Fannie Mae

Beyond the Guide

Section 2

Prefunding QC – Because It Drives Change!

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Prefunding QC is a foundational element of an effective QC program.

Fannie Mae provides tools, like this guide and our ***Quality Insider*** articles, among other things, that enable you to move your quality control (QC) program to the next level. Reimagining your prefunding QC (PFQC) is a logical starting point. Lenders with a deliberate and strategic method of pulling suspected quality issues forward to PFQC can make timely changes to loans moving through the pipeline. This approach yields tangible benefits by correcting quality issues before closing and reducing costly risk exposure. Only PFQC can effect change *before* mistakes are final and material impacts to both the borrower and the business are realized!

The *Selling Guide* outlines the essential PFQC requirements, but it's intentionally not prescriptive. This allows a lender flexibility to use PFQC to best address the risks unique to its organization. Sampling loans with known risks earlier in the manufacturing process enables actions that:

- prevent closing or acquisition of ineligible loans,
- permit corrections to individual loans,
- control for inaccurate or incomplete file data and documentation,
- identify and reduce fraud or misrepresentation,
- test corrective process changes for effectiveness, and
- provide real-time feedback on the origination process.

These benefits can be realized only if the PFQC focus is strategic and deliberate. The *Selling Guide* gives lenders the room to use PFQC with the intention that they would match QC sampling scope and sample sizes with the current quality risk environment. This allows for timely, efficient, and **actionable** file reviews. In past market cycles, many lenders did not increase PFQC as quality deteriorated – which was the driver for Sept. 2023 *Selling Guide* policy update.

This section highlights new concepts and tactics that can put greater focus on PFQC and take quality to the next level.

Prefunding development phases and attributes

Effective PFQC processes allow for real-time risk management. The graphic below shows the spectrum of structures and attributes Fannie Mae has observed. These processes range from a fundamental structure designed to meet minimum requirements to a highly proficient structure that is tailored to the organization's risks and flexible enough to adapt to changing markets.

Advancement stages of prefunding QC

Fundamental

- Static selections
- Checklists and spreadsheets
- Limited/no system stops to prevent closings
- Basic fraud tools
- Basic reporting

Proficient

- Thoughtful targeted selections
- Component/full-file reviews completed in loan origination system (LOS) or QC software
- Controls built in LOS with hard stops for clearing QC findings
- Fraud tools with metric or message-driven actions
- Better reporting

Highly proficient

- Use random post-closing results to expand targeted selections (defect capture approach)
- Expanded PFQC sampling for full-file, component, and digital reviews integrated with QC software
- Focus human capital on highest risk loans
- Fraud screening through integrated software
- Unified reporting that tracks and trends defect detection and mitigation processes across prefunding and post-closing QC, tying identification → actions → results

This information is intended to help a lender strengthen or enhance current processes, regardless of where its organization falls on the spectrum.

Sampling strategy and defect rates

Sampling strategies and objectives for PFQC, when implemented thoughtfully, are one of the most effective ways to identify and remediate quality risk prior to closing. The PFQC sample should be one of a lender's most dynamic samples – ensuring the process is looking for the right risks.

A targeted approach to PFQC loan sampling helps achieve four goals:

1. Fix loan-level defects prior to closing.
2. Review areas of known risk to lower instances of defects, issues, or problems.
3. Test theories to tease out pockets of risk.
4. Test effectiveness of action plan controls.

Effective targeted sampling allows a lender's PFQC process to become an advanced tool in their manufacturing control arsenal.

The *Selling Guide* states that loans selected for prefunding QC reviews must target areas that the lender identifies as having a higher potential for errors. The *Selling Guide* requires a minimum prefunding sample size that represents 10% of the prior month's total originated loans or 750 loans. In addition to the required targeted sample, a best practice is to implement a random sample in PFQC. A random sample of a lender's pipeline is not required as part of a PFQC sampling strategy, but it can be a useful tool to understand current health of the loans in process and identify emerging issues in real time.

