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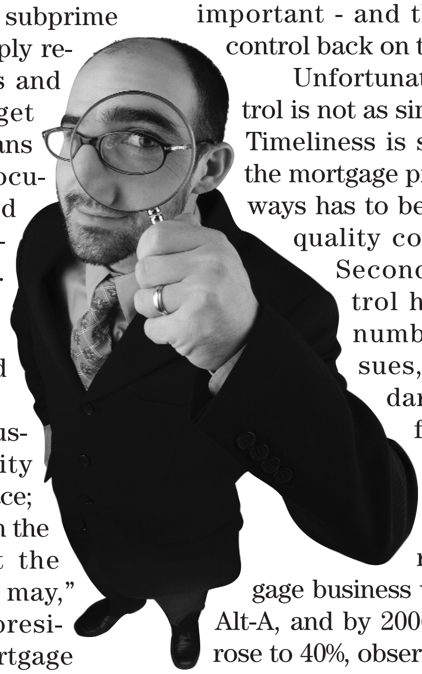
Is Quality Control Possible In Today's Mortgage Banking?

The answer is "yes" - provided you are willing to work somewhat harder in maintaining very high standards.

By Steve Bergsman

After the collapse of Irvine, Calif.-based New Century Mortgage Corp., the company's mortgage brokers revealed they were under intense pressure by their own firms to increase production - and quality control be damned.

New Century was not atypical; plenty of other originators sacrificed quality control for the sake of high production numbers. In fact, there was so much liquidity in the market, especially for subprime loans, that lenders simply reduced their standards and credit guidelines to get mortgages signed. Loans were done with no documents, based on stated income and concessions on credit scores. As a result, many people were put into mortgages that they could not afford to pay.



"The mortgage industry always had quality control measures in place; lenders just put them on the back burner and let the chips fall where they may," observes Lee Allen, president of Callender Mortgage Services, Bonham, Texas, specialists in mortgage industry quality control.

The subprime market, Allen adds, was not interested in quality control because there were so many different investors and no specific requirements governing the market.

There was so much business out there that if a loan failed because of quality issues, it could be overlooked because sheer volume still made the business profitable.

Those days are over, and subprime wreckage is scattered over the lending landscape. With mortgage volume decreasing, lenders have come to realize every loan is important - and that puts quality control back on the front burner.

Unfortunately, quality control is not as simple as it sounds. Timeliness is still important in the mortgage process, so that always has to be weighed against quality control measures. Secondly, quality control has to address a number of varied issues, including standards, procedures, fraud and even data accuracy.

In 2005, 15% of all loans in the residential mortgage business were subprime or Alt-A, and by 2006, those numbers rose to 40%, observes Joseph Badal, chief lending officer and senior executive vice president at Santa Fe, N.M.-based Thornburg Mortgage Inc.

"This huge loan increase was based on relaxed lending standards," he says. "It's not that lenders made mistakes with the information they had in the processing or the underwriting, but they changed their policies, saying 'Okay, we are going to reduce our standards in order to make more loans.'"

So, the first step in regard to quality control is to return to operating standards.

"Lenders have to be willing to turn down product," adds Bill Rinehart, vice president and chief risk officer for Ocwen Financial Corp. in West Palm Beach, Fla. "For quite a while, that was not happening in the industry because, clearly, the only focus was on production. Underwriting guidelines were loosened up and product changes were incorporated to allow more people to qualify for a loan. The only incentives for people were in regard to the processes surrounding production, not in the quality of the production."

To refocus on operating standards means changing personnel, incentives and corporate culture.

Unless lenders bring in competent people to review loans, mix in the right kinds of incentives and create a culture that encourages people to identify problems, underlying issues won't get corrected.

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"Most of the processes in the lending industry are built around increasing production," says Rinehart. "There are no incentives to embrace loan quality and how those loans will ultimately perform."

Callender's Allen is an advocate of doing prefunding audits. "When you have quality control audits, you are much more likely to prevent any problems from occurring later," he maintains.

The problem in the mortgage industry is that it has time constraints on getting a loan closed. There is a rush to get things done before a "lock" expires, so lenders don't take the time to do prefunding quality control audits - preferring to do post-funding audits instead.

"It's the prefunding random audits that are the ones that will really prevent any kind of problems from occurring," Allen continues. "The random audits will detect problems before the loan is funded, but lenders are only detecting after the loan is funded. If you get verification of employment, verification of deposit, verification of alternative documents, you are going to catch the problem loans."

Technology can do some screening here, but Allen stresses that an audit has to be a hands-on investigation.

If one follows Allen's advice, then one of the first things lenders need to do is create a quality control process with procedures for doing an audit. This can be done internally, but if it is cost-prohibitive, then this task can be outsourced.

"It takes a long time to do audits properly," he says. "You can look at the loans superficially just to make sure that certain documents are signed in the time frame required, but to look deeply at the loans takes time. All this is after the fact, however. If you don't do automatic prefunding audits, then when the cow is out the barn, it doesn't do you a lot of good."

James Robinson, president of Cogent Economics Inc. of San Francisco, states there are two kinds of technology available for quality control: one is for prefunding and the other, for compliance checking. While these are generally good products, Robinson warns, "The majority of claims paid by companies providing fraud insurance are on loans that went through the screening processes, and automatic underwriting tools are fairly easy to be manipulated by unscrupulous originators."

