Beyond the Guide

How to get the most from your quality control program

December 2016
Welcome to Fannie Mae’s significantly revised edition of *Beyond the Guide*, providing tips to help you get the most return on your quality control investment. When it was first published in 2010, *Beyond the Guide* was a ground-breaking statement of our commitment to building a lasting culture and framework for ensuring that loan quality was a permanent part of the industry’s risk management principles. We provided insight into every area of mortgage loan manufacturing that could assist lenders in building their own capability for ensuring quality, and hence certainty around their reps and warrants.

Our joint efforts have paid off. In late 2016, loan quality is at all-time highs, and repurchases are at all-time lows. Fannie Mae is committed to an ongoing partnership with our lenders to ensure your investment in loan quality contributes to your bottom line.

With our new Rep and Warrant framework, and as we learn and innovate with the industry, we found new challenges and many additional insights that we wanted to share toward our objective of continuously improving loan quality. This edition of *Beyond the Guide* reflects those fresh perspectives in areas like quality standards, action planning, and anti-fraud discipline. Just as important, this edition brings awareness to the impact of our unique technology advancements – such as Collateral Underwriter® and the DU® validation service – that enable both greater precision and efficiency in loan quality management. We outline how these new technologies are changing the responsibilities and focus of our joint quality control activities.

We hope you find this latest edition of *Beyond the Guide* as valuable as the first one. It is written to be meaningful to every individual in your organization and we encourage you to share it that way. As always, we seek your feedback on this industry resource to improve its usefulness to you.

Steve Spies  
Vice President – Loan Quality

P.S. Be sure to check out the many resources we provide on the Loan Quality web page.
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The mortgage industry has undergone significant transformation over the past several years. One area that has gained greater attention is the manufacturing quality of mortgages that are being originated. Fannie Mae has dedicated significant resources to help the industry re-establish the importance of loan quality as a key underpinning of the foundation that is needed to successfully manage this business.

Loan quality is generally defined as mortgage loan files that contain accurate and sufficient documentation supporting a borrower’s ability and willingness to repay. Acceptable and adequate collateral is also a key element of a quality loan. In addition, a quality loan meets internal corporate requirements, investor guidelines, and general eligibility standards as well as applicable federal, state, and local laws and regulations.

The second edition of Beyond the Guide was developed to help lender organizations of all sizes implement a strong quality management process that is flexible to your firm’s needs and helps increase your level of certainty about your current originations. An effective, fully integrated quality control program can provide your business great value in these ways:

• **Predictable Output** – Regardless of the path a lender takes to sell a loan into the secondary market or place into its own portfolio, having a loan that meets investor expectations or the lender’s own requirements is a key tenet of risk management. It improves (or deters, if lacking) a lender’s ability to make key, confident market decisions that ultimately impact the bottom line.

• **Reliable Data** – Data accuracy is a constant pursuit in today’s digital world and critical to a lender’s operation. Many lenders spend time analyzing segments of the business that they are willing to lend in, but that analysis is all predicated on the final product or loan being what the lender expected. For example, does this loan really have a 75 percent loan-to-value ratio, a 23 percent debt-to-income ratio, and a 720 borrower credit score? Ensuring that loans are manufactured with a high degree of quality helps keep that data as reliable as possible.

• **Investor Confidence** – The entire industry makes risk decisions based on the accuracy of loan information and data. This is why Fannie Mae requires lenders to have effective quality control (QC) processes throughout their origination cycle. Our commitment to quality is demonstrated by Fannie Mae’s long-term investment in systems, processes, and controls to help lenders originate quality loans – that is, loans that meet investor and/or lender requirements.

• **Reduced Cost To Produce** – Process efficiency is fundamental to achieving the lowest cost to produce a product. In today’s highly competitive mortgage lending market, a lender’s ability to produce investment-quality mortgages consistently, predictably, and efficiently can mean the difference between business success and failure. Properly implemented, a lender’s QC process contributes to business profitability and long-term success. QC pays for itself.

Beyond the Guide expands on Fannie Mae’s QC requirements described in Chapter D of the Fannie Mae Selling Guide. The intent is to provide additional thoughts and insights to help lenders ensure that they have an effective quality management process. Nothing in this publication should be viewed as overriding or replacing Fannie Mae’s lender QC requirements as described in the Selling Guide.

In Beyond the Guide you will find ideas for meeting QC requirements effectively and enhancing your efforts beyond the minimum Fannie Mae Selling Guide standards. These ideas include approaches that work for many of our lenders, “do’s and don’ts” that may prevent critical errors in the origination process, and other tips. Fannie Mae’s Loan Quality page is another resource that provides tools, applications, and training to help your organization ensure its QC program is as comprehensive and effective as possible.
Cultures: Creating a culture of quality – management and board accountability

Why It Matters

A lender’s internal loan quality data should be viewed as a key performance indicator for the organization and should ensure that lenders are acting on the information generated from their respective pre- and post-funding quality reviews. Too often, Fannie Mae engages with lenders and finds that the organization has a well-functioning QC team that provides timely and accurate information to leadership only for that information to not be acted upon. To be effective, QC must be a part of the company’s culture and leveraged by senior management as a key measurement of operating efficiency and cost control.

To be effective, QC must be a part of the company’s culture and leveraged by senior management as a key measurement of operating efficiency and cost control.

Fannie Mae Selling Guide Requirements

D1-1-01: Lender Quality Control Programs, Plans, and Processes

The Guide and Beyond the Guide

Lenders that embrace a successful quality culture employ similar tactics for implementing and driving quality in their organization. Fannie Mae conducts regular reviews of Fannie Mae Approved Sellers to evaluate compliance with our guidelines and assess the lender’s operational risks. Reviews are conducted by the Mortgage Origination Risk Assessment (MORA) team, which operates independently of customer account relationship management in Fannie Mae’s Single-Family Mortgage Business.

View an overview of the MORA process.

Establishing a Target Defect Rate

A lender’s senior management team and, if applicable, board of directors, should believe that loan quality is vital to a successful lending operation. The company should build into its risk culture a commitment to produce loans with file data that is accurate and complete to meet investor eligibility requirements, and to support a sound credit decision. This is achieved through metrics established by the board and with goal attainment tied to the lender’s compensation structure.
An effective way to establish loan quality targets is to model the financial exposure created at a certain defect level. While attaining a zero defect rate over an extended period of time is mainly aspirational, your target defect rate should be set as reasonably low as possible – and the organization should periodically reassess the target with the view of striving toward reducing defects over time. To the right is a simple illustration of how to determine a target defect rate.

Once the target is defined, the lender should build a culture of quality around its defect rate targets. Also, management and the board should review performance against the target at least quarterly and demand immediate action if defects exceed the target. The target should be evaluated at least annually, updating variables of performance, default, and capital needs. Fannie Mae’s post-purchase QC reviews can provide guidance to help lenders assess the accuracy and effectiveness of their QC program. In a MORQA review, Fannie Mae will assess how the lender’s chosen defect rate affects our own risk exposure, and may provide input on the appropriateness of the targets.

Additional tools on Fannie Mae’s website include:

- Loan Defect Categories
- Defect Rate Tutorial
- Occupancy Defect Guidelines
- Loan Defect Categories Spreadsheet

**Determining a Target Defect Rate**

One key Selling Guide requirement is for lenders to document the rationale for their target defect rate. If your QC reporting is properly calibrated (see calibration discussion on pages 20-21), defects with multiple severity levels should be reported with the highest severity representing investor ineligibility. Simply put, the highest level of severity represents the percentage of loans that you originated that did not meet key investor (or portfolio) eligibility criteria and must either be self-reported to the investor or expected to trigger a repurchase demand from an investor. Your target defect rate is a direct measure of financial risk resulting from poor quality.

One way to model the financial risk of your defined defect rate target is shown below.

