3RD EDITION

Understand Top Defects to Help Strengthen Loan Quality – January 2025

What are the top defects and trends Fannie Mae saw in the most recent six months of post-purchase loan file reviews? Understanding the industry's top quality control defects and trends helps to strengthen loan quality and support sustainable homeownership.

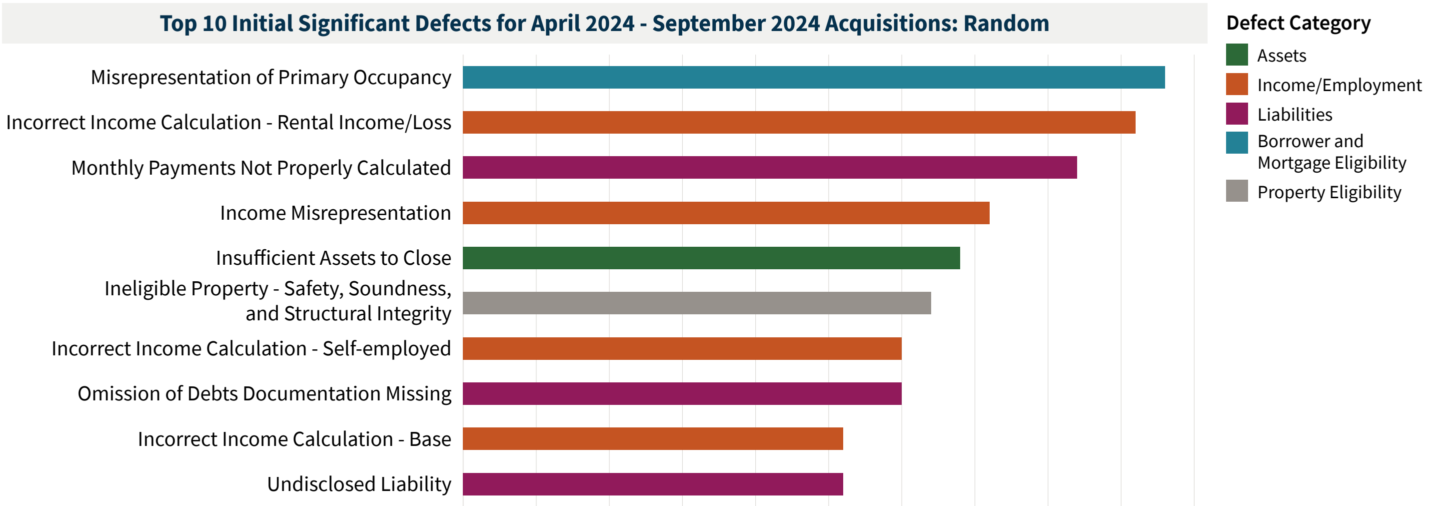
As you review this information, ask yourself:

- **Are you taking a strategic approach to discretionary/targeted sampling?** Is there an opportunity to use this information to enhance your discretionary/targeted sampling in both prefunding and post-closing quality control (QC) reviews?
- **Are your QC results aligned with Fannie Mae results?** If you're not experiencing the same defects, is it because you have effective origination controls in place or is there a blind spot in your QC review process?
- **Are you staying current on industry defect trends and training to prevent them?** Monitoring recent defect trends across the industry allows for more dynamic QC, better action planning, and prevention of similar defects in your organization.
- **Is your organization leveraging available Fannie Mae tools to help prevent these defects and drive certainty?** If so, are your QC processes set up to identify and review loans using a component of the Desktop Underwriter® (DU®) validation service or loans using Income Calculator?

Understanding the industry's top quality control defects and trends helps to strengthen loan quality and support sustainable homeownership.

Initial significant defect trends (random sample):

Below are Fannie Mae's top 10 **initial* significant defects** identified in a random sampling of loans acquired by Fannie Mae in **Q2** and **Q3** of 2024 (April 2024 – September 2024).

