The Quality Control Process and Its Impact on Compliance Goals

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Bankers ADVISORY
A CliftonLarsonAllen LLP Division

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A CliftonLarsonAllen LLP Division

- A consulting firm focused on helping mortgage institutions across the United States with regulatory compliance and quality control

- Provide premium file evaluation services for mortgage credit risk and compliance assessments in the area of fair lending, state, and federal regulations

About CliftonLarsonAllen

- A professional services firm with three distinct business lines
  - Accounting and Consulting
  - Outsourcing
  - Wealth Advisory

- 3,600 employees

- Offices coast to coast

- Serve more than 1,100 financial institutions

Speaker Introductions

- **Marissa Aquila Blundell**
  Marissa is a client services director with Bankers Advisory – a CliftonLarsonAllen LLP Division. She serves as a contracts administrator and customer relationship manager. Marissa develops and implements compliance training to clients and serves on the compliance committee and co-chairs the Legislative Committee for the Massachusetts Mortgage Bankers Association.

- **Sarah Lagattolla**
  Sarah is a quality control services director with Bankers Advisory – a CliftonLarsonAllen LLP Division. She manages all quality control analysts and client service managers for post-funding quality control. In addition, she manages the firm's software criteria to comply with secondary market requirements.

Learning Objectives

- Understand Ability To Repay compliance strategies that include originating Qualified Mortgages using the special rules applicable to loans that are eligible for purchase by Fannie Mae or Freddie Mac while under conservatorship of the Federal Housing Finance Agency

- Explore how not adhering to the Government Sponsored Enterprise's underwriting requirements results in losing the transaction's Qualified Mortgage status

- Know how an institution can use its procedures for post-closing quality control to monitor Qualified Mortgage compliance, and understand the components of a robust post-closing quality control program

Ability to Repay (ATR) Rule

Truth-in-Lending Act Section 43

- Creditors are prohibited from making a loan without first determining the consumer has the ability to repay the loan according to its terms

- Determination must be based on the consideration of eight underwriting factors related to repayment ability

- Information relied on for ATR determination must be based on reliable third party records

ATR Determination

"Good faith"

- Based on consideration of minimum required underwriting factors***:***

  1. Income
  2. Employment
  3. Monthly P&I payment
  4. Monthly payment for mortgage related obligations
  5. Monthly payment for simultaneous loans (if any)
  6. Recurring monthly debts
  7. Total Debt to Income Ratio
  8. Credit History

- Standard is meant to be flexible but may increase likelihood of challenges

ATR and Qualified Mortgage (QM)

Compliance with ATR rule may be achieved by originating a QM loan

- *Two levels of legal protection:*
  - Safe Harbor for QM loan that is not higher-priced
  - Rebuttable Presumption of Compliance for QM that is higher-priced

- *Higher-priced QM:*
  - APR exceeds the APOR for a comparable transaction as of the date the interest rate is set 1.5 percentage points for first lien
  - 3.5 percentage point for subordinate liens

General QM Criteria

QMs are transactions satisfying the following six criteria:

1. Regular periodic payments that are substantially equal

2. Loan term ≤ 30 years

3. Total points and fees payable in connection with loan do not exceed established limits *(3% of total loan amount for loans ≥ $100,000)*

4. Monthly payment used for underwriting must be based on maximum interest rate applicable during first 5 years and fully amortizing periodic payments, and monthly payment for mortgage-related obligations must be considered

5. Current or reasonably expected income or assets, other than the value of the security, and the consumer's current debt obligations, alimony, and child support verified in accordance with Appendix Q

6. Ratio of consumer's total monthly debt to total monthly income is ≤ 43%

QM Criteria

Requirement #4 Maximum Interest Rate and Mortgage-related Obligations

- Monthly payment for principal and interest calculated using the ***maximum interest rate*** that may apply during the first five years after the date on which the first regular periodic payment will be due
- Periodic payments of principal and interest that will repay either the loan amount over the loan term, or the outstanding principal balance over the remaining term
- Monthly payment for any mortgage-related obligations

QM Criteria

Requirement #5 Verification of consumers income, assets, and debt obligations

- Consumer's current or reasonably expected income or assets, other than the value of the security, and the consumer's current debt obligations, alimony, and child support must be verified using **Appendix Q** guidelines

Requirement #6 Total monthly debt to total monthly income ratio must be ≤ 43%

- Ratio of total monthly debt to total monthly income is ≤ 43% calculated in accordance with the standards in **Appendix Q,** and using the consumer's monthly payment on the covered transaction, including mortgage-related obligations and any simultaneous loan

QM Special Rules

Eligible Loan QM

- Loans eligible to be purchased or guaranteed by any of the following:
  - Fannie Mae or Freddie Mac (GSEs) while under conservatorship or receivership of FHFA
  - Eligible for FHA Insurance or Rural Housing Service
  - Eligible to be guaranteed by VA or USDA
- Sunsets at the earlier of: effective date of a rule issued by each agency or January 10, 2021

To utilize this special rule loans must be underwritten using the required guidelines of agency or GSE while under conservatorship

