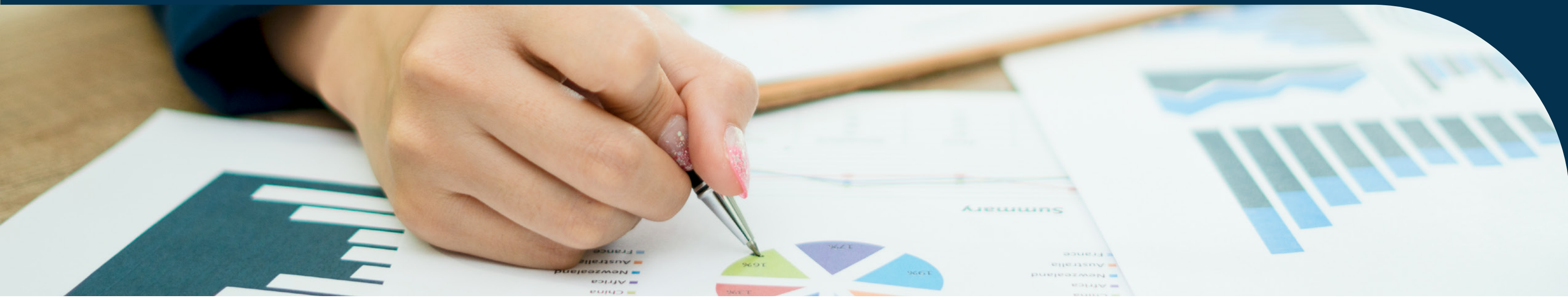

Strengthen your QC program: prefunding

This edition of *Quality Insider* is the third installment in our series designed to strengthen core QC governance elements. This article focuses on the importance of leveraging prefunding quality control to reduce risk and improve loan quality.

A prefunding process that is nimble and well thought out can be a powerful tool as it provides almost real-time loan quality information. Prefunding reviews bring the risk forward and provide a unique advantage over post-closing and investor review results since they are performed as the loan is being manufactured. This provides lenders an opportunity to correct defects before the loan closes and helps prevent manufacturing a loan with eligibility issues. An ineligible loan can lead to repurchase risk and impact your bottom line due to the time and effort needed to remediate defects. Getting it right the first time has many benefits such as manufacturing eligible loans and providing lenders confidence that the borrowers are in a sustainable home loan.

Your quality control (QC) department can provide quicker feedback for operations to take action, as well as leverage the post-closing QC results to help develop a prefunding sampling strategy. By using this strategy, your operations department gains insight into the manufacturing process where specific risk elements, such as income calculation opportunities, appraisal quality, etc., can be identified early and gives management the opportunity to implement action plans to help prevent the same errors from repeating.

Ask yourself:

- Does our prefunding QC process include action planning that drives change in our organization?
- Does our QC plan clearly detail the prefunding process and set expectations for all relevant stakeholders?
- How confident are we that our prefunding department operates independently from outside influence?
- Is our QC plan compliant with Fannie Mae *Selling Guide* requirements, including:
  - Timing of the review,
  - Loan selection process,
  - Verification of data and documents, and
  - Reporting.

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What is Fannie Mae observing?

Frequently missing:

- **Document the timing of loan file reviews in the QC plan**

  The point at which a loan is selected for prefunding review can make a big difference in the amount of information in the file. Loans must be chosen early enough in the origination process to complete all steps of the review, but also at a point when sufficient information validates a correct credit decision was made.

  It is important to choose a milestone in the production process that meets both criteria. Documenting that milestone in the QC plan helps set expectations with the business unit and allows a full and detailed remediation process as needed. If the loan is acquired from a third-party originator (TPO), the review should be performed pre-purchase.

- **Fully document the prefunding loan selection process and criteria in the QC plan, including:**

  - Establishing a process for selecting loans,
  - How often the selection criteria are revisited, and
  - Who can change the selected criteria.

  The *Selling Guide* requires loans with a greater chance of errors, misrepresentation, or fraud be selected in the prefunding sample. This requirement provides lenders the opportunity to strategically select higher risk loans and/or loans with a greater chance of having a defect. Fannie Mae recommends lenders use a discretionary sample that best supports their quality goals.

  Build a robust prefunding sample strategy with selection criteria that includes emerging risks, testing of action plans, validation of employee, TPO performance, or a review to target a specific component, such as complex income calculations. The discretionary sample is an important and flexible tool to gain insight and actionable information that will help drive additional sampling criteria as well as loan quality. Documenting the sample selection process keeps the sample at the forefront and establishes a cadence to review and change the criteria, which prevents a 'set it and forget it' mentality.

- **Ensure the QC plan includes all required data and documents for a prefunding review as listed in section D1-2-01 of the *Selling Guide***

  A complete re-underwrite and re-validation of the credit decision is essential to fully understand the loan manufacturing quality. It's important for lenders to precisely document exactly what items are to be reviewed. Review elements must be included in the QC plan to ensure full file reviews are thorough and a true validation of the credit decision. This also ensures all prefunding reviewers understand the required elements of the full file review.

  The minimum requirements are outlined in the *Selling Guide*; however, Fannie Mae encourages lenders to go above and beyond these minimum requirements.

- **Actionable prefunding reporting delivered on time and with all required elements**

  Fannie Mae audits reveal prefunding reports are often incomplete and frequently not generated monthly.

  Management analysis is driven by summary reporting that includes a description of the review sample. Prefunding samples may be completely discretionary or include targeted component reviews that can change based on business needs. For more details on component reviews, refer to our November 2021 *Quality Insider* article. Defect trending over time (i.e., three, six, or even 12 months) helps identify opportunities for improvement. Defect trending that includes enough granularity allows action planning to target and correct specific defects. Identifying and trending both gross and net defects provides a more comprehensive view of initial quality (gross) and the effectiveness of your remediation efforts (net).

  Fannie Mae believes reporting is a critical component of a strong QC program. Effective reporting allows identification of trends, promotes action planning, and drives change in the organization. Prefunding reporting has the advantage of providing actionable information much earlier in the manufacturing process.

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- **Prefunding QC needs to be independent from the business unit**

  Prefunding quality control should function without outside influence from operations and deliver a true picture of the organization's loan manufacturing quality. If the organization's reporting structure doesn't have the capacity to separate these duties, it may lead to a potential conflict of interest and can cause a failure to maintain an impartial view of the lender's performance. Have guardrails and testing in place to confirm prefunding results aren't overridden without proper documentation. A lender's audit of the review process can help ensure QC assessments and conclusions are consistently applied. This type of audit is especially important if a lender is in a situation where an independent prefunding process isn't possible. The QC plan needs to reflect an audit process in place to confirm the QC department is performing their work correctly and independent from undue influence.

Next steps

✓ Review your QC plan to ensure all required prefunding elements are included.

✓ Determine if an audit process is in place to confirm prefunding QC is free from outside influence.

✓ Review your prefunding reporting to confirm it is compliant with *Selling Guide* for content, cadence, and timing.

✓ Review your prefunding reporting for opportunities to improve the information provided to management.

Resources

Selling Guide Part D Ensuring Quality Control

Selling Guide D1-2-01, Lender Prefunding Quality Control Review Process (03/28/2017)

Loan Quality page

Improving Loan Quality Through Effective QC Reporting (2021 Boot Camp webcast)

QC Reporting eLearning

Know your choices — QC sampling

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