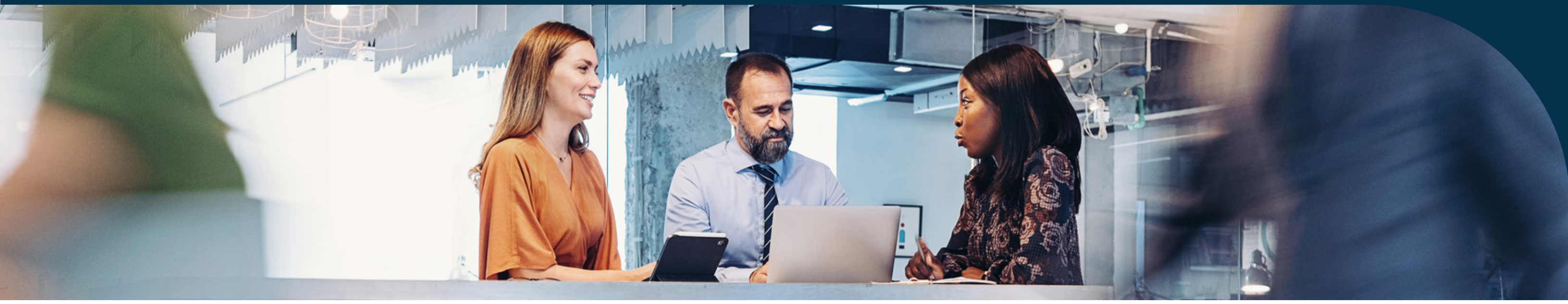


2ND EDITION

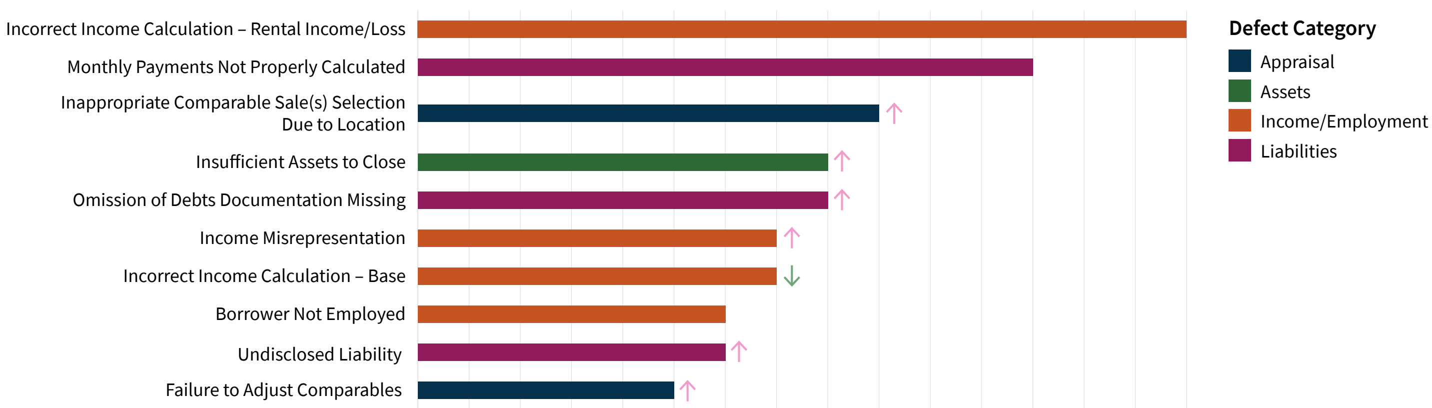
Understand Top Defects to Help Strengthen Loan Quality

What top defects and trends is Fannie Mae seeing in our most recent quarter of post-purchase loan file reviews? Understanding the industry's top quality control defects and trends help 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 you proactively staying current on recent industry defect trends and creating training opportunities to prevent them?** Following recent defect trends across the industry allows for more dynamic QC, better action planning, and prevention of similar defects in your organization. Are you leveraging this data to develop training for your QC function to prevent trending defects?
- **Are your QC results calibrated with Fannie Mae results?** If you're not experiencing the same defects, is it the by-product of having effective origination controls in place or is there potentially a blind spot within your QC review process?
- **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 sufficiently review loans that contain various components of Desktop Underwriter® (DU®) validation service or that used Income Calculator?