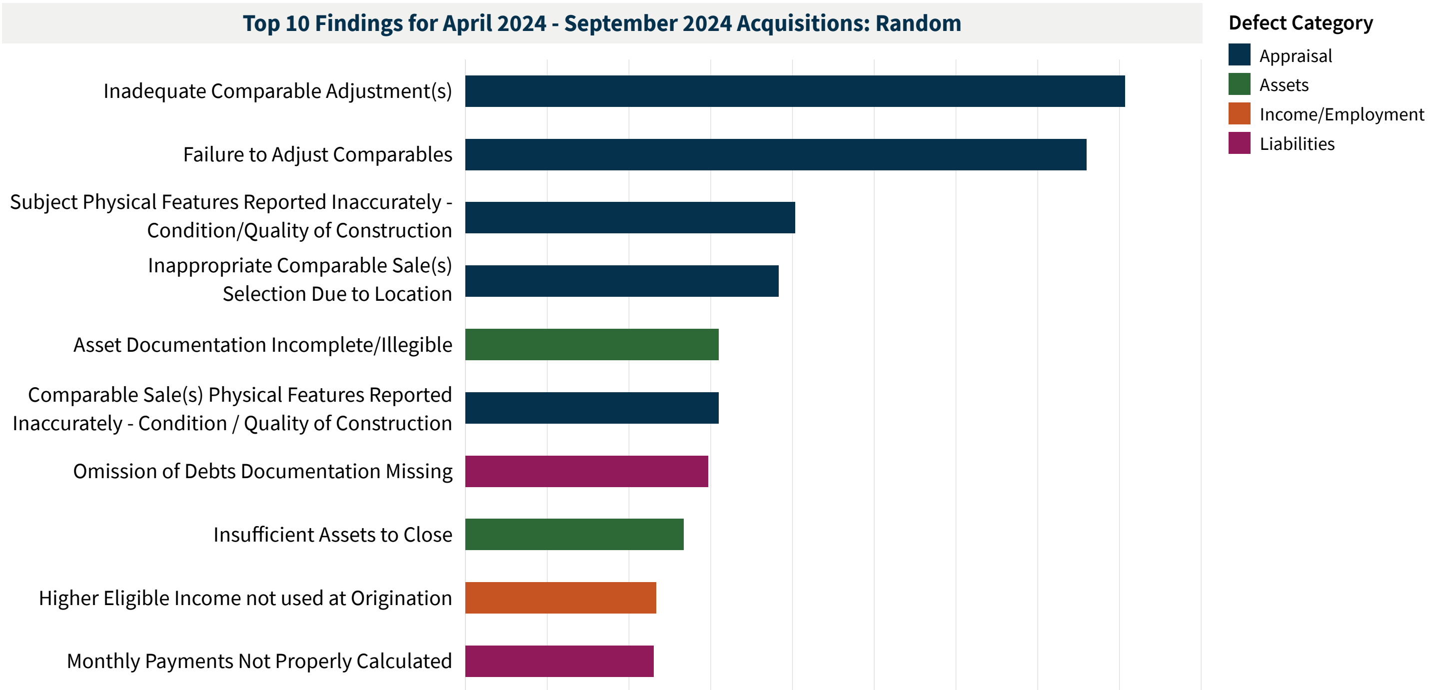


*Significant Defect: A loan manufacturing error that makes the loan ineligible for delivery to Fannie Mae and requires a remediation. A potential repurchase is possible. *Initial Significant Defect: When a significant defect has been cited prior to a final remediation activity.*

- Miscalculated *rental income* was a top defect in this review period and has consistently ranked at or near the top of the list in the prior two-year period. The miscalculated rental income pushed the debt-to-income (DTI) out of tolerance, making the loan ineligible.
  - Most issues result from a lower-than-actual rental loss. For example, the lender submitted the loan with a rental loss of $200, and the review calculation reflected the rental loss at $600, pushing the DTI over 50%.
  - Fannie Mae's **Income Calculator** can help lenders calculate accurate rental income. The tool also provides representation and warranty relief for the calculation. Lenders remain responsible for accurate entry of data.
- *Misrepresentation* defects were more prominent relative to prior periods. Approximately 25% of the initial significant defects cited for this review period related to income misrepresentation or primary occupancy misrepresentation.
  - A common document found in many of these loan files is a fabricated lease agreement. In many cases, the lease agreement was dated for the lease term to begin shortly after closing; post-closing research then confirmed the property was listed for sale or sold.
  - In several cases, homes purchased were simply posted online for rent shortly after closing.
    - In some instances, the subject properties were inferior to the borrowers' current residences. In others, insurance policies indicated the property was to be occupied as a rental property.
  - See **Best Practices for Rental Income Verification** for actions you can take to prevent or reduce the instances of misrepresentation.
- For *Monthly Payments Not Properly Calculated* defects, student loan payments are the most common defect. Lenders typically used .50% instead of 1% of the student loan payment to calculate the monthly payments. Also appearing were miscalculated principal/interest/taxes/insurance (PITIs) on departing residences; in these instances, the PITI from the credit report was used for qualifying despite the file containing a mortgage statement or credit supplement with updated information (i.e., due to increases in tax or insurance amounts).
- Lenders often did not include documentation of auto loan payments; properly including these liabilities may result in a DTI that makes the loan ineligible.