<table>
<thead>
<tr>
<th>Critical Defect Rate</th>
<th>Loan Production in units</th>
<th>Repurchase Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>1%</td>
<td>2,500/month</td>
<td>25 loans/month</td>
</tr>
<tr>
<td>2%</td>
<td>2,500/month</td>
<td>50 loans/month</td>
</tr>
<tr>
<td>5%</td>
<td>2,500/month</td>
<td>125 loans/month</td>
</tr>
<tr>
<td>10%</td>
<td>2,500/month</td>
<td>250 loans/month</td>
</tr>
</tbody>
</table>

Modeling the financial costs associated with different severity levels will help a lender determine the amount of resources to apply in managing quality. Consider this: If the target defect rate is a true model of financial risk as well as a key metric that management is measured against, it would be expected that all management areas – particularly senior management – would know 1) what the target is, 2) where the organization is currently in relation to the target and, 3) if not within target, what action is being taken to get within target.
Process governance

All secondary mortgage market investors have requirements for lender quality control. Fannie Mae annually selects lenders (based on certain risk characteristics) for a review of their operational processes, and one area that has the highest level of operational review findings is lender QC operations. Executives should expect your QC management to provide evidence that QC operations are functioning as expected. Key areas to focus on include:

- **Timeliness** – Are your QC reviews being performed and reported on as expected by your investors? Timeliness of reviews is one key to effectiveness.
- **Accuracy** – Are the reviews your staff perform of high quality so that you have an accurate measure of your organization’s quality risk exposure?
- **Completeness** – Are all required process steps being completed? Fannie Mae’s required QC process is designed to validate that the information relied upon to make your lending decision was accurate and factual. To say that another way, was your analysis of required loan documentation done correctly and was the information you relied upon factual?
- **Reporting and Action** – Are actionable management reports being issued and actions taken? If reports are being issued to senior management without operational management review and response, you do not have a true picture of your organization’s quality.

The example below illustrates a simple method of tracking the steps in the regular QC review process. It documents when specific tasks are started and completed and can highlight areas that are exceeding time deadlines and that may need more attention and/or resources to ensure all functions are completed in a timely manner.

<table>
<thead>
<tr>
<th>Closing Month</th>
<th>January 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sample Selected</td>
<td>Completed Due Date Days to Target</td>
</tr>
<tr>
<td>File Sent</td>
<td>2/25/2015 2/28/2015 -3</td>
</tr>
<tr>
<td>Reverification</td>
<td>Completed Due Date Days to Target</td>
</tr>
<tr>
<td>Remittance Response</td>
<td>4/18/2015 4/15/2015 3</td>
</tr>
<tr>
<td>Final Decision</td>
<td>4/25/2015 4/25/2015 0</td>
</tr>
<tr>
<td>Management Report</td>
<td>6/10/2015 5/31/2015 10</td>
</tr>
</tbody>
</table>

**Operational Reviews**

Failing to adequately manage operational risk has been cited as one of the catalysts to the financial collapse so doing it right is of critical importance. Lenders must make sure they include specific reviews that target this risk in a tangible manner. Lenders that originate loans only through a retail channel have a certain level of control over their operations, which provides a good view of risks.

Lenders that originate loans through third-party origination (TPO) channels are exposed to additional layers of operational risk over which they have limited control, and they should perform additional tests to help mitigate some of that risk. Fannie Mae requires a lender to have effective management control and audit systems for its loan production operations. For lenders with TPO operations, similar evaluations are recommended to enhance your risk framework.

**Managing Fraud Risks**

One of the more painful lessons of the past is the impact of fraud in our business – perpetrated by people both external and internal to a lending organization. While awareness, understanding, and automation provide greater ability to guard against fraud risk, the lure of large payoffs, homeownership, or even simple shortcuts to completing a job and receiving a commission will ensure the risk never goes away. It is executive management’s responsibility to communicate a clear and consistent “zero-tolerance” message to the organization. While this seems to be a “no-brainer,” one need only look at past news stories to see illustrations of corporate cultures that failed to communicate a “zero-tolerance” message and subsequently fell victim to major fraud losses and reputational damage.

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message and subsequently fell victim to major fraud losses and reputational damage. A company’s defensive toolkit should include at least the following:

- **A strong corporate ethics policy** – The policy should be specific and include regular (at least annual) situational ethics training. Enforcement should be swift and consistent, regardless of employee position or influence.

- **Holistic automated fraud detection tools** – An automated fraud detection tool, preferably used on 100% of production, may catch potential fraud trends. Use of a fraud detection tool should be accompanied by regular staff training and adaptive programming to ensure it is updated to address the most current fraud risks and not subject to excessive “false positives” that tend to reduce employee sensitivity to true risks.

- **Pattern recognition software** – Pattern recognition software (commonly used to identify credit card fraud) can highlight anomalies in loan data to identify areas for targeted QC audit reviews. Systemic fraud schemes can be difficult to see on a loan-by-loan basis but may be more apparent in the broader origination pipeline view that this type of software can highlight.

- **Data mining** – Use “data mining” of TPO (correspondent/broker) and employee production to find abnormalities based on origination source, location, error rates, conversion rates, and customer sources. High, rapidly increasing levels of production (sales or operations) should be monitored closely.

- **Expanded QC reviews in response to red flags** – Suspicious attributes, activities, or patterns surfaced through loan or fraud reviews should be included in the QC discretionary or targeted sampling criteria. Samplings should be done upon discovery, but also repeated periodically as fraud schemes or practices are frequently recycled as different markets present different opportunities to fraudsters.

- **Multi-level detection tactics** – Look for high-level patterns that could indicate fraud by tracking early payment defaults and unusual servicing activity (payments made by parties not on the loan), and periodically share information across departments and other mortgage fraud investigators. For more granular detection, add fraud red flag items to review processes of appraisals, preliminary title work, closing disclosures, quit claim deeds, deed satisfactions, and rapid transfers of title.

- **Red flag training of sales and operations staff** – This training should be performed regularly and endorsed by senior management.

The most powerful deterrent to mortgage fraud is a strong support culture that encourages front-line employee vigilance and a blameless environment in which employees can report suspicious activity without fear of retribution or losing business. It is far cheaper for a company to bypass a loan or relationship than be subject to the dollar and reputational exposure that fraud can bring to an organization.

Visit Fannie Mae’s [Mortgage Fraud Prevention page](https://www.fanniemae.com) to view fraud alerts, tools, tips, training, and data that can help lenders maintain a well-informed fraud prevention program in their organizations.

### Internal Oversight

Internal audit is generally defined as an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Further, “the internal audit activity must be independent, and internal auditors must be objective in performing their work. Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board.”

Fannie Mae’s [Selling Guide](https://www.fanniemae.com) requires lenders to have “internal audit and management controls to evaluate and monitor the overall quality of its loan production and/or servicing.” See A1-1-01: Application and Approval of Lender.

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2 The Institute of Internal Auditors, Independence & Objectivity IIA Guidance 1100 and Interpretation; accessed December 1, 2016: [https://na.theiia.org/standards-guidance/topics/Pages/Independence-and-Objectivity.aspx](https://na.theiia.org/standards-guidance/topics/Pages/Independence-and-Objectivity.aspx)
An appropriate internal audit program should at a minimum include the following key elements:

- An independent reporting structure with direct report to senior management and/or the board of directors. There should be no shared reporting lines within the QC functional areas to be reviewed by the internal audit function.

- A risk assessment methodology used to identify the operational areas and functions to be audited and the frequency of those audits. The risk assessment is generally completed annually by the internal audit department to identify the scope of the review and apply risk rating to the areas to be reviewed. The risk assessment generally identifies the frequency of reviews based on the risk rating applied to the areas listed.

- Documented policies and procedures to detail the internal audit review processes, govern reporting to senior management, and address the remediation of findings.

- A departmental and functional audit schedule for a minimum 12-month period. The schedule should identify the areas subject to review during the current period and align with the risk assessment.
Framework: A risk control framework in the life of a loan
Quality life-of-loan model

The Risk Control Framework graphic traces the mortgage loan process from first customer contact to a comprehensive post-closing analysis and action plan to improve the quality of future loans with nine critical control points in the QC life cycle:

1. Validating Application Data [Internal/Third-Party Data and Fraud Tools]
2. Underwriting and Eligibility
3. Appraisal and Collateral Assessment
4. Prefunding Quality Control
5. Pre-Closing Document Review
6. Post-Closing Document Review
7. Post-Closing Quality Control
8. Reporting
9. Action Plan to Prevent Future Defects

Some of these control points are managed by QC personnel and some by operations personnel. Regardless of the person completing the reviews and checks, lenders that have these or similar controls in place will ensure active management of loan quality. The control points are discussed in more detail following a review of some foundational principles for good risk management.

