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Fannie Mae's Loan Quality Initiative: Six Questions to Ask about Detecting Undisclosed Liabilities

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With the **June 1** deadline to implement new loan quality control changes outlined by **Fannie Mae's Announcement SEL-2010-01** here today, many lenders have been scrambling to put a process into place that helps them improve their compliance and mitigate repurchase risk.

The prime area of concern involves how best to perform a second check of liabilities just prior to close to verify that no new debt has been added. Lender strategies for dealing with this new process vary significantly, depending on the specific market and risk management policy of each.

Key challenges include how to respond proactively; finding the best approach with respect to cost and benefits; and reducing the chance of false positives that might result in additional expense, including more research, documentation or unnecessary loan fall out. While there is no sure-fire solution, one thing is certain: the best overall source for detecting undisclosed liabilities is credit data--and more specifically, credit inquiries.

Much depends on finding a way to detect undisclosed liabilities without triggering negative consequences. Applicants who have gotten to closing have already invested heavily in the mortgage finance transaction, and a faulty indicator can be devastating.

Given the way real estate loans have traditionally been handled, delay or denial just before close may put the applicant in an adverse situation. Many may already have their current and future homes under contract, or will have let their current lease expire, only to be told hours before close that the transaction will be delayed or might not happen at all. They will need to find another place to live until the dispute can be resolved.

What can lenders do to create a solid strategy to meet the new requirements and recommendations, and avoid the expense, additional work, borrower heartache and headache, as well as litigation risk related to a loan being delayed or denied at the last minute?

Six Key Questions
At a time like this, when the stakes are high and there are no easy answers, it is critical to ask the right questions to ensure with reasonable certainty, speed and expense that no new liabilities that can derail the transaction or lead to loan buy backs go undetected.

1. How many credit bureaus should I search during the pre-close review?
Because lenders pull tri-merge credit reports at application, searching any single-bureau report at close will reveal any pending mortgage applications (inquiries). Those who prefer to review a one- or two-bureau report cite the advantages of lower cost compared to a tri-merge report, with nearly complete coverage of the most current credit information. A three-bureau search does provide a marginal increase in coverage, which many lenders find justifiable, given the risk profile of their market and applicants.

Segmenting applicants based on the individual risk profile of a prospective borrower is another approach being considered by some lenders. For example, a single-bureau search may be performed on low-risk applicants, while the three-bureau option can be used for those with a higher-risk profile. This selective approach can reduce costs; but opponents say that while it may be effective for catching innocent activities by borrowers, it is not as successful at catching fraud, because fraudulent loan applications are doctored to look good and avoid scrutiny, and are not likely to be identified as a higher-risk case. A selective approach must also be carefully evaluated for compliance with fair

lending practices to ensure that there are no unintended effects that result in a pattern of unequal treatment.

Generally, there is no question that a pre-close review of credit standing is prudent, but the specific credit search criteria must be tailored to fit each lender's market and risk policy. Regardless of the approach taken, it is important to verify as part of the evaluation whether the credit information provider has been approved as a direct provider to Fannie Mae.

2. Should I require a score?
Opinions are fairly unanimous that a credit score is not needed for the pre-close review for undisclosed liabilities. According to Fannie Mae, the intent of the pre-close review is to "determine that borrower liabilities incurred up to, and concurrent with, closing are disclosed and evaluated in qualifying the borrower for the loan." A credit score is not useful or appropriate to achieve this stated purpose; however, credit information is necessary to determine the presence of new, undisclosed liabilities.

Fannie Mae guidance suggests that "a credit report just prior to closing may uncover additional debt or credit inquiries," and that "inquiries listed on the credit report should be investigated to determine whether the borrower did in fact open additional debt resulting in repayment obligations." If new liabilities are detected and confirmed, and those liabilities disqualify the applicant, the applicant will receive a denial on the existing loan from the lender.

Depending on the situation, the lender may proceed with prequalification for a counter-offer, or walk away. If the new liabilities turn out to be non-existent or immaterial, per Fannie Mae guidelines, the deal can proceed to close. Either way, the credit score is superfluous when it comes to detecting undisclosed liabilities.

3. What should I know about MERS and mortgage lien searches?
MERS is an excellent tool for detecting undisclosed mortgages on a given property, either by the same borrower or a different party. Unfortunately, the MERS lien search covers only mortgages produced by originators that use the MERS system as the lien holder of record, which is about 60 percent of all originations. Another concern is that MERS lien data is posted after the fact, usually two to five days post-close.

A new service from MERS holds promise for the future, however. It allows lenders to register a loan at the time of application, without making MERS the lien holder. At this time, the service is in its inception and coverage is minimal.

