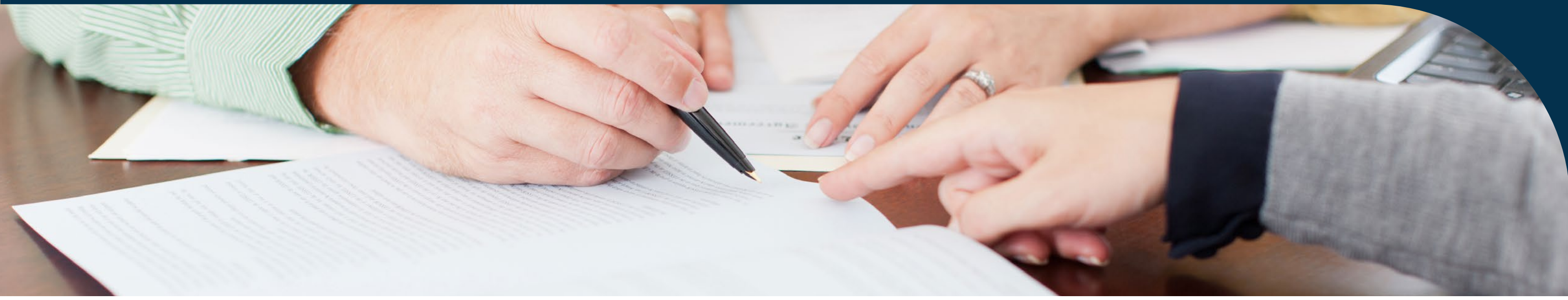

Loans with little margin for error

The mortgage industry is highly sensitive to changes in the economic landscape. We can look back to the Federal Reserve's actions over the past 12 months to put the recent interest rate roller coaster in context and see a perfect example of rapid change in the mortgage business.

Interest rates have jumped to highs not seen in decades. Borrowers are seeing higher monthly housing payments with minimal opportunities to lower their payments. Everyone is also being impacted by persistent inflation for day-to-day needs such as groceries. The Federal Reserve Bank of New York has found that borrowers are taking on more debt to support their standards of living, with credit balances increasing rapidly. Many property values continue to slip from their recent highs.

These factors have combined to create an environment that has little margin for error within the loan manufacturing process. Lenders are more likely to originate loans at or near eligibility thresholds. Originating more loans at or near eligibility thresholds creates a high degree of uncertainty in the manufacturing process. Errors that put borrowers into loans they cannot sustain is detrimental to the entire industry and increases repurchase risk for your organization.

In the past 12 months, Fannie Mae has seen a notable increase in loans that have both loan-to-value (LTV) ratios over 90% and debt-to-income (DTI) ratios over 45%. We're also seeing that borrowers are more likely to fall outside of traditional credit boxes; examples include purchasers whose credit approval is partially based on rental income history or borrowers who have no credit score at all.

To meet this challenging environment, lenders are highly encouraged to maximize the benefits from their prefunding quality control (QC) program and look closely at loans with little margin for error. Prefunding QC offers the best opportunity to review loans prior to funding and decreases the likelihood of putting borrowers into a product they can't afford. A well-structured and thought-out prefunding process can help to confirm eligibility, minimize risk, and ensure borrowers are receiving loan products for which they qualify. This is especially true as qualifying borrowers are pushing outside of the credit box.

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Consider the following examples of significant defects in which prefunding QC reviews could have corrected the defects before delivery. In each, the margin for error was small.

Category	Defect
Missed liability	Not including monthly homeowners' association (HOA) dues of $25 pushed the DTI out of tolerance from 49.84% to 50.16%.
Interested party contributions (IPCs) (*Selling Guide* B3-4.1-03)	The sales price of the subject was $130,000. The net interested party contributions received by the borrower were $4,252. The maximum IPC allowed was $2,600 (2.00%). Reducing the sales price by the amount of the excessive contribution resulted in an LTV of 86.09%, which required mortgage insurance.
Excluded debt	A $25/month debt that appeared on the credit report was excluded without documentation supporting the exclusion. With the $25/month obligation, the DTI was pushed out of tolerance from 49.05% to 50.37%.
Student loans	Calculating student loan payments at 0.5% instead of 1.0% pushed the DTI out of tolerance from 47.15% to 51.41%.
Rental income	A loan was delivered with a total rental loss calculated at $25,041.88. The actual rental loss, at $25,101.01, was only $59.13 higher. This difference, less than 1% of the total rental loss, helped push the DTI out of tolerance.
Self-employment income	A loan was delivered with self-employment income calculated at $5,962.71. The actual income, at $5,824.29, was only $138.42 lower. This difference, only 2% of the calculated income, helped push the DTI out of tolerance.

Correctly structured prefunding component reviews of areas where there is little margin for error could have fixed the student loan payment calculation, sent the loan back to get documentation to support excluding the debt, or caught the IPC error.

Initiating these prefunding reviews involves creating loan samples with DTI ratios above 40%, higher-than-average submissions to Desktop Underwriter® (DU®), excluded debt, or any high-risk areas in your origination pipeline. Do you originate loans for many first-time homebuyers? If so, perhaps a review of gift funds is in order. Are you concerned about specific underwriting personnel? A statistically valid sample of their work may be in everyone's best interest. Loans underwritten on weekends, loans originated in certain counties, loans on second homes … the topics for samples are numerous.

Once you identify your high-risk topic, you must determine how to sample your origination population. The sample can be comprised of **every** loan in the pipeline with the identified characteristic or can be based on the total of loans closed in the **prior month** that had that characteristic. Next, develop a timeline, determine how long you'll spend reviewing loans in the sample, and determine a course of action if a problem is surfaced. Identifying a solution and a responsible party are vital to action planning, which can and should be a part of your prefunding framework. Prefunding QC reviews can identify areas where a process can be improved or a problem can be nullified.

Ask yourself:

- Have you adapted your prefunding review framework to the current market?
- Have you found high defect rates in prefunding reviews? If so, have you worked with your operations department and other key business areas to implement action plans?
- If you have found low defect rates in your prefunding reviews, have you pivoted to reviewing other loans with characteristics that may be creating unwanted risks?

Next steps

✓ Review internal and external reporting to find loan populations with little margin for error that could make up prefunding reviews.

✓ Determine how you would allocate current staffing to complete effective prefunding reviews.

✓ Identify key contacts in operations who can assist with determining root causes of defects and who can help correct them. Establish a regular communication cadence.

✓ Create a schedule with target start and end dates for your reviews.

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