Doing It Right: The Growing Ethical Crisis in Mortgage Lending

By Rebecca Walzak, President, *rjbWalzak Consulting Company, Inc.*

REPRINTED FROM SCOTSMAN GUIDE RESIDENTIAL EDITION, JANUARY 2005

Editor's note: From the significant number of senior business executives who have been indicted for fraud during the last several years in the USA and throughout the world, it is evident that many men and women consider fraud to be an acceptable business practice. Our own mortgage industry in the USA is no exception to this problem. ***Scotsman Publishing*** *deplores fraud and similar unethical business practices. Consequently, we are pleased to present Rebecca Walzak's article which offers very constructive suggestions to mortgage executives who want to operate their businesses in an ethical manner.*

Have you heard about the latest crime wave in America? The FBI is actively pursuing the criminals who perpetrate this crime. State after state is passing new laws in an attempt to protect its citizens. The press and television news channels warn listeners of the dangers. Industry newsletters and magazines report on the impact on the victims of these crimes, while the list of convicted felons continues to grow. What is this crime wave spreading across America? If you guessed terrorism, you would be wrong. It is, in fact, mortgage fraud and related predatory lending problems. Where once these crimes seemed to be limited to specific types of fraud scams, industry members have recently come to realize that this problem is pervasive throughout the industry. More and more frequently, mortgage professionals are viewed by the general public as being less than trustworthy. Recently a senior manager in the industry was heard to ask, "When did mortgage banking replace selling used cars as the sleaziest profession?"

More important than when is why this has occurred. Many will tell you that it is the result of new products that appear to encourage "little white lies" to qualify the applicants as well as an easing of standards to increase homeownership opportunities. There is no doubt that the apparent "easy pickings" for less-than-honest individuals have resulted in an expanding number of them entering the business. Likewise, the escalating housing values over the past five years have also made it easy to reap greater and greater ill-gotten gains for those willing to take advantage of unsuspecting consumers.

But, do these circumstances account for the proliferation of fraudulent transactions or is there some deeper underlying cause? The decision of what to do when faced with the opportunity to "fudge a little" comes down to ethics. Many industry members believe that the fundamental cause of these problems is an apparent deterioration of ethical values in the industry,

As defined by Webster, "ethics is the discipline of dealing with what is good and bad and with moral duty and obligation." The basic ethical discipline of individuals is the way they express moral approval or disapproval. Just like individuals, companies have ethics as evidenced by the way they conform to the accepted professional standards of conduct. It is not uncommon that a company's Code of Conduct is one of the first items that new employees are asked to read and agree to follow. Professions also have stated ethical standards as guiding principles for their members. Consider the medical profession, whose primary ethical value is stated in the phrase: "First, do no harm."

Ethics in the Mortgage Business

On a regular basis, mortgage professionals make ethical decisions with each application taken. Are the programs and rates offered the best for this consumer, or is the loan program the result of the potential for increased income? Are applicants encouraged to "fudge" their income or assets? Are consumers "qualified" for mortgages that they cannot afford and that, in fact, have the potential to place them in financial jeopardy?

Mortgage brokers also are faced every day with making ethical decisions. At the NAMB convention in Salt Lake City, numerous organization presidents decried the fact that, while they knew that behavior such as switching applicants to stated income loans when they did not qualify for other programs was wrong, they were told by the account executives from major conduits that it was acceptable. In fact, they were told this behavior was expected since the program was designed for these exact situations. In fact, this situation occurs much more frequently than either brokers or lenders would like to admit and places them in a position where the "right" decision results in loss of income and business opportunities.

These ethical dilemmas are not limited to the sales units but are faced by processors, underwriters, closers and other back office staff. For example, some individuals are faced with skipping steps to get the loan done in time; others refuse to admit responsibility for mistakes or problems that occur. Staff members are more frequently dealing with issues that place them in positions that force ethical decisions.

Doing It Right: The Growing Ethical Crisis in Mortgage Lending

Unfortunately, many times they have no guidance from managers on how to handle the situation and are pressured by loan officers whose income is riding on the outcome of the application and/or closing.

Despite the various companies with clearly articulated Codes of Conduct, it is not difficult to find those that do not follow their own standards. How often are staff members told to forward loans to the investor for funding, even when a problem such as fraud has been discovered? Many times, managers are unwilling to admit their involvement in a problem, simply pass it off to the next entity and hope that the problem is not discovered in the due diligence process. For non-regulated entities, there is a general perception that the regulations intended to protect the consumer can be ignored. It is truly "let the buyer beware" for these lenders.

