Announcement SEL-2010-11 August 13, 2010

Undisclosed Liabilities and Re-underwriting Requirements

In Announcement SEL-2010-01, *Selling Guide Updates for the Loan Quality Initiative,* Fannie Mae updated the policy related to undisclosed liabilities. The Announcement reiterated that the *Selling Guide* requires every mortgage loan delivered to Fannie Mae be underwritten to establish that the borrower has the willingness and ability to repay the debt. It also stated that lenders delivering mortgage loans to Fannie Mae should have mortgage loan underwriting standards in place that recognize a variety of factors when evaluating a borrower's ability to repay a loan, including (but not limited to) an assessment of the borrower's debts and all liabilities that may affect the borrower's ability to fulfill the mortgage payment obligation.

Additionally, the update "required lenders to determine that all debts of the borrower incurred or closed up to and concurrent with the closing of the subject mortgage are disclosed on the final loan application and included in the qualification for the subject mortgage loan."

Lender Representation and Warranty

These updates emphasized Fannie Mae's longstanding requirement that lenders have prudent processes and controls in place that support their ability to fully assess the borrower's financial circumstances and ability to successfully repay the loan. Fannie Mae expects lenders to have in place:

1. processes to facilitate borrower disclosure of changes in financial circumstances throughout the origination process; and
2. prefunding quality control processes to increase the likelihood of discovery of material undisclosed debts (e.g., other mortgages). (See D1-2-01, General Information on Lender Prefunding QC Review Process.)

In addition, Fannie Mae's intent was to remind lenders of certain representations and warranties outlined in the *Selling Guide* and the Mortgage Selling and Servicing Contract (MSSC) that address fraud and misrepresentation, and the investment quality of the mortgage. Specifically, because the selling warranties are generally not limited to matters within a lender's knowledge, the action or inaction (including misrepresentation or fraud) of the borrower, or a third party, as well as the action or inaction (including misrepresentation or fraud) of the lender may constitute the lender's breach of a selling warranty.

An unintended consequence of Announcement SEL-2010-01 was the misinterpretation by some lenders that Fannie Mae was implementing a new requirement that the borrower be requalified up until closing. Therefore, many lenders believed this required a new credit report just before the closing of the loan. This was not Fannie Mae's intent, and as previously stated, the intent was and continues to be to reinforce lenders' existing representations and warranties outlined in the *Selling Guide* and MSSC, and to emphasize the need to employ the processes outlined above.

Re-underwriting Requirements

As a result of feedback Fannie Mae has received regarding Announcement SEL-2010-01, Fannie Mae has re-evaluated the Announcement and is providing the following updated requirements. The requirements address when a lender has to re-underwrite a mortgage loan **after the underwriting decision has been made** up to and concurrent with loan closing for both Desktop Underwriter® (DU®) and manually underwritten mortgage loans, and includes a new re-underwriting tolerance for manually underwritten loans and simplification and expansion of the DU resubmission policy.

Re-underwriting Criteria

The following concepts are used in the remainder of this Announcement:

Changes to debts or income: Additional debt(s) or a reduction in income that are disclosed by the borrower or discovered by the lender through the lender's normal processes and controls.

Debt-to-income (DTI) ratio tolerance: Additional debts and/or reduced income that cause the DTI ratio to exceed 45%, or that cause the DTI ratio to increase by 3 percentage points or more.

Re-underwriting: When re-underwriting is required, it means loan casefiles must be resubmitted to DU with updated information; and for manually underwritten loans, a comprehensive risk and eligibility assessment is performed.

Applying the Re-underwriting Criteria

The following steps are required if the borrower discloses or the lender discovers additional debt(s) and/or reduced income after the underwriting decision was made up to and concurrent with loan closing:

1. The lender must document the additional debt(s) and reduced income in accordance with existing *Selling Guide* documentation requirements.
   - For each additional debt, the lender must verify the unpaid balance, the terms of repayment, and the borrower's payment history (if applicable) by obtaining documentation from the borrower or creditor. (See B3-6-01, General Information on Liabilities.)
   - For income, the lender must verify the income the borrower receives based on updated documentation. (See B3-3, Income Assessment.)

***Note*: The lender is not required to obtain a new credit report to verify the additional debt(s).**

2. If there is new subordinate debt on the subject property, the mortgage loan must be re-underwritten.

3. The lender must recalculate the DTI ratio based on the changes to debts and income noted above. (For DU loan casefiles, the DTI ratio should be recalculated outside of DU.)

4. If the recalculated DTI ratio exceeds 45%:
   - DU loan casefiles: The online loan application must be updated with the new information and the loan casefile must be re-underwritten through DU. DU offers flexibilities in the maximum allowable DTI ratio for loan casefiles with strong compensating factors, and for DU Refi Plus™ loan casefiles.
   - Manually underwritten loans: Unless other factors have changed that have a positive impact on the DTI ratio (e.g., increased income), no re-underwriting is required because the loan is not eligible for delivery to Fannie Mae.

