Selling Guide Lender Letter LL-2012-07

October 19, 2012

To: All Fannie Mae Single-Family Sellers and Servicers

Fannie Mae's Quality Control Process – Additional Information

On September 11, 2012, Fannie Mae issued *Selling Guide* Announcement SEL-2012-08, *New Lender Selling Representations and Warranties Framework*, announcing that, at the direction of the Federal Housing Finance Agency (FHFA) and jointly with Freddie Mac, it was implementing a new selling representations and warranties framework that would apply to mortgages purchased or securitized on or after January 1, 2013. Under the new representations and warranties framework, for mortgages that establish an acceptable payment history and satisfy other eligibility criteria, Fannie Mae will not exercise its remedies in connection with a lender's breach of certain selling representations and warranties generally relating to the underwriting of the borrower, the mortgaged premises, and the project in which the mortgaged premises is located.

Integral to the new representations and warranties framework is Fannie Mae's quality control review process and enforcement for violations of the selling representations, covenants, and warranties set forth in the *Selling Guide* and Lender Contract. Simultaneously with its issuance of SEL-2012-08, Fannie Mae published a Lender Letter (LL-2012-05, *Fannie Mae's Quality Control Process*) generally describing current quality control practices and providing an overview of future changes to the quality control and enforcement processes in support of the new representations and warranties framework.

In *Servicing Guide* Announcement SVC-2012-21, *Servicing Guide Updates to Conform to the FHFA Directive on Harmonized Contracts,* Fannie Mae announced revisions to the quality control time lines and repurchase requirements first previewed in LL-2012-05. Based on industry feedback, today Fannie Mae is expanding on the detail in LL-2012-05 on some of the quality control and enforcement processes and practices that support the new representations and warranties framework. This Lender Letter, which is issued at the direction of FHFA and in coordination with Freddie Mac, provides supplemental information on the following topics, identifying what is new and the effective date of each new provision:

- Overview of Quality Control Principles
- Quality Control Sample Process
- Quality Control Review Practices
- Enforcement Practices
- Ongoing Communications
- Preview of Change to Automatic Repurchase Trigger
- Clarification of Life of Loan Representations and Warranties Related to Misstatements, Misrepresentations, Omissions, and Data Inaccuracies

Overview of Quality Control Principles

The quality control review process is Fannie Mae's way of validating whether the loans Fannie Mae purchases were originated in accordance with applicable underwriting standards, and it provides lenders with tangible data and feedback about the quality of their loan origination process. As such, every lender is subject to quality control review of mortgages sold to Fannie Mae. In connection with the new representations and warranties framework, Fannie Mae will continue efforts to confirm the mortgages purchased by Fannie Mae comply with the *Selling Guide* and Lender Contract.

Fannie Mae's objective is to continue improving upon its quality control processes. Fannie Mae's quality control efforts will be focused on identifying loans that are not originated in accordance with applicable underwriting and eligibility requirements. Fannie Mae views the origination quality risk as distinct from the credit risk associated with a loan. While there may be instances where the two risks overlap, the quality control reviews for the new representations and warranties framework will focus on identifying those loans that fail to meet underwriting and eligibility requirements.

Fannie Mae expects that lenders will use the quality control review results and feedback, as well as the various loan evaluation tools made available by Fannie Mae, Freddie Mac, and the mortgage finance industry, to improve their own loan origination processes. Together, Fannie Mae and its lenders should have a shared goal of improving the quality of loan originations.

