MORTGAGE QC AUDIT TRENDS AND OBSERVATIONS

2025 YEAR END

Ed's perspective:

Welcome to the New KLR QC Trend Report! The big difference in the new report is the data, it now comes from multiple Review Management/QC systems with the audit completed by an objective and quality driven auditor- All data and results are independent QC Auditor based. You will see some differences in the defect percentages, however, all are net of rebuttal and lender specific rule normalization. The result is a truly independent defect report across Pre-fund and Post Close production from all types of lenders and loan programs. The data is broken down appropriately for your analysis and benchmarking across loan programs and FNMA defect categories. I truly hope this report is helpful….. If there are any aspects that would improve it's value, please send me feedback directly; ehunter@theklrgroup.com, and we will try to incorporate into future editions. The news letter will be quarterly and due to Post Close audit processes, rebuttals and defect validation, the data will be 1 quarter in arears.

While this is a year end summary report for 2025 I do want to address the combined Critical Defect trend from a macro level last year trending down then Q4 took a sharp upward trend driven primarily by an increase across 3 categories: Eligibility; Liabilities and a distinct rise in Compliance. Combine this with the lower volume industry wide and I think this is an effect of reaching for volume. As always Income and Employment are a top 2 defect category. Liabilities is broad but we did see a concentration in Undisclosed Debt (new debt not run through AUS) and Credit Reverification.

From KLR's perspective the results have focused us on going beyond the direct audit black/white and into redflag identification as well as fraud identification in the reverification process- we continue to fine tune reverifications around VOE/I with direct contact and on-line searches. We do see more Informational category findings as a result- no clear defect but the results just don't add up sometimes and we are able to help lenders target underwriting best practice improvement.

I dislike using the "F" word but Fraud has been an issue, coming from both the LO (yes) and Applicant/Borrower arenas- primarily focused on Income and Debt. We do find ourselves searching State/County/Local data sources more often. If you have experienced this you are not alone.

Best - Ed

President, The KLR Group

KLR Morgage QC Trends Report represents an analysis of nationwide quality control findings based on data derived from KLR Analytics benchmarking software.

2025 SUMMARY

2025 was a year that saw the aggregate Critical Defect rate begin the year at 3.79%, fall to 1.85% then move back up to 3.91%. We will be trending this as we publish each quarter results in 2026. As mentioned, the leading category is Loan Documentation at 25% of the total defects, followed by Employment/Income at 21.48% of the total defects. There were no specific standout issues, they ran the table of defect type.

