SECONDARY MARKETING EXECUTIVE®

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When Silence Isn't Golden

Lenders need to be aware of problematic borrower behavior during a mortgage's "quiet period."

By Greg Holmes

The time frame known in mortgage lending as the "quiet period" has been generating more than its share of noise lately. Fortunately, new options are available to keep the problems that emerge during this sensitive time from triggering a shouting match at the loan's closing.

Mortgage bankers in today's restrictive underwriting environment must become increasingly vigilant about financial transactions that take place between the original pulling of a credit report and the closing of a mortgage loan. Activity during the quiet period in the mortgage origination process can sometimes be a warning sign of fraud, particularly when an unscrupulous borrower attempts to take out more than one loan on a property in a scam known as "shot gunning."


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Quiet period problems are equally likely to emerge when dealing with honest, everyday borrowers who do not realize they are causing a problem. Borrowers may innocently take on installment debt without realizing the effect of their actions on their debt-to-income (DTI) ratio, potentially jeopardizing the mortgage's approval, the loan officer's commission and the lender's bottom line. Even when their banker carefully explains the risks of additional debt as part of the mortgage application process, oblivious borrowers can easily fall prey to a variety of DTI risks without ever realizing it.

Here are a few examples you may be familiar with:

- An excited borrower celebrates his approved application by buying a couch for his new living room during a "no payments until January" furniture store promotion.
- A borrower decides to fit in a quickie vacation before the hard work of moving day begins and puts all of the travel expenses on his or her credit card.
- A borrower shopping at the cosmetics counter of a local department store is convinced to apply for a store credit card in order to receive a promotional price on a package of skincare products.
- A farmer fills out a mortgage loan application in July. One month later, he follows his annual farm management plan and borrows the money to plant his winter wheat crop.

Today's stricter underwriting standards have transformed borrowing that would once have seemed innocent into an event that sends red flags flying. Examples like those cited above could easily lead to an increase of 3% or more in DTI, a level sufficient for disqualification of an otherwise-acceptable mortgage.

The result is an angry and frustrated borrower who sees this hitch in the mortgage application process as unreasonable. The outcome for the lender could be even more costly: the income lost and time wasted in a failed mortgage loan.

Everybody's doing it

The problem of credit score changes during the quiet period is far more widespread than people in the mortgage banking industry might expect. According to a research project on undisclosed debt performed by Equifax, nearly 20% of all borrowers with a pending mortgage application - one borrower in every five - will apply for at least one new line of credit during their loan's quiet period.

A normal amount of debt fluctuation (including typical credit card purchases) is factored into most credit-scoring algorithms. However, exceeding the norm with a new credit obligation is sufficient to change loan viability levels even for those with solid credit scores and DTI ratios. The Equifax research revealed the surprising fact that undisclosed debt was more common among borrowers with average credit scores than among those with the lowest or highest rankings.

The most recent statistics from Fannie Mae indicate that the incorrect detailing of liabilities is a growing problem despite increased stability in the mortgage market. Twenty-seven percent of all misrepresentations on 2010 mortgages examined by Fannie Mae could be directly attributed to new and unreported liabilities incurred during the quiet period. Misrepresented liabilities doubled to become 46% of all

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misrepresentations in 2011 and 2012.

The DL on LQI

Fannie Mae, Freddie Mac and other players in the secondary mortgage market are understandably concerned about the issue of undisclosed debt. It is not surprising that the Loan Quality Initiative (LQI) recommended by Fannie Mae in 2010 had a strong focus on uncovering undisclosed debt problems in existing loans. Fannie Mae has stated that if "any debts were not adequately disclosed on the application, the mortgage loan will be subject to repurchase by the lender."

This year will bring another significant change in the way Fannie Mae assesses the quality of a residential loan. A brand-new LQI quality-control model will soon be instituted that shifts the focus away from reviewing loans in default, placing greater attention on a loan's health at the time it is sold into the secondary market.

Mortgage originators can expect that a much larger sampling of future loans will be subjected to a rigorous quality-control process aimed at uncovering undisclosed debt. This change also makes it likely that mortgages with substantial undisclosed debt will trigger a buyback request, exposing lenders to significant financial risk.

Heightened LQI standards mean that repurchase demands from Fannie Mae, Freddie Mac and other mortgage investors were once a problem only for large nationwide banks. Today, repurchase demands are increasingly common among midsize and smaller mortgage lenders. A secondary market still overcrowded with subpar loans is tightening the screws on loan quality. The potential for repurchasing requests is a major worry for everyone in the industry, which moves an issue like undisclosed liabilities to the front burner for mortgage bankers and loan officers of all sizes.

A mortgage banker without a plan in place for uncovering undisclosed debt is risking serious financial fallout. Unfortunately, the most common remedy for the situation creates problems of its own. Fannie Mae's LQI policies have prompted mortgage bankers to protect themselves against the risk of undisclosed debt by pulling a second credit report in time for the closing date.

Newly discovered debt that increases the borrower's DTI by more than 3% can allow the lender to take action to avoid the potential for fraud or a repurchase request. This scenario leaves the lender no choice but to rescind the loan or postpone the long-awaited closing to a later date, risking an angry response from the borrower and leaving no time to discuss remedies.

The possibility of a last-minute credit check, extra closing expenses and procedural delays are bound to drive normally stressed-out borrowers even crazier in the busy hours before closing day. Postponements and hiccups also reflect poorly on the professionalism of lenders or loan officers, discrediting them in the eyes of Realtors, lawyers and other industry professionals who might otherwise be sources of referrals.

It is tempting to solve the problem by pulling a credit report well in advance of the closing date, but this approach creates problems of its own. Advanced ordering could mean easier closing, but it also gives "shot gunning" operators an extra window of time to set up fraudulent loans. Dishonest borrowers may also be able to incur new debt without being detected.

Most borrowers do not get very excited about a staid, routine mortgage closing. Smooth, uneventful closings are far more satisfying when you sit on the lender's side of the conference table. But there is one thing on which both sides agree: Last-minute complications caused by undisclosed debt are best left out of the room. SME

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