Good procedures and a strong risk management culture will also provide a clear and accessible escalation process when staff or management have concerns. In Beyond the Guide, we provide ideas on how to reach maximum effectiveness for each control point.

- **Good Data** – The lack of a robust control process for verifying file data is a common gap in QC programs. Control point #1 focuses on ways to confirm the accuracy of loan data. The Data Validation Tools table shows pros and cons of some tools and suggestions on how to best utilize them.

- **Continuous Feedback for Improvement** – The QC process should drive a continuous feedback loop that results in improvement to the origination process. A strong culture of quality will motivate those who first touch the loan to focus on the accuracy of information in the file. While a rigorous prefunding QC process should become the lender’s most powerful tool over time, the cornerstone of an effective QC program is an accurate process for measuring, analyzing, and reporting on loan quality. The organization can determine the need for action only if standards are in place to identify a defect. See pages 23-24 for sample reports that can help to drive action planning. The lender must empower staff to stop a loan from processing or closing when a significant defect is found – otherwise, the QC program will lack “teeth” and not be effective.

- **Document Control** – Fannie Mae has observed a widespread lack of control in the management of file documents. A lender’s failure to either obtain all required documents to support an underwriting decision or to maintain copies of those documents

   Make sure your QC program is all it can be by completing a [Self-Assessment Worksheet](https://example.com).

A strong culture of quality will motivate those who first touch the loan to focus on the accuracy of information in the file.
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in the loan file has led to a significant number of QC findings. We cannot over-emphasize the need to implement processes and require accountability to ensure that all documents are obtained before closing and properly stored for later retrieval. Compliance activities also have a critical role in a QC program. Given the targeted and specific nature of compliance reviews, they are not addressed in Beyond the Guide, which focuses on manufacturing quality.

A loan file with a missing document is like a jigsaw puzzle with a missing piece. Get more ideas on how to reduce missing docs.

- **Taking Action** – At each control point, the lender should assess the accuracy of loan information and, if a defect exists, take action.

  - Identify the defect
  - Cure the loan-level defect
  - Address the root cause

In our own internal QC processes and in our industry observations, we’ve seen that organizations with a disciplined approach to remediation of defects and errors have demonstrated the best performance related to loan quality. Enforcing a discipline related to tracking, monitoring, and testing action plans builds in a continuous improvement loop and helps these risk organizations have lower level of defects that are sustainable over longer time periods.

Finally, once all the QC components are correctly implemented, the lender should be able to transition from concern about the “cost of quality” to appreciation for the “return on quality.”
Validating Application Data [Internal/Third-Party Data and Fraud Tools]
Early validation of application data

Underwriting and Eligibility
Empower underwriters to manage risk

Appraisal and Collateral Assessment
Confirm correct and complete data to establish accurate value

Prefunding Quality Control
Sample production to prevent closing loans with defects

Pre-Closing Document Review
Assembly and critical evaluation for right parties, terms, documents, and dollars

**A Culture of Quality**
Senior Management Accountability

Action Plan to Prevent Future Defects
Act on QC results to achieve defect rate goals

Reporting
Transform data into actionable information

Post-Closing Quality Control
Sampling and evaluation of loan data and credit quality

Post-Closing Document Review
Look for and cure critical errors

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A Culture of Quality

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Inform compliance

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Control point  Stop loan  Remediate  Feedback

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QC Risk Control Framework

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Each control provides feedback to previous control points to effect change in real time.
Control Point #1 – Validating application data

Why It Matters

Loan application data should be validated as early as possible in the origination process to catch errors and/or identify intentionally misrepresented information. Used properly, third-party and lender internal data and fraud tools can provide significant risk mitigation.

Fannie Mae Selling Guide Requirements

D1-2-01, General Information on Lender Prefunding QC Review process, Verification of Data and Documents

The Guide and Beyond the Guide

Data aggregators and innovations in validation continue to improve the mortgage industry’s ability to rely on directly sourced data to streamline the origination process and improve the quality of underlying transactions. Fannie Mae is taking a leadership role, introducing the DU® validation service to help lenders more simply perform third-party verification of borrower data through our industry-leading automated underwriter system, Desktop Underwriter®.

New tools and processes can significantly improve quality and risk management, but they do not eliminate all risk.

As new validation tools and processes are implemented, lending organizations should evaluate how these automated processes are changing the risk dynamic. New tools and processes can significantly improve quality and risk management, but they do not eliminate all risk. QC processes should be regularly evaluated and adjusted to leverage validation tools and processes effectively. The following practices are expected for loans or loan components on which automated validation is not completed.

- Compare loan application data to origination, servicing, or other customer databases to identify issues such as multiple applications, occupancy concerns, or erroneous or fraudulent social security numbers.
- Loan officers should be trained to be a vital part of the data-gathering and validation process and encouraged to ask the borrower for additional information when appropriate.

Proper use of data validation tools reduces a lender’s exposure to adverse selection, misrepresentation, and fraud. The table on the next page shows tools that may provide value in the data validation process, with strengths and weaknesses that should be considered for adoption.

Some “do’s and don’ts” in implementing third-party data and fraud tools:

- Do run all loans through the tools, if possible. However, due to cost and the significance of a hit on a particular data validation screen, more targeted use of a tool may be appropriate. If the use is targeted, have protocols that define selection strategies and, as always, consider fair lending implications. Do not leave the decision to select or bypass certain loans to employee discretion.
- Do provide clear guidance on when and how to address a red flag. Identify who has authority to clear or stop the loan.
- Do have reporting, evaluation, and oversight of tool usage by an internal group independent of the origination and underwriting staff.
- Do monitor the level of false positives for tool efficiency. Adjustments should be made to address false positives or limited alerts to align with desired or recommended tolerances by the vendor.
- Do not rely on these tools as the sole pre-funding QC activity.
- Do not assume tools are always accurate or all-encompassing. A red flag-free loan still needs review.
# Data Validation Tools

<table>
<thead>
<tr>
<th>Tool</th>
<th>Where/when deployed</th>
<th>Scope</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Raw Data Analysis</strong></td>
<td>After application</td>
<td>Match application data with data in origination and servicing systems</td>
<td>Stop avoidable mistakes</td>
<td>Typographical errors can create false positives. Small volume lenders may have limited matches.</td>
</tr>
<tr>
<td><strong>Fraud Scoring</strong></td>
<td>After application/ before underwriting</td>
<td>Run checks against public and proprietary data</td>
<td>Assimilates data checks in one process. Leverages other lenders’ data</td>
<td>False positives. Need to validate or underwrite alerts.</td>
</tr>
<tr>
<td><strong>Employment Validation</strong></td>
<td>After application/ before underwriting</td>
<td>Automated income and employment verification process</td>
<td>Third-party verification, process efficiency, and consistent process</td>
<td>All employers do not participate. Data can be somewhat dated even if pulled recently.</td>
</tr>
<tr>
<td><strong>SSN Validation</strong></td>
<td>After application/ before underwriting</td>
<td>Confirm borrower SSN</td>
<td>Confirm borrower identity</td>
<td>False positives create need to validate, which can be costly.</td>
</tr>
<tr>
<td><strong>MERS® System</strong></td>
<td>After application/ before underwriting</td>
<td>Identify multiple mortgages borrower has in process or recently closed</td>
<td>High reliability</td>
<td>Not all lenders register their mortgages.</td>
</tr>
<tr>
<td><strong>IRS Tax Transcript Services (Form 4506-T)</strong></td>
<td>After application/ before underwriting</td>
<td>Validation of borrower tax returns</td>
<td>Actual return filed with IRS</td>
<td>Errors in borrower information on Form 4506-T can result in transcript not being obtained. Joint returns for individual borrowers can be misleading.</td>
</tr>
<tr>
<td><strong>Collateral Underwriter® or Other Property Value Review Tools</strong></td>
<td>After application/ before underwriting</td>
<td>Automated valuation or comparable sales</td>
<td>Confirm information provided in appraisal; leverage Fannie Mae data and analytics through Collateral Underwriter</td>
<td>May not be reliable in changing market (especially if declining)</td>
</tr>
</tbody>
</table>
Control Point #2 – Underwriting and eligibility

Why It Matters

Underwriters are not only responsible for making credit decisions on the data presented, they also play a key role in ensuring the file information is accurate and complete. Underwriters should be fully empowered to act on red flags and stop or delay processing if all required documents are not in the file.

