Enterprise QC

The Impact of the Basel Accords on Quality Control in the Mortgage Industry

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In the twenty years since I first managed a quality control department in the mortgage industry, the attitude of the industry toward the QC function has evolved markedly. In that Pleistocene era of mortgage QC – the 1980's – the quality control department was securely quarantined in the basement of the building. Data could get in, but meaningful information could not get out – not even to management, let alone to regulators and investors.

Since most senior managers were compensated on origination volumes, the last thing anyone wanted was for a slice of their production to be sent back because of poor quality. Further, only those with suicidal tendencies would reveal to the secondary market that they had quality control 'issues'. So the thinking was that no news was good news, and if there was any bad news, it needed to be changed into good news (i.e., the loan must be fixed) before it was released. That way, the mountains of reports we produced every month could safely be ignored and everyone could get on with business as usual.

In recent years, however, we have seen the results of industry carelessness with regard to quality. A number of well-publicized breakdowns – which resulted in hefty regulatory fines – tell the story: Household Finance, $484 million; Associates, $215 million; First Alliance, $60 million; Fairbanks Capital, $40 million.

In each of these cases, the problem was not so much bad policies as it was a failure to control operational risk – the risk that policies and procedures might not be followed in practice. This kind of operational risk is inherent in any business process, but it is particularly pronounced in mortgage origination and servicing, which involve hundreds of human actions for every loan originated, serviced and paid off (or not).

These high-visibility events have coincided with other related trends to force a sea change in the industry. The intense scrutiny of fair lending practices by regulators and advocacy groups (together with enhanced reporting requirements under HMDA), the introduction of new legislation such as Gramm-Leach-Bliley and Sarbanes-Oxley, and the increasing acceptance of Six Sigma process improvement principles by the financial services industry have all resulted in an unprecedented focus on quality and a much higher profile for the quality control function in the mortgage industry. To these driving factors, we can now add another: the Basel Accords.

The Basel Accords, which establish international guidelines for risk assessment and control, primarily impact large, internationally active banks. These banks are already subject to the 8% minimum capital requirement agreed to in Basel I in 1988, and they will be required to use the "advanced approaches" of risk assessment spelled out in the new Basel II Framework, released in June 2004. But these advanced approaches to risk assessment will be incorporated by U.S. regulatory agencies into their supervisory guidelines for all regulated institutions, and they may be adopted by additional U.S. banks and thrifts that see the opportunity to have their capital requirements minimized. Although the effective date of the final regulations is not until January 2008, many institutions are beginning preparations now in order to be ready on the implementation date. (In May, 2005, the agencies announced that the notice of proposed rulemaking, which had been scheduled for mid-year 2005, would be issued "at the earliest possible date".)

The Basel II Framework articulates three pillars of sound financial management. The first pillar deals with minimum capital requirements, the second is supervisory review, and the third is market discipline. It is the first pillar which concerns us most, because it establishes risk measurement techniques which will determine minimum capital requirements based on credit and operational risk. Leaving aside credit risk for the purpose of this discussion, the accords define operational risk as, "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk." All facets of operational risk, with the exception of certain external events, are covered by a sound QC program, which we at Cogent term "Enterprise QC".

Enterprise QC is a commitment to raising quality in all steps of the loan origination and servicing process. Its goal is to produce meaningful results that influence management decisions, stimulate process improvements and improve the bottom line. QC reviews occur pre-funding, post-closing, and for each servicing department or process, and also address fair lending and other compliance issues.

Enterprise QC is also a self-reflexive process; that is, the QC process itself is continually monitored as well, so that it may be streamlined over time. Cogent clients utilizing the Enterprise QC model have successfully boosted the quality of their loans while simultaneously reducing the cost of their QC process. Enterprise QC stresses using statistical principles and targeting reviews where they have the greatest impact on reducing operational risk.

Basel II codifies what we at Cogent have argued all along, which is that lenders with less operational risk and more effective QC processes can achieve a higher return on their investments. The Accords will put this principle into practice by authorizing lower capital requirements for lenders who demonstrate a strong commitment to quality.

Lenders have three options for determining their capital requirements vis-à-vis operational risk. The first is known as a Basic Indicators Approach. The second is the Standardised Approach. The third are the Advanced Measurement Approaches ("AMA"). The Basic Indicators and Standardised approaches will apply standard coefficients to determine how much the minimum capital requirement may be reduced. Current indications are that these two approaches may allow lenders to reduce the operational risk component of their risk-based capital from the current 50% (overall) weighting for residential mortgage assets to as low as 40%, increasing the potential return on capital for these assets (assuming a constant credit risk-based component). The Advanced

Measurement Approaches, on the other hand, will allow banks to calculate their own capital charge based on the results of an internal analysis of their (or a consortium of lenders') data. Suffice it to say that most lenders would rather use this approach than the other two, as minimum capital requirements could be significantly lower (possibly as low as 25%), and lenders can develop their own standards for determining them.

The primary reason for banks not being able to adopt the AMA is the lack of loss data related to operational risk. Few banks have actually collected such data as part of their risk management processes. But that lack of data is rapidly being addressed, by the Basel Committee, by individual banks and by consortia that are attempting to compile databases of operational loss data which would be suitable for calculating expected losses. For example, the Committee, in March 2003, published a summary of the data collected through the 2002 Operational Risk Loss Data Collection Exercise launched by the Risk Management Group in June 2002, for which 89 banks provided data. More data collection and analysis by the Risk Management Group is currently underway.

Basel II identifies three minimum requirements to use an Advanced Measurement Approach. Any bank that wishes to do so must meet the following criteria:

- Its board of directors and senior management, as appropriate, are actively involved in the oversight of the operational risk management framework;
- It has an operational risk management system that is conceptually sound and is implemented with integrity; and
- It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

These requirements are a clarion call for a robust in-house QC program. The Accords stress repeatedly the importance of having a strong internal risk management function. Regular and prompt reporting to senior management is another requirement. Additionally, to qualify to use AMA, a bank must regularly review its QC processes in order to ensure their effectiveness. Finally, banks are allowed to implement AMA on a partial basis, meaning that it is not necessary to develop a comprehensive QC function for all facets of the business, but only for those that would benefit the most from an AMA. For mortgage lenders that keep their QC departments separate from the bank's broader functions, this means that a commitment to mortgage QC can pay off immediately, regardless of what the rest of the bank does.

Quality control in the mortgage industruy has come a long way since I emerged bright-eyed from business school in the early 1980's. Previous barriers to collecting and analyzing data are melting in the face of advances in software and QC methodology. The application of Six Sigma approaches to the financial services industry has revolutionized the QC function and enabled QC departments to have a real impact on their companies' bottom lines. It is our hope that the Basel Accords will provide additional political impetus to motivate all mortgage lenders to seriously consider the role that quality control plays in their business.