SECONDARY MARKETING EXECUTIVE®

Reprinted with permission from the October 2003 issue.

Quality Control Can Be An Anchor In Uncertain Mortgage Seas

Learning how to avoid repeating mistakes can improve productivity.

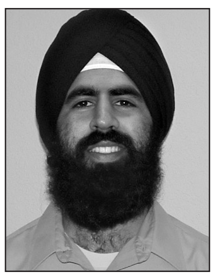
BY TEJINDER SINGH

Mistakes are inevitable. But repeated mistakes become problems when we don't correct them. And they become dangerous when we refuse to acknowledge they were mistakes in the first place.

This is true in every facet of life and business, and loan originations are no exception. Fortunately, there are few mistakes in the world of mortgage lending that are beyond identification and correction. Through discipline and quality control (QC), lenders can find mistakes, minimize their occurrence and correct them when necessary.

This article has two distinct goals. The first is to establish the importance of an effective QC process to lenders in today's residential mortgage marketplace.

Loan quality is a key consideration when dealing with originations of loans headed to the secondary market. James Robinson, president of Cogent Economics, contends that, "Quality is the new frontier of value creation in mortgage banking. As the process of getting a loan from application to the secondary market becomes more automated and uniform, it will not be products or pricing that differentiate lenders; it will be quality."



SINGH

Today, the quality of a loan origination process is a principal determinant of the value of the portfolio of loans it produces. Rejects, repurchases, pricing discounts or having to rework individual loans as a result of poor quality can cost originators dearly, both in the short term as they drain capital reserves and in the long term as an originator's reputation gets damaged. Most educated lenders are aware that quality can mean the difference between eating well and closing the doors.

Knowing that quality is important, however, does not translate directly into understanding how to improve quality. This brings us to the second goal of this article, which is to outline the elements of an effective QC process, because not all QC techniques are created equal.

Maximizing returns on investments in QC means much more than simply purchasing software or contracting with an outsourcing firm. It requires knowledge, creativity, flexibility, cooperation and perseverance. Nevertheless, the odds of success improve dramatically if one has the right tools available.

The cost of poor quality

Improving quality control at your firm will help you save money in at least two ways. First, improvements in QC will translate into a more efficient QC process; your auditors are likely to become more productive, your reviews more targeted, and the results you produce more useful. The net result is that you can transform QC from a hindrance into an asset.

To get some idea of the impacts of streamlining QC, consider the following: A poor QC process may require a lender to review as many as 10% of its originations in order to arrive at sound conclusions. For a lender who closes 3,000 loans a month, this means reviewing 300. Depending on the scope of the review, this process can cost as much as $150 per loan.

Let's take a conservative estimate of review cost and say that it costs $75 per loan to conduct an audit. In this case, audits alone will cost the lender $22,500 per month, or $270,000 per year. On the other hand, if the lender used a sophisticated statistical sample, it could achieve similar precision with probably a 2% to 3% sample.

In this case, only 90 loans per month would require review. This would be a cost of $6,750 per month, or $81,000 per year, an annual savings of $189,000 from altering sampling practices alone!

The most substantial cost reductions from quality control, however, are not dollars saved during the review

Tejinder Singh is director of research at Cogent Economics in San Francisco. He received his education in business administration, economics and interdisciplinary studies at the University of California at Berkeley. Cogent Economics develops best-in-class quality control systems for originators, servicers, compliance officers and prefunding reviewers. For more information, visit the resources section of the Cogent Economics Web site, www.cogentqc.com.

process, but rather costs avoided down the road as the origination process improves. The returns are difficult to quantify.

Joseph Grimes, senior vice president and current head of quality control at Aames Financial Corp., says, "It's not really possible to determine the cost of a particular error at the loan level. A missing document from a file might not have any impact 90% of the time, but 5% of the time will reduce the value of the loan substantially, and the other 5% will require a repurchase.

And a pattern of errors may tarnish an originator's reputation in the eyes of purchasers. Even though each error may not compromise the value of the loan, it indicates that the originator has a sloppy process, which will impact pricing."

