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Is Your Quality Assurance Program Ready for a CFPB Exam?

New Rules by the CFPB require all Mortgage Originators to have an effective

Quality Assurance Program

Since the creation of the Consumer Finance Protection Bureau (CFPB) in July 2011, the CFPB has had the authority to regulate non-bank mortgage originators. In January 2012, the CFPB published an update to the Supervision and Examination Manual titled *Mortgage Origination Examination Procedures*. In this update, the CFPB states that the objectives of mortgage originator examinations are to:

1. Assess the quality of a supervised entity's compliance management system in its mortgage origination business.

2. Identify acts or practices that materially increase the risk of violations of federal consumer financial law, and associated harm to consumers, in connection with mortgage origination.

3. Gather facts that help determine whether a supervised entity engages in acts or practices that are likely to violate federal consumer financial law in connection with mortgage origination.

4. Determine, in accordance with CFPB internal consultation requirements, whether a violation of a federal consumer financial law has occurred and whether further supervisory or enforcement actions are appropriate.

In the underwriting section of the examination manual (i.e. module 4), it specifically states that the examiners will "confirm that the lender has an adequate **Quality Assurance Program** both pre-funding and post-closing to detect and correct any violations of its underwriting policies." In others words, all mortgage originators are expected to have a quality assurance program in place. Whether the loans are kept in portfolio or sold in the secondary market, every mortgage originator must establish a quality assurance (QA) function.

Mortgage originators who sell their loans to the GSEs (Freddie and Fannie) and/or originate FHA loans are very familiar with the requirement to have a documented quality assurance program. These GSE/FHA mandated programs typically require ten percent or more of closed loans to be reviewed by an independent group to assess compliance with underwriting policies/guidelines, regulations, and laws.

CFPB has made it very clear that they will be extensively examining non-bank mortgage originators. The CFPB is in the process of completing risk assessments for each mortgage originator for which they have oversight and has begun performing examinations. The risk assessment determines which organizations will be examined first and the scope of the examinations.

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Quality Assurance Requirements

For your organization to have an effective quality assurance program, it should cover credit, collateral, data integrity, and fraud in order to effectively assess the loans' adherence to your underwriting guidelines. Additionally, the program must address the review for compliance with government regulation.

Specifically, the quality assurance review should include the following:

- *Evaluation of the borrower's credit worthiness* – For manually underwritten loans, a determination is made that the underwriter used sound underwriting judgment and followed all applicable guidelines. If underwritten using an automated underwriting system (AUS), the reviewer should validate the integrity of the data submitted and confirm all conditions of the AUS were satisfied.

- *Evaluation of the borrower's income stability and employment* – The monthly income figures should be reviewed to verify that these are adequately supported by the documents in the file. The documentation and calculation of income should be validated (use of part-time income, non-taxable income, etc.). Most importantly, there should be an assessment of the borrower's capacity/ability to pay the mortgage.

- *Determination of whether the borrower's verified funds were sufficient and the sources were properly verified* – It should be determined that the lender properly documented the assets/reserves and the assets/reserves were sufficient to meet the program requirements. The review should also take into account whether any down payment and gift funds were properly sourced.

- *Exceptions and compensating factors* – Each loan should be reviewed to determine if there were exceptions to underwriting policies documented in the file and if so, that the exceptions were approved by an individual with authority. If there are exceptions documented in the file an assessment should be made if compensating factors were present in the file to support the final underwriting decision.

- *Collateral* – The appraisal should be reviewed for risk factors and "red flags" using an appraisal review checklist. This review includes items such as comparables that are not similar to the subject property, comparables that do not bracket the subject in price or location, excessive adjustments, and declining value trends.

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- *Fraud* – File documents should be reviewed for indicators of potential misrepresentation during the origination process, including income, occupancy, identify theft, and straw buyers. A more thorough "outside the file" investigation can be performed if the file appears to reflect any of these fraud indicators. This consists of fraud investigative tools and re-verifications of third party documents.

- *Compliance* – The review should verify adherence to the Real Estate Settlement Procedures Act (RESPA) and its implementing regulation, Regulation X, the Truth in Lending Act (TILA) and its implementing regulation, Regulation Z, and the Equal Credit and Opportunity Act (ECOA) and its implementing regulation, Regulation B. The Good Faith Estimate and HUD-1 Settlement Statement should be reviewed and reconciled.

In addition to the above requirements for the loan review, the quality assurance plan should address sampling methodology, re-verification of borrower information (e.g. assets, income), and reporting.

Quality Assurance Reporting

A critical component of any quality assurance program is management's awareness of and response to the results of the quality assurance review. Quality assurance results should be reported to management through a clear concise set of reports. These reports should cover QA findings at a high level and summarize any trends. A process must be in place to respond to and resolve all QA findings.

Quality assurance reporting also serves as the mechanism for establishing a feedback loop in which the results of the quality assurance review are received by operating personnel and used as the foundation for ongoing process improvements and training.

Timeliness of review and reporting of results is important to establishing a useful feedback mechanism. The best programs perform sample selection shortly after month-end followed by completion of reviews and production of reports within 60 days. Management should respond to the reported results within 30 days of report issuance.

Using a Third-Party Provider

The use of a third-party quality assurance provider results in additional independence and also provides flexibility as monthly volumes rise and fall. Quality assurance firms can also share industry best practices because they service many mortgage originators.

Mortgage originators typically have based selection of their QA firm provider mainly on price (i.e. the lowest cost per file reviewed) and speed of reporting the result of the review. When selecting an outside firm for quality assurance the following should also be considered:

- *Experience* – How long has the firm been in business? How large is the staff? What is the background and experience of firm personnel? Does the firm also bring advisory capabilities?

- *Flexibility* – Can the firm adapt its process and reporting to the client's needs?

- *References* – Which other lenders does the QA firm service?

- *Technology* – Will loan files and borrower information be secure? Does the vendor's system provide sufficient reporting capabilities?

Engaging a third-party quality assurance provider does not remove the mortgage originator's overall responsibility for the QA process. The lender must ensure that work performed by the provider meets the requirements of regulators and investors. The lender should review and monitor the quality of the third party's work.

Examination Findings

While the CFPB has only just begun its examinations of mortgage originators, the following are examples of findings cited in exams by bank regulators, GSEs, and HUD and may be illustrative of findings to be seen in CFPB exams:

- QA plan is not thorough in that it does not indicate all processes performed and the implementation of the plan is not adequately independent.

- Reports do not identify specific findings and/or trending information and do not address management response or actions taken.

- Fees on the binding GFE are not accurately reflected on the final HUD and the fees associated with the loan are not reflected on the binding GFE and/or HUD.

The mortgage industry is a top priority of the Consumer Financial Protection Bureau. By ensuring your institution has implemented a comprehensive quality assurance program, your organization will demonstrate its commitment to fulfilling the requirements of an effective management control.

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