Targeted sample effectiveness

If a sampling strategy is on point, the number of gross defects cited during PFQC should be **high**. Understanding this concept can help management know whether prefunding sampling strategies are targeting the right population of loans. Higher gross defect rates in the PFQC should be the desired outcome. Low defect rates on targeted populations should not be dismissed without understanding the reason. If the criteria were selected because the business believed there was a higher likelihood of defects, the absence of those defects should be examined.

Ask yourself:

- Were the auditors performing the QC tests that target the areas identified as being high risk or having a higher potential for errors?
- Has the likelihood of a defect occurring been mitigated through systems, processes, or market changes?

Constant examination of sampling criteria and how it is tested ensures that PFQC has the best chance of efficiently capturing loans with defects that can be corrected.

Defect capture rate

As a complement to assessing sample effectiveness, it is important to assess the effectiveness of the defect capture rate. Defect capture rate is a measure of how much quality risk you can identify based on your targeted samples. The measure of how much quality risk and where that risk lies is based off your post-closing random sample. Your post-closing random sample results are a representation of the quality of your total originations. In the example below, if your defect rate is consistently 3% and you originate 1,000 loans a month, you close approximately 30 loans a month with significant defects.

Defect capture rate is a measure of how much quality risk you can identify based on your targeted samples.

Example

	Jan.	Feb.	March
Loans closed	1,000	1,000	1,000
Defect rate	3%	3%	3%
Number of defective loans closed	30	30	30

Top defects:

- Self-employed income calculation
- Omission of debt not documented
- Base income calculation

Having this information and understanding your top defect drivers allows you to enhance your targeted samples to find these loans. The defect capture rate reflects how many of those defective loans you were able to find by either expanding your prefunding targeted selections or using your post-closing discretionary reviews.

Don’t forget

- Defects identified in post-closing can show hidden or emerging risks that can be incorporated into the PFQC samples. (And as noted above, once solutions to drivers of these defects are implemented, prefunding tests those solutions, thus creating a cycle of pre- and post-closing QC synergy.)
- Assess sampling methodology at *least* quarterly, but more often if possible. Consider:
  1. What is happening in the economy that may lead to manufacturing risks (e.g., rising interest rates = fewer rate/term refinances and more purchase transactions)?
  2. What personnel changes have happened in operations that could affect manufacturing quality (e.g., high rate of personnel turnover and role transitions)?
  3. What new products has the organization introduced (e.g., home equity line of credit, manufactured housing)?

- Utilize the same taxonomy for PFQC that you use for post-closing QC.
- Create a comprehensive view of risks by aggregating QC results from investors, mortgage insurers, servicing entities, and your internal data. The collection may yield information that can help you determine high-risk areas to target.
- Use technology to identify risk by targeting high-risk data points within loan transactions. Deploy sampling models and tools that select loans with heightened risk based on the information available to you.

Prefunding versus pre-purchase

PFQC requirements apply to loans closed by the lender (prefunding reviews) as well as any closed loan that a lender acquires (pre-purchase reviews). At their most basic levels, both reviews must be designed to protect the lender from funding or acquiring defective loans, but each review type should consider the unique risks and limitations of its origination source.

Prefunding reviews	Pre-purchase reviews
Retail and wholesale (broker) originations	Correspondent originations
Loan file is completed through underwriting	Loan file is funded with closing documents
Corrections **can** be made before loan is closed	Corrections **cannot** be made to the loan
If defects identified cannot be corrected, loan is not closed	If defects identified cannot be cured, loan is not purchased
Review results give insight to process or staff effectiveness	Review results give insight to counterparty production quality

Full-file versus component

The *Selling Guide* requires that some portion of a lender's PFQC contain full-file reviews so that new risks can be identified earlier than post-closing random reviews would reveal, but no minimum requirement is set. This gives lenders flexibility to use component reviews to target specific risk attributes. The chart below is not all inclusive but provides examples of full-file and component review options.