Underwriters should be fully empowered to act on red flags and stop or delay processing if all required documents are not in the file.

While underwriters can suggest valuable solutions for loan roadblocks, “no” should be an acceptable decision. It should be just as valued as a “yes” if it stops a defective loan from closing, and can help alleviate the pressure on underwriters to approve all loans.

Fannie Mae Selling Guide Requirements

Subpart B2, Eligibility, and Subpart B3, Underwriting Borrowers

The Guide and Beyond the Guide

An underwriter’s role is not only to ensure the validity of individual pieces of information but also to make a decision considering all information in the file.

The underwriter should take a big-picture view of inconsistent data and ask broad questions such as:

• Do the borrower’s income and occupation seem consistent?
• Does the home fit the borrower’s financial profile?
• What is the distance from the home to the borrower’s employment and banking? Is there a reason to doubt the occupancy status?
• Are the sources of funds likely for this borrower?
• Do the comparables on the appraisal have too many or too few adjustments?
• Does the credit report align with borrower financial and personal attributes?

The underwriter should ask if each critical data element makes sense. Don’t underestimate the value of a good red flag checklist.

If a data element looks erroneous or inconsistent, it may need more support.

Obtaining Desktop Underwriter and Collateral Underwriter output is only one step in the underwriting process. Automated underwriting recommendations are only as good as the accuracy of the underlying data.

Consider integrating a document control process with your automated underwriting system. Often, one missing document triggers a red flag or the need for more documents.

Consider underwriters as the traffic cops for production and empower them accordingly.

Avoid, whenever possible, collecting documentation at closing as there is little or no time to review for inconsistencies.

When property value is questionable, there is a tendency to just ask the appraiser for another comparable that supports the value. Before doing this, the underwriter should clearly identify what about the existing comparable makes the value suspect and state why the additional comparable will overcome the issue. (See next section for more discussion of property value risk mitigation.)

Sound underwriting requires having the right information from independent sources to validate data or statements. An explanation letter alone may not be sufficient. For example, asking the borrower for a statement that they intend to occupy a property does not necessarily resolve an occupancy question.

Scorecards that objectively evaluate an underwriter’s assessment of a file have proven to be an effective feedback and training tool.

Management should cultivate a strong working relationship between the underwriting and QC teams. A culture should be encouraged that avoids underwriting seeing QC as “fault finders” and QC positioning the review of underwriting as a “Gotcha!” exercise. Always emphasize that QC and underwriting are partners on the same side.
Control Point #3 – Appraisal and collateral assessment

**Why It Matters**

Why is appraisal quality important? Correct and complete data is essential to establishing an accurate property value. A misleading appraisal impedes the underwriter’s ability to make a sound decision. Poor quality undermines the appraiser’s credibility, casting doubt on his/her body of work. Analysis of historical data suggests correlation between overvaluation and risk of default.

Correct and complete data is essential to establishing an accurate property value.

**Fannie Mae Selling Guide Requirements**

B4-1, Appraisal Requirements

**The Guide and Beyond the Guide**

Establish clearly-defined and strategic policies and procedures for appraisal quality management addressing the following:

- Do you actively manage your appraiser panel or appraisal management company?
  - What metrics do you use for appraisal quality?
- Are your appraiser engagement letters, underwriting checklists, and QC processes aligned...
  - with each other?
  - with Fannie Mae’s policy evolution?
  - with the latest technological advances in appraisal risk analysis?
- Do you regularly review Fannie Mae’s Appraiser Quality Monitoring list?
- How do you train staff to review appraisals?
- How do you measure appraisal risk and appraisal quality?
  - Do you use the appraisal quality reports available in Fannie Mae Connect™?
- How do you communicate performance results internally and externally?
  - Do you have a robust feedback loop between QC and loan production (inclusive of underwriting/operations)?

Leverage Collateral Underwriter as part of your underwriting and QC functions. It is free and gives lenders access to the same market data and analytics used in Fannie Mae’s post-acquisition quality control framework. Benefits of this powerful tool include:

- **Transparency** – CU™ gives lenders greater transparency and certainty by providing access to the same market data and analytics used in Fannie Mae’s post-acquisition quality control framework.
- **Quality** – Appraisal feedback at point of submission enables lenders to proactively address potential issues upfront and improve the overall quality of loans delivered to Fannie Mae.
- **Efficiency** – Segmenting appraisals by risk profile facilitates efficient workflow management and resource allocation. CU may also lead to fewer – but more informed – correction requests to appraisers.
- **Dynamic functionality** – The web application provides robust content and dynamic functionality at the click of a button including comparable sales data, mapping, aerial/street-view imagery, public records, and more.
- **Cost Savings** – Fannie Mae provides CU at no charge so lenders can take full advantage for a variety of quality control and risk management purposes.

Effective December 10, 2016, lenders receive freedom from representations and warranties on property value on eligible loans with a CU risk score of 2.5 or lower on final submission of the appraisal. About 60 percent of all appraisals submitted to Fannie Mae get a CU risk score of 2.5 or lower!³

Even with a 2.5 or lower CU risk score, the lender remains responsible for a few simple tasks, including confirming property eligibility, accuracy of the property description, and accuracy and completeness of certain data on the appraisal. Conduct a basic review of the appraisal. For example, confirm that interior photos of the property support the Quality and Condition ratings on the appraisal.

Use the CU web-based application in the appraisal review process to help complete required tasks, investigate and act upon findings, or investigate a CU risk score higher than 2.5. If an appraisal is resubmitted, it is rescored by CU as if it were a new appraisal.

³ As of December 2016.
A CU risk score, flags, and messages are provided in real time when an appraisal is submitted to Fannie Mae through the Uniform Collateral Data Portal, and detailed information on CU’s analysis of an appraisal is provided in the CU web-based application.

Here are some tips for using CU:

- **Messages** – The CU messages are automated risk identifiers. Did CU give out any flags or messages? What aspects of the appraisal do the messages draw attention to?
- **Property Records** – Is the appraiser’s description of the subject consistent with other sources?
- **Imagery/Map** – Does the CU aerial imagery reveal characteristics of the subject or its surroundings that could impact eligibility, marketability, or value? Is the imagery consistent with the description of the subject provided by the appraiser? Does the subject property conform to the neighborhood?
- **Sales History** – Does the subject’s three-year sales history in CU match that reported by the appraiser?
- **Comp Review Table** – Sort by the Amount column to see how the subject fits in the price range. Sort by the Model (Mdl Adjst) column to see how the subject fits in the adjusted range. Does the appraiser’s value estimate seem well supported by the market data?

Select from a variety of tools in CU to assess specific issues:

- **Limited/No Issues** – On many appraisals there will be no material risks identified. The review scope can be streamlined for efficiency.
- **Factual Issues (examples: discrepant or misreported characteristics, non-uniform data, external influences, or potential eligibility issues)** – Users can consult the Characteristic History, Pictometry® and other imagery, Construction Records, exhibits in the appraisal report, and more to determine the materiality of the issues.
- **Judgement Issues (examples: adjustment rates; condition, quality, view, or location ratings; comparable selection; reconciliation; or marketability)** – Users can consult the Adjustment Analysis, Heat Maps, Histograms, Update Model Data, Define Region, Comp Review table, imagery, and more to determine the materiality of the issues.

Not all messages or model comps need to be addressed. In many cases the issues may have been adequately addressed through substantive analysis in the appraisal report. When they haven’t, CU offers users the ability to assess the materiality of the risk and inform the resolution options. In fact, lenders may use CU to independently resolve potential red flags without engaging the appraiser. But when you do need to talk to the appraiser, CU allows you to have a direct, informed conversation leading to more productive outcomes.

Learn more about CU.
Control Point #4 – Prefunding quality control

Why It Matters
Prefunding quality control (PFQC) brings QC to the forefront of the loan manufacturing process. Effective PFQC can provide a substantial return on your QC investment because it prevents closing loans with defects. In addition to preventing closing loans with defects, the feedback to the underwriter, processor, or closer is more real-time (i.e., closer to the mistake) and allows for immediate correction of the underlying issue and more effective root cause analysis.