Is it any wonder that employees in these organizations see nothing wrong with "fudging" the facts a bit? What many managers and executives fail to realize is that this approach creates a growing operational risk for the organization that can have significant impact in the future. The number of companies with major financial and underlying ethical or fraudulent problems, including Fannie Mae and Freddie Mac, is growing each day.

Addressing the problem

Addressing these problems must start from the top down. Congress has recognized this in its passage of the Sarbanes-Oxley Law. Despite the fact that many companies from all industries are spending billions of dollars to comply, many in this industry have not yet even begun to deal with the requirements. One of the primary requirements of this law is the identification and monitoring of risks that occur in the operational processes, including unethical or fraudulent acts. These must be reported, and potential losses from these acts must have a financial reserve established to ensure shareholders do not suffer because of them.

Many industry members express the opinion that there are already laws designed to address these problems. Through the diligent efforts of the MBA's Quality Assurance Fraud and Ethics task force, the FBI and state and local law enforcement are becoming more active in the detection, arrest and prosecution of these criminals. However, while the detection and punishment of offenders will stop a fraction of the problem, they do not address the basic issue—the apparent deterioration of an ethical foundation in conducting business that is visible in many companies today.

Attacking this basic problem must also start at the top—the top of each company as well as the top leadership in the industry. Identifying the various options available for members of the industry leadership would undoubtedly result in an article too large to publish. However, there are ideas and suggestions that can be implemented immediately by both companies and the industry as a whole.

Companies

- Implement a company Code of Conduct: Have the senior members of the organization discuss and document their beliefs on how the company should be run. Be sure to include treatment of consumers, investors, employees and shareholders in addition to return-on-investment and profitability. If the company already has a Code of Conduct, pull it out of the mothballs and review it to ensure that it is still meaningful in today's operating environment.
- Review the literature on value-based management. Over the past few years, more and more books and articles are being published that discuss how and why companies that have a clearly articulated value system are succeeding more often than those without one. An easy read is the book *Managing by Values* by Ken Blanchard and Michael O'Conner.
- Develop an incentive program within the organization that rewards employees for ethical behavior. Frequently, reward programs are based strictly on production and/or profitability, even if the means to these ends are unethical.
- Remove the individuals involved when unethical behavior is discovered within the company. Nothing makes a stronger statement about management's commitment to value leadership than this action.
- Conduct mandatory training sessions within the company to teach ethical values and ethical decision-making. Ensure that all levels of management, including the executive staff, attend. There are numerous educational programs available to support this initiative.
- Develop an executive support system. Making ethical decisions is not always easy. Having a resource or group of other executives with whom to discuss hypothetical issues makes the right decision easier.
- Expedite the development of measures and metrics within operational processes to identify and address ethical issues. Ultimately, this will establish confidence in the company's product within the secondary market.

The Industry

- Develop an Industry Standard for ethical behavior. If one currently exists, it should be publicized along with the commitment by industry leaders to follow it. This may help support the current congressional activity for passage of a national Predatory Lending Law.
- Include a separate ethics course in the CMB program, if it does not exist.

Doing It Right: The Growing Ethical Crisis in Mortgage Lending

- Strip individuals of their CMB designation (or any other MBA-related designation) if unethical behavior is brought to light and validated.
- Develop a uniform Operational Risk Measurement and Reporting Program with MBA support so that the secondary market maintains confidence in the integrity of the mortgage product.

These are a few suggestions to begin re-establishing the integrity of this industry. Most likely, there are numerous others already in place or under discussion. However, until we acknowledge this problem collectively and collectively begin to address it, even the best of intentions will be less than successful. Individuals in this industry whom I know want to be proud of what they do. It is time to make that happen.

Rebecca Walzak is the President of rjbWalzak Consulting Company, Inc., in Deerfield Beach, Fl. She specializes in Operational Risk Management, Quality Control and Regulatory Compliance. The company specializes in setting up measures and metrics that provide process risk information to management and help to identify weaknesses that could lead to fraud issues. Ms. Walzak can be reached at: 954-415-4537 or by e-mail at: Becky@rjbwalzak.com. For more information: www. rjbwalzak.com. ◆