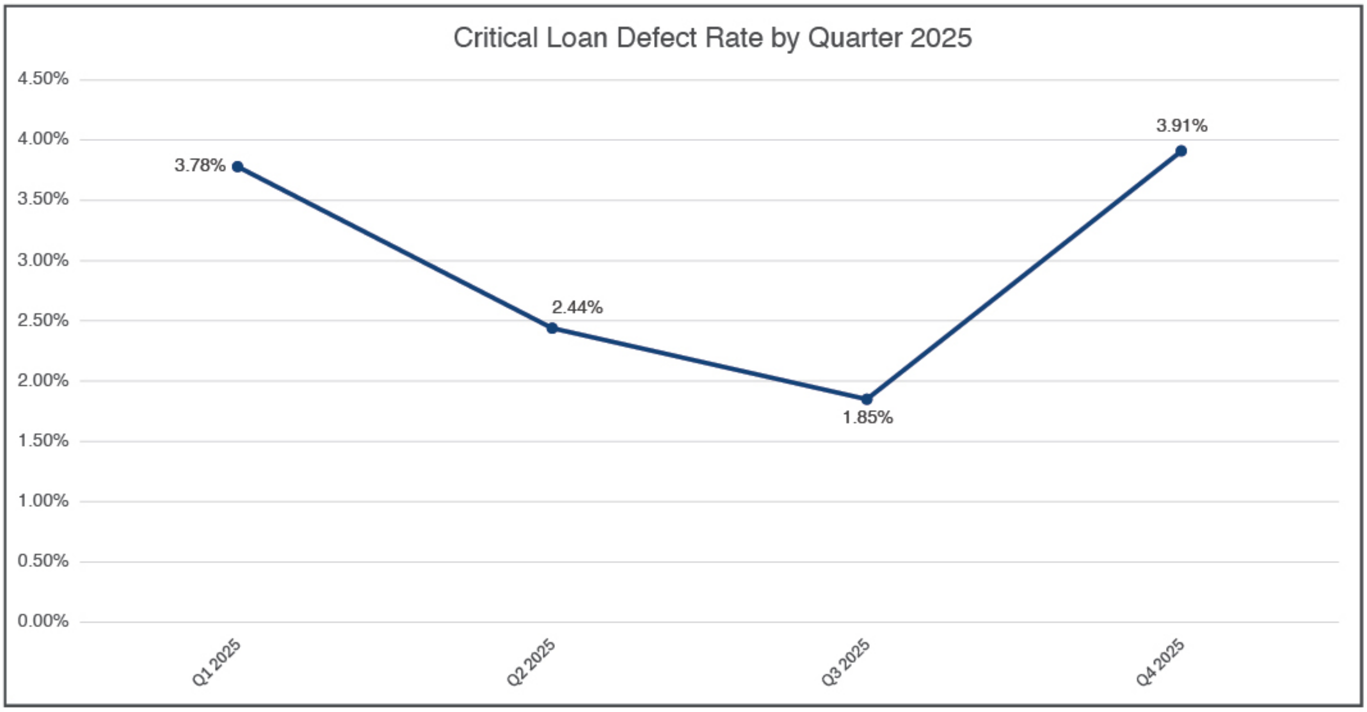
FROM THE FRONT LINE

Kelley Cooper Spencer, SVP Operations:

Through the daily interaction with origination teams, QC teams and our audit staff, we acquire a lot of information that isn't as easy to graph- here are some observations based on the various meetings, rebuttals and deep dives into specific findings:

- Income and earnings have become very creative, unreasonable increases in multiple jobs (part time jobs to supplement full time employment, more job hopping, significantly increasing pay with each change)
- Increase in 2nd liens & HELOCs to give borrowers more disposable funds
- Increase in verification portals/providers- simply discerning where and how to reverify has become a process (assets, income & employment) - not to mention the escalating costs
- We are seeing elevated DTI's which result in an increase in manual underwrites
- Decrease in interest rates from January to December has given a small bump in volume
- Alternative financing increased: NonQM, DCSR, Portfolio; which allows more alternative documentation and drives client specific audit parameters

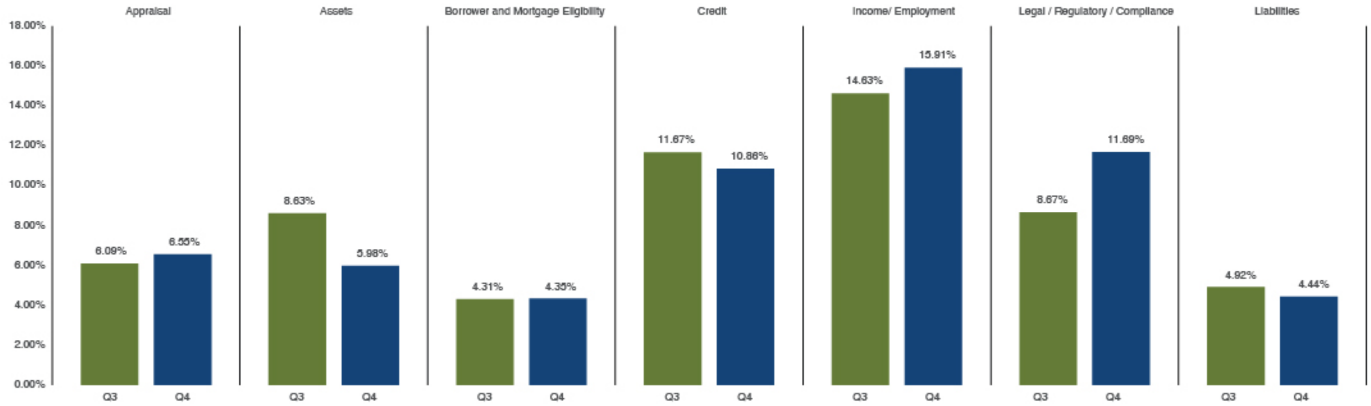
CRITICAL DEFECT RATE 2025 BY QUARTER



The graphic illustrates the increase in defects Q3 to Q4 - certainly in part due to the challenges with volume weighing in as the pipelines diminished and the effort to source loans expanded in Q4.