Below are Fannie Mae's top 10 **initial* significant defects** identified in a **random** sampling of loans acquired in **Q1 of 2024**.



↓ *Indicates a notable **decrease** in issuance since prior acquisition quarter (4Q23)*

↑ *Indicates a notable **increase** in issuance since prior acquisition quarter (4Q23)*

Significant Defect: An issue that makes the loan ineligible for delivery to Fannie Mae and requires a remediation or could result in a potential repurchase.

**Initial Significant Defect:* When a significant issue has been cited prior to a final remediation activity.

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Initial significant defect trends (random sample):

- Six new defects moved into the top 10 while six defects dropped out of the top 10 since the prior acquisition quarter (*4Q23*). It is important to keep a line of sight on defects that decrease in issuance to avoid reemergence. The most noteworthy shift was with the improvement of defects for Incorrect Income Calculation – Self-Employed & Bonus/Commission/Overtime. Other notable shifts include an increase of defects tied to misrepresenting income and properly documenting omitted debts.
- Significant defects that **moved into** the top 10 since prior acquisition quarter (*4Q23*)
  - *Inappropriate Comparable Sale(s) Selection Due to Location:*
    - Over half had a CU score above 3.4 combined with an overvaluation flag for location.
    - In most instances, there was no explanation from the appraiser about using comps from different neighborhoods instead of comps from the subject's same neighborhood.
  - *Insufficient Assets to Close:* Mainly due to assets not being properly documented, including large deposits and proceeds from sale of home.
  - *Omission of Debts Documentation Missing:* Split between revolving debt and auto loans with a common theme that the debt was being paid by a different person/entity. In such instances, either no evidence or incomplete evidence that another person/entity was paying the debt was provided.
  - *Income Misrepresentation:* The root causes consisted of falsified lease agreements, specifically with qualifying rental income used from departure primary residence and property not rented out; concealed self-employment status; and inaccurate verifications of employment, including handwritten verifications of employment (Form 1005).

