

Desktop Originator/Desktop Underwriter Release Notes

Version 7.0

March 31, 2008

During the **weekend of May 31, 2008**, Fannie Mae will implement Desktop Underwriter® (DU®) Version 7.0. This release will include a number of changes to DU's credit risk assessment and eligibility requirements. In addition, this release will support the policy changes described in Announcement 08-08 and in Lender Letter 06-07, and will include several other changes as described below. For details on the policy changes, refer to the referenced Announcement and Lender Letter.

The changes included in this release will apply to new loan casefiles submitted to DU on or after the weekend of **May 31, 2008**. Loan casefiles created in DU Version 5.7 and resubmitted after the weekend of May 31 will continue to be underwritten through DU Version 5.7.

Changes to DU's Credit Risk Assessment

As part of normal business operations, Fannie Mae regularly reviews DU to ensure its capacity to analyze risk is constantly fine-tuned based on new data and loan performance information. As a result of recent and extensive reviews of DU, and in light of continued deterioration in the housing market, DU Version 7.0 will include a comprehensive update to DU's credit risk assessment. With this release, DU will:

- Continue to analyze each loan casefile using validated, statistically significant variables that have been shown to be predictive of mortgage default; and
- No longer consider the existence of mortgage insurance as a mitigating risk factor when evaluating higher-LTV loans, most notably for the purchase of a one-unit property that will be the borrower's principal residence.

These changes are intended to help Fannie Mae's customers better manage default risk; underwrite to current market realities; and provide reasonable, prudent, and sustainable homeownership options to borrowers.

Details of the changes to the specific risk factors used by DU appear in Appendix A, later in this document.

Below are some of the changes customers should expect to see:

- Improved credit quality across all DU recommendation levels, especially for Expanded Approval® (EA) recommendations.
- Some loan casefiles will receive more conservative recommendations, while others may receive improved recommendations when compared to similar loan casefiles submitted to DU Version 5.7.
- Reduced Approve and/or EA recommendation rates, although the overall impact will vary depending on the mix of business the customer submits to DU.

Desktop Originator, Desktop Underwriter, DO, and DU are registered trademarks of Fannie Mae.

Consideration of Authorized User Accounts

As stated in Announcement 08-08, DU Version 7.0 will not take into consideration credit report tradelines in which the applicant has been designated as an “authorized user.” If the mortgage loan falls into the instance stated in Announcement 08-08 where the lender has information available that an applicant is an authorized user on a spouse’s credit report tradeline, and that spouse is not an applicant in the mortgage transaction, the lender must manually underwrite the mortgage loan in order to ensure such “authorized user” tradelines are taken into consideration in its underwriting decision.

Delivery Eligibility Updates

Total Expense Ratio

With this release, the maximum allowable total expense ratio in DU will be updated to take into account certain risk factors contained within the loan casefile. In general, the updates to the maximum allowable total expense ratio in DU Version 7.0 will be more conservative than in previous versions of DU.

If current debts exceed the maximum allowable total expense ratio, loan casefiles that would have otherwise received an Approve recommendation will receive a Refer recommendation, and loan casefiles that receive a recommendation other than Approve or Refer will receive an Ineligible recommendation.

Minimum Credit Score Requirements

As stated in Announcement 08-08, Fannie Mae is establishing a minimum “representative” credit score of 580 for all loans delivered to Fannie Mae that are underwritten through DU Version 7.0. Although DU does not use credit scores in its risk assessment, loan casefiles submitted to DU Version 7.0 with a “representative” credit score below 580 will receive an Ineligible recommendation.

Note: The term “representative” credit score is defined in the Fannie Mae Selling Guide. Refer to the Fannie Mae Selling Guide for additional information.

Adequacy of Funds

DU will no longer issue a Refer recommendation for a loan casefile due to insufficient funds to close. However, if at any time the borrowers’ funds are less than those required, DU will issue a message stating that the required funds must be obtained from eligible sources and must be qualified and verified prior to closing.