A good way to catch problems is to use a combination of prescreening technology and hands-on review. "Any of those loans that get kicked out or red-flagged should automatically undergo prescreening or be sampled in a post-funding review. They are a targeted risk," says Robinson.

In addition, he says, "You need to do a random sampling of all production - even those loans that don't show up as a red flag in the prescreening. You need to target the most risk, and that includes new brokers, new appraisers or loan officers that have a high defect rate."

The struggle continues

This is a continuous process, Robinson stresses. "It's important that the management of origination processes get the feedback on what is being found so they can act upon the problems and put in place corrective actions."

Robinson's checklist for ensuring quality control includes:

■ Independence. A truly independent quality control function should be reporting to risk management, not to production management. Fannie and Freddie have long required this arrangement from prime lenders, and it's probably even more important in the subprime arena.

■ In-house review. Conduct your own in-house reviews. If the reviews are outsourced, the sampling, reporting and feedback process should still be done in-house. In-house quality control departments generally know a lot more about the risks of their origination and servicing processes, and this knowledge grows over time.

■ Statistical sampling. As in other industries, using statistics in mortgage quality control minimizes sampling rates and review costs while ensuring quality assessments are statistically valid.

■ Reviews. Randomly selected reviews will establish a baseline quality, while risk-targeted reviews will catch problems in higher-risk loans and sources.

■ Enterprise. The "enterprise approach" means doing quality control reviews at each critical part of the process – prefunding, post-funding and servicing – and sharing information across the enterprise so the same issues don't keep reappearing.

■ Technology. Using the best available technology to ensure quality control takes root.

Data accuracy

Two specific issues that quality control needs to address are data integrity and fraud. The latter refers to purposeful deceit for gain, but the data issue is really about mistakes, and it is no less a problem.

Recently, Experian Group Ltd. asked a sampling of U.S. companies how much bad data was costing them. The answer was about 7% of annual revenue. For a $4 billion company, the 7% price tag could be as high as $280 million.

"The potential for large financial mistakes because you didn't get good data is a major concern," says Ed Albrigo, a senior vice president for enterprise services at Freddie Mac. "I don't believe you can always get 100% accurate data, nor do I believe you should. But I do think companies should start looking at controls they have in place for information transitioning through the mortgage process."

According to Albrigo, companies need to first understand what the requirements are for the quality of data and then decide what is an acceptable error rate.

"We have a program here at Freddie Mac that is focused on what is truly critical data," he says. "We move a lot of data in the mortgage industry, and not all of it is critical, high-risk data. We have to understand the quality threshold, the business processes and what controls we have in place to help us achieve the appropriate level of quality control around that critical data."

Albrigo suggests all companies need to go through a four-step process to address data quality.

First, companies need to understand what are the most critical data because until that aspect of data is defined, the scope of any quality control effort will be too large and unmanageable.

Second, companies need to know what is going on with the data that they do have, and metrics should be applied to understand what those data are telling you.

Third, focus should be considerable on the quality control processes that apply to the data.

Fourth and finally, it is important to intelligently use technology to monitor the data.

"It is important to focus on the truly critical data," Albrigo reiterates. "You can rush to implement technology around lots of data and find out you have a huge technology project on your hands - and it may not get you what you need. Once you decided on the critical data, you can put technology in place to monitor the quality of the data."

As for improving data integrity, he recommends establishing a formal data management program that treats data as an asset, defines quality standards and establishes a governance process. He also recommends embracing rules-based technology and using MISMO XML data standards.

Unmasking fraud

Fraud can attack any procedure along the mortgage process continuum - and usually does. Billions of dollars are lost annually through deception of one sort or another. How lenders address this situation obviously says much about a company's quality control processes and adherence to standards.

Over at Thornburg Mortgage, Badal boasts that fraud among its clientele is almost non-existent. Asked what's the best way to approach the fraud problem, he says that instead of addressing each loan as a potential problem, it's better to have an overarching, institutional solution in dealing not with the borrowers, but with partners and personnel.

"The top thing to do is make sure the people you buy loans from have been vetted and have the same corporate ethics as you do," says Badal. "I would also be very careful about those people who are hired for sales. Again, they need to have the same corporate ethics as the company and will only sign accounts that comply with corporate principles."

Badal also advises making sure that in-house processing and underwriting staff consists of "real professionals who understand the processes of underwriting, collateral and documentation, thus making sure 'docs' are on the up-and-up and collateral is secure. Finally, a lender needs to have good, sound quality control processes on a pre-closing and post-closing basis."

Joan Ferenczy, director of institutional investigations at Freddie Mac, says there are a few basic policies lenders should institute to help prevent fraud in the mortgage process. These including hiring a quality staff and training them to recognize red flags, while simultaneously making sure you know who your business partners are. A no-tolerance fraud policy is also essential, she adds.

"Fraud prevention starts before anyone on staff considers a specific loan," says Ferenczy. "It begins with hiring ethical, high-qualified, well-trained employees, and secondly, making sure the business partners - appraisers, title agents, etc. - are high-quality and ethical as well." SME