5. If the recalculated DTI ratio does not exceed 45%, but it increases by 3 percentage points or more, the mortgage loan must be re-underwritten (or resubmitted) with the updated data to determine if the loan is still eligible for delivery.

6. The final loan application signed by the borrower must include all income and debts verified, disclosed, or identified during the mortgage process.

7. Upon delivery to Fannie Mae, the lender must deliver the qualifying monthly income and expense amounts that are on the final loan application. (See the Changes to Loan Delivery Edits section below for additional information.)

Changes to the DU Resubmission Policy

Currently, the *Selling Guide,* B3-2-10, Accuracy of DU Data, DU Tolerances, and Errors in the Credit Report, requires that verification documents be reviewed and verified values be compared to the data submitted to DU. The terms of the closed loan must match the terms of the final loan casefile submission in DU or fall within certain tolerances that are outlined in the *Selling Guide*. If the data does not meet allowable tolerances, the loan casefile must be resubmitted to DU.

Fannie Mae is simplifying the tolerances and DU resubmission policy to accommodate the re-underwriting policy outlined above and to facilitate compliance with the maximum DTI ratio policy. The tolerances for income, debt, and interest rate changes have been combined (because they all affect the DTI ratio). Additionally, the restriction that limits the use of only one tolerance per casefile has been removed.

The following table describes the changes to the DU tolerances and resubmission requirements. The other tolerances in the *Selling Guide* remain unchanged (decreases to the interest rate, increases in income, changes to assets, and loan amount changes).

Previous Resubmission Requirements[1]	New Resubmission Requirement
Income: Verified income is less than the income on the loan application submitted to DU by more than 5% of the borrower's total income	Loan casefiles must be resubmitted to DU if the result of the following changes cause the DTI ratio to exceed 45%; or if less than 45%, to increase by 3 percentage points or more: • verified income decreases, • discrepancies between the payments and balances on the credit report and those listed on the online loan application are identified
Debts: Discrepancies between the credit report payments and balances and those listed on the online loan application, including the presence of undisclosed debt that affect the DTI ratio by more than 2	

Previous Resubmission Requirements[1]	New Resubmission Requirement
percentage points	(including undisclosed debts),
Interest Rate Fixed-rate: For principal residences or second homes (without a temporary buydown), DU issues a message identifying the maximum interest rate at which the loan can close without being resubmitted. (No tolerance exists for investment properties.) ARMs: Interest rate increase that results in the total expense ratio increasing by more than 2 percentage points	• additional debt(s) disclosed by the borrower or identified by the lender, and • increase in the interest rate.

[1] The current policy only allows one tolerance to be used per loan casefile.

Changes to Loan Delivery Edits

In Lender Letter LL-2010-03, *An Introduction to Fannie Mae's Loan Quality Initiative*, Fannie Mae notified lenders of upcoming changes to Loan Delivery edits, including edits related to the DTI ratio. Fannie Mae is modifying the implementation of those edits as follows:

- The edit indicating that Loan Delivery's calculation of the DTI ratio for a given loan (using the monthly income and monthly debt expenses delivered by the lender) exceeds Fannie Mae's maximum published limit will become "fatal" as of January 3, 2011. (This is now a warning that was scheduled to become fatal on July 26, 2010). With this change, Loan Delivery will prevent loans from being delivered if the calculated DTI exceeds the published limits.
- The DU Compare functionality that compares the calculated DTI ratio in Loan Delivery to the DU loan data was to become fatal on January 3, 2011. Fannie Mae will not be implementing this as a fatal edit – it will continue to be a warning message.
- The DU Compare functionality will be updated to accommodate the new 3 percentage point tolerance. This will accommodate the delivery of loan casefiles that were not required to be re-underwritten, and instances in which the DTI ratio calculated by DU is less than the DTI ratio calculated by Loan Delivery (due to differences in the monthly income and debts delivered by the lender).

Additional Information

- These requirements are not applicable to Refi Plus™ loans (manually underwritten) since lenders are not required to calculate the borrower's DTI ratio to determine eligibility.
- If the lender *chooses* to obtain a new credit report after the initial underwriting decision was made, the loan must be re-underwritten and the final loan application updated accordingly.
- As a reminder, the monthly housing expense used to calculate the DTI ratio must contain all applicable components of PITIA as described in B3-6-03, Monthly Housing Expense.
- DU will be updated in a future release to remove the maximum interest rate message that is issued on certain fixed-rate loan casefiles. Until that time, lenders may disregard the maximum interest rate message when complying with the new DU resubmission policy.
- As a reminder, lenders are responsible for determining that their mortgage insurance providers will provide insurance coverage accordingly.

Updated *Selling Guide* Topics

The *Selling Guide* topics that are impacted by this Announcement will be updated in a future *Selling Guide* update.

Effective Date

This Announcement replaces the undisclosed liabilities policy communicated in Announcement SEL-2010-01. Lenders are encouraged to implement these changes immediately, but must apply them on loan applications dated on or after December 1, 2010.

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Lenders who have questions about this Announcement should contact their Customer Account Team.

John S. Forlines
Vice President
Single-Family Chief Risk Officer