Mortgage Delinquencies

Loan casefiles in which the borrower’s credit report contains a mortgage tradeline that was reported within the last six months, and was 60 or more days past due when the account was last reported, will receive a Refer with Caution/IV recommendation. However, if the mortgage tradeline was not 60 days or more past due when the account was last reported, but has been 60 days or more past due in the last 12 months, the loan casefile will receive an Ineligible recommendation.

Foreclosures

As stated in Announcement 08-08, Fannie Mae is modifying its policy on prior foreclosures. If a foreclosure was reported within five years of the credit report date, the loan casefile will receive a Refer with Caution/IV recommendation.

DU will no longer issue a Refer recommendation when the date of a foreclosure cannot be determined. However, DU will issue a message stating that if the foreclosure was filed within the last five years and has not been satisfied, the loan is not eligible for delivery to Fannie Mae.

Bankruptcies

DU will no longer issue a Refer recommendation when the date of a bankruptcy cannot be determined. However, DU will issue a message stating that if the bankruptcy was filed within the last 24 months the loan is not eligible for delivery to Fannie Mae. In addition, if the bankruptcy is not fully discharged, the loan is not eligible for delivery to Fannie Mae.

Expanded Approval Enhancements

As stated in Announcement 08-08, DU Version 7.0 will include a number of eligibility updates that will apply to loan casefiles that receive an EA recommendation in DU.

Eligibility Expansion

With this release, the following additional transactions will be eligible for delivery to Fannie Mae across all EA recommendation levels (EA-I, EA-II, and EA-III):

- MyCommunityMortgage[®]
- Manufactured housing
- Flexible mortgages with CLTVs up to 100%
- Mortgage loans with CLTVs up to 105% with an eligible Community Seconds[®] mortgage
- 30-year fixed-rate interest-only mortgages (10-year IO period only)
- 5/1 interest-only ARMs with 2/2/5 caps and 10-year IO period (ARM plans 3515 and 3516)
- Three- and four-unit properties
- Cash-out refinance transactions on two-unit primary residences
- Cash-out refinance transactions on second homes
- Cash-out refinance transactions on investment properties
- Investment properties with LTVs over 80%

The following transactions will remain ineligible for delivery to Fannie Mae with any EA recommendation:

- Balloons
- 6-month ARMs, 1-year ARMs, 3-year ARMs , and 5/1 ARMs with 5/2/5 caps
- Fixed-rate interest-only loans with terms other than 30 years
- Interest-only ARMs other than 5/1 ARM plans 3515 and 3516
- Financed mortgage insurance
- “Reduced” or “Lower Cost” MI options

The following transactions will remain ineligible for delivery to Fannie Mae with an EA-III recommendation:

- HomeStyle[®] Renovation mortgages
- Loan purpose of Construction

All loan casefiles with Refer with Caution/IV recommendations will continue to be ineligible for delivery to Fannie Mae.

Retirement of Expanded Approval with Timely Payments Rewards Feature

As stated in Announcement 08-08, the Timely Payment Rewards[®] (TPR) feature will be retired and will not be available on loan casefiles that are underwritten through DU Version 7.0.

Special Feature Codes for Delivery

As stated in Announcement 08-08, the following additions and modifications will be made to those special feature codes (SFCs) required when delivering specific mortgage loans to Fannie Mae that are underwritten through DU Version 7.0.

Note: Please refer to Announcement 08-08 for specific delivery instructions for loans underwritten through DU Version 5.7.

Expanded Approval

The three special feature codes (SFCs) that are currently used for delivery of mortgage loans that receive EA recommendations (SFCs 340, 341, and 342) will be replaced by a single new SFC, 716, for the delivery of loan casefiles that receive an EA recommendation through DU Version 7.0.

MyCommunityMortgage

A new SFC, 612, will be required on MyCommunityMortgage (MCM[®]) loan casefiles that were underwritten through DU Version 7.0. This SFC will supplement the SFCs currently required for delivery of MCM mortgage loan that are used to identify the unique MCM product.

Flexible Mortgages

The Flexible mortgage SFCs will not be required on Flexible mortgages delivered to Fannie Mae that received an EA recommendation through DU Version 7.0; however, these mortgage loans will be subject to pricing associated with EA pricing as defined in the Loan Level Price Adjustment Matrix in Announcement 08-08. With DU Version 7.0, DU will no longer issue SFC 446 (Flexible Mortgage with Subordinate Financing) on EA recommendations.