To this end, Fannie Mae will continue to enhance its ongoing quality control sampling and review efforts using some of the technology and data-gathering tools it has implemented to evaluate borrower credit and capacity, the collateral, and product eligibility. These tools include:

- Desktop Underwriter® – This is the automated loan assessment system that increases a lender's productivity and ability to make informed credit decisions.
- EarlyCheck™ – This Fannie Mae application assists lenders in identifying and correcting potential eligibility and/or data issues early in their processes and prior to loan delivery.
- Uniform Appraisal Dataset (UAD) – The UAD defines all fields required for an appraisal submission for specific appraisal forms, standardizes definitions and responses for a key subset of fields, and is intended to enhance the accuracy and integrity of collateral data.
- Uniform Collateral Data Portal (UCDP) – This portal is used for the electronic submission of the UAD and provides error messages regarding UAD data fields that are incomplete or incorrectly completed.
- Fannie Mae Appraisal Messaging – Fannie Mae has developed proprietary appraisal rules and related messaging to offer feedback to lenders on the quality of the appraisal data submitted to both GSEs (Fannie Mae and Freddie Mac) or to Fannie Mae only via the UCDP. The messages, scheduled for rollout in January 2013, are designed to help lenders detect data inconsistencies and improve the overall reasonableness and quality of appraisal data.
- Uniform Loan Delivery Dataset (ULDD) – The recently-implemented ULDD expanded the number of loan-level data elements provided to Fannie Mae in connection with the delivery of a mortgage. ULDD also standardized definitions and valid values for each of the data elements, with the goal of enhancing the accuracy and integrity of the loan data.
- Loan Delivery – Fannie Mae's Web-based application that allows the lender to submit loans for whole loan sale and MBS pools to Fannie Mae as well as perform edits to facilitate error-free delivery.

In addition to these data-gathering and validation tools, Fannie Mae will continue to provide lenders with timely, meaningful information on their loan quality, and greater transparency and predictability regarding the remedies Fannie Mae may exercise when a defective loan is identified in the quality control review process.

> ***What is new?*** *While Fannie Mae continues to refine and enhance several of the tools listed above, nothing contained in this section related to quality control principles is new.*

> ***When is this effective?*** *The provisions in this section are currently effective and are anticipated to remain effective after implementation of the new representations and warranties framework.*

Quality Control Sample Process

Random and Discretionary Sampling

Under its core performing loan sample process and strategy, Fannie Mae selects a random sample of new mortgage deliveries that ensures statistical validity across the entire book of business. The random sample is augmented with discretionary samples that focus on detecting defects that may indicate loans that were ineligible for delivery to Fannie Mae because they failed to meet Fannie Mae's underwriting and eligibility requirements.

Random and Discretionary Sample Sizes

As communicated in LL-2012-05, Fannie Mae does not anticipate making any material changes to its random sample size or process in the near future. However, with respect to the discretionary samples, as Fannie Mae avails itself of the new technology and data-gathering tools to analyze loan-level data, it is expected that the discretionary samples for performing mortgages acquired under the new representations and warranties framework will increase in the aggregate across all loans and all lenders. This increase will likely occur in early 2013 but will fluctuate based on the lender's loan origination quality. The quality and volume of the mortgage loans delivered to Fannie Mae will directly impact the size of the discretionary sample. Longer term, though the number of legacy nonperforming loan reviews will decrease, the overall total of all mortgages selected for review is not expected to increase significantly from current levels.

As Fannie Mae has done in the past, it will continue to refine its sampling methodology based on loan origination quality and ongoing industry changes. Lenders can expect to see future adjustments in the performing loan discretionary sample sizes. Furthermore, Fannie Mae does not intend to make changes in how it calculates defect rates. Findings that result from discretionary sample reviews and from reviews of nonperforming loans do not have an impact on the calculation of the random defect rate.

File Request Timelines for Performing Loan Reviews

With respect to performing loan reviews, the random sample is generally selected from mortgages acquired by Fannie Mae during the prior 60 days. The discretionary sample will generally be selected within 150 days after mortgage acquisition. The goal is to complete performing loan file reviews and provide lenders with notice of any deficiencies within 90 days of Fannie Mae's receipt of the requested information and mortgage file. This will result in lenders receiving notices of any deficiencies closer to the acquisition date.

