Getting It Right – Reverification of Occupancy

Minimize risk and originate high-quality loans by implementing effective processes and procedures during loan origination and quality control (QC). A strong QC environment can help lenders detect red flags and uncover discrepancies during the reverification of occupancy. When lenders discover discrepancies, they should validate the data used to determine the borrower's eligibility was accurate. The validation can spark insights related to potential gaps across their internal control environment.

Ask yourself:

- Are you aware of the associated risks on loans with inaccurate occupancy status?
- Do you have established processes to spot occupancy red flags during origination and underwriting?
- Do you train every person in the manufacturing process on evolving trends in potential occupancy fraud for housing and for profit?
- Is your QC team well-versed on how to investigate occupancy red flags?

Occupancy type – why it matters

The Fannie Mae *Selling Guide* B2-1.1-01, Occupancy Types, describes three types of occupancy and each poses a different level of risk:

- **Principal residence** – The subject property will be occupied by the borrower as their primary residence. This occupancy type represents the least amount of risk, as borrowers are less likely to default on a mortgage loan for the home that they occupy.
- **Second home** – The subject property will be occupied by the borrower for some portion of the year, such as a summer or vacation home. This occupancy type represents a higher risk than a principal residence.
- **Investment** – An investment property is owned but not occupied by the borrower and is rented out to others. This occupancy type represents the highest level of risk.

As a result of the varying levels of risk, there are different eligibility rules based on the occupancy type. Lower-risk transactions often allow for higher loan-to-value ratios and lower interest rates for the borrower. This cost differential could potentially incentivize the borrower to misrepresent an investment property as a primary residence so they can borrow more at a lower cost. Occupancy risk is one of the variables that secondary market investors, such as Fannie Mae, consider when pricing loans. For example, when a primary residence is discovered to be an investment property, the higher risk profile can result in financial losses for the stakeholders.

Reverse occupancy is a type of occupancy misrepresentation in which the borrower purchases a home as an investment property and claims rental income to qualify for the mortgage loan. Instead of renting the home out, the borrower moves in and occupies it as a primary residence, thereby not receiving the rental income that was used to qualify for the mortgage.

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Identifying red flags

A vital step to validating occupancy of the subject property is identifying inconsistencies in the loan file that raise questions about the authenticity of the occupancy as disclosed. It is critical to research and resolve red flags to ensure the occupancy status is accurate. The presence of one or more red flags in a file does not necessarily mean the occupancy is inaccurate, but it should warrant further investigation.

Table 1: Examples of occupancy red flags and additional considerations when a particular red flag is identified.

Red Flag	Purchase	Refinance	Additional Considerations
Subject property disclosed as owner-occupied			
Property insurance policy is inconsistent with occupancy type	X	X	• Property insurance policy does not include personal property • Subject property address is different from insured mailing address • Property insurance policy includes rental coverage
Loan file documentation indicates the borrower is not currently occupying the subject property		X	• Borrower's mailing address is a PO box • Credit report, bank statement, or other documentation reflect a different address • Occupancy affidavits show the borrower does not intend to occupy
Borrower purchased or refinanced properties around the same time as purchasing an owner-occupied property	X	X	• Desktop Underwriter® message indicates multiple owner-occupied loans within the last 60-days • Undisclosed mortgage(s) • Subject property is located in a resort/vacation area
Borrower is downgrading to a notably smaller or less expensive home	X		• Borrower intends to lease current residence • Borrower owns other properties near the subject property
Borrower has other rental properties	X	X	• Converting current owner-occupied residence to rental • Borrower current residence is more expensive or larger • See 'Significant or unrealistic commuting distance' • See Fannie Mae's "Best practices for rental income verifications"
Significant or unrealistic commuting distance	X	X	• Type of employment is inconsistent with the commuting distance • Type of position supports remote employment
Occupant field on appraisal reflects tenant or vacant	X	X	• Photos indicate the subject property is vacant (refinance) • The rent comparable schedule is included on a single-family residence • Appraiser comments reference a tenant or rental income • Can the owner legally occupy the property, or will something such as an existing tenant's lease prevent occupancy
Schedule E of the borrower's tax return or transcript reflects the subject property as a rental property		X	The filing address does not match the subject property
Borrower currently resides in a single-family residence and is moving to a 2- to 4-unit property	X		The appraisal reflects all units are currently rented
Sales contract includes furniture, recreational equipment, etc.	X		• The sales contract indicates an existing lease is being assumed • The Final Closing Disclosure shows a rental credit for the subject property
Borrower will be a first-time landlord on departure residence	X		• Pre-existing relationship or relative of the borrower • See Fannie Mae's "Best practices for rental income verifications"