Updated Resubmission Policy

The *Guide to Underwriting with DU* currently lists tolerances under which a resubmission is not required. This policy will be updated to state that only one of these tolerances may be used on any loan casefile. If the loan casefile contains more than one of the tolerances covered under the resubmission policy, all of the items in the loan casefile must be updated and resubmitted to DU.

Expiration of Disaster Relief Flexibilities for Hurricanes Katrina and Rita

As stated in Lender Letter 06-07, the disaster relief flexibilities that DU applies to loan casefiles that were impacted by hurricanes Katrina and Rita will expire on June 30, 2008. DU Version 5.7 loan casefiles identified as impacted by hurricanes Katrina or Rita that are submitted or resubmitted on or after July 1, 2008 will no longer receive the credit flexibilities that were previously applied by DU.

Loan casefiles submitted to DU Version 7.0 will not receive the credit flexibilities that were applied by previous versions of DU.

Additional Changes

ARMs with Negative Amortization

DU will no longer assess the risk of negatively amortizing adjustable-rate mortgages. These loan casefiles will receive an Out of Scope recommendation.

Amortization Terms Longer Than 40 years

DU will no longer assess the risk of loan casefiles with amortization terms that are longer than 40 years. These loan casefiles will receive an Out of Scope recommendation.

Retiring DU Version 5.6

When DU Version 7.0 is implemented, DU Version 5.6, which went into production in August 2006, will be retired. Therefore, effective the weekend of May 31, 2008, customers will no longer be able to resubmit loan casefiles to Version 5.6; however, users can view the online loan applications and the DU Underwriting Findings reports that were created under Version 5.6. To obtain an updated underwriting recommendation, the user must create a new loan casefile and submit it to DU.

For More Information

For more information about the Announcement and Lender Letter referenced in these Release Notes, lenders may contact their Fannie Mae customer account team; mortgage brokers should contact their DO sponsoring wholesale lenders.

Updates to the *Guide to Underwriting with DU* are anticipated in the summer. For information about upcoming training opportunities, refer to the Training & Education area on eFannieMae.com.

Appendix A: Comparison of Risk Factors Evaluated by DU Versions 5.7 and 7.0

Risk Factor	How Factor is Viewed in DU Version 5.7	Change with DU Version 7.0
Credit history	<p>A borrower's credit history is an account of how well the borrower has handled credit, both now and in the past. An older, established history—even though the accounts may have zero balances—will have a more positive impact on the borrower's credit profile than newly established accounts.</p> <p>A borrower who has a relatively new credit history (a few recently opened accounts) is not automatically considered a high credit risk. Making payments as agreed on newly established accounts signifies lower risk than not making payments as agreed.</p>	No change.
Delinquent Accounts	<p>Payment history is a significant factor in the evaluation of the borrower's credit. DU considers the severity of the delinquencies (30, 60, 90, or more days late), the length of time since the delinquencies, the number of accounts that were not paid as agreed, and the type of accounts with delinquencies.</p> <p>A payment history that includes bills that are 30 days or more past-due, or a history of paying bills late as evidenced by a number of accounts with late payments, will have a negative impact on the borrower's credit profile. A history of paying a mortgage loan late will have an even more negative impact on the credit profile. The amount of time that has elapsed since an account was delinquent is an important factor included in the evaluation of the payment history. For example, a 30-day late payment that is less than three months old indicates a higher risk than a 30-day late payment that occurred several years ago.</p>	No change.