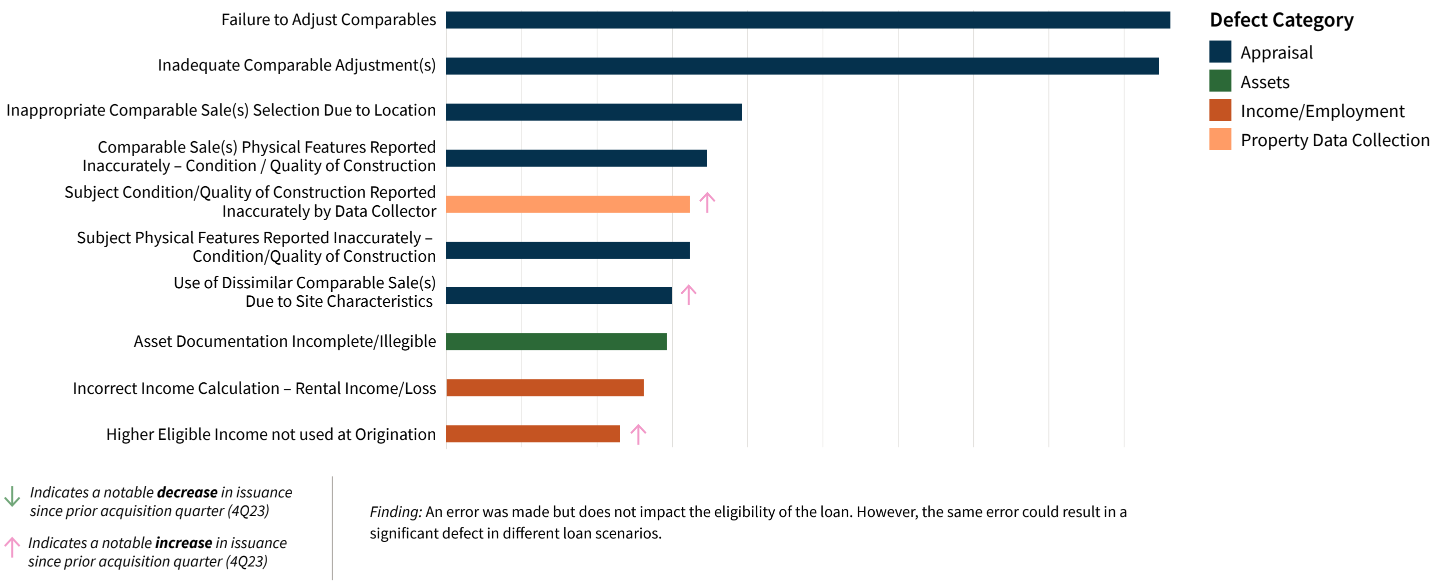
Fannie Mae best practices

- Check state business registration records to verify self-employment status when employment history is unclear.
- Use publicly available information/records to assess the departure property status.
- Look for relationships that appear to be either family or interested parties to the transaction.
- Request a copy of the Hazard Insurance Policy for the departure property to check for a change to a rental policy or for tenant occupancy.

  - *Undisclosed Liability:* Over half tied to auto loans with an average payment of $650/mo, along with an average qualifying debt-to-income of 46%.
  - *Failure to Adjust Comparables:* Occurs when the subject has noticeable deferred maintenance (condition/quality) or different features (e.g., less bedrooms, no basement) compared to the comparables, with no adjustments made.

It is important to keep a line of sight on defects that decrease in issuance to avoid reemergence.

Below are Fannie Mae's top 10 **findings** identified in a **random** sampling of loans acquired in **Q1 of 2024**. The identified findings during this quarter tell a different story compared to the initial significant defects and compared to the prior acquisition quarter *(Q42023)*. Review the findings and noteworthy changes below.



Finding: An error was made but does not impact the eligibility of the loan. However, the same error could result in a significant defect in different loan scenarios.

Findings trends (random sample):

- Findings for collateral-related discrepancies remained as the top driver with seven of the top 10 this quarter. It's important to note that due to the nature of appraisal errors and our defect taxonomy, it is common for multiple appraisal defects to be cited on a single loan resulting in an overrepresentation of total appraisal defects.
- The biggest shift was an increase of defects tied to property data collection (PDC) due to the increased utilization of this newer appraisal alternative offering. It is not uncommon to see manufacturing errors when operationalizing a new tool or product, which is why it's important to have prefund and post-close QC samples specifically target new tools during the initial months in usage.

It is not uncommon to see manufacturing errors when operationalizing a new tool or product.

- Findings that **moved into** the top 10 since prior acquisition quarter *(4Q23)*
  - *Subject Condition/Quality of Construction Reported Inaccurately by* ***Data Collector****:* The majority of errors stem from the data collector inaccurately rating the condition of the subject property. As of April 1, 2024, data collector vendors are no longer rating condition/quality. Instead, they will provide assessments of each room in the subject property with information related to property updates. Data collectors are still responsible for providing accurate data.

Fannie Mae best practice

- Perform QC checks of the property data collection (PDC) to validate the data accuracy by reviewing it within Fannie Mae's Property Data API Review Tool (PDART) *(available in Technology Manager)*.

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- *Higher Eligible Income not used at Origination:* Implemented in April 2024, this defect is cited when we use additional documented income found in the file that the lender did not utilize as qualifying income. It is only cited in conjunction with a separate defect that negatively impacts debt-to-income to offset ineligibility. (e.g., undisclosed liability, omission of debt, incorrect income calculation, etc.).

