

Mortgage Professionals Rethink Quality Assurance

Robust post closing QA plans help identify and prevent errors that could become very costly if they are not discovered and addressed early.

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Mortgage Quality Assurance (QA) programs have always protected investors, but it has become increasingly clear in today's climate that effective QA programs protect originators, borrowers, and communities.

We have all heard about the recent turmoil in the secondary mortgage market, particularly with subprime origination and sales. It is important to emphasize that FHLBI does not purchase subprime loans through the Mortgage Purchase Program (MPP), a policy that has not changed since the program's inception. Recent events, however, have caused many to re-think their company's strategy, including the value of a comprehensive QA plan.

FROM THE INVESTOR'S POINT OF VIEW

MPP participating sellers know that MPP has a robust post sale QA plan in place for review of loans sold to the FHLBI, which includes quarterly sampling, 100% sampling of severely delinquent loans, and special state specific testing. The FHLBI also requires that sellers have their own post closing QA plans in place.

The need for post closing QA plans is often questioned by members when they sign up for MPP, but in today's climate, the protection they afford is invaluable, regardless of whether the plan is executed in house or outsourced.

It is easy to see why the investor desires post closing and post sale QA plans. The plans protect the investor by ensuring that loans meet or exceed program requirements, and they help prevent possible financial risks associated with fraud or predatory lending. Loans that don't meet investor requirements are put back to the seller. But how do these plans protect originators, borrowers, and communities?

QA BENEFITS ORIGINATORS, BORROWERS, & COMMUNITIES

Originators that sell loans to investors benefit from robust post closing QA plans because the plans help identify and prevent errors that could become very costly for their company if they are not discovered and addressed early. Investors, including FHLBI, will return a loan to the seller if misrepresentation, fraud, predatory lending, or other defects are found in the file. Identifying issues and weaknesses early helps sellers avoid repeating costly mistakes. Additionally, helping to identify and avoid fraud for housing and inflated appraisals helps originators protect their communities.

FRAUD FOR HOUSING

One of the single most overlooked problems in mortgage lending is fraud for housing, which differs from fraud for profit in that the fraud is committed with the intention of getting a borrower into a house, who intends to make payments on the loan. This type of fraud has often been perceived as more "innocent" than fraud for profit, and many lenders found themselves not looking at it, or its risks, closely. Traditionally, originators, investors, and even the FBI have focused on investigating fraud-for-profit scams, since these typically involve multiple parties and large dollar losses. However, fraud for housing can be very damaging for borrowers and communities over the long term.

With fraud for housing, borrowers seek to overextend their borrowing ability by falsifying key information on their application (such as income, time on the job, or assets), thus falsely qualifying for more home than they can afford. When times are good (i.e., real estate prices are

You can refer to the FHLBI's MPP Guide on Member Link for information about developing a good QA plan.

f. Credit summary documentation requirements.

| | History/Documentation Requirements |
|-----------------------------------|---|
| All Files | <ul style="list-style-type: none">Borrower file must contain<ul style="list-style-type: none">Residential mortgage credit report (RMCR), orTwo-repository, in-file, merged/purged credit report, andMortgage/rental history for 12 months must be verified.Minimum credit score of 620 |
| Borrowers with Established Credit | <ul style="list-style-type: none">Minimum four credit referencesThree open and active in the last 24 months |
| Borrowers with Non-... | <p>If four credit references cannot be documented through RMCR or a two-repository, in-file, merged/purged credit report, the FHLBI requires alternative credit sources for each alternative credit source for 12 months.</p> |

rising), if a borrower gets into a jam, he can place his house on the market, turn a profit, and leave if he can't afford the payments long term. However, in a market where real estate prices are steady or falling, these borrowers are faced with living in a property that they can't afford and can't unload. If too many loans go into foreclosure in a neighborhood, property values can continue to shrink, and the problem perpetuates.

Fraud for housing negatively impacts borrowers and communities by harming property values due to increases in foreclosures. Additionally, fraud for housing can negatively impact a community lender's borrowing base by affecting customers' creditworthiness. Overextending a borrower's ability to pay on a mortgage can ultimately impact other lending areas too, such as small commercial loans and consumer loans.

Fraud for housing is usually identified in post closing QA by re-verifying loan documentation such as employment verifications, pay stubs, tax returns, and verifications of deposit. QA often detects problems such as a borrower who hand carried his verification of employment to be filled out by the employer. In a fraudulent instance, the borrower may have someone at their work other than human resources sign the documentation, which provides the opportunity to inflate their salary or length of time on the job. The original loan documentation looks real, but when the post close QA runs a re-verification through the company's human resources department, it comes back with conflicting information. If a lender's QA process discovered this and found a pattern

existed with a specific loan originator, branch, or third party originator, they could take action to prevent this from happening in the future.

OVERSTATED APPRAISALS

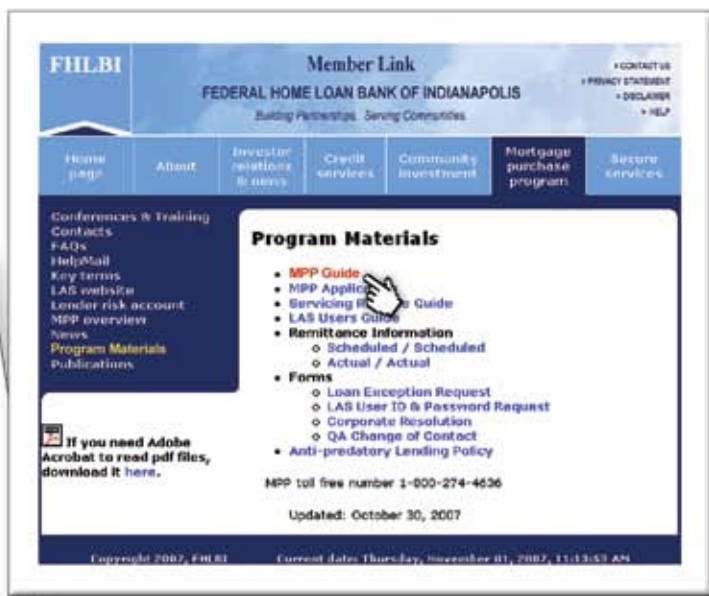
As we have seen in the past few months, mortgage lending and real estate values have a huge impact on communities and the economy at large. Post closing QA plans can identify problems, such as inflated values on appraisals, which, if addressed early, could help keep bubbles in check. Additionally, post closing QA plans help protect neighborhood values overall by ensuring that property values are in line and that borrowers are not entering into a riskier transaction than they think.

Overstated appraisals have a similar impact on the community to that of fraud for housing. By falsifying value, appraisers are creating a situation with the potential to over issue debt, which can lead to problems should the borrower need to sell the house. While the mortgage may appear to be 80% loan to value on paper, a good appraisal may show that it is a 95% loan to value deal. This could mean that if the buyer had to sell the house shortly after purchase, he could be "upside down" in the equity position of the home. Identifying appraisers that have a pattern of misstating values is a key component of a good QA program; committing to stop using that appraiser once a pattern surfaces helps to mitigate future risks.

Inflated appraisals are usually identified in post closing QA by a desktop review of the appraisal, which involves closely looking at the comparables, adjustments, and comments. Often, simply looking at the map of where the comparables are located helps. In many situations, neighborhood lines are very distinct on maps; they may be divided by an interstate or body of water. If it appears that comparables were pulled from another neighborhood, and adjustments are not in line, the QA provider will often order a review appraisal. Using automated valuation models (AVMs) has also proven effective unless an entire area has already been inflated in value.

WHERE DO WE GO FROM HERE?

The MPP Guide, which is published on www.fhlbi.com, is a good place to start to research the elements that constitute a good mortgage post closing QA plan. Additionally, the Mortgage Bankers Association (www.mbaa.org) publishes books, kits, and teaches classes on starting post closing QA plans.



For more information on executing a mortgage QA plan in house or outsourcing one, call the FHLBI MPP department a call at 1.800.274.4636. Visit www.fhlbi.com/mpp/progmaterials.asp to view the MPP Guide.