

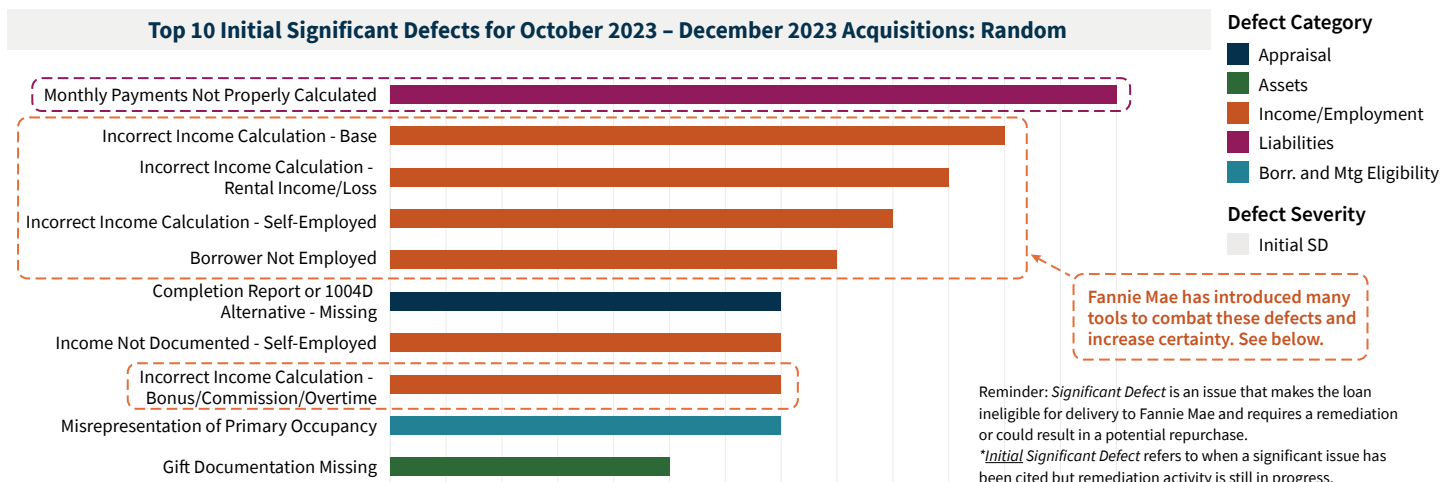
# Understand Top Defects to Help Strengthen Loan Quality

What are the top defects and trends Fannie Mae is seeing in our post-purchase loan file reviews? Understand the industry’s top quality control defects and defect trends to help strengthen loan quality and support sustainable homeownership.

As you review this information ask yourself:

- **Are you taking a strategic approach to discretionary/targeted sampling?** Is there an opportunity to use this information to enhance your discretionary/targeted sampling in both prefunding and post-closing quality control (QC) reviews?
- **Are your QC results calibrated with Fannie Mae results?** If you’re not experiencing the same defects, is it the byproduct of already having effective origination controls in place or is there potentially a blind spot within your QC review process?
- **Are you leveraging defect trends to develop training opportunities for your staff?** Can your QC team get ahead of the trending defects? Develop training to prevent these defects from occurring.
- **Is your staff aware of the risks being identified in the industry?** Lenders often face many of the same challenges. Being aware of the defect trends across the industry allows for more dynamic QC, better action planning, and prevention of similar defects in your organization.

Below are Fannie Mae’s top 10 **initial\* significant defects** identified in a random sampling of loans acquired in Q4 2023.



## Significant defect trends (random sample):

### Monthly payments not properly calculated

This is a top defect for this quarter, with a particular uptick around monthly student loan payments. Specifically, defects occur when the student loan monthly payment doesn't appear on the credit report and the payment is calculated using 0.5% repayment calculation instead of the Fannie Mae requirement of 1%. The 1% repayment calculation should be needed less frequently with payments restarting in late 2023.

#### Fannie Mae best practices

- ✔ Assess student loan statements to determine if a loan is deferred. If deferred, the Fannie Mae requirement of 1% repayment calculation applies.

- **Incorrect calculation – rental:** Over half of the rental income defects issued are a result of using rental income from a departing residence for qualification purposes and the property not being rented. This scenario can also be cited as misrepresentation of occupancy as well.