Nonperforming and Anti-Predatory Lending Compliance Reviews

Fannie Mae's current nonperforming loan sample process and review strategy will remain unchanged. Additionally, Fannie Mae does not anticipate making any changes to its anti-predatory lending compliance review sampling process. Compliance with applicable laws and regulations remains the sole responsibility of lenders.

> ***What is new?*** *Fannie Mae's discretionary samples for performing loans will likely increase in aggregate across all loans and lenders.*
>
> ***When is this effective?*** *The increase in the size of discretionary samples will occur in early 2013. All other provisions of this section are currently effective and are anticipated to remain in effect after implementation of the new representations and warranties framework.*

Quality Control Review Practices

The quality control review practices for Refi Plus™ and DU Refi Plus™ mortgage loans differ from the practices Fannie Mae employs in reviewing all other loan products. These differences are described below.

Mortgage File Review Process--for Mortgages other than Refi Plus and DU Refi Plus Mortgages

As communicated in LL-2012-05, mortgages sampled are reviewed on a comprehensive basis by evaluating the entirety of the requested mortgage file, with a primary focus of identifying significant deficiencies. Fannie Mae reviews the mortgage file against the loan program eligibility requirements set forth in the *Selling Guide* and Lender Contract and conducts an in-depth analysis of the credit and capacity of the borrower, including the borrower's ability to repay the loan, and an analysis of the underlying collateral.

When reviewing a mortgage on a comprehensive basis, there may be circumstances in which certain characteristics may be deficient, but when considered with other loan attributes, the mortgage may be deemed overall to be of acceptable quality. Similarly, some individual defects are significant in and of themselves; in other cases, a mortgage file may present a layering of deficiencies that, when considered comprehensively, make the mortgage unacceptable.

As a result of the mortgage file review, Fannie Mae may impose a condition to retaining the loan, such as requiring the lender to cure the deficiency or to agree to an alternative remedy to repurchase. (Refer to "Alternatives to Repurchase and Replacement of Informational Findings Letters" below.)

> ***What is new?*** *Although Fannie Mae has not previously provided the specificity regarding a comprehensive review that is set forth in this subsection, this is not a change in quality control review practices. Fannie Mae continues to be committed to considering the mortgage file as a whole when making a determination on the eligibility of a sampled loan.*
>
> ***When is this effective?*** *The provisions in this subsection are currently effective and are anticipated to remain effective after implementation of the new representations and warranties framework.*

Mortgage File Review Process--for Refi Plus and DU Refi Plus Mortgages

For Refi Plus and DU Refi Plus mortgages, Fannie Mae's quality control review will confirm that the mortgage loan being refinanced was owned by Fannie Mae and meets the loan program eligibility requirements set forth in Section B5-5.2, DU Refi Plus and Refi Plus Mortgage Loans, of the *Selling Guide* and Lender Contract, as applicable. Fannie Mae does not conduct a full analysis of the credit and capacity of the borrower nor does it review the value, condition, and marketability of the property securing any Refi Plus and DU Refi Plus mortgage.

> ***What is new?*** *In Announcement SEL-2012-09, Updates to Refi Plus™ and DU Refi Plus™, Fannie Mae recently announced changes to the property representations and warranties, which resulted in changes to the related quality control practices. Other changes to Fannie Mae's quality control review practices (which are to review the mortgage file against the loan program eligibility requirements) are not anticipated to change.*
>
> ***When is this effective?*** *The quality control review practice currently in effect is anticipated to remain in effect after implementation of the new representations and warranties framework.*

Subsequent Mortgage File Review

Prior to establishing an acceptable payment history, Fannie Mae's objective is to complete comprehensive reviews on loans when the files are initially selected and reviewed. If new information is discovered – such as a title defect that prevents a foreclosure – Fannie Mae may review that new information. It is not Fannie Mae's intention to re-review the eligibility or underwriting of loans previously reviewed.

