Putting **Quality** and **Control** Back in **Quality Control**

As our industry struggles through its significant difficulties, most of us are focused primarily on cleaning up the aftermath—and rightfully so. As we do so, we find ourselves asking how we came to be in the current situation and what we need to do to try to ensure it never happens again.

While tightening credit standards, improving loan disclosures and eliminating opportunities for fraud and predatory lending may be on the top of most companies' lists, it is hoped that reinvigorating their attention to the quality of their production and the application of quality controls—making quality control (QC) a vital and responsible part of the lending process—finds its place as well.

The role of quality control

For many years, in too many organizations, quality—and purpose—have been lacking from quality control. QC was a drudge, a post-funding paper-pushing exercise mandated by the agencies and a few investors. As competition among investors grew, investors with minimal QC requirements were leveraged against those with higher standards as a means to negotiate the requirements down. As volumes heated up, the quality of the production reflected this reduced attention to QC.

To make matters worse, QC as a department and function sat at the end of the production cycle, where its outputs generally fell on deaf ears—the functional equivalent of a dead-letter office. Some extra work may have funneled back to post-closing or other departments, the occasional loan may have been repurchased or held in portfolio rather than sold, but companies by and large failed to institute changes based on what was learned by the QC process. The QC reports generated little attention aside from addressing specific loan-level issues. In short, QC was largely relegated to being a required but meaningless function.

Certainly, some would argue that increased emphasis on pre-funding due diligence in the form of outsourced compliance checking, fraud detection and default-risk analysis improved the overall quality of the loan and thus reduced the need for quality-control review on the back end. It was believed that the traditional QC review was an anachronism, a holdover from another time.

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But many believe that perspective is about to change, and the role of QC within the lending process is about to move into the limelight.

Steve Schroeder, executive vice president and co-founder of Sacramento, California–based First American CoreLogic Inc., puts it this way: "In six months, the QC function will be seen as very important. Right now, it's all about stemming the bleeding—but by then, the focus will shift to making sure we don't bleed again. Executives will actually start to read QC reports, and when they do, they will start to ask some very hard questions—and QC will start to shape process."

Elevating QC to the level of importance that has been missing in recent years will require some re-evaluation of the processes of ensuring quality and applying controls. There are three critical but too-often-overlooked components to an effective, high-quality QC operation: loan-sampling controls, workflow management and statistical monitoring.

Loan sampling deals with the process of selecting the loans for review. Workflow management aids with the efficiency of the process itself, helping to ensure the quality of the review. And statistical monitoring provides a mechanism for learning from the reviews themselves and providing feedback mechanisms to create an environment for continuous improvement in the lending process. Without sufficient automation of these vital pieces, it's easy for QC to fall short of its mission and retreat to an exercise in paper pushing. Let's look at each of these components separately and in more detail.

Loan sampling

The traditional approach to QC sampling has been to randomly select 10 percent of recently closed loans for review (a percentage generally dictated by your negotiated terms of business with your investors). For larger lenders (and even most lenders in times of big volume spikes), this can be a significant burden when applied across the full spectrum of loans being originated. When the volume of loans slated for review outpaces capacity, something has to give—and chances are it will be the quality of the review itself.

Working for Fannie Mae's quality-control group more than 20 years ago, I helped to solve this problem by developing a statistically based sampling system that focused on risk. By oversampling the relatively smaller loan populations that met certain risk criteria (at the time, the factors included high loan-to-value [LTV] ratio, investment properties and seasoned loans), we could undersample the larger population that represented less risk, to effectively reduce the total number of loans reviewed while managing inherent risk better than with the traditional sampling approach.

San Francisco–based Cogent Economics Inc.'s CogentQC™ products are among those that provide statistical sampling algorithms today. The vendor claims that by applying its models, its clients can effectively reduce sample sizes to as little as 2 percent while remaining statistically valid. Other QC tools can do risk-based sampling as well, including products from Tena Companies Inc., St. Paul, Minnesota. First American CoreLogic's Schroeder suggests leveraging CoreLogic's predictive analytics tools to drive sampling to achieve similar results.

It is important to remember, however, that statistical validity does not always equate to investor requirements. Nonetheless, the same techniques—albeit ratcheted up to meet contractual obligations—are still a good means for targeting your reviews where they will likely provide the greatest value.

Workflow management

Quality control, like many functions in lending, is comprised of a complex series of tasks often performed in a discontinuous manner. Files have to be ordered. Certain aspects may be outsourced to third parties. The processor, underwriter, closer or post-closer have to be contacted for additional information.

The process is full of stop-and-go. Effective workflow-management automation serves to reduce, if not eliminate, the waste inherent in such processes and helps to balance workloads among the staff.

For many, the answer to workflow management is simple: If you image your files, you use the workflow tools provided by your imaging vendor to automate the process. SourceCorp Inc., Dallas, is one imaging vendor that offers quality-assurance workflow functionality—in this case, specifically geared toward correspondent lending.

Visionet Systems Inc., Cranbury, New Jersey, markets its VisiLoanReview® as a business-rules-driven workflow engine for compliance and quality control that is independent of any imaging platform. The system features configurable task templates and roles-based task assignment to help manage the process. CoreLogic also provides image-independent workflow through Atone™, its collaborative workflow product.

Statistical monitoring

The real payoff from your quality-control program should be learning from the reviews and improving your processes, with the aim of continually improving and eliminating the recurrent problems that surface in QC. Results must be interpreted and a continuous process-improvement feedback loop created.

Critical to success in this regard are good, clear reporting and the ability to view historical trend analysis. Recurrent problems by branch or closer could be indicative of training issues or bad processes. Consistent errors across the board may be the result of system problems such as calculation errors or faulty data capture.

Two other important aspects of effecting continuous improvement through quality control are governance and timing in the production cycle. Some argue that for QC to truly wield authority to effect change, it needs to be positioned under risk management and not be a part of the production chain of command. This has long been a requirement of the government-sponsored enterprises (GSEs), but not necessarily strictly adhered to across the board—particularly outside the prime loan arena.

When it comes to the timing of the review in the process, most argue that sooner is better. While there is great value to be derived from an independent, conscientious review of a representative loan sampling no matter where it occurs in the loan life cycle, many believe the best time is before the loan is funded rather than after. While pre-funding QC has the advantage of helping to prevent the funding of bad loans, it also has the disadvantage of missing errors in the executed closing package.

SecondLook®, QC software from Tena Companies, is feature-rich when it comes to reporting and trend analysis, with scores of pre-defined reports, a custom-report generator and statistical algorithms designed to weed out recurring problems at any level of granularity. CogentQC also provides robust reporting capabilities with its products, giving you the opportunity to view detailed reports and graphical roll-ups of trends over time.

Another vendor, Walzak Risk Analysis LLC, Boca Raton, Florida, has a proprietary risk score, WRAPS™, that combines fraud, compliance, collateral and credit into an automated re-verification process. The resulting QC score provides a basis for examining the origination process for improvement opportunities, with inconsistent scores indicative of process inconsistencies and significantly different levels of experience among the process performers.

The time is now

While this column just touches the surface of the products and services available to help lenders improve the quality and benefits of their QC efforts, I hope I've succeeded in making the case that QC deserves the respect and attention needed to make it a vital part of lending operations going forward.

The tools are readily available to help you, even as the regulatory scrutiny and investor demands make the call for action. Evaluate your options and take the time to plan how you can make the most of the resultant benefits, but the time for action on quality control is now.

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