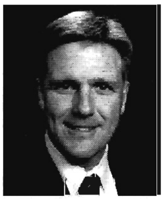
Understanding Quality Control and Business Plans



By THOMAS A. MORGAN

A mortgage company owner's first encounter with the need for a formal quality control or business plan usually comes as a request from a wholesale lender or a state or federal regulator. At this stage, the lender or regulator acts like a parent, "Before you can play, you have to do your homework." Our response, as new financial entrepreneurs, is similar to the child's response, "OK, here. It's done. Now can I play?"

With this attitude the company misses the real entrepreneurial moment. The question should be "How will I survive the coming market?" A quality control plan, business plan, or policy document is the written process that describes a business operation. Without it, we are just a bunch of people running around trying to do loans the best we can. High revenues during business booms conceal the huge operational inefficiencies of running a business without a plan. Changing business conditions, lower revenues and super-vigilant regulators are going to force companies that are intent on staying in business to look at business management systems. Understanding quality control, business plans and management systems will be instrumental in whether your company survives leaner times.

The Quality Control Misnomer

Of course, mention quality control and many mortgage professionals will say, "That's a back office function, right? It's got nothing to do with production." Historically, quality control meant the pre- and post-closing fraud review process. But recently, HUD, state agencies and warehouse lenders have all used the phrase interchangeably with other processes and a more expansive meaning is evolving.

When you receive a request for a quality control plan, take pains to specify what that actually means. Are audit function procedures or business management documentation being requested? There are many aspects of business process management that can be referred to as "quality control." Depending on your business model—banker, broker or wholesaler—a quality control plan can mean different things. Here are some basic definitions:

- **Quality Control Audit**—The process by which loans are selected before or after closing to review loan documentation authenticity for alterations or fraud. Commonly used by brokers, bankers and wholesalers.
- **Quality Control, Business Plan, Best Practices or Origination Policies**—The documentation that defines who is responsible for each step in the loan process. Each origination function—originator, processor, underwriter, closer and branch manager/owner—has a set of duties. The quality control business plan identifies the written policies and practices adhered to by the company. The broker uses this in origination, processing, human resources/company policy and branch operation. It is the same for bankers but also includes underwriting and closing/funding. Wholesalers use it with wholesale/broker/third party policies and procedures.

No One Plans to Fail

Many people simply fail to plan. Businesses fail at an alarming rate. When we underwrite self-employed borrowers we treat one factor as absolute—you must have been in business for two years. Why? Ninety percent of new businesses fail during their first two years. Of the 10 percent that make it two years, 50 percent fail in the next three years. Confronted with these stunning statistics, new mortgage company principals react with disbelief—we are somehow immune from the inevitable Darwinian process. A review of a perpetual national mortgage wholesaler's customer list supports this fact. Of 6,500 approved brokers, fewer than 250 were on the approved list prior to 2000. Eighty percent of the brokers and correspondents were added after January, 2004.

Why We Fail

Business climate exacerbates the failure rate of mortgage businesses. The phenomenon of contraction and expansion, boom and bust, is a side effect of the interest rate cycle. Seasonality of related businesses, specifically real estate, adds to the cycle management challenge.

The book, "Re-Visiting the E-Myth" looks at the failure rate of small businesses and the divergent roles of entrepreneur, sales and management that principals have to play. It asks the question, "Isn't there a way to guard against these high failure rates?" The answer lays in the most successful business model anywhere—the franchise. Approximately 75 percent of start-up franchises succeed beyond the five year mark. This statistic alone should draw attention. Why is it that these models are so much more successful?

Think about the franchises you visit: McDonalds, Marriott and Radio Shack (the list goes on) run like machines. That is the key. Before the first product or service is offered for sale, the entire process, down to the smallest detail, is already in place. Not one has a "figure it out as we go" quotient. This is a business. As a manager or owner, you can focus on strategy. If you experience a hiccup in the process you adjust the machine.

Plan

A business plan—a sales and marketing concept with financial projections—is not a franchise model. If the plan revolves around the principals performing myriad duties, or if one person or personality is solely responsible for the business, it's not a business. It's a job.

Every task in our business revolves around a set of steps. We seem to think these involve more complexity or difficulty than they do. Maybe they seem so self-explanatory to the seasoned professional that they don't appear to require explanation. The reality this creates is that most companies rely heavily on highly skilled (and highly compensated) individuals to carry out relatively mundane tasks.

It's not you...It's me

With no written explanation or documentation, when a problem arises in the process, the issue gets addressed with the individual handling the task. It becomes personal. We get involved in "blame storming" to assign fault to an individual. We hold him or her accountable to correct the problem going forward. We do this repeatedly until the individual becomes hyper-vigilant and successfully avoids repeating the problem. Of course, other similarly handled problems arise and eventually the individuals feel personally responsible. This recipe for burnout is repeated thousands of times a day across the country at incredible personal and financial cost.

This doesn't happen in a franchise. If the machine breaks, we fix the machine. Individuals can't be held responsible for a faulty system. In this way everyone (the individual, the manager and the owner) has a vested interest in making sure the system works correctly. Everyone has input into the best practice. Problems don't repeat because if we follow the system, we don't make the same mistake twice.

It's the System

Keep it simple. Each step broken down into its smallest components seems like overkill. "It's so simple, everyone knows that," is a common response to the documentation process. Inevitably it is these small pieces breaking down that create huge problems at the end. Think about it. You only need one missing document to postpone a closing or get a loan denied.

A Franchise System

There were 325,000 loan officers in 2000. By the end of 2005, there were 675,000. The business levels shrink which results in a smaller pie, and more people clamoring for it. More competition means lower revenues. Lower profit margins mean that losing one loan, or spending a disproportionate amount of time solving problems on loans instead of getting new ones, affect the survivability of the business. A franchise level business management system allows you to gauge profitability, project manpower accurately and spend time on refining a marketing strategy.

Problem loans also provide a temptation to cut corners to get a loan done—exigent fraud caused by circumstances. That is why the regulators and lenders want you to have a business management system. You have controls in place.

Business Management System = Quality Control = Business Plan

Calling it "quality control" may have had you pouring yourself another cup of coffee. You may have seen it as a hurdle to overcome. But quality control really is an opportunity to build a machine—one that will run without us. We are now free to use our creativity to market our business or solve other problems. We are relieved of the stress of being personally responsible for success. If the franchise model business management system doesn't work the way you plan it to, change it until it does. Statistically speaking, you have a 1400 percent better chance of success with the model than without. Your business has a 70 percent statistical probability of success with a business model. Without one, the statistical probability of success is 5 percent. Which statistic will you choose?

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