Fannie Mae Selling Guide Requirements

D1-2-01, General information on Lender Prefunding QC Review Process

Prefunding QC (PFQC) can have significant impact on your quality and profitability.

The Guide and Beyond the Guide
Prefunding QC can have significant impact on your quality and profitability. It usually is customized to the lender’s business model and must be a part of the overall QC program. PFQC should be as comprehensive as possible and incorporate many of the following elements:

• Evaluate all origination channels while targeting specific risk concerns such as incomplete asset documentation, income calculation errors, or manual workarounds. Also test remediation activities.

• Evaluate the entire file, not just the raw data as reviewed in control point #1.

• Perform PFQC after file approval, but before closing. If loan is being acquired from a third-party originator, the review should be performed pre-purchase.

• Report PFQC activities (sampling methods, number, percentage, types of reviews, etc.) and results to management monthly. Reports should also include results from data validation tools and provide feedback to individuals and units that have a role in the origination process including underwriters, appraisers, loan officers, processors, and branches.

• Be sure that PFQC reports mirror post-closing reports, using similar severities, weights, and metrics. Monthly PFQC reports can stand alone, but are most impactful when presented and tied to post-closing QC results.

• Give PFQC personnel the authority to stop loans from closing if problems cannot be corrected.

• Align prefunding review methodology with post-closing QC, and have a process to inform post-closing QC of possible areas of investigation. There should be active sharing of information and data between the two functions. Post-closing QC results can drive PFQC targeting.

• Leverage discretionary (full file) or targeted (component) selection criteria for file reviews before closing.

• Be sure that your PFQC consists of a series of defined activities embedded into the loan process.

• Set expectations for production staff and the borrower that QC activities are necessary steps that may add additional time to the closing date.

Some effective PFQC activities include:

• Obtain IRS tax transcripts before underwriting if applicable for the borrower’s income type.

• Always use red flag checklists for appraisals.

• Repeat the verbal verification of employment the day before or day of closing.

• Clear credit report and other anti-fraud alerts prior to approval.

• Always obtain proof of liquidation of assets that are to be the source of funds for closing.

If you use the DU validation service, learn more about prefunding and post-closing QC considerations.
Control Point #5 – Pre-closing document review

**Why It Matters**

Proper control of a closing can prevent costly mistakes. It is the critical final assembly of the entire loan and the last line of defense to prevent defects.

**Fannie Mae Selling Guide Requirements**

[D1-2-01](#), Lender Prefunding Quality Control Review Process

**The Guide and Beyond the Guide**

Our research shows that many curable defects occur during the closing process, yet we see a noticeable lack of controls during closing. We strongly suggest that lenders dedicate resources to provide an independent QC review of the closing package.

Many curable defects occur during the closing process, yet we see a noticeable lack of controls during closing.

Even though the Selling Guide provides a checklist for evaluating the closing documents after closing (see D1-3-01), this validation should also take place before closing. The closer should be inquisitive, asking questions like:

- Will the borrowers pay more money at closing than verified or disclosed?
- Has the sales contract changed since completion of underwriting? If so, the loan should be stopped and sent back for underwriting.
- Occupancy, Occupancy, Occupancy – make sure it is right.
- Are insurance elements correct? Do you have mortgage insurance? Does the homeowner’s policy match the transaction? Is flood insurance required and adequate coverage provided?

Other important considerations include:

- Many things can occur just before closing that result in changes in the loan amount, such as payoff differences or a change in the down payment. These require redrawing the closing documents or possibly re-underwriting the loan.
- Sometimes payoff amounts on refinances are larger than estimated. Does the borrower need to bring funds to closing, and were those funds verified?
- Review the Closing Disclosure thoroughly. Review the seller side of the Closing Disclosure just as thoroughly as the buyer’s.
- Changes may occur at many points during processing of a loan that might alter the terms of the transaction. Never assume the underwriting team is aware of a change. Always inform and secure the necessary approvals.
- Closing is time-sensitive and pressure-filled. Provide the closer with sufficient time to make an accurate assessment as well as the authority to stop or delay closing to get it right.
- Limiting items to be collected at closing may help reduce errors.
Control Point #6 – Post-closing document review

Why It Matters

There is limited time prior to funding to determine if the loan you closed is the loan you thought you closed. However, if prefunding QC was done well and a disciplined funder/closer has reviewed key data points, many defects can still be prevented. Even in states where table funding is typical, it should not be considered taboo to bring the borrower and seller back to the closing table to get it right. In escrow funding states where a mandated time period exists between document signing and funding, there should be ample opportunity to ensure the accuracy of the loan documents.

Fannie Mae Selling Guide Requirements

D1-3-05, Lender QC of Closing Documents

The Guide and Beyond the Guide

Review the executed closing documents to ensure completeness, accuracy, and compliance with all underwriting and eligibility requirements. To help ensure an objective review, the person funding the loan should not be the person who prepared the closing documents.

The person funding the loan should not be the person who prepared the closing documents.

The following are some of the documents and critical data elements where errors commonly occur.

<table>
<thead>
<tr>
<th>Closing Documents</th>
<th>Data to Review and Questions To Consider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security Instruments, Riders, Note, Assignments</td>
<td>Are borrower name, address, date, signatures, and loan amount consistent with other docs in the file?</td>
</tr>
<tr>
<td>Insurance Documents: Mortgage Insurance, Hazard, Flood, Fire Policy</td>
<td>Amount, product, loan type, sufficient coverage, type of policy. Is there indication of an occupancy type other than what’s indicated on the loan closing documents?</td>
</tr>
<tr>
<td>Title and Survey</td>
<td>Borrower name, exclusions, liens removed-released, address, endorsements, property address, legal description, encroachments, easements. Is title clear? Are there unexpected liens or title holders? Consider requiring photo IDs of all parties to the transaction.</td>
</tr>
<tr>
<td>Closing Disclosure</td>
<td>Signatures, charges, costs paid by borrower and seller, loan amount, all pages, cash to and from the borrower. Do the math! Did funds meet eligibility requirements? Who paid whom and who paid what?</td>
</tr>
<tr>
<td>Occupancy</td>
<td>Is occupancy clear and consistent throughout the documents?</td>
</tr>
</tbody>
</table>

If errors are discovered, lenders should:

• Determine the significance of the errors and correct or obtain corrected documents as necessary.
• Take corrective action in all internal and applicable Fannie Mae systems, including DU and any pre-populated delivery systems.
Control Point #7 – Post-closing quality control

Why It Matters

The post-closing QC process answers the question, “Is the loan you closed, the loan you thought you closed?” If the loan is not exactly as expected, (i.e., if any errors are detected), the lender has a responsibility to remediate the loan and take action to eliminate errors on future production. It may also indicate a problem with the lender’s manufacturing process that could impact other loans not reviewed, which could have implications beyond the loan being remediated and result in greater unknown risk.

Fannie Mae Selling Guide Requirements

D1-3, Lender Post-Closing QC Mortgage Review

The Guide and Beyond the Guide

Management should first make sure the company and the staff know why QC is necessary. QC is essential not just to comply with Fannie Mae’s Selling Guide, but also because QC is one of the lender’s most valuable loss-prevention controls. Don’t make the mistake of underfunding and understaffing QC. It is wise to put some of your most experienced people in QC because of their ability to identify issues.

QC is one of the lender’s most valuable loss-prevention controls.

Effective post-closing QC:

- Tells you whether you correctly originated a specific loan.
- Ensures all mistakes are identified and addressed. Severity and accountability should not be debated at this stage.
- Is embraced by the lender’s culture because the discovery of errors is a way to improve quality. And the culture should not create anxiety over retribution if errors are surfaced.
- Determines if the credit decision was correct.
- Tells you the loan quality of your entire book of business and your exposure to repurchase risk.
- Is one of the primary tools to drive improvement in your loan origination process and is vital to effective management of third-party originations.
- Alerts you to whether your policies and procedures are being followed, if your staff needs training, and if prefunding controls are working.
- Can confirm the effectiveness of any previous remediation efforts.
- Distinguishes random sampling from discretionary or targeted sampling. Random sampling provides statements about entire populations of loans. Discretionary or targeted sampling is used to test suspected high-risk or adverse populations – it should almost always include first and early payment defaults, and should be expected to have higher finding rates than random samples.
- Evaluates the ability of your staff and other participants in the loan manufacturing process, including appraisers, title companies, and others.
- Is timely. Effective lenders select and review loans well within Fannie Mae’s minimum requirements and address issues as soon as possible.
- Almost always finds something. If your QC is not consistently discovering errors or only reports minor findings, your file reviews may not be thorough enough.