Risk Factor	How Factor is Viewed in DU Version 5.7	Change with DU Version 7.0
Mortgage accounts	<p>Research has shown that borrowers who have no history of mortgage obligations represent a higher risk than borrowers who have had mortgage obligations. In addition, the relationship between the original mortgage balance and the current unpaid balance has proven to be an indicator of risk. The lower the percentage of principal that has been paid down on the mortgage, the higher the risk. The length of time since a delinquency (if any) has occurred, the severity of delinquency, and the age of the mortgage accounts are also factored into the credit analysis.</p>	No change.
Revolving credit utilization	<p>The establishment, use, and amount of revolving credit a borrower has available are important. Generally, the lower the balances are on revolving credit as a percentage of the credit limit, the lower the risk. A borrower whose revolving credit utilization is high is considered a greater risk than someone who has a history of managing his or her credit card accounts more conservatively.</p>	No change.
Public records, foreclosures, and collection accounts	<p>A credit history that includes any significant derogatory credit event that was reported as a public record, such as bankruptcy filings, foreclosures, deeds-in-lieu of foreclosure, judgments, tax liens, or accounts that have been turned over to a collection agency, is considered a high risk.</p> <p>The more recently such events occurred, the more adverse the impact is on the credit profile. Although most public record information is retained in the credit history for seven years (ten years for bankruptcies), as time passes, it does become less significant to DU's credit evaluation.</p>	No change.

Risk Factor	How Factor is Viewed in DU Version 5.7	Change with DU Version 7.0
Inquiries	<p>DU evaluates inquiries made within the most recent six months of the credit report date. Historically, a high number of inquiries can indicate a higher degree of risk. However, multiple inquiries made by several creditors within a short time frame because a borrower was attempting to obtain the most favorable loan rate or terms generally do not indicate higher risk and are not considered as such in the credit evaluation. Borrowers who have frequently applied for, or obtained, new or additional credit represent a higher risk.</p>	No change.
Borrower's equity and LTV	<p>The amount of equity in the property is a very important component of the risk analysis. Research has shown that a borrower who makes a large down payment or who has considerable equity in his or her property is less likely to default on a mortgage loan than a borrower who makes a small down payment or has a small amount of equity in a property. In other words, the more equity a borrower has in the property, the lower the risk associated with the borrower's mortgage loan.</p> <p>DU may use a low LTV ratio to offset other risks that it may identify in the loan application.</p> <p>Furthermore, DU considers the existence of mortgage insurance as a mitigating risk factor when evaluating higher LTV loans (greater than 85%), most notably for the purchase of a one-unit property that will be the borrower's principal residence.</p>	DU will continue to use the LTV and CLTV in its risk assessment; however, the existence of mortgage insurance will no longer be considered a mitigating factor.

Risk Factor	How Factor is Viewed in DU Version 5.7	Change with DU Version 7.0
Liquid reserves	<p>Liquid reserves are those financial assets that are available to a borrower after a loan closes. Reserves are calculated as the total amount of liquid assets remaining after the loan transaction closes divided by the proposed monthly housing expense.</p> <p>DU considers higher amounts of liquid reserves as more favorable than lower amounts or no reserves. Research has shown that mortgages to borrowers with higher amounts of liquid reserves tend to have lower default rates. As with a low LTV ratio, DU may consider high amounts of reserves as an offset for other risks that it may identify in the loan application.</p>	No change.
Loan purpose	<p>There is a certain level of risk associated with every transaction, whether it is a purchase or a refinance. In general, a purchase transaction represents less risk than a refinance transaction.</p> <p>In its evaluation of refinances, DU analyzes the increase in the new loan amount from the unpaid principal balance (UPB) of the first mortgage that is being refinanced. The increase in the new loan amount may be the result of equity taken out of the property (cash to the borrower), the financing of closing costs and prepaid fees, or the payoff of subordinate liens. As the loan amount increases as a percentage of the existing UPB, the level of risk increases.</p> <p>In addition, Fannie Mae's historical default experience indicates that the level of default risk is even greater for higher LTV refinance mortgages relative to higher LTV purchase transactions when all other risk factors are held constant.</p>	<p>Purchase transactions continue to represent less risk than refinance transactions. When evaluating refinance transactions, a limited cash-out refinance transaction represents less risk than a cash-out refinance transaction, and lower LTV/CLTV refinance transactions will be viewed as representing less risk than higher LTV/CLTV refinance transactions.</p> <p>DU will no longer analyze the UPB increase when assessing the risk of a refinance transaction, but will use the purpose of refinance entered on the loan application, when the loan purpose is refinance.</p> <p>On construction-to-permanent transactions, DU will continue to determine the purpose of refinance based on the amount of cash the borrower is receiving at closing.</p>