Fannie Mae best practice

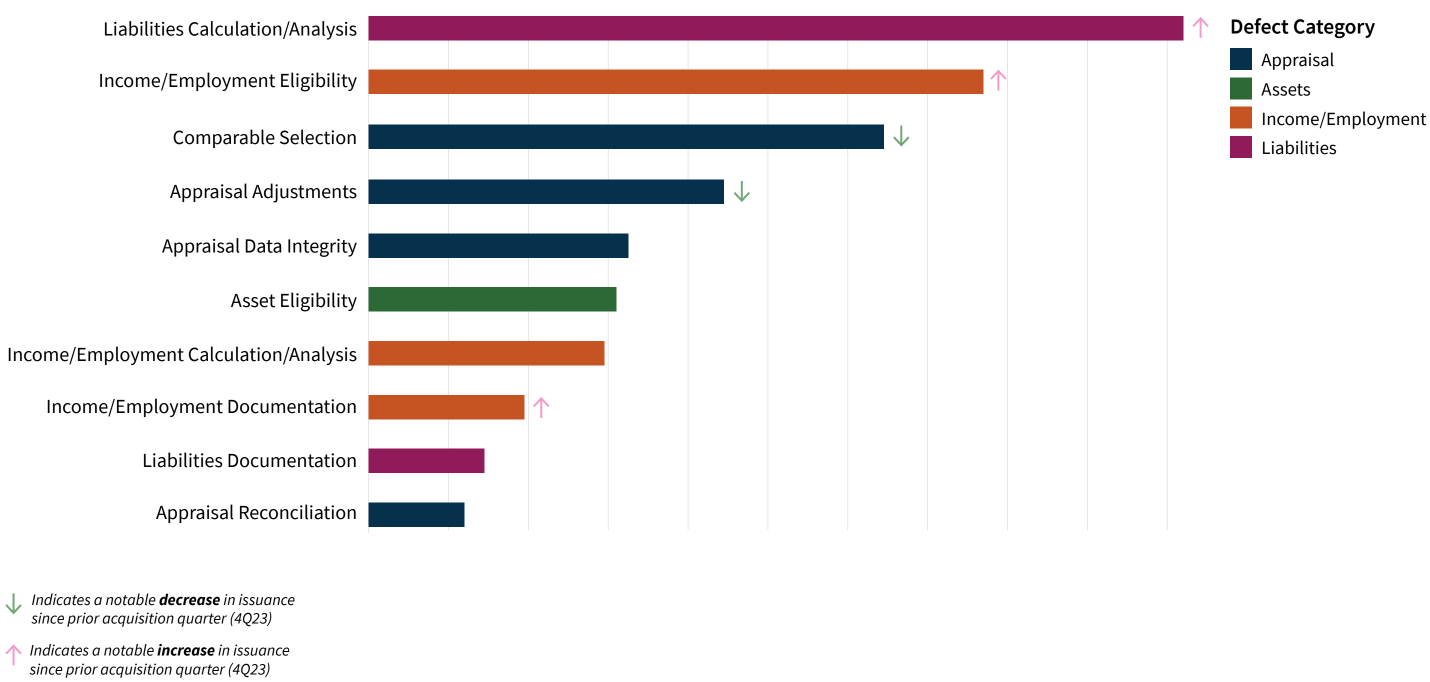
Qualify borrower(s) with the maximum amount of fully documented and allowable income.

- *Use of Dissimilar Comparable Sale(s) Due to Site Characteristics:* The result of the appraiser not providing adequate explanation for the use of comps with substantial differences in lot size or lot features compared to the subject property.

Targeted and discretionary samples

Fannie Mae also performs reviews on a discretionary sample to supplement our random sample. The discretionary sample intentionally looks for loans with a greater likelihood of being defective or ineligible. Since these reviews are purposely targeted, there a few differences in the types of 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* in **Q1 of 2024**.