This is particularly the case with respect to sampled performing loans for which the borrower subsequently meets the payment history requirements of the new representations and warranties framework as detailed in SEL-2012-08 (that is, either 12 or 60 months for Refi Plus and DU Refi Plus mortgages, and either 36 or 60 months for other mortgages). However, as noted above, if Fannie Mae obtains additional information about the loan, either before or after the borrower meets the payment history requirements, that indicates the mortgage may violate one of the life of loan selling representations and warranties described in SEL-2012-08, Fannie Mae may at its discretion request the mortgage file for an additional quality control review.

For mortgages that were not subject to a quality control review by Fannie Mae that first became delinquent after the borrower met the payment history requirements of the new representations and warranties framework, Fannie Mae may conduct a nonperforming quality control review if it becomes aware of information that would indicate the mortgage violates one of the life of loan selling representations and warranties described above.

> ***What is new?*** *The mortgage file review practice described in this subsection is new, based on SEL-2012-08, in which Fannie Mae announced the new representations and warranties framework.*
>
> ***When is this effective?*** *The mortgage file review practice described in this subsection will be effective for mortgages purchased or securitized on and after January 1, 2013.*

Enforcement Practices

Repurchase and Appeal Process

When Fannie Mae identifies a defective mortgage, it issues a repurchase request which describes the defects that render the mortgage ineligible for purchase by Fannie Mae. The defects that would give rise to a repurchase request consist of errors or failures that would have resulted in Fannie Mae's refusal to purchase the mortgage at the time of delivery had they been known. Employing the tools discussed in "Overview of Quality Control Principles" should help decrease the number of Fannie Mae repurchase requests over time as fewer ineligible mortgage loans are delivered. For more details regarding the repurchase alternatives available for mortgage defects that do not rise to the level of a repurchase request, see the following section.

Fannie Mae will continue to maintain a process for lenders to appeal repurchase requests. The appeals process is very effective for loans with defects such as missing documentation or other curable deficiencies. A substantial proportion of the repurchase requests issued are resolved and the repurchase request is rescinded because the lender provides documentation or otherwise cures the defect identified in the repurchase request within the time period specified by Fannie Mae (when a cure has been offered to the lender).

Under the appeals process, when Fannie Mae issues a repurchase request for a particular mortgage loan, the lender is entitled to review and respond to the loan-level findings within 60 days and to provide any required documentation to address the deficiencies identified in the repurchase request, with the goal of resolving significant deficiencies. The goal of Fannie Mae and the lender should be to resolve repurchase requests as expeditiously as possible during the first appeal. However, if Fannie Mae does not approve the initial appeal and the lender discovers new information to support its contention that the mortgage complies with the *Selling Guide* and Lender Contract, a second appeal will be permitted within 15 days, provided the lender submits documentation concerning the new information with its appeal.

> ***What is new?*** *Fannie Mae currently provides lenders with the opportunity for a second appeal if new information is provided that supports the lender's contention.*

> ***When is this effective?*** *All other provisions in this subsection are currently effective and are anticipated to remain in effect after implementation of the new representations and warranties framework.*

Alternatives to Repurchase and Replacement of Informational Findings Letters

In certain circumstances, Fannie Mae may provide the lender with an alternative to the immediate repurchase of the identified mortgage. In each such case, Fannie Mae will notify the lender of the type and terms of the repurchase alternative. The alternatives may include any one or more of the following, as determined by Fannie Mae in its sole discretion:

- Recourse – an agreement by the lender to provide recourse for the life of the loan or for some other specified time period.
- Collateralized recourse – recourse as described above, with respect to which the lender's obligation is secured by a specified collateral account.
- Indemnification – an agreement by the lender to indemnify, defend, and hold harmless Fannie Mae from any losses, costs, claims, actions, damages, liabilities, judgments, counterclaims or defenses to which Fannie Mae may become subject relating to the mortgage.
- Collateralized indemnification – indemnification as described above, with respect to which the lender's obligation is secured by a specified collateral account.
- Loss share – an agreement between Fannie Mae and the lender to each pay a specified proportion of the losses that have arisen or may arise in the future relating to the mortgage.
- Loss reimbursement – an agreement by the lender to reimburse Fannie Mae for specified losses relating to the mortgage.
- Pricing adjustment – the assessment by Fannie Mae and payment by the lender of a guaranty fee adjustment or additional loan-level price adjustment with respect to the mortgage.