#### Fannie Mae best practices

- ✔ Leverage data and perform due diligence during origination and in QC to confirm the property is actually being rented.
- ✔ Ensure you are familiar with the **recent policy change for using rental income** from a departing residence. Changes include restricting the rental income amount to not exceed total monthly payment of the property and additional documentation requirements.

### Income and employment

Calculation errors account for four of the top ten significant defects. Roughly two-thirds of significant defects issued had an initial debt-to-income (DTI) ratio above 43%.

#### Fannie Mae best practice

- ✔ During prefunding QC, be sure to target complex income streams, especially on higher DTIs.
- ✔ Use our new Income Calculator to calculate monthly income in alignment with current *Selling Guide* requirements.

- **Incorrect calculation – self-employed:** Many of the defects resulted from using one year to calculate income when Desktop Underwriter® (DU®) required two years.

#### Fannie Mae best practice

- ✔ Reconcile that you are using the required timeframe showing in DU to calculate the qualification income.

- **Incorrect Base Calculation:** Roughly half of the miscalculations were associated with new employment, most of which included average income across multiple employers with incentive pay, overtime, and/or bonus included.

#### Fannie Mae best practices

- ✔ Perform an assessment of the year over year trends. The variable income requires evaluation of consistency and predictability.
- ✔ Evaluate whether the year-to-date income stream supports the hours used in the calculation and are consistent with prior earnings. If the borrower has a history of receiving shift differential or incentive payments, does the current paystub show evidence of current receipt?

### Borrower not employed

Continues to be one of the top significant defects.

#### Fannie Mae best practices

- ✔ Perform extra due diligence in addition to the verbal verification of employment. (ex. internet searches; email borrower at job address as close to closing as possible; track and move the verification timeline up.)
- ✔ Be aware of specific volatile jobs or industries that are more susceptible to workforce disruptions.

Fannie Mae has made tools available that help lenders mitigate the quality risk on the some of the defects listed above. Here are a few that have been introduced to help prevent these defects:



**Income Calculator NEW!**

Use our free tool to calculate self-employed income more accurately and help decrease significant defects which may reduce risk of repurchase.

**Fannie Mae best practice**

- ✔ QC should check for data integrity accuracy.



**DU validation service**

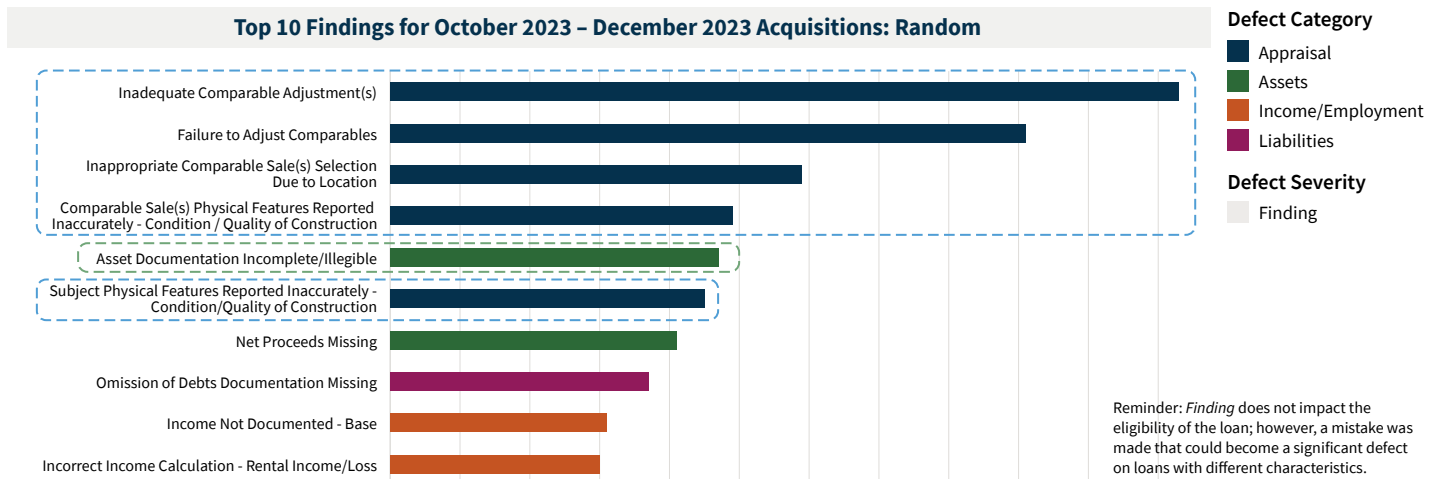
**Income and employment validation using an asset report NEW!**

Verify borrower income, employment and assets using a 12-month asset verification report which may help prevent defects tied to employment and income calculation.

