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AUDIT REPORT

Use of Independent Contract Loan Officers to Originate FHA-Insured Loans

HUD's Single Family Mortgage Insurance Programs

2004-DE-0002

April 23, 2004

Office of Audit, Region 8
UMB Plaza, 1670 Broadway, 24th Floor
Denver, Colorado, 80202

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Issue Date	April 23, 2004
Audit Case Number	2004-DE-0002

TO: John C. Weicher, Assistant Secretary for Housing - Federal Housing Commissioner, H

FROM: Robert C. Gwin, Regional Inspector General for Audit, 8AGA

SUBJECT: Use of Independent Contract Loan Officers to Originate FHA-Insured Loans HUD's Single Family Mortgage Insurance Programs

We have conducted reviews of eight HUD/FHA approved non-supervised loan correspondents (mortgagees) located in the Salt Lake City, Utah, and Denver, Colorado metropolitan areas. These mortgagees were selected for review primarily based on information that they were using independent contract loan officers to originate FHA-insured loans. The objective of our review was to determine whether the mortgagees use independent contract loan officers to originate FHA-insured loans.

Our report contains one finding with recommendations requiring action by your office. We appreciate the courtesies and assistance extended by the management and staff of the mortgagees and the HUD Denver Homeownership Center and the HUD Santa Ana Homeownership Center.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without management decisions, a status report on: (1) the corrective action taken, (2) the proposed corrective action and the date to be completed, or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact Ernest Kite, Assistant Regional Inspector General for Audit, at (303) 672-5452.

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Executive Summary

Information was provided to us that five HUD/FHA approved non-supervised loan correspondents (mortgagees), located in the Salt Lake City, Utah metropolitan area, were using independent contract loan officers to originate FHA-insured loans. The objective of our review was to determine whether the mortgagees use independent contract loan officers to originate FHA-insured loans. Our review of these five mortgagees[1] plus three previously audited mortgagees[2] located in Utah and Colorado disclosed that seven of these mortgagees were using independent contract loan officers to originate FHA-insured loans contrary to HUD requirements. Five of these mortgagees established agreements with their independent contract loan officers, which were not in compliance with HUD requirements. Combined, for these seven mortgagees, 802 of their approximately 811 (99 percent) loan officers were independent contractors or non-employees.

Similar irregularities involving the use of independent contract loan officers or non-employees to originate FHA-insured loans have occurred at other HUD approved mortgagees in Region 8 (Rocky Mountain Region). In recent years the Denver Homeownership Center (HOC) has referred at least 28 mortgagees to the Mortgagee Review Board (MRB) for findings, in part, involving independent contractor or non-employee loan origination issues. The MRB has completed action on 22 of the 28 referred cases imposing civil money penalties of over $1.6 million and requiring 65 mortgagee loan indemnification actions.

By using independent contract loan officers or non-employees to originate FHA-insured loans, these mortgagees could not, and in fact did not exercise direct control and supervision over their loan origination officers as required by HUD. The lack of direct control and supervision, coupled with quality control deficiencies, contributed to increased default and claim rates and therefore unnecessarily higher risk to the FHA insurance fund.

Use of Independent Contract Loan Officers

Four of the five Salt Lake City, Utah metropolitan area mortgagees did not comply with HUD's loan origination requirements. Specifically, American Liberty, Aspen, Citywide and First Source (Midvale branch office) used independent contract loan officers or non-employees to perform loan origination functions that HUD specifically requires mortgagee employees to perform. Three previous audits of mortgagees in Colorado and Utah also disclosed violations of this HUD requirement.

[1] The five Utah mortgagees were: (1) American Liberty Financial Services, Inc. (American Liberty); (2) Aspen Financial, LC (Aspen); (3) Citywide Home Loans (Citywide); (4) First Source Financial USA (First Source); and (5) Jefferson Nationwide Mortgage Corp. (Jefferson).

[2] The three previously audited mortgagees were: (1) Clarion Mortgage Capital, Inc. (Clarion), Centennial, Colorado, Audit Memorandum 2001-DE-1801; (2) American Union Mortgage, Inc. (American Union), Sandy, Utah, Audit Memorandum 2002-DE-1801; and Treehouse Mortgage, LLC (Treehouse), Denver, Colorado, Audit Memorandum 2004-DE-1002.

We found that five of the seven mortgagees established agreements with their independent contract loan officers that defined the loan officers as independent contractors and/or included provisions indemnifying the mortgagees from any risk associated with the loans originated by these contract loan officers. These agreements are clearly contrary to HUD's position that the mortgagee is responsible for the quality of FHA-insured loans and compliance with HUD requirements. Furthermore, the mortgagees desire for risk avoidance is evident, implying the mortgagees' willingness to relinquish their fiduciary responsibilities regarding the FHA-insured loan origination process.