CRITICAL DEFECTS Q3 vs Q4 2025

Critical Defects by Fannie Mae Category: Q3 2025 vs. Q4 2025



The changes Q3 to Q4 across FNMA category relate directly to the challenges in documenting compliance as alternative programs increase in volume and closing deadlines loom. The graph above details changes from Q3 to Q4:

CRITICAL DEFECTS:

This report will focus on the top defects only. Defined as categories with greater than a 2% share of the total. Categories with negligible percentages include:

- Insurance
- Property Eligibility
- Title/Lien
- Loan Docs
- Project Eligibility
- Property Data Collection
- Value Acceptance
- Client Overlays

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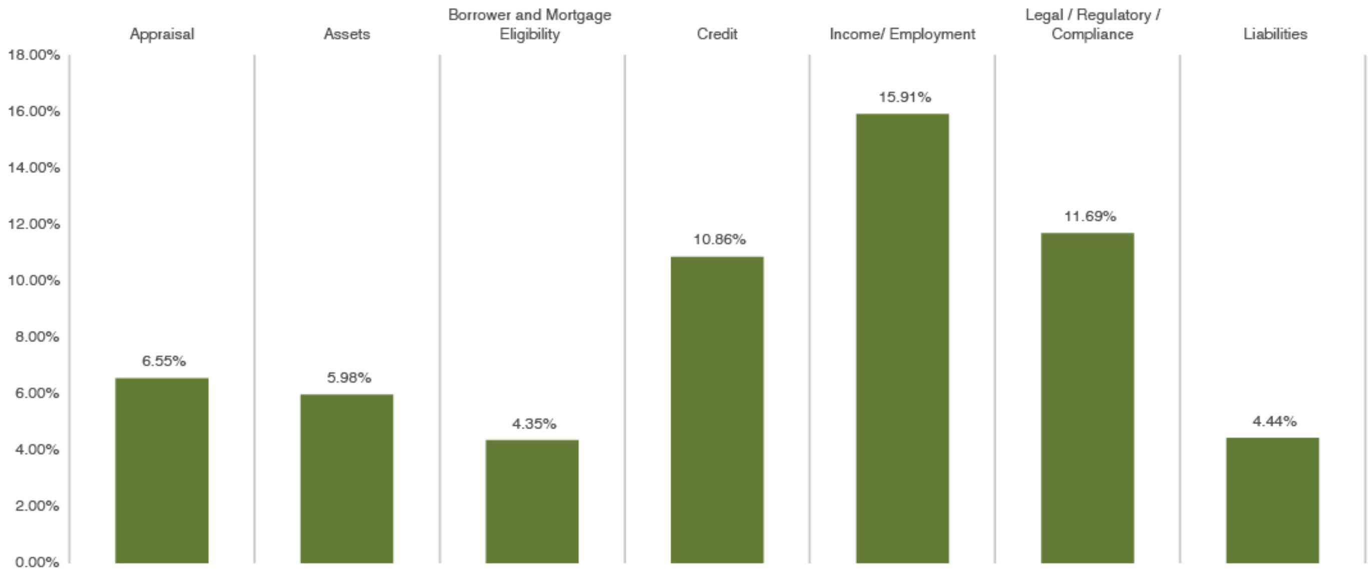
CRITICAL DEFECTS BY TOP FANNIE MAE CATEGORY: Q4 2025



This represents a total of 60% of all defects. The remainder 40% is spread evenly across miscellaneous areas, significantly below 2%.

Q4 2025 NOTABLE CRITICAL DEFECTS

This graph indicates the Q4 critical defects represented by the top 7 sub-categories by defect percentage. A bit more granularity on where we see the most defects.