Red Flag	Purchase	Refinance	Additional Considerations
Subject property disclosed as second home			
Close proximity between subject property and primary residence	X	X	Subject neighborhood has high number of rental properties
12-month lease on subject property	X	X	Schedule E of the tax return or transcript reflects the subject property rented for 12 months
Use of gift funds	X		Borrower's financial profile is inconsistent with the borrower owning a second home
Subject property disclosed as investment property			
Borrower is currently renting or living with relatives	X	X	• Borrower does not own real estate • Rental income is essential to qualifying • Substantial liquid assets in relation to income
Borrower is a first-time homebuyer	X		Borrower has minimal or no established credit
Homeowner's insurance policy is inconsistent with occupancy type	X	X	• Homeowners insurance includes personal property • Property insurance policy does not include rental coverage

Investigating occupancy

Identifying and investigating red flags during origination and prefunding QC reviews is critical; however, some aspects of the loan file cannot be validated until after the loan has closed. As a part of post-closing QC, lenders are required to reverify the accuracy of the information used to support the lending decision for loans selected for a QC review. The review requires a look at the property insurance policy and other documentation in the file to verify owner-occupancy for a principal residence.

Lenders can also employ additional methods to investigate occupancy before and after closing, including:

Methods to Investigate Occupancy	Origination	Prefunding Quality Control	Post-closing Quality Control
Review the insurance policy to confirm whether the coverage includes contents, rent loss, or tenant coverage. Compare the loan occupancy to the terms of coverage.	X	X	X
Contact the insurance company and validate the terms of coverage. Has the homeowner's policy been converted to a landlord policy or vice-versa?	X	X	X
Reverify any lease agreements in the file, especially on the borrower's previous home to confirm the authenticity.	X	X	X
Perform internet search of the subject property to identify whether the property has been listed for rent.			X
Perform internet search of the departure residence to identify whether the property is listed for sale or rent in conflict with loan documentation.	X	X	X
Perform internet search of the borrower's name to identify any anomalies in the loan documentation.			X
Use third-party tool to identify potential undisclosed mortgages. Is the borrower in the process of purchasing a new primary residence or investment property? Is the borrower in the process of obtaining a cash-out refinance on another property?	X	X	X
Use third party tools to validate the borrower's primary residence with driver's license renewal, voter registration, vehicle registration, etc.			X

Methods to Investigate Occupancy	Origination	Prefunding Quality Control	Post-closing Quality Control
Confirm whether the borrower has applied for homestead exemption at the subject property.			X
Use third-party tools and/or door knocker services to confirm who presently resides in the subject property.			X
Review the servicing notes to identify changes to the mailing address or indications that the occupancy is not accurate at origination.			X
Track any returned mail that was addressed to the subject property.			X

Preventing occupancy discrepancies

Creating a culture focused on loan quality and continuous improvement is a vital part of an organization's risk management strategy. To build a strong QC culture and proactively identify and investigate potential occupancy discrepancies, consider implementing the following best practices:

- Perform regular surveillance of your mortgage pipeline across all lines of business, including the servicing platform. (Do you have any loans in process for the same borrower? Are you servicing any loans with the same borrower?)
- Target loans with unresolved red flags at origination for post-closing occupancy validation.
- Create a review process for borrowers who change their mailing address shortly after closing or onboarding for servicing.
- Include language in occupancy certifications that outlines the potential consequences if the borrower misrepresents occupancy.
- Notify the borrower that a post-closing occupancy verification may be performed (and for loans with red flags, perform a targeted QC review).
- Establish internal procedures for escalating a suspected occupancy misrepresentation. The internal reporting process should specify who is managing the due diligence investigation and identify the final approval authority that is required to clear loans for closing. Internal reporting should outline the consequences for any employee involvement in occupancy misrepresentation.
- Provide regular staff training on red flags, fraud trends, and top QC defects.
- Hold borrowers accountable when misrepresentation of occupancy is confirmed.

Next steps

Validating occupancy ensures that loans are properly closed, priced, and delivered. To safeguard your company's financial and credit risk exposure, consider the following:

- Assess your training program and operational procedures to determine potential gaps in identifying occupancy red flags and discrepancies. Schedule periodic updates to ensure you're training on evolving trends.
- Leverage best practices to enhance your methods for investigating occupancy and augment your detection capabilities.

Resources

Reverse Occupancy Fraud Alert

Occupancy Defect Guidelines and Scenarios

Best Practices for Rental Income Verifications

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