**Fannie Mae best practice**

- ✔ QC should check that the DU close by date was met and be familiar with other QC factors outlined in [D1-3-02](#).

Below are Fannie Mae’s top 10 **findings** identified in a random sampling of loans acquired in Q4 2023. The identified findings during this period tell a different story compared to the significant defects. Review the findings below as well as the recommended best practices.



## Findings trends (random sample):

### Appraisal

Unlike our top significant defects, appraisal defects are the top driver in our findings space with five of the top ten this quarter. The nature of appraisal errors and our defect taxonomy can commonly result in multiple appraisal defects being cited on a single loan. This can result in an overrepresentation of total appraisal defects.

- The main driver of the collateral findings are comparable adjustments and condition and quality rating discrepancies.
- Fannie Mae identifies a disproportionate level of collateral defects compared to lender QC results. This misalignment underscores an opportunity for lenders to calibrate their internal QC results with Fannie Mae and provide a feedback loop to production and the appraiser community.

#### Fannie Mae best practice

- ✔ Utilize Collateral Underwriter® (CU®) to help with your appraisal assessment.

### Asset documentation

We saw an increase in asset documentation defects due primarily to lenders only providing one-month statements when two months are required by DU.

#### Fannie Mae best practices

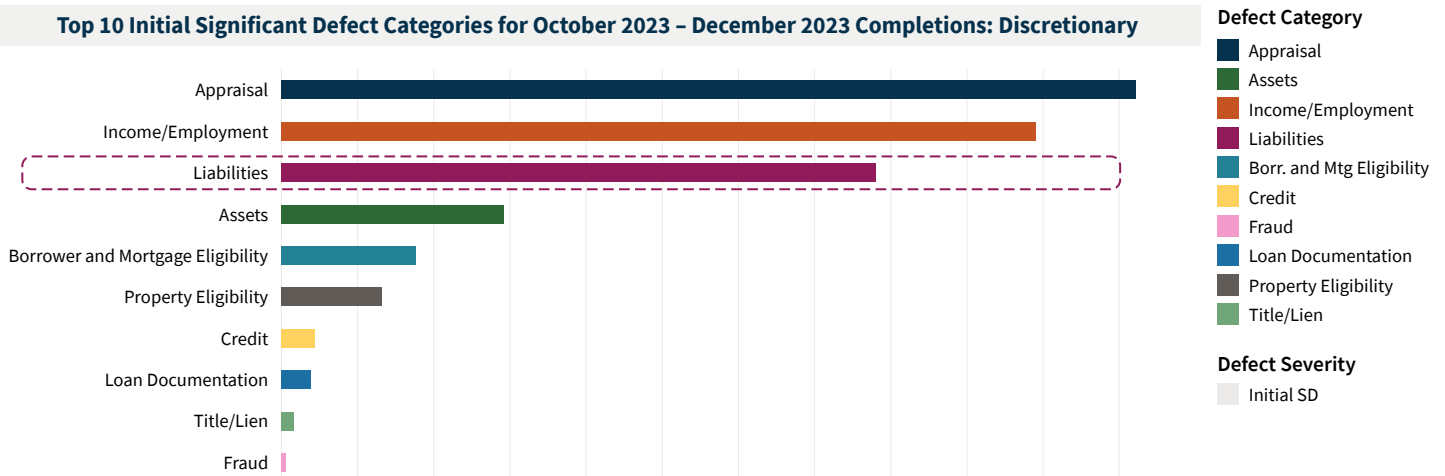
- ✔ Leverage DU validation service and an asset verification report with at least 12 months of data to validate income and employment.
- ✔ Reconcile asset statements in the file against DU findings and income documents prior to closing.

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Much like in a lender's QC process, Fannie Mae also performs reviews of a **discretionary** sample in addition to the random sample. The discretionary sample intentionally looks for loans with a greater likelihood of being defective or ineligible.