Public records are another source of lien data, but coverage and timeliness vary greatly depending on the county and jurisdiction of the subject property. This variability reduces the value of public records, particularly when there is a need to standardize processes across multiple regions or for national lending operations.

A little-known fact is that a single-bureau credit pull will offer nearly all recorded mortgage loans, as well as pending mortgage applications (inquiries). Credit reports are also a good source for detecting non-arms-length transactions, because they provide a method for confirming the borrower's current address. This is particularly effective for uncovering one of the most common types of occupancy fraud, where parents buy homes that will be occupied by children, or vice versa.

4. Can I use risk assessment products in lieu of the pre-close credit review?
Some lenders that focus on markets with very low risk, such as small regional banks specializing in prime borrowers, have indicated they may forego the pre-close review and rely on predictive analytics to flag applications that match certain risk criteria. Since Fannie Mae recommends the credit review, but does not require it, lenders are free to decide how best to identify undisclosed liabilities. However, in considering the option to forego the pre-close credit review, it is critical to do a cost-benefit analysis of any potential savings realized from this approach versus the potential for higher losses that may result from repurchase demands and mortgage insurance rescission.

5. What solutions are available to assist with the pre-close review?
Solution providers are scrambling to create new products to streamline the pre-close review process. While there is as of yet no proven method, there are a few primary approaches emerging and in various stages of introduction that should be evaluated.

Credit Comparison Reports attempt to streamline the pre-close review by matching an original credit report to a new credit report and providing a summary of the changes. Those who see benefits to this approach appreciate the ability to quickly scan a side-by-side comparison of credit data. Those who don't like this approach worry that the

complex matching logic can lead to the wrong conclusion, either false positives or false negatives. Those who are considering using a comparison report should get a thorough description of the logic used to produce the report to ensure that the business rules match their specific risk policy.

Monitoring Services are aimed at notifying the lender when an inquiry or potential new liability is posted to a borrower's credit file. In this type of service, the borrower's credit file is monitored and lenders are notified of changes daily. Those who favor this approach are looking to receive the earliest possible warning when there is a new inquiry. Monitoring presumably provides more time to verify or clear issues and reduces the overall number of hands-on pre-close reviews that need to be performed.

Those who dislike this approach cite that the handling of events on a daily basis is impractical for operational reasons and may increase, rather than decrease, workload by, in effect, creating a daily pre-close review. Perhaps the most important concern about this approach comes from those who prefer to perform a three-bureau search, because most monitoring services cover only a single bureau and may not include changes in tradeline balances.

Despite the differences in opinion on this service, those who intend to perform a pre-close credit review, as recommended by Fannie Mae, would be well served to post a definitive document to the loan file to reflect that the review has been completed for all applicants, whether it was done through a monitoring service or through a hands-on review of credit information.

Specialized Loan Review Reports aggregate the results of multiple data searches into a simple, tabular report based on each lender's specific risk policy. For example, detail on credit inquiries, new tradelines and tradeline balances, liabilities, liens and lates for the most recent 45 to 60 days can be instantly compiled from a search of credit data, public records, MERS, etc. Lenders can set preferences and filters for the number of bureaus, and set thresholds for criteria such as lates and balance increases.

Those who prefer this approach like that the new information is prominently listed with the option to drill into the entire credit history for in-depth review should a concern emerge. This approach offers the transparency of a tabular report, leverages the knowledge of existing staff with regard to reviewing credit information and tends to fit well into existing processes.

6. How can I quickly verify or clear the file when a potential new liability is detected?
One of the biggest challenges with the pre-close review is how to quickly clear inquiries that do not materialize into new liabilities. No one knows how many false positives will occur, but most agree the issue will be significant.

When choosing an approach, it is critical to address tradeline and inquiry research as a pivotal part of the overall solution, because this will be a critical step that needs to be performed in hours, not days, to reduce the chance of fall out and negative impacts to applicants. Ideally, the provider of the pre-close review solution should also perform the research to ensure the highest level of efficiency and accuracy.

Conclusion
As lenders are discovering in the process of creating a strategy to deal with the new guidelines, there is no single, best approach to comply. Each lender will have to select tools and processes that meet its specific needs and market. Perhaps the single most effective step a lender can take to prevent undisclosed liabilities is to ensure that all applicants receive sufficient up-front counseling regarding the consequences of initiating new credit prior to close.

(*The views presented do not necessarily reflect the platform or policies of the Mortgage Bankers Association.* ***MBA NewsLink*** *welcomes your articles; submissions should be 600-1,000 words and deal with issues of general or specific interest to the mortgage banking industry. Inquiries/submissions should be sent to* ***Mike Sorohan****, editor, at* msorohan@mortgagebankers.org.)