Sampling Strategy – Post-Closing QC

All of your samples should be built to help you find and fix risk in your organization. You have valuable resources (staff or per-file review costs) that are tied into loan quality. As leadership in your organization, you should be keenly focused on getting the highest return possible for this resource allocation. Being attentive to your samples, and making sure you methodically identify areas of potential risk and test to validate, are key.

Fannie Mae requires lenders to have a minimum of two different post-closing QC samples. First, we require a random sample that is reflective of your entire book of originations. The purpose is to help you understand the overall quality of your originations regardless of who your investor is. A true random sample allows you to see pockets of risk that may exist outside of areas that lenders typically think of as high risk. For example, is your origination team less diligent on lower loan-to-value transactions about making sure all derogatory credit is properly addressed?
The chart below is a simple depiction showing distribution of a random QC sample. This approach can help you make sure your sample is providing the proper coverage for different origination segments and allows management to see that the sample provides a representative view of different products/purposes/origination sources. Again, this helps you uncover potential risks that may exist in loans that you deem to be lower risk that might be overlooked if you were only targeting perceived high-risk loans.

<table>
<thead>
<tr>
<th>Product, Purpose, and Channel</th>
<th>Conv. (%)</th>
<th>FHA (%)</th>
<th>VA (%)</th>
<th>RD (%)</th>
<th>Portfolio (%)</th>
<th>COR (%)</th>
<th>LCOR (%)</th>
<th>Purch (%)</th>
<th>Retail (%)</th>
<th>CORR (%)</th>
<th>Broker (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closed Loan (curr. mo.)</td>
<td>55.00</td>
<td>35.00</td>
<td>5.00</td>
<td>2.00</td>
<td>3.00</td>
<td>15.00</td>
<td>23.00</td>
<td>62.00</td>
<td>75.00</td>
<td>20.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Post-Fund QC (curr. mo.)</td>
<td>52.00</td>
<td>33.00</td>
<td>6.00</td>
<td>3.00</td>
<td>6.00</td>
<td>12.00</td>
<td>28.00</td>
<td>60.00</td>
<td>71.00</td>
<td>24.00</td>
<td>5.00</td>
</tr>
<tr>
<td>Closed Loan (roll 3 mo.)</td>
<td>50.00</td>
<td>35.00</td>
<td>5.00</td>
<td>5.00</td>
<td>5.00</td>
<td>5.00</td>
<td>20.00</td>
<td>35.00</td>
<td>45.00</td>
<td>78.75</td>
<td>17.25</td>
</tr>
<tr>
<td>Post-Fund QC (roll 3 mo.)</td>
<td>49.50</td>
<td>34.50</td>
<td>5.00</td>
<td>5.00</td>
<td>5.00</td>
<td>5.00</td>
<td>17.00</td>
<td>33.00</td>
<td>50.00</td>
<td>73.00</td>
<td>20.00</td>
</tr>
</tbody>
</table>

Sampling Strategy – Discretionary Post-Closing QC

While a randomly selected QC sample offers insights across your origination platform, discretionary selections should be selected to target different risk elements. While sampling high-risk elements is important, targeted risk elements do not necessarily all have to be high risk. Discretionary selections allow a lender to methodically evaluate areas of risk and either validate that no issues exist or potentially highlight areas that need additional controls.

Discretionary reviews may be best completed as full-file reviews, but flexibility offered in the Fannie Mae Selling Guide allows a lender to perform a component review (i.e., income, assets, liabilities) versus a full-file review. Part of your sample strategy should be to decide if each discretionary sample is best served by a full-file review or a component review. One advantage of a component approach is that reviewers may be able to look at a larger sample of loans by reviewing only one or two components of a transaction. For example, perhaps you are concerned with your staff’s ability to analyze self-employed income. Leveraging a component review allows you to look at only the income documentation and calculation portion of a loan versus reviewing the entire transaction. A component review saves time by focusing your discretionary reviews only on that single risk element. It is not necessary to spend time and effort reviewing the other areas of the transaction that you are less concerned with.

Suggested items to consider when building your discretionary selections:

- **Magnitude** – What percentage of your origination volume does this risk element represent? For example, does this element represent less than 1 percent of your origination volume or does it account for 20 percent?

- **Financial exposure** – What elements cause the most financial risk to your organization when they are manufactured incorrectly?

- **Compliance risk** – Do certain elements of your origination process offer higher degrees of difficulty and in turn increased potential for regulatory or compliance risk?

- **Employee-based risk** – Do you have new staff and want to establish a deeper knowledge base about their ability, or are you in the process of reducing staff, which might increase the potential for manufacturing errors?

Regardless of the reason that you select loans for a discretionary review, **your QC team should be able to provide a crisp risk assessment as to why you are performing certain discretionary selections and the amount of risk that represents for your organization**. We often find in reviewing lender QC reports that their discretionary selections do not change over a very long period of time even though the level of defect found might not be commensurate with the ongoing sample need. To say this in a different way, spending staff hours (or vendor file review costs) on samples that do not change often or are not focused on key risk elements not only wastes time and money but also creates a missed opportunity to evaluate a different risk element and either validate that you are operating as expected or highlight potential opportunities for risk reduction.

Fannie Mae provides access to many tools that can enhance and expand the depth of your QC program. Visit our Loan Quality page to find tools, guidance, and suggestions such as the QC Self-Assessment Worksheet that can assist lenders in ensuring their loan quality program is sufficiently comprehensive and compliant with today’s market expectations.
Control Point #8 – Reporting

**Why It Matters**

Robust reporting is the mechanism for communicating with those directly involved or overseeing the loan manufacturing (origination) process. It transforms data into meaningful information useful in analysis, decision-making, and taking remedial action. When reports are effective and QC is part of the culture, the executive and senior leadership are as interested in QC reports as those directly involved in the QC function.

Robust reporting transforms data into meaningful information.

**Fannie Mae Selling Guide Requirements**

[D1-3-06, D1-2-01](#) (Reporting subsection)

**Calibration**

The overwhelming majority of post-acquisition file reviews that Fannie Mae completes are on performing loans selected and reviewed within months of acquisition. This presents an ideal opportunity to not only leverage your own internal QC results but also to augment your review results with those from Fannie Mae. Historically, Fannie Mae did not select files for review until much later in a loan's life cycle, and thus the review results could not be leveraged as easily to make an impact on current production.

Based on Fannie Mae's current sampling strategy, leveraging our results to improve your own QC processes and results can be more impactful than ever. One way to do this is to make sure your results are calibrated with Fannie Mae's review results.

What does being calibrated mean? In this reference there are several meanings. First, if both organizations review the same loan, would we find the same thing? Second, if we would find the same thing, do we think of the severity similarly? One hundred percent calibration is not feasible, but over time lenders certainly can obtain a high degree of calibration, which has several benefits.

First and foremost, it increases the level of certainty that you have about your financial exposure from manufacturing quality mistakes. When highly calibrated, your own internal QC results serve as your own early warning system about what other secondary market investors might think about that quality of a particular transaction, or more importantly about a certain population of loans. Second, when you have a high degree of certainty in your own results, you have more flexibility to look at different samples to find additional pockets of risk, or more importantly the flexibility to potentially decrease certain sample sizes. There are several ways to perform calibrations, and not all of them increase cost. A few examples are provided below.

**Transaction-Level Calibration**

- Loans that both organizations review – Over time it is likely that you and Fannie Mae will review a similar loan or loans. In this instance, no additional file review is required. Simply compare the results from both reviews and take the time to understand any differences.
  - Did we find the same thing? Yes or No
  - If no, why not? Scope difference? Different loan file documents?
  - If yes, did we rate the same?