By using independent contract loan officers or non-employees to originate FHA-insured loans, these seven mortgagees could not, and in fact did not exercise direct control and supervision over their loan origination officers as required by HUD. The lack of direct control and supervision, coupled with quality control deficiencies, contributed to increased default and claim rates and therefore unnecessarily higher risk to the FHA insurance fund.

At First Source's branch office in Midvale, Utah, we saw a significant increase in their default and claim rates from March 2003 to January 2004. Loans currently in default increased 57 percent and claims paid increased 800 percent. At American Union we saw similar significant increases in the same areas, loans currently in default increased 93 percent and insurance claims paid increased 100 percent.

Recommendations

We are recommending that HUD/FHA issue appropriate guidance and specific instructions to HUD's Homeownership Centers and to FHA approved mortgagees requiring the use of mortgagee employed loan officers versus contractor or non-employees to originate FHA-insured loans. We also recommend that HUD require mortgagees to report their originating loan officer's income on IRS form W-2, which would include withholding of federal income tax, Social Security tax and Medicare tax.

Auditee Comments

We submitted a discussion draft of the audit report to the Office of Housing - Single Family on March 26, 2004. We received verbal comments on the draft report on April 8, 2004. We considered their verbal comments to the draft report, and made the appropriate changes. We submitted the final draft report to the Office of Housing - Single Family on April 14, 2004. They provided verbal comments to our final draft report on April 15, 2004. The Office of Housing - Single Family concurred with our audit results and agreed with our recommendations. Upon issuance of the audit report they will initiate corrective action on the finding and related recommendations. The Office of Housing - Single Family is aware of the issue discussed in the audit report and has drafted a proposed rule (FR-4761-P-01), which among other things, provides a definition of a lender employee.

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Abbreviations

CFR	Code of Federal Regulations
FHA	Federal Housing Administration
HMDA	Home Mortgage Disclosure Act
HUD	United States Department of Housing and Urban Development
IRS	Internal Revenue Service
MRB	Mortgagee Review Board
OIG	Office of Inspector General
RESPA	Real Estate Settlement Procedures Act
VA	United States Department of Veterans Affairs

Introduction

Under Section 203 of the National Housing Act (12 U.S.C. 1709), HUD insures mortgages made by private lending institutions. Dependent upon their designation, the institutions have the authority to originate, purchase, sell and/or service FHA-insured mortgages. As a HUD/FHA approved non-supervised loan correspondent, the principal activity is the origination of mortgages for sale or transfer to an approved sponsor under HUD's Single Family Direct Endorsement program. Under Direct Endorsement, the approved sponsor underwrites and closes the mortgage loan **without prior HUD/FHA review or approval**. Therefore, HUD has established various Regulations, Handbooks, Notices and Mortgagee Letters that govern the program.

As discussed in HUD Handbook 4060.1 REV-1, HUD requires mortgagees to exercise control and responsible management supervision over their employees. The requirement regarding control and supervision must include, at a minimum, regular and ongoing reviews of employee performance and of work performed. This implies direct control and supervision by the mortgagee over its employees.

In Mortgagee Letter 95-36, HUD recognized there are certain **loan origination functions that do not materially affect underwriting decisions, which may be contracted out** by mortgagees without increasing the risk to the FHA insurance fund. The following administrative/clerical functions may be contracted out: (1) clerical assistance, (2) preparation of loan documents, (3) mailing out and collecting verification forms, (4) ordering credit reports, (5) preparing for endorsement and shipping loans to investors, and (6) such other functions as may be approved by the Department.

HUD was explicit in the Mortgagee Letter that underwriting and **customary loan origination functions may not be contracted out**, as the mortgagees are held responsible for the quality of loans and compliance with HUD requirements. For example, the following customary loan origination functions may not be contracted out: completion of the loan application, analysis of the prospective borrower's income and debt for prequalification, educating the prospective borrower in the home buying and financing process, and collection of financial information. Moreover, loan origination functions may not be contracted out to third party loan originators, real estate brokers and other similar entities. HUD further strengthened its position against the use of non-employees to originate FHA-insured loans in Mortgagee Letter 00-15 as it increases the risk to the FHA insurance fund.

Our reviews of HUD/FHA approved mortgagees in Utah and Colorado, have disclosed a number of the mortgagees to be using independent contract loan officers to originate FHA-insured loans and reporting their income on IRS form 1099-MISC. The independent contract loan officer is responsible for filing and paying appropriate taxes. Therefore, the mortgagee avoids associated administrative costs, providing worker's compensation and other benefits (e.g., retirement, health, vacation leave). HUD requirements do not stipulate whether income be reported on IRS form 1099-MISC versus IRS form W-2.[3]

[3] IRS form 1099-MISC is used to report miscellaneous income for payments for services performed for a trade or business by people not treated as employees (e.g., independent contractors). IRS form W-2 is used to report wages and other compensation paid to employees.

In addition, we found a number of the mortgagees enter into agreements with their independent contract loan officers that define the loan officers as independent contractors. In some cases the agreements require the independent contract loan officer to indemnify the mortgagee from any risk associated with loans originated by its independent contract loan officers. HUD requirements stipulate, as discussed previously, the mortgagee is held responsible for the quality of loans and compliance with HUD requirements.