Targeted areas may include:	Full-file	Component
Loans with characteristics or circumstances related to errors or defects identified in prior prefunding and post-closing review results	✓	✓
Loans that were impacted by a recent policy change	✓	✓
Loans with complex income calculations (for example, rental income, self-employed, and short history of receipt of income)		✓
Loans requiring the use of nonstandard processing or underwriting guidelines (for example, multiple financed properties, assets used as income, or manual reserve calculations)	✓	
Loans originated or processed through various business sources, branch office, staff person, contractor, third-party originator, or appraiser	✓	✓
Loans that require a higher level of documentation	✓	

Being intentional about when to use component reviews versus when to use full-file reviews can help with defect capture rates and staff efficiencies. Component reviews typically take less time to complete, which enables you to cast a wider net over known risk components, yielding more efficient utilization of review resources. The time saving created by performing the component review allows lenders to increase the percentage of loans that can be reviewed without having to increase staff. Perform full-file reviews for loans with layered or broader risk.

Prefunding cycle timing

Prefunding reviews must be effective in identifying and preventing ineligible loans from funding. Timing is critical. Selections must be made when the documentation is complete and, at a minimum, when the loan is conditionally approved or cleared to close *but not* closed. PFQC needs a reasonable amount of time to perform the review and operations needs adequate time to make any corrections identified by PFQC - all while minimizing manufacturing delays.

Selections must be made when the documentation is complete and, at a minimum, when the loan is conditionally approved or cleared to close but not closed.

Here are some best practices to facilitate smooth and efficient reviews:

Set expectations

Partner with operations to ensure reasonable expectations for process.

Define process expectations

Define turn times that make sense (4-hour, 6-hour, or 24-hour turn time).

Flexible selections

Select files early in the process but only perform review when sufficient documents are received.

Process for priorities

Define expedited process for reviewing and clearing high-priority loans to meet special circumstances without sacrificing quality.

Clear escalation contacts

Consider establishing defined points of contact between operations and QC that oversee remediation processes, ensuring timely remediation.

Define checkpoints in the process

Use QC checkpoints for fraud and data screening tools that highlight red flags throughout the process to streamline the final review. Include LOS hard stops requiring documenting of operations/QC comments and actions.

Reporting

The best PFQC program will lose an important piece of its value if management reporting is not done well. The *Selling Guide* requires that PFQC's selection details and file review results are reported to management monthly. You might meet this requirement by publishing a simple spreadsheet with flat numbers, but you won't be giving management what it needs to drive quality and act where needed. If the underlying root cause or source of defects is not addressed, the same defects are likely to occur and the PFQC function will be like a "whack-a-mole" exercise.

Refer to *Beyond the Guide* Section 6, QC Reporting, for an in-depth view of various methods lenders have used to design, create, and publish actionable report packages. These reports keep the organization apprised of its performance relative to its quality standards. The Reporting section provides specific suggestions for prefunding areas such as:

- Designing informative, uniform prefunding reports
- Quantifying the value of prefunding QC
- Highlighting patterns, trends, and process gaps
- Merging operations and QC metrics for action
- Tying prefunding QC results back to post-closing QC results

Considerations

- Publish your most recent month's prefunding QC report with your current monthly post-closing results (report May PFQC results with February post-closing results).
- To be effective, prefunding reports must include overall defect trending and granular defect-level trending. Trending only general categories fails to provide sufficient information to drive action.
- Display selection reasons in plain language.
- If prefunding is testing for action plan effectiveness, ensure results are called out and include expected confirmation of effectiveness in post-closing results. (Refer to *Beyond the Guide* Section 7, Corrective Action and the Action Plan, for additional details.)
- Include loan amounts in relevant reports and highlight costs and/or repurchase risks that were avoided to provide regular visibility into the contribution PFQC provides to the bottom line.
- Create a system that allows for identification of the areas responsible for deficiencies (also known as points of failure) to help align QC functions, produce better action planning, and improve communication.

Resources

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