These repurchase alternatives will replace the practice of providing informational findings letters to lenders. With the notification of repurchase alternatives, Fannie Mae will be providing all lenders with information on quality control results as well as greater flexibility in repurchase alternatives.

> ***What is new?*** *The process of offering alternatives to repurchase is not new, since Fannie Mae has always asserted the right to offer repurchase alternatives. However, this is the first time Fannie Mae has specifically described the alternatives. Discontinuing the informational findings letters and replacing them with information on quality control results plus potential repurchase alternatives is new.*
>
> ***When is this effective?*** *Replacing informational findings letters with the repurchase alternatives will be effective for mortgages purchased or securitized on and after January 1, 2013. The other provisions of this section are currently effective and are anticipated to remain effective after implementation of the new representations and warranties framework.*

Considerations in Determining Alternative to Repurchase

In determining whether to offer an alternative to repurchase, Fannie Mae considers a number of factors, including the following.

- Type of loan defect - Certain types of loan defects cannot be cured, violate internal policies, and/or are deemed egregious, and will not be considered for an alternative to repurchase. An example of such a mortgage is a loan product, such as a negative amortization loan, that Fannie Mae does not currently purchase. Other examples of loans that will not be offered a repurchase alternative include loans with significant misrepresentation by any party of the transaction, loans that violate the Fannie Mae Charter, and loans that violate state or federal lending laws.

- Misidentified loans delivered without a fee - Some loans may be considered ineligible because they were misidentified and delivered without the appropriate loan-level price adjustment or other pricing-related adjustment. In these cases, Fannie Mae may consider offering a pricing adjustment or imposition of a fee as an alternative to repurchase.
- Lender's financial viability - Other alternatives to repurchase may be based on the financial viability of the lender as counterparty, such that a financially sound counterparty might be permitted to provide recourse on the loan, while a financially weaker lender may not be allowed to provide recourse or might be required to collateralize the obligation.
- Other factors - Fannie Mae may also consider other factors such as any compensating factors related to the origination of the loan; layering of risks that exist on the loan; the status of the loan (that is, whether it is performing or nonperforming); the potential loss associated with the defective loan; and the lender's past repurchase practices.

In each case, Fannie Mae's decision to offer a repurchase alternative and the terms and conditions of the alternative will be at Fannie Mae's sole discretion.

> ***What is new?*** *The factors considered by Fannie Mae in determining whether to offer a repurchase alternative are not new, but this is the first time those factors have been specifically described.*
>
> ***When is this effective?*** *The provisions in this subsection are currently effective and are anticipated to remain effective after implementation of the new representations and warranties framework.*

Ongoing Communications

Fannie Mae provides lenders with ongoing feedback about their overall quality control performance, including identifying repurchases by defect types and reporting frequent or common defects. This information is provided through a variety of methods that range from regular electronic transmissions to more formal periodic discussions.

Fannie Mae's goal is to continue engaging in frequent, meaningful exchanges of information with its lenders on quality trend analyses and significant underwriting deficiencies identified through the quality control review process. Fannie Mae believes such communications strengthen the alignment between Fannie Mae and its lenders on what constitutes a significant deficiency and provides both parties with a clear understanding of underwriting philosophy and how it applies to loan-level findings. Fannie Mae requires that lenders implement and enforce strong underwriting processes and, if necessary, will work with lenders to develop action plans to improve origination quality.