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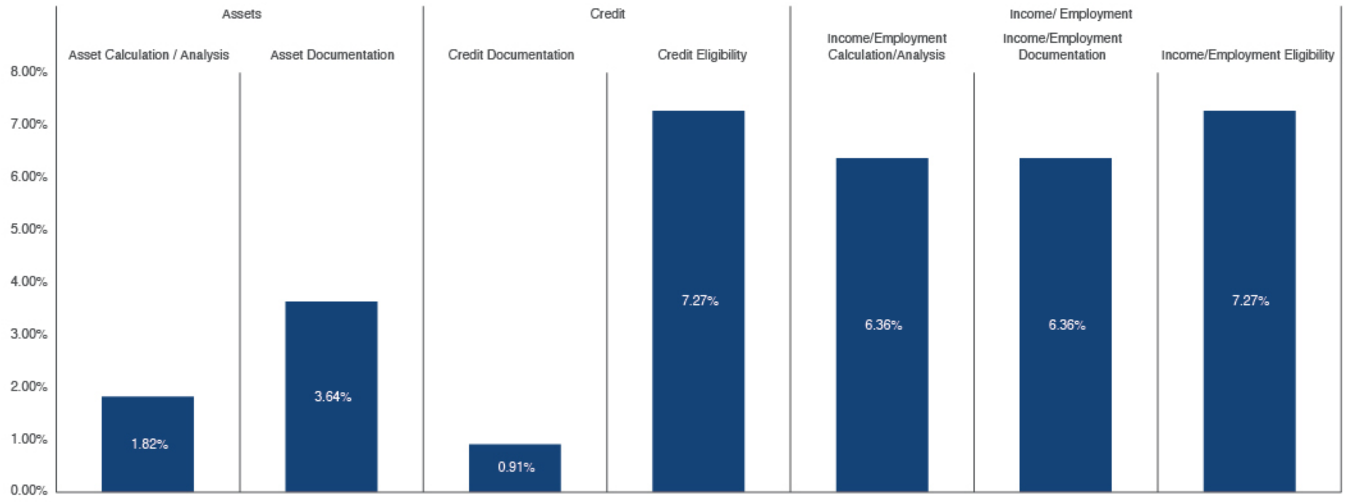
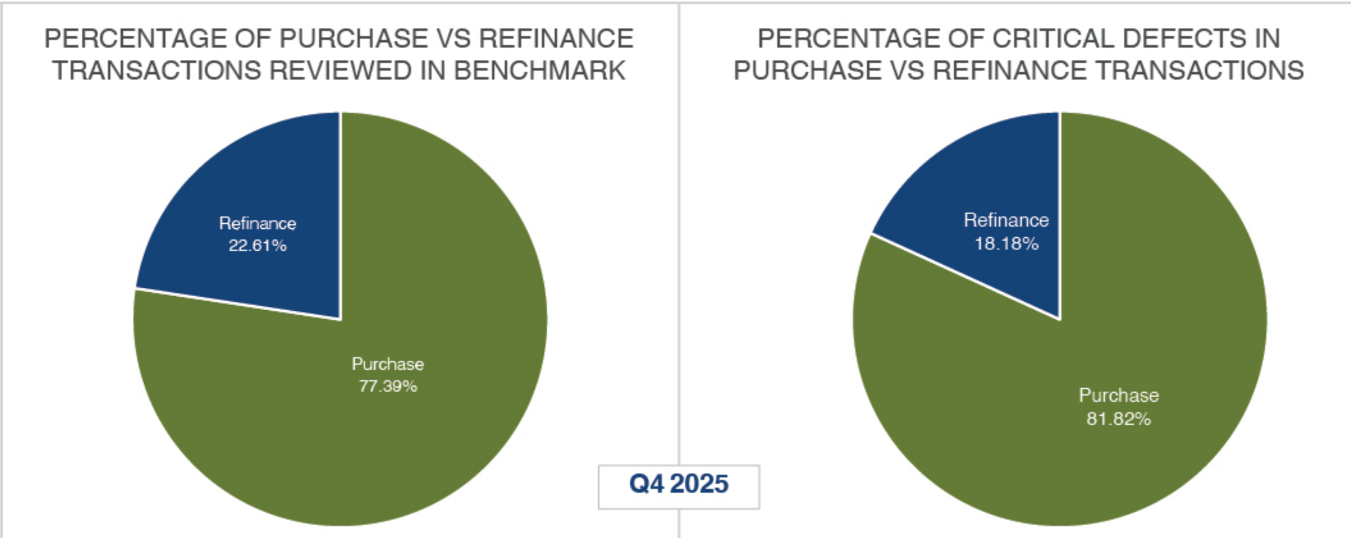
NOTABLE CRITICAL DEFECTS BY FNMA WITHIN ASSETS, CREDIT AND INCOME EMPLOYMENT: Q4 2025