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Initial significant defect trends (discretionary sample):

- While the top 10 defect sub-categories remained similar to the prior completion quarter (*4Q23*), there was some interesting movement in the rankings. The most noteworthy shift was with the improvement of defects cited related to Comparable Selection and Appraisal Adjustments.
- Significant defects that had a noteworthy uptick since prior completion quarter (*4Q23*)
  - *Undisclosed Liabilities/Mortgages:* Similar to the defects cited in random sampling, these loans had an average qualifying debt-to-income ratio of 45%, with auto loans as the leading driver for this defect. What's different is an emerging trend with increased undisclosed mortgages (including seconds) and home equity lines of credit. Consider reviewing title reports, attorney opinion letters, and public records for other recorded loans.
  - *Borrower Not Employed at Closing:* In many instances, the employment data was validated in DU; however, the loan did not close by the DU "Close-by Date" which voided the validation. There were no trends identified in any specific industry or region.
  - *Income/Employment Documentation:* The main driver is missing self-employed and rental income/loss documentation. There was a slight increase with borrowers that were qualified with incomplete job offer letters, which ties into borrower not employed defects.

QC must ensure the accuracy and integrity of the input data and check that the DU "Close by Date" was met, when applicable.

Loan quality resources

Fannie Mae's *Selling Guide* policies are designed to support lenders in originating quality loans to drive sustainable homeownership. Fannie Mae is committed to providing new offerings and enhanced tools to bring greater upfront certainty. For instance, roughly 75% of the loans Fannie Mae acquired in 2023 benefited from at least one form of DU validation service (income, employment, assets and value). However, the biggest lift comes when lenders leverage as many of the certainty services as possible. When all four validation types are leveraged, repurchase risk is reduced by 75%.

With the use or implementation of any Fannie Mae loan certainty tools, it is imperative that QC personnel are familiar with the requirements outlined in section D1-3-02 of the *Guide* and are sufficiently testing for compliance. **QC must ensure the accuracy and integrity of the input data and check that the DU "Close by Date" was 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

Verifies borrower income, employment, and assets using a 12-month asset verification report.

Benefits include:

- Increased process efficiencies leading to lower costs both in production and QC, including reduced reverification and documentation requirements.
- Provides Representation and Warranty relief for income and/or employment.*
- Helps prevent defects tied to employment eligibility, income calculation, and assets.

Income Calculator

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

Benefits include:

- Maximizes qualifying income which could help offset other defects that negatively impact debt-to-income, such as undisclosed liabilities.

- Provides Representation and Warranty relief for the qualifying income amount calculated.
- Helps prevent defects tied to the calculation and analysis of self-employed 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:

- Can be deployed by production and QC to target loan reviews with higher CU scores and with CU risk flags.
- Provides Representation and Warranty relief on property value for eligible appraisals with CU risk scores of 2.5 or lower.
- Helps prevent appraisal defects tied to comparable selection, adjustments, and condition/quality inaccuracies.

Value Acceptance and Property Data Collection VA(+PDC)

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

Benefits include:

- Reduces costs and time compared to a traditional appraisal. Fannie Mae estimates that value acceptance on loans acquired in 2020-2022 saved borrowers over $2.1 billion. (using $500 as the average appraisal cost savings)
- Provides Representation and Warranty relief on the value, condition, and marketability.**
- Helps prevent appraisal defects tied to comparable selection, adjustments, and condition/quality inaccuracies.

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

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[1] Lenders receive relief from enforcement of related representations and warranties if the loan closes by the date specified in the DU messages and all other conditions of the DU validation service are met.

[2] Lender remains responsible for the accuracy and completeness of all data that pertains to the property and project (if applicable) that is submitted to DU (other than the property value). This includes lender's warranty that the property is safe, sound, and structurally secure.