> ***What is new?*** *Nothing contained in this section is new; it reflects the same process that has been in effect.*
>
> ***When is this effective?*** *The provisions in this section are currently effective and are anticipated to remain effective after implementation of the new representations and warranties framework.*

Preview of Change to Automatic Repurchase Trigger

In Announcement SEL-2012-08, Fannie Mae announced a new policy regarding an automatic repurchase request for any mortgage loan for which no full monthly payment was made for the first three months after acquisition. Upon further review, it has been determined that the automatic repurchase trigger will not be implemented. Fannie Mae will continue its current practice of conducting quality control reviews of mortgages that exhibit early payment defaults. The percentage of mortgages delivered to Fannie Mae that fall into this category is minimal and is expected to remain so.

The retraction of the automatic repurchase trigger policy will be announced when the *Selling Guide* is updated to incorporate the contents of Announcement SEL-2012-08.

Clarification of Life of Loan Representations and Warranties Related to Misstatements, Misrepresentations, Omissions, and Data Inaccuracies

Announcement SEL-2012-08 describes a number of representations and warranties for which the lender remains responsible for the life of the loan. The following information is intended to clarify the policies pertaining to misstatements, misrepresentations, omissions, and data inaccuracies that apply **after** a loan has established an acceptable payment history and qualified for the enforcement relief.

Misstatements, Misrepresentations, and Omissions

If the lender or Fannie Mae discovers that one party to the transaction has misstated, misrepresented, or omitted information used to originate that loan, the loan is still eligible for relief if it otherwise satisfied the representations and warranties relief eligibility requirements. The following example provided in Announcement SEL-2012-08 illustrates a scenario where there was an individual borrower misrepresentation, but the loan is eligible for relief:

- A borrower borrows $10,000 from his friend as part of a down payment on a home. He has promised to pay his friend back with interest. The borrower provides a falsified gift letter to the lender. After 36 timely payments, the lender would *not* be required to repurchase the loan even if the lender subsequently discovered that part of the down payment was borrowed because the borrower's misstatement to the lender affected only one loan.

Mortgage loans that have a misstatement, misrepresentation, or omission that involve two or more parties to the transaction **and** two or more mortgage loans are ineligible for relief. The following example from the Announcement illustrates an omission that involved two or more parties and two or more mortgage loans sold to Fannie Mae:

- A realtor and a property developer decide that in order to sell several new homes faster, they provide several borrowers with a $15,000 rebate outside of closing that was not disclosed in the sales contract or HUD-1 Settlement Statement. This practice is in violation of Fannie Mae's undisclosed interested party contributions policy. In this instance, the lender *must* repurchase the loans, if requested, even if the loans are otherwise eligible for relief.

Data Inaccuracies

The policy in the Announcement pertaining to data inaccuracies addresses operational or other risks that a lender fails to deliver accurate data to Fannie Mae. Fannie Mae's focus will be on identifying delivery data that differs from the information documented in the lender's loan files on multiple loans that resulted from the lender's failure to properly implement, monitor, or maintain its data capture and delivery process or system. If the information in the loan files indicates the loans were not eligible for sale to Fannie Mae on the terms delivered, lenders may be required to repurchase the loans, or Fannie Mae may impose an alternative repurchase remedy. The following example provided in the Announcement illustrates a data issue of this nature:

- As a result of a system upgrade, a coding error is introduced into a lender's system such that the representative credit score is incorrectly calculated and the lender reports inaccurate representative credit scores at loan delivery. A review of the credit reports in the lender's origination files shows that for multiple mortgages the actual representative credit scores were lower than those reflected in the data provided at delivery and the actual representative credit scores did not meet Fannie Mae's eligibility requirements. The lender would be responsible for remedying the systemic error, and may be required to repurchase the affected loans.

> NOTE: *This clarification only addresses a subset of the policies in Announcement SEL-2012-08 pertaining to misstatements, misrepresentations, omissions, and data inaccuracies. Refer to the* [*Announcement*]() *for the complete policies.*

*****

Lenders who have questions about this Lender Letter should contact their Account Team.

John Forlines
Senior Vice President
Chief Credit Officer for Single-Family