Improving quality

It is important to note at the outset that the QC department cannot impact a firm's number of defective loans by itself. The principal ingredient to any effective QC process is a timely feedback and response loop that ensures recommendations from QC are translated into actions to improve quality. Companies who do this can expect to see dramatic improvements in overall quality that manifest themselves through increased profitability.

The key element of successful QC is a set of tools and people oriented around a common philosophy toward quality. Having an institutional blueprint for QC procedures is immensely valuable.

An example of such a blueprint is the Six Sigma model for quality control. Six Sigma, a philosophy to quality originally from manufacturing, has been adapted to the mortgage industry. Its methods emphasize statistical sophistication and sound metrics for quantifying results. Six Sigma techniques follow the basic blueprint of DMAIC, which stands for:

- **Define** the goals for improvement. These goals must be defined at all levels, from macro-enterprise goals to individual project-level goals.
- **Measure** the existing system. Learn how to quantify the cost of quality and to see improvement.
- **Analyze** current processes to determine what is going wrong and where improvements can be made. Make targeted inquiries into potential problem areas in addition to overarching assessments.
- **Improve** the system. Find creative ways to enhance quality. Recognize that change won't happen in a day, and improve facets of the business through targeted projects with clear goals.
- **Control** the new system by keeping an eye on issues that matter for quality origination. Watch for lapses and monitor old trouble areas while searching for new ones.

These guidelines seem simple enough, but implementing them is by no means an easy task. For originators, it requires the following capabilities:

- **Sophisticated sampling capabilities.** Sampling is where quality control starts. Statistical samples for overall loan quality analysis are important, but so are stratified samples that differentiate between origination sources, targeted samples that allow you to focus on particular loan types, branches, or underwriters, and occasionally manual samples which allow you to choose specific files based on your intuition and expertise.
- **The right personnel -** seasoned auditors who either have or can develop good instincts about which loans are likely to be defective, as well as the willingness to listen to their recommendations.
- **A stable, efficient workflow.** Audit reviews are mostly manual labor, and so automating the process as much as possible will get them done in less time and make the results available for reports that much quicker. It will also allow QC staff to spend their time on other tasks, such as identifying new risk areas or improving skills.
- **Concise, relevant reports**. Sophisticated samples and brilliant auditing procedures cannot help improve quality unless the results can be clearly enunciated. Management reports that show trends over time and highlight problem areas are important, and so are reports that monitor the QC workflow and process.

Reporting requires balance; too few reports display too little data, or clump data together inappropriately, and too many reports become impossible to wade through. An effective reporting process is not static. It will necessitate ongoing customization to meet the changing requirements of origination products and processes.

- **Communication.** The QC office needs to be able to provide input to both upper management and branch managers. Getting the point across to remote locations is essential to improving quality. It's all for nothing if nobody moves when QC speaks. It's also important to remember that effective communication is a two-way process. Executives and local managers alike need to be able to provide QC with feedback to ensure the long-term viability of the process.
- **Flexibility**. Techniques in quality management should change and improve over time. What once was TQM is now Six Sigma. To take advantage of this, a QC department must be able to incorporate improved methods when they come along and modify their own processes without interrupting production. A customizable QC system ensures maximum returns to investment because it means that you don't ever have to choose between keeping an obsolete system or dealing with gut-wrenching overhauls to implement change.

In today's marketplace, very little is certain, except that things are going to change soon as refinances dry up and interest rates rise. Volume and margins are both likely to get smaller as competition intensifies for remaining business. In these stormy waters, poor quality will leave you adrift, whereas good quality will be your strongest anchor.

This article is not designed to address all of your quality concerns. I wish it was that easy. What this article hopefully has done is made you more aware of two facts.

Important facts

First, quality matters. Even if it's not possible to directly quantify the cost of each error, those errors add up to serious dollars in the aggregate. The effects are not always directly connected to the severity of a particular error, because purchasers may view even small errors as trace elements of a sloppy process.

Secondly, for lenders serious about improving quality, there is a right way and there is a wrong way to go about doing it. As with most other serious problems, throwing money at poor quality will not make it go away.

The only way to improve quality is to engineer both disciplined and innovative responses oriented around a consistent philosophy and implemented by the right people with the right tools. It's a substantial commitment, but ultimately, one you'll be happy you made. SME