Findings trends (random sample):

Below are Fannie Mae's top 10 **findings** identified in a random sampling of loans acquired by Fannie Mae in Q2 and Q3 of 2024 (April 2024 – September 2024).



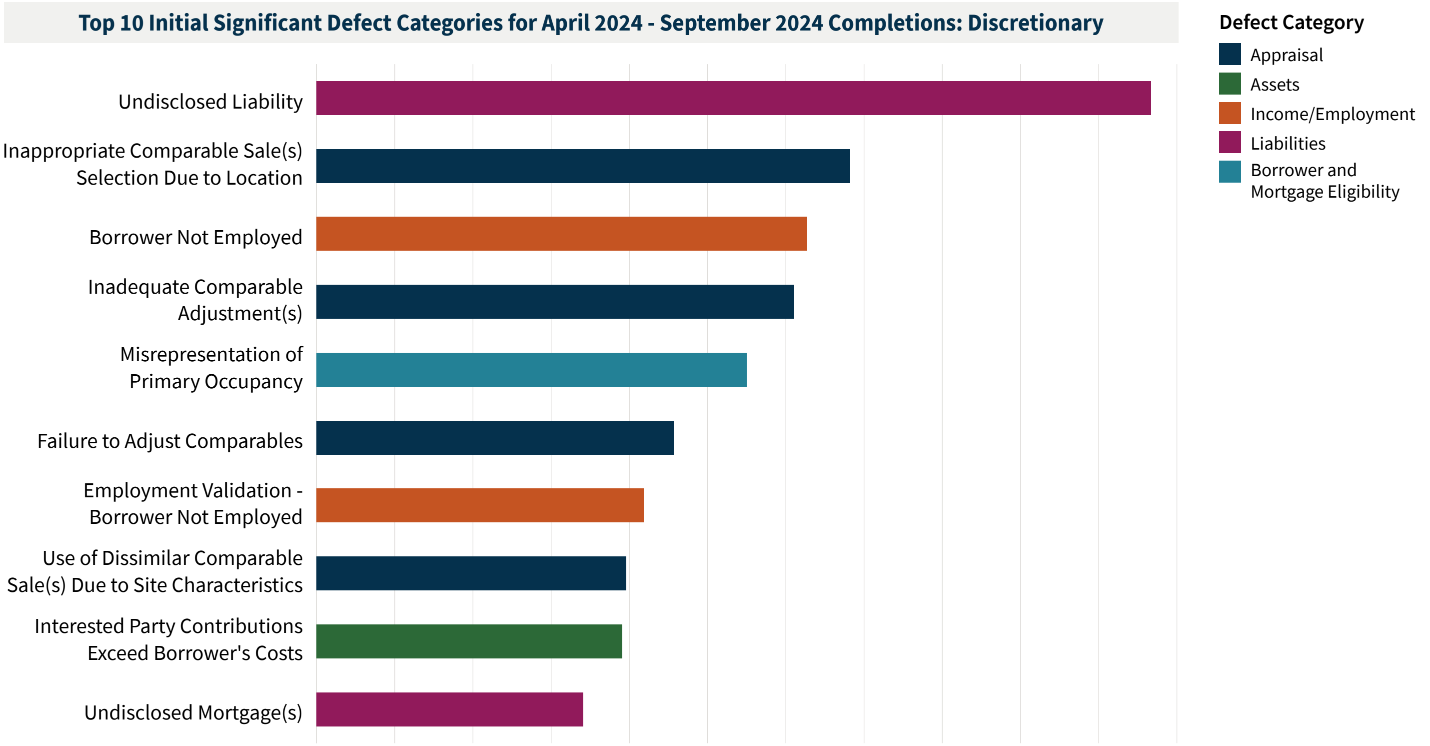
Finding: A loan manufacturing error that does not impact the eligibility of the loan. However, the same error could result in a significant defect in different loan scenarios.

- Findings for collateral-related discrepancies were cited most often. Given the nature of appraisal errors and our defect taxonomy, it is common for multiple appraisal issues to be cited on a single loan. The multiple issues result in an overrepresentation of total appraisal findings.
- Asset-related findings were primarily the result of loan files containing only 30 days of banking activity when 60 days are required.
- Liability-related findings were cited in instances when an obligation was miscalculated or improperly excluded but the DTI stayed within tolerance.
- *Higher Eligible Income not used at Origination:* Implemented in April 2024, this defect is cited when Fannie Mae uses additional documented income found in the file that the lender did not utilize as qualifying income. It is cited only in conjunction with a separate defect that negatively impacts DTI or to offset an eligibility defect (for example, undisclosed liability, omission of debt, incorrect income calculation, etc.).
  - Fannie Mae encourages lenders to qualify borrower(s) with the maximum amount of fully documented and allowable income.