As demonstrated above, it is clear that HUD's intent is that employees and not independent contractors perform customary loan officer functions relating to the origination of FHA-insured loans. Furthermore, direct control and supervision is implied (regular and ongoing supervision), which the use of independent contract loan officers negates.

We reviewed five HUD/FHA approved non-supervised loan correspondents (mortgagees), American Liberty, Aspen, Citywide, First Source, and Jefferson located in the Salt Lake City, Utah metropolitan area. Appendix A contains additional information on these five mortgagees. For four of the five mortgagees, we identified approximately 1,334 FHA-insured loans with a beginning amortization date between April 1, 2001 and March 31, 2003 that were originated by independent contract loan officers or non-employees during the audit period.

Previous audits of three Utah and Colorado mortgagees, Clarion, American Union, and Treehouse also disclosed the use of independent contract loan officers to originate FHA-insured loans. For these three mortgagees, we identified approximately 4,722 FHA-insured loans that were originated by independent contract loan officers or non-employees during the audit period.

Combined, for these seven mortgagees, 802 of their approximately 811 (99 percent) loan officers were independent contractors or non-employees. To illustrate, the ratio of independent contract loan officers to employees was approximately 50 to one at American Union, who had a total of 200 independent contract loan officers and only four employees. The employees held management and administrative positions. At Aspen all staff were independent contractors. At First Source even the branch office manager/loan officer was an independent contractor.

In addition to the information we obtained during our reviews of mortgagees using independent contractors to originate FHA-insured loans, the Quality Assurance Division at the Denver HOC has been tracking the usage of independent contract loan officers by HUD/FHA approved mortgagees within their region.[4] In fact, in recent years the HOC has referred at least 28 mortgagees to the MRB for findings involving, in part, the use of independent contract loan officers or non-employees to originate FHA-insured loans.

Audit Objective

The overall objective of our review was to determine whether mortgagees were using independent contract loan officers to originate FHA-insured loans.

[4] The Denver HOC's region encompasses a total of 17 states (Arkansas, Colorado, Iowa, Kansas, Louisiana, Missouri, Minnesota, Montana, Nebraska, New Mexico, North Dakota, Oklahoma, South Dakota, Texas, Wisconsin, Wyoming and Utah).

Audit Scope and Methodology

To accomplish our audit objective we reviewed FHA-insured loan origination and quality control processes and related activities at five mortgagees located in Utah. This included a review of FHA-insured loans originated by the mortgagees to determine whether independent contract loan officers originated the loans. We selected FHA-insured loans from a universe of 1,916 FHA-insured loans originated by the five mortgagees with a beginning amortization date between April 1, 2001 and March 31, 2003.

In addition, we examined program records and related documents of the five mortgagees for the origination of FHA-insured loans. We also reviewed applicable HUD records relating to the five mortgagees' non-supervised loan correspondent activities. Furthermore, we conducted interviews with key managerial and technical personnel of the five mortgagees and the Denver HOC’s Quality Assurance Division. In addition, we worked with Denver HOC officials to develop statistics on MRB referrals/actions involving mortgagees using independent contactors or non-employees to originate FHA-insured loans.

We also used data obtained during previous audits of mortgagees in Colorado and Utah regarding the use of contract loan officers to originate FHA-insured loans.

Our audit generally covered the period of April 1, 2001 through March 31, 2003. This period was expanded to include the most current data while performing our review. Therefore, where applicable, the audit period was expanded to include current data. We conducted our field work from June 2003 through January 2004.

HUD Data Systems Used

We relied, in part, on data maintained by HUD in the Single Family Data Warehouse. However, we did not perform a detailed analysis of the reliability of HUD’s Single Family Data Warehouse data.

Generally Accepted Government Auditing Standards

Our review was conducted in accordance with Generally Accepted Government Auditing Standards.

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Use of Independent Contract Loan Officers to Originate FHA-Insured Loans

We completed a review of five HUD/FHA approved non-supervised loan correspondents (mortgagees) located in the Salt Lake City, Utah metropolitan area to determine whether these mortgagees were using independent contract loan officers to originate FHA-insured loans contrary to HUD requirements. Our review of loan origination and related quality control activities disclosed that four of the five mortgagees, American Liberty, Aspen, Citywide and First Source, use independent contract loan officers or non-employees to perform loan origination functions required by HUD to be performed by mortgagee employees. This same deficiency of improper use of independent contract loan officers to originate FHA-insured loans was identified in our completed audits of three other mortgagees (Clarion, American Union and Treehouse) in Colorado and Utah.

We found five of these mortgagees, Citywide, First Source, Clarion, American Union and Treehouse, established agreements with their independent contractors that were not in compliance with HUD requirements. In addition, our review disclosed noncompliance in: (1) implementation of a quality plan and related activities, (2) execution of control