- Intentionally selecting files to review – This method increases the level of effort and cost as incremental file reviews are required. To use this method, simply perform QC reviews on a population of loans that Fannie Mae has selected for review and then compare the results. One caution with this method is that review bias can be introduced if your staff knows they are being evaluated against someone else’s review of that same file.

**Sample-Level Calibration**

If you do not want to perform calibration at the loan level, another way to calibrate is at the sample level. First, think about all of the loan file reviews your organization completes on a monthly basis and then add in the review of your loans by outside investors (chart below):
Calibrating data in an aggregate fashion provides a different perspective that is not transactional. Evaluating results differences at the sample-level answers questions similar to:

- Over the past three months, if Fannie Mae has noted a certain number or type of defects in their review of your loan, do you see the same trends?
  - If yes, you should have a sense that your quality organization is finding similar manufacturing errors and more importantly, action plans should be in place already to resolve them.
  - If no, do you have different samples, levels of documentation, or scope, or is your organization potentially not catching key errors?

Good tools to help you in the calibration effort can be found on Fannie Mae’s Loan Quality web page:

- [Loan Defect Categories](#)
- [Loan Defect Categories Spreadsheet](#)

### The Guide and Beyond the Guide

- Effective reporting leads to improved quality and loss prevention.
- Thorough loan-level reviews are the foundation for reporting. However, QC reports that provide only loan-level information and do not evaluate the entire origination process are not effective tools for management action.
- QC reports should have trending information to be of the most value.
- Effective reporting compiles loan review data into meaningful information that can support continuous improvement and fewer defects. Effective reports:
  - Measure the quality of originations,
  - Evaluate performance against requirements and goals,
  - Confirm compliance with policies and procedures,
  - Address the effectiveness of processes and controls,
  - Identify actionable items,
  - Track effectiveness of actions taken,
  - Feed individual compensation and performance plans, and
  - Predict your risk exposure.
- Reporting is typically unique to each lender, reflecting the desired credit culture, defect rate goals, and specific risks, including those reflected in their products, origination channels, third-party partners, and geographical markets.
- Lenders that outsource their QC to contractors (vendors) should still take the lead in report design to provide meaningful information for all levels of employees up to executive and senior management. These lenders also need to develop reports that facilitate the evaluation of the QC contractor.
- Reporting supports understanding of the severity of findings and distinguishes between compliance and credit findings, which should be reported and assessed separately.
- Proactive lenders develop expanded reports that consider the personnel involved in the loan manufacturing process and their needs specific to quality. They identify the information that users need (content) and how often they need it (frequency).
QC reports should have trending information to be of the most value.

The following is one suggested reporting strategy:

<table>
<thead>
<tr>
<th>User</th>
<th>Potential Needs</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Officers, Underwriters</td>
<td>Loan-level defect details, miscalculations</td>
<td>Weekly</td>
</tr>
<tr>
<td>Department Managers</td>
<td>Predominant defect categories, responsible parties, summary of defect details</td>
<td>Biweekly</td>
</tr>
<tr>
<td>Senior Management</td>
<td>Key risk factors, trends, potential repurchases</td>
<td>Monthly</td>
</tr>
<tr>
<td>Executive Management</td>
<td>Results versus goals, remediation plans, effect on financials</td>
<td>Quarterly</td>
</tr>
</tbody>
</table>

Proactive lenders accelerate the delivery of reports to senior management well before the required 120 days – sometimes as soon as 45 days after the end of the month being reviewed.

Each type of review, whether prefunding, random/statistical post-closing, or post-closing discretionary, should have its own set of reports. However, reporting should use consistent methodology and terminology. Additionally, there should be collective reporting that incorporates all review types.
Report Samples

NOTE: these and the above examples are not all-inclusive.

Random Post-Closing Review Summary: Defect Rate vs. Goal

Discretionary Selection Trending

Defect Rate by Channel

Post-closing QC Review Defect Summary by Channel
Pre-Funding QC Review Defect Summary by Defect Category

Top 5 Significant Defects - Q1 vs. Q2

<table>
<thead>
<tr>
<th>Defect Type</th>
<th>March</th>
<th>April</th>
<th>May</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment and Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Verbal VOE not or improperly completed</td>
<td>4</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>Borrower not employed at closing</td>
<td>2</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Calculation error</td>
<td>2</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Required reserves not verified</td>
<td>2</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Insufficient funds to close</td>
<td>1</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>Gift letter not suitable</td>
<td>1</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Documents</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Errors in Final 1003</td>
<td>1</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Note improperly executed</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Appraisal and Collateral</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Improper comparable selections</td>
<td>4</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Appraiser did not have final sales contract</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

Post-Closing QC Review Results Summary

<table>
<thead>
<tr>
<th>Significant Findings</th>
<th>Q1</th>
<th>Q2</th>
<th>Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Calc</td>
<td>0%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>Asset Verifications</td>
<td>0%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>Improper Comparables</td>
<td>4%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Undisclosed Liabilities</td>
<td>3%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>Incomplete Application</td>
<td>2%</td>
<td>2%</td>
<td></td>
</tr>
</tbody>
</table>
Control Point #9 – Action plan to prevent future defects

Why It Matters
If no action is taken to remediate observed defects and prevent recurring defects, repurchase and other risks will persist. Without a formal process for acting on QC results, the lender’s QC program is incomplete and ineffective.

Fannie Mae Selling Guide Requirements

D1-1-02: Lender Quality Control Staffing and Outsourcing of the Quality Control Process

The Guide and Beyond the Guide
Identify the root cause of each defect. For example, was income calculated incorrectly due to a lack of understanding of the right calculation components, or was it due to a flaw in the calculation process itself?

With each defect, should a specific individual be part of the remedial action? Untrained staff or staff and third parties who intentionally misrepresent information create a significant source of defects that must be addressed.

If a specific individual is the issue, one-on-one training may be appropriate. If the issue occurs more broadly among staff, group training should be a part of systematic changes to address the root cause.

Were there indications that a specific process, policy, control, or system is flawed? Look first for the possibility of system wide changes in controls, processes, or policy to fix the issue(s).

Provide loan quality performance scorecards to each origination channel and origination unit (branch, region etc.).

Provide loan quality performance scorecards to each individual in the origination process, including loan officer, processor, underwriter, appraiser, closer, and funder. These scorecards should influence both performance review and compensation for that individual.

Include guidance on how to prevent quality issues in procedure manuals.

Report to the QC team on the remediation action taken.

QC should test and report on the effectiveness of remedial actions.

Senior management should evaluate the effectiveness of the remedial actions and direct changes if the actions are not working. Management actions should be documented.
### Sample Action Plan Reports

**Defect Detail – Action Plan Report**

<table>
<thead>
<tr>
<th>&lt;Pre-Funding&gt; &lt;Random Post-Closing&gt; &lt;Discretionary Post-Closing&gt;</th>
<th>&lt;Month/Year&gt; Reporting Period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Observed Defect</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Defect Category</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Period Observed</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Frequency of Occurrence in Period</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Business Channel</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Business Line</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Product or Program</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Business Lead</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Stakeholder(s)</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Action Plan Owner</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Root Cause</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Proposed Corrective Actions</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Key Assessment Metric(s)</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Date Discussed at QC/QA Management Meeting</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Meeting Comments</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Anticipated Implementation Date</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Testing #1 Date</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Testing #1 Notes</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Testing #2 Date (if applicable)</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Testing #2 Notes</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Actual Resolution Date</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Resolution Notes</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Other Comments</strong></td>
<td></td>
</tr>
</tbody>
</table>