Defects as a Percentage of the Total Sub-Categories

When we breakdown down the critical defects by FNMA sub-categories: General Eligibility, Liability and Federal Compliance made up the majority for a total of 46% combined and all other categories not eclipsing 10% individually. Benchmarking via granular measures is helpful to ID specific areas for improvement in both work-flow and best practices.

PERCENTAGE OF CRITICAL DEFECTS BY LOAN PURPOSE CALENDAR YEAR 2025



Total loans audited as a percentage were 22.6% Refi and 77.4% Purchase with the total percentage of critical defects following closely- Refi had 18% of the critical defects and Purchase had 82% of the total critical defects. We do not see a distinct difference in total quality and audited defects between Refi and Purchase at this point.

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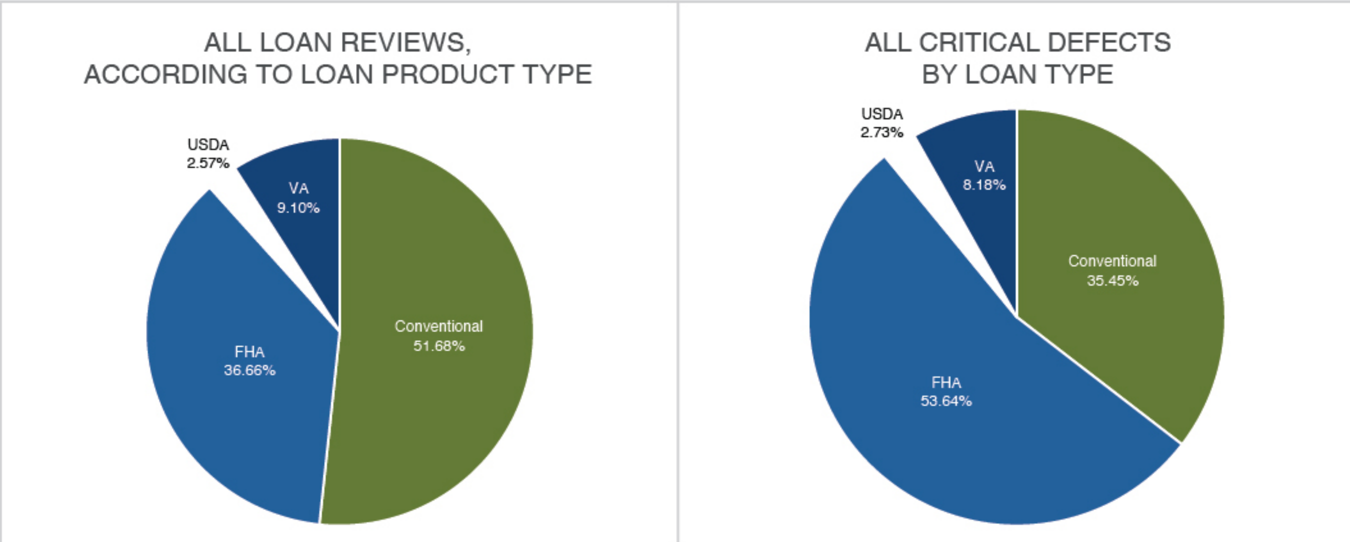
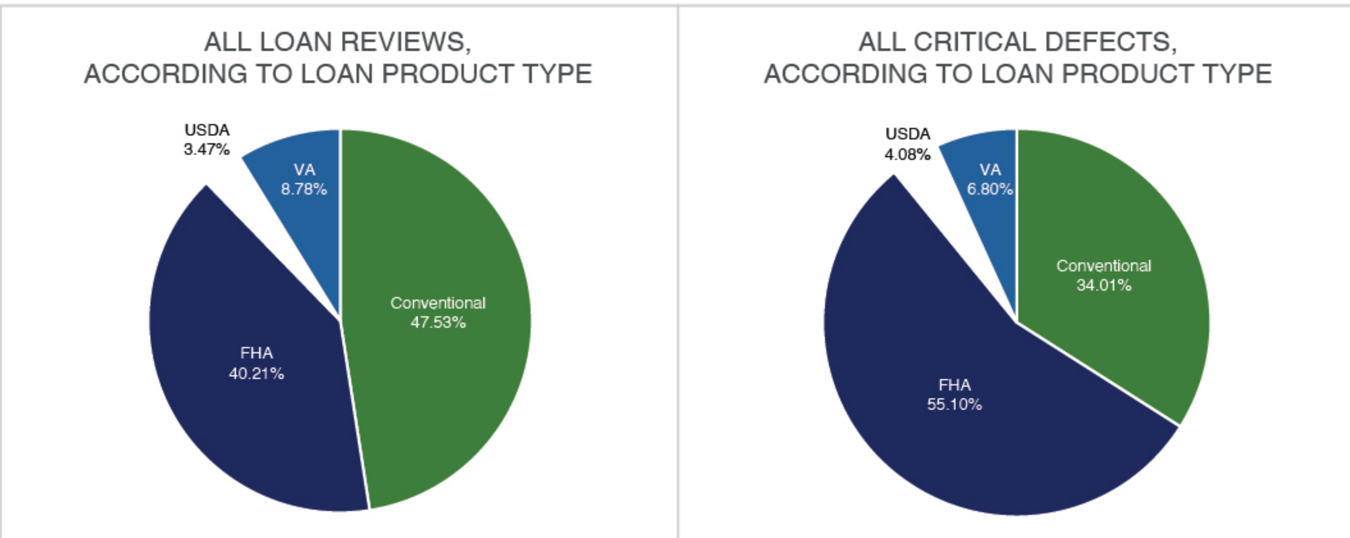
Q4 2025 CRITICAL DEFECTS BY LOAN PROGRAM