Fannie Mae's top 10 **initial significant defects** based on the discretionary sample from Q4 2023 reflects some similarities as the random sample. However, there are also a few key differences.

**Top 10 Initial Significant Defect Categories for October 2023 – December 2023 Completions: Discretionary**



## Significant defect trends (discretionary sample):

### Appraisal

Defects for using comparable sales with inappropriate locations and adjustments are a top driver in our discretionary results with the main difference being a higher propensity of the defect being significant. This is due to CU's ability to identify higher risk appraisals and flagging those with potential quality issues.

### Liabilities

The large majority of defects cited in this category are for undisclosed liabilities/mortgages. Although undisclosed debt defects remain in our discretionary top ten, these defects have steadily decreased since 2022 acquisitions. This notable improvement is a testament to the heightened focus and diligence in the industry to better control for this gap.

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### Fannie Mae best practices

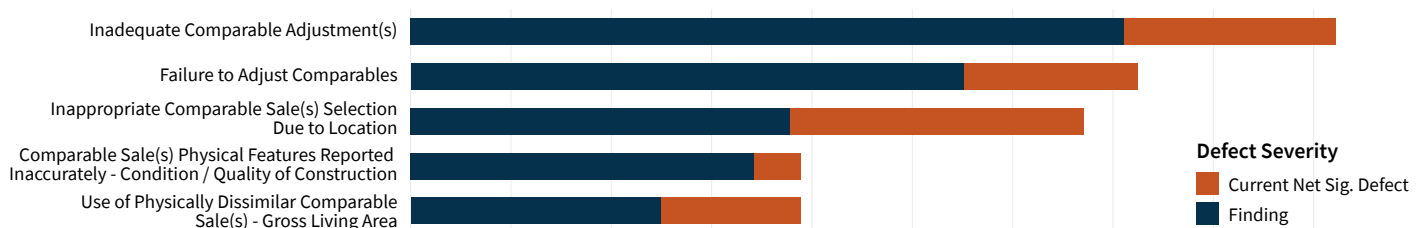
- ✔ Implement a robust credit inquiry reconciliation process to ensure all inquiries are accounted for. A large portion of undisclosed debt is opened weeks prior to closing and has a correlating inquiry appear on the credit report.
- ✔ Target loans in prefunding QC with qualifying debt-to-income (DTI) ratios above a certain threshold (e.g. greater than 40%) where an average payment amount increase could result in an ineligible loan and perform through inquiry assessment.
- ✔ Educate borrowers on the importance of disclosing all debts and ask borrowers about new debt with every touchpoint.
- ✔ Implement a standalone disclosure to be signed by the borrowers at application and prior to closing that no new debt was opened.
- ✔ Look for automatic withdrawals on asset statements that might indicate a new debt has started repayment.
- ✔ Employ an undisclosed debt monitoring (UDM) service to look for new debt as well as new inquiries throughout the loan process. The best outcome is when the UDM service covers all three credit repositories and monitoring includes weekends.
  - To lower UDM costs, the tool could be deployed only on targeted loans with a higher likelihood of being ineligible if an average undisclosed payment was added to the qualifying DTI.

## Appraisal defects

Appraisal quality is critical to sustainable homeownership for borrowers. It is very important to understand your appraisal risk and take preventative steps to avoid appraisal related defects. **Collateral Underwriter** is an effective tool to help prevent collateral issues early in the manufacturing process. We highly recommend using this tool in pre-fund and post-close QC as well.

Below are Fannie Mae's top 5 **appraisal defects** from Q4 2023 derived from both the random and discretionary loan reviews.

**Top 5 Appraisal Defects for October 2023 – December 2023 Completions: Random and Discretionary**





## Appraisal defect trends:

- Loans with **appraisal related significant defects** presented the following high-risk flags:
  - Had a median CU score of **4.6**
  - ~95% had an Overvaluation Flag (OVF): Most common OVF reason is = Comparable Similarity & Location
  - ~22% had both an OVF and Appraisal Quality Flag (AQF)
- Roughly two-thirds of appraisal related significant defects are issued on loans with **75%+ LTV**

## Appraisal quality

### Fannie Mae best practices

- ✓ Lenders should utilize **value acceptance + property data (VA+PD)** when applicable to increase certainty, better manage risk, and gain process efficiencies.
- ✓ Target loans with **high CU scores (4+)** combined with **multiple CU risk flags** and **with LTVs above 75%** in both prefunding and post-closing QC.
- ✓ Calibrate your origination appraisal review process with your QC collateral risk assessment process to ensure alignment.
  - Are all parties reviewing the same data, addressing the same risk flags, and using the same tools?
  - Consider using **Form 1033** in production as well as prefunding and post-closing QC reviews.
  - Verify that Collateral Underwriter is being leveraged effectively and consistently.