---

### Action Plan Tracking for Random Post-Purchase Review Results - For May 2016 Meeting Update

<table>
<thead>
<tr>
<th>Item</th>
<th>Significant Finding</th>
<th>Meeting Discussed</th>
<th>Root Cause</th>
<th>Actions to be Taken</th>
<th>Owner</th>
<th>Date To Implement</th>
<th>Expected Improvement Date</th>
<th>Observed Improvement Date</th>
<th>Date Closed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Insufficient Assets are documented for closing (e.g., need $100,000 but only document $90,000)</td>
<td>4/6/16</td>
<td>Lack of understanding by staff</td>
<td>Training in development. July rollout.</td>
<td>J. Smith</td>
<td>7/12/16</td>
<td>9/1/16</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>2</td>
<td>Declining income averaged</td>
<td>3/5/16</td>
<td>Policy unclear</td>
<td>Internal Policies &amp; Procedures Manual to be edited to clarify</td>
<td>B. Jones</td>
<td>4/15/16</td>
<td>6/1/16</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>3</td>
<td>Large deposits not sourced</td>
<td>2/6/16</td>
<td>Correspondent process</td>
<td>Correspondent issue; terminate business with correspondent</td>
<td>H. Taylor</td>
<td>4/1/16</td>
<td>5/1/16</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>4</td>
<td>4506-T not secured for borrowers with multiple financed properties</td>
<td>1/7/16</td>
<td>Internal Process Issue</td>
<td><em>Priority Action</em> - these loans to go to Sr. UW at East Branch only. Update Process document.</td>
<td>B. Jones</td>
<td>2/1/16</td>
<td>4/1/16</td>
<td>4/6/16</td>
<td>To be discussed / finalized at May Mtg.</td>
</tr>
<tr>
<td>5</td>
<td>Project warranty documentation not included in mortgage file</td>
<td>12/4/15</td>
<td>Missing on checklist; Policy not up to date</td>
<td>Memo to staff; addition to doc checklist</td>
<td>T. Scott</td>
<td>12/19/15</td>
<td>2/1/16</td>
<td>3/3/16</td>
<td>4/6/16</td>
</tr>
</tbody>
</table>
Cost Control: Good quality pays – a profit preservation tool

QC in manufacturing is typically viewed as a protective function that ensures a predictable, high-quality product produced by a cost-efficient production line. QC in the mortgage business has not always been viewed in a similar light, but there are opportunities to leverage QC findings to improve loan manufacturing processes and translate those improvements to a reduced cost-to-originate. By doing so, lenders can effectively offset some QC costs by the quantified savings of averted fraud, reduced re-work, lower secondary marketing costs and labor expense, and improved customer service that are part of improved efficiencies in the loan production process.

As mentioned at the beginning of this publication, “Properly implemented, a lender’s QC process contributes to business profitability and long-term success. QC pays for itself.”

There are opportunities to leverage QC findings to improve loan manufacturing processes and translate those improvements to a reduced cost-to-originate.
Determining how good quality avoids unnecessary expenses

To quantify the savings resulting from QC improvements, define a method to determine the costs of current inefficient or ineffective processes. Below are some simple methods of calculation that a lender can begin with, and as understanding grows of where poor quality costs exist, other methods can be developed and used to illustrate cost savings.

**NOTE:** Use research and collaboration between departments to accurately capture each cost basis (Human Resources, Capital Markets, Post-Closing and Shipping, etc.) to ensure senior management reporting is neither under nor over-estimated and reflects true costs.

### PROFIT PRESERVATION OPPORTUNITY #1 – Pre-Funding Fraud Savings

#### Calculating Projected Pre-Funding Fraud Savings

\[
\text{Loan Amounts Not Funded} \times \text{Est costs of closing / holding unmarketable loan (expressed as basis point)} = \text{Potential Repurchase / carrying cost avoided} (\$)
\]

**Example Report:**

<table>
<thead>
<tr>
<th>Quarter</th>
<th># Loans Not Funded</th>
<th>Loan Amounts Not Funded</th>
<th>Potential Repurchase Loss Avoided (50bps per loan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 2016</td>
<td>2</td>
<td>$325,000</td>
<td>$1,625</td>
</tr>
<tr>
<td>Q2 2016</td>
<td>1</td>
<td>$175,000</td>
<td>$ 875</td>
</tr>
<tr>
<td>Q3 2016</td>
<td>3</td>
<td>$615,000</td>
<td>$3,075</td>
</tr>
<tr>
<td><strong>2016 Total</strong></td>
<td><strong>6</strong></td>
<td><strong>$1,115,000</strong></td>
<td><strong>$5,575</strong></td>
</tr>
</tbody>
</table>

Figures are for illustration purposes only

### PROFIT PRESERVATION OPPORTUNITY #2 – Post-Funding Significant Defect Cost-to-Cure Expense

Determine man-hour costs for curing Significant Defects on loans (eligibility defects)

\[
\text{Man-hours expended curing 1 loan with Significant Defects)} \times \text{Salary cost (est. hourly rate of FTE curing loans)} = \text{Salary cost for curing Significant Defects}
\]

**Example:**

15 minutes or 0.25 man-hours (Avg. time determined through time-study) \( \times \) $24.04 (Avg annual salary $50,000 / 2080 hrs per yr) = $6.01 per file ($24.04 \times 0.25)

Determine monthly expense for curing loans with Significant Defects (eligibility defects)

\[
\text{# of loans with Significant Defects cured per month} \times \text{Salary cost for curing Significant Defects} = \text{Cure Cost per Month (\$)}
\]

**Example:**

10 loans cured for June \( \times \) $6.01 per file (Avg. man-hour cost per file) = $60.10 man-hour costs for June

### PROFIT PRESERVATION OPPORTUNITY #3 – Secondary Marketing Carrying and Liquidation Costs

Determine monthly expense of carrying closed loans with incurable Significant Defects (eligibility defects)

\[
\text{# of loans with Significant Defects not cured per month} \times \text{Margin loss on pricing} = \text{Monthly Secondary Marketing Cost (\$)}
\]

**Example:**

# of loans with Significant Defects not cured per month \( \times \) Margin loss on pricing = Monthly Secondary Marketing Cost (\$)
Periodically tabulating and applying these metrics to the company’s regular reporting can help tangibly translate to senior management and production staff the benefits of investing in QC. This method of communicating helps the organization speak with a single language (dollars) and provides incentive for all areas of the organization to seek cost savings through QC. Illustrating the profit preservation element of QC in this way helps drive the quality culture from a “have-to-do” to a “must-have” business tool.

Although we used a single-loan example, keep in mind that your cost savings will be multiplied by the hundreds or thousands of loans you originate annually. Additional savings can be quickly tabulated by adding costs from other areas of the organization that these examples influence, such as:

- **Prefunding**
  - Errors corrected = reduced re-work man-hours
  - Process corrections from discovered errors = improved time to funding
  - Improved time to funding = reduced re-lock expense

- **Post-Funding**
  - Process corrections from discovered errors = reduced warehouse carrying costs
  - Employee weaknesses = better, more targeted training
  - Reduced defect rates = possible reduction in reserve requirements
  - High initial QC defect cure rates (defects corrected with documents already in the file but mishandled / misfiled) = discovering improved document management processes and reduced man-hours on “the paper chase”

These are just a few examples of cost associated with poor quality. Once the perspective of QC is changed, the value of reduced defects and improved efficiency becomes more visible. As the value becomes more visible, staff begin to see improving quality as a way to improving their quality of life at work – reduced stress, improved ease of work, and feeling more valued. These can translate to reduced employee turnover and the associated recruitment/training costs.
The road to quality – it’s a journey

Achieving a level of high-quality loan production is more of a journey than a destination. Ten years ago, good loan quality was considered a loan that performed as expected. Today, good loan quality means a loan that was manufactured as expected.

As the industry experiences the benefits of high-quality loans and efficient loan manufacturing, loan quality will need to be expanded to include lower costs-to-produce and faster, more streamlined processing experiences for consumers in addition to quality manufacturing and performance. Achieving that next level of quality will still follow a similar road map that encompasses fundamental elements as shown in this QC road map:

Quality Control – A Road Map

- Governance
  - Independence
  - Staffing
  - Outsourcing
  - Standards
  - Measures
  - Procedures
  - Third-party mgmt.
  - Program audit

- File Reviews
  - Prefunding
  - Post-closing
  - Random reviews
  - Discretionary reviews
  - Minimum Components
  - Flexibilities
  - Sampling criteria
  - Timing
  - Post-closing reverifications
  - Prefunding validations
  - Full file reviews
  - Targeted (aka component) reviews

- Review Results
  - Internal results
  - External results
  - Identified defects
  - Measured defect rates
  - Severity distribution
  - QC reports

- Taking Action
  - Analysis including root cause analysis
  - Action plans and implementation
  - Self-reporting

Fannie Mae wants to help you on your journey to achieving the next level of quality in your organization. Thank you for partnering with us on this journey Beyond the Guide.