Risk Factor	How Factor is Viewed in DU Version 5.7	Change with DU Version 7.0
Loan term	<p>Research has shown that mortgages to borrowers who <i>choose</i> to finance their mortgages over shorter terms and build up equity in their properties faster generally tend to perform better than mortgages with longer amortization periods. This is true particularly at lower LTVs. As a result, DU considers the loan term in combination with the LTV in its evaluation. Shorter-term mortgages at low LTVs represent lower default risk than short-term mortgages at high LTVs. In addition, shorter-term mortgages at low LTVs represent lower default risk than long-term mortgages at any LTV.</p>	<p>DU will continue to use the amortization term of the loan in its risk assessment for fixed rate mortgages, but will no longer look at the loan term in combination with LTV.</p>
Loan type/ amortization type	<p>Research has shown that there is a difference in loan performance based on the manner in which the mortgage amortizes. Fully amortizing fixed-rate mortgages and fixed-period ARMs (3-, 5-, 7-, and 10-year ARMs) represent the least amount of risk. Balloon mortgages and interest-only mortgages represent additional risk. Of moderate risk are six-month and one-year ARMs. Finally, negatively amortizing ARMs (or those that contain the potential for negative amortization) represent the greatest risk of all amortization types.</p>	<p>The level of risk associated with each amortization type is as follows, starting with those loan types representing the least amount of risk:</p> <ul style="list-style-type: none"> • Fully amortizing fixed-rate mortgages; • Fully amortizing five-year, seven-year, and ten-year adjustable-rate mortgages; • Six-month, one-year, and three-year ARMs as well as fixed-rate interest-only mortgages; and • Interest-only ARMs and balloon mortgages.
Occupancy type	<p>Performance statistics on investor loans are notably worse than those of owner-occupied or second home loans, especially at higher LTVs. Therefore, DU will assign a higher level of risk to all investment property transactions.</p>	<p>No change.</p>
Total expense ratio	<p>In DU's evaluation, generally, the lower the borrower's total expense ratio, the lower the associated risk. As the ratio increases, the level of risk also tends to increase; and a high ratio will have the greatest adverse impact on the recommendation when there are also other high-risk factors present.</p>	<p>No change.</p>

Risk Factor	How Factor is Viewed in DU Version 5.7	Change with DU Version 7.0
Property type	<p>Another important factor that DU considers in the risk analysis is the collateral or property type. DU currently differentiates the risk based on the number of units, and in some cases the property type (e.g., manufactured home and cooperative properties). One-unit properties that are not in a cooperative project represent the least risk; two-unit properties and units in cooperative projects represent increased risk; and manufactured homes and three- and four-unit properties have significantly increased risk.</p>	<p>The level of risk associated with each property type is as follows, starting with those property types representing the least amount of risk:</p> <ul style="list-style-type: none"> • One-unit properties that are not in a cooperative project and are not attached condominiums; • Attached condominiums, units in cooperative projects, and two-unit properties; • Three- and four-unit properties; and • Manufactured homes, including those in a condominium or cooperative project.
Co-borrowers	<p>DU considers the number of borrowers (who have traditional credit) on a mortgage application in its evaluation because, generally, the presence of more than one borrower with traditional credit helps to reduce risk. Research has shown that mortgages that have more than one borrower tend to have a lower default rate than mortgages with one borrower. However, additional borrowers tend to reduce risk only when they have good credit histories.</p>	<p>No change.</p>
Self-employment	<p>Self-employment introduces an additional layer of risk to a mortgage loan application that is not present with salaried borrowers. Research has shown that self-employed borrowers tend to default on their mortgages more often than salaried borrowers, when all other risk factors are held constant.</p> <p>DU takes this additional risk into consideration in its overall evaluation. However, this additional risk is generally considered adverse only when a self-employed borrower has other risk factors associated with his or her loan that are considered higher risk.</p>	<p>Self-employment will no longer be a risk factor with DU Version 7.0.</p>