## Resources

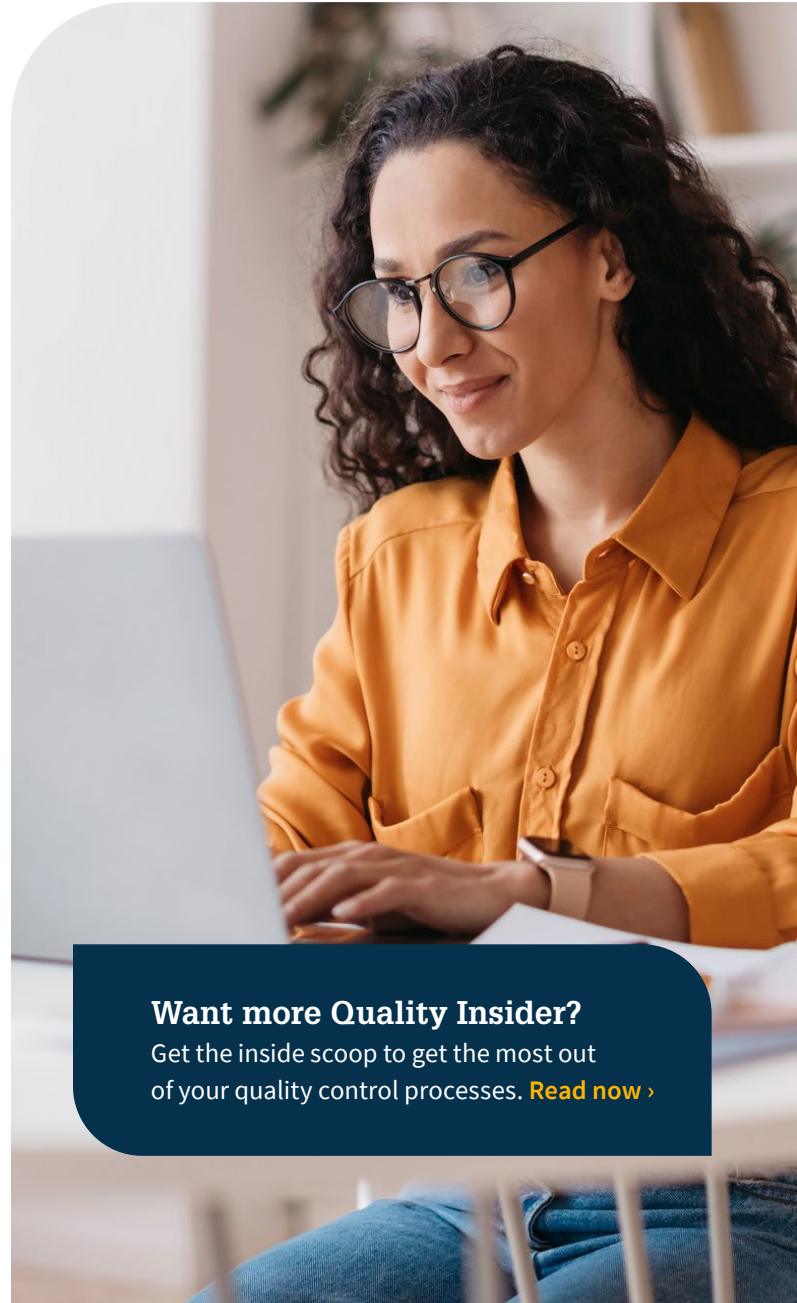
[Income Calculator](#)

[DU validation service](#)

[Selling Guide: D1-3-02 Lender Post-Closing Quality Control Review of Approval Conditions, Underwriting Decisions, and Documentation](#)

[Selling Guide Announcement \(SEL-2023-09\)](#)

[Quality Insider](#)



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