Targeted and discretionary samples

Fannie Mae performs reviews on discretionary samples of loans to supplement our random samples. The discretionary samples intentionally look for loans with a greater likelihood of having a manufacturing quality error. Since these reviews are purposely targeted, there are a few differences in the defects identified compared to our random sample.

Below are Fannie Mae's top 10 **initial* significant defect** sub-categories identified in a discretionary sampling of loan reviews *completed* by Fannie Mae in **Q2** and **Q3** of 2024 (April 2024 – September 2024).



- Undisclosed liabilities were the top defect in this period and have remained among the top two defects in the discretionary sample over the last two years.
    - Undisclosed liabilities result in a DTI that makes the loan ineligible, typically related to auto loans.
    - Fannie Mae encourages lenders to enhance debt monitoring capabilities and engage borrowers early in the loan origination process to emphasize the benefits of not taking on new liabilities before closing.
    - We also encourage lenders to ask borrowers about inquiries on credit reports because undisclosed liabilities often result after a credit inquiry. On loans with undisclosed debt findings, borrowers often had inquiries from similar creditors (i.e., auto finance companies) visible on the origination credit report.
- Instances of *Misrepresentation of Primary Occupancy*, like in the random sample, continue to increase. Loans delivered with the subject as a primary residence were found, often via public records, to be put on the market for sale or rent shortly after closing.
    - Fannie Mae encourages **occupancy best practices** to combat misrepresentation of occupancy.

Loan Quality Resources

Fannie Mae is committed to providing enhanced tools to bring greater upfront certainty. For instance, over 80% of the loans Fannie Mae acquired in 2024 leveraged at least one form of Day 1 Certainty® (DU validation service, value acceptance, and/or certainty on appraised value). The greatest benefit comes when lenders leverage as many of Fannie Mae Day 1 Certainty services as possible. Based on our review of loans acquired in 2023,when all three are leveraged, repurchase risk is reduced by almost 70%.

With the use or implementation of any Fannie Mae loan validation tools, it is imperative that QC personnel are familiar with the requirements outlined in section D1-3-02 of the *Selling Guide* and are sufficiently testing for compliance. **QC must (1) ensure the accuracy and integrity of the input data and (2) check that the "DU close by date" is met, when applicable.**

Here are a few Fannie Mae offerings and tools that are available to deliver certainty, improve loan manufacturing quality, and reduce repurchase risk.

DU Validation Service

Validates borrower income, employment and assets.

Benefits include:

- Increased process efficiencies in both production and QC, including reduced reverification requirements.
- Provides representation and warranty relief for income, employment, and/or assets.
- Helps prevent defects tied to employment eligibility, income calculation, and assets.

Income Calculator

Assists with calculating self-employed income and rental income more accurately and efficiently.

Benefits include:

- Maximizes qualifying income that can help offset other defects that negatively impact DTI and affect eligibility (such as undisclosed liabilities).
- Provides Representation and Warranty relief for the accuracy of the income amount calculated.
- Helps prevent defects tied to the calculation and analysis of self-employed income and rental income.

Collateral Underwriter® (CU®)

Helps manage collateral repurchase risk by allowing lenders to preemptively address known appraisal deficiencies such as risk flags for overvaluation/undervaluation, safety/soundness, and eligibility.

Benefits include:

- Appraisals with CU Risk Scores of 2.5 or less qualify for relief of lender reps and warrants on property value as a part of Day 1 Certainty®.
- CU allows for effective workflow management and resource allocation by segmenting appraisals by risk profile.
- CU's dynamic functionality - comparable sales data, mapping, aerial imagery, public records, local market trends and more, helps lenders manage appraisal and valuation risk.

QC must (1) ensure the accuracy and integrity of the input data and (2) check that the "DU close by date" is met, when applicable.

Value Acceptance and Property Data

Designed to leverage data and analytics to help all stakeholders manage collateral risk and cost more efficiently and effectively.

Benefits include:

- Reduces origination cycle time and may reduce borrower costs.
- Promotes safety / soundness by obtaining current observation of the subject property.
- Provides operational simplicity and certainty at application.

Note: Lender receives relief from enforcement of related representations and warranties if the loan closes by the date specified in the DU findings report and all other conditions of the DU validation service are met.

Resources

Income Calculator

Single Source Data Validation

DU Validation Service

Valuation Modernization

Collateral Underwriter

Form 1033

Selling Guide: D1-3-02 Lender Post-Closing Quality Control Review of Approval Conditions, Underwriting Decisions, and Documentation