Loan Program defects followed expectations of VA and FHA having a higher critical defect rate than the sample percentage and Conventional having the higher sampling rate but lower defect rate.

CY 2025 CRITICAL DEFECTS BY LOAN PROGRAM



The full year in 2025 of defects by loan program type skewed a bit – by volume Conventional was 47.53% but 34% of the critical defects and FHA volume at 40.21% delivering over 56% of the total critical defects.

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TPO EFFECT ON QUALITY

We have seen an increase in TPO volume from last year of 10-15% and actually one client moving to 100% TPO as they exited all other channels. We have just started to track the TPO QC trending, look for some detail starting in the next edition. However, with confidence, we do observe more challenging loan files in the TPO arena, increased red flag scenarios in particular, primarily around Income/Employment.

ECONOMY

There are 2 primary drivers right now (not a revelation!) the Iran war and interest rates. Thrown into that mix is also housing availability and the potential to use Crypto as collateral ("certainly not going to be a problem").

2025 Selected tidbits:

- Non-Agency Jumbo loans increased 40% year over year
- FNMA share of MBS fell to a 10 year low of 24%
- As of Sept 2025 there were 10.5 million 1 st lien loans originated
- Yearly total originated was $1.75 trillion
- Q3-2023 to Q3-2025 saw a steady decline in origination volume each quarter moving from approximately 12m loans to the 10.5m

Surveying all the experts as they pontificate, where interest rates go, how long the war will affect the economy, inflation and the government actions to create a more liquid housing market, the comments run the full range.

The QC effect will be a focus on discretionary and targeted sampling to put a focus on underwriting improvement targets and increased risk management. The auditing going beyond the "check list" to cover red flag and higher risk territory.

FNMA UPDATE FROM APRIL 1, 2026 (SEL-2026-03)

There are updates and changes in Part D related to reverification and sampling. Please refer to the guide or send us an email (ehunter@theklrgroup.com) to discuss. Actual changes may depend on your volume and practices.

Best - Ed
President, The KLR Group

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