Maximum DTI cap of 43% applicable to general QMs does not apply

Eligible Loan QMs

Eligibility may be shown by any of the following:

- Valid recommendation from a GSE Automated Underwriting System (AUS) or an AUS that relies on an agency underwriting tool
- GSE or agency guidelines contained in official manuals
- Written agreements between a GSE or agency and the creditor (or a direct sponsor or aggregator of the creditor)
- Individual loan waivers from a GSE or agency

Eligible Loan QMs

"Wholly Unrelated to Ability to Repay"

- Clarification provided in July 2013 Final Rule
- GSEs and agencies impose a wide variety of requirements relating not only to underwriting potentially eligible loans, but also to mechanics of sale, guarantee, or insurance and post-consummation activities
- Underwing is a complex process that involves assessment of the consumer's ability to repay the loan as well as other credit risk factors, CFPB believed appropriate to base QM-status for "eligible loans" on the GSE's and agencies general standards concerning borrower product and mortgage eligibility and underwriting
- Attempting to disaggregate factors relating more closely the ATR assessment would defeat the purposes of the temporary definition in adopting widely recognized standards to facilitate compliance and access to responsible credit

GSE Underwriting Standards

Fannie Mae Selling Guide – Part B Origination through Closing

- Mortgage Eligibility
- Borrower Eligibility
- Property Eligibility
- Underwriting Borrowers and Properties
- Insurance
- Legal Documents

GSE Underwriting Standards

Fannie Mae Selling Guide – Underwriting Borrowers

- Income Assessment – Employment

  i. Base Pay, Bonus, Overtime
  ii. Commissions
  iii. Secondary Employment
  iv. Verbal VOE
  v. Rental Income

- Income Assessment – Self Employment

  i. Stability and financial strength of the business
  ii. Length of self-employment
  iii. Tax Return analysis
  iv. Treatment of business expense deductions

Monitoring Eligibility

Underwriting Defects Affect Eligibility and QM Status

- 100% of Eligible Loans present risk
- Sampling Characteristics
- Timeliness of reviews and remediation of defects
- Reporting of findings and implementation of remediation efforts
- Setting targets for acceptable level of risk
- Monitoring defect rates

Operational Efficiencies

Established practices for pre- and post-closing Quality Control

- QC Program should establish processes designed to achieve standards for loan quality
  - Identification of deficiencies
  - Implementation of plans to quickly remediate those deficiencies

- Personnel
  - Adequate training and experience
  - Independence

- Standards for Loan Quality
  - Methodology for categorizing loan defects based on severity

QC Timeline

Pre-closing QC

- Performed when there is sufficient documentation to perform the required review of the date and documentation

Post-closing QC

- Sample Selection (30 days)
  - QC sample for January closings completed by end of February
- Review of Files (60 days)
  - QC reviews including rebuttals completed by the end of April
- Final Reporting (30 days)
  - Final reports distributed by the end of May

QC Selection

Pre-closing QC

- Target areas with potential for errors, misrepresentation, or fraud
  - Loans with multiple layer of credit risk, such as high LTV, low credit scores, and/or high DTI ratios
  - Loans with characteristics related to defects identified in prior reviews
  - Loans originated or processed through various business sources or newly hired personnel, or TPOs
  - Loans with complex income calculations

Post-closing QC

- Random 10% Sampling characteristics must be representative of all originations
  - Size
  - Production channels
  - Geographic areas of operation
  - Specialty products/programs

QC Selection

Post-closing QC Selection continued

- Discretionary sampling focused on loans with a higher potential for errors, misrepresentation or fraud
  - Unique underwriting/processing/ appraisal techniques
  - Lender personnel
  - Patters identified in other reviews
  - TPOs
  - Early payment defaults

QC Reporting

Post-closing QC

- Defect rate
- Identification of defects by Branch, Originator, Underwriter, Processer
- Defect rate trending issues
- Include root cause trending by category/subcategory
- Corrective actions

QC Reporting

Target Defect Rate

- Highest severity level assigned to defect which renders loan ineligible for delivery to Fannie Mae
- Set a target and monitor actual defect rate calculated during QC process against target
- Loans with highest level defect and lowest level defect are counted only once in calculation—in the highest severity category
- Sample calculation
  - 10% QC Sample contains 100 loans
  - # of loans with defect rated at highest level (ineligible for delivery) is 5
  - 5% gross Significant defect rate

QC Management Response

Corrective Action

- ✓ Defect
- ✓ Source of finding
- ✓ Root cause
- ✓ Remediation
- ✓ Implementation Date
- ✓ Controls
- ✓ Outcome/resolution
- ✓ Re-test

QC Defects and QM Status

Discover of whether a particular loan failed to satisfy agency or GSE criteria at consummation may be uncovered during QC

- Assume QC determines reported income of $50,000 was not documented and DU would not render Approve/eligible if accurate income figure of $35,000 was used
- Loan was never a QM

Remediation vs Cure

- Currently no 43% “cure” provisions
- Recent confirmation from CFPB permitting cure when 3% QM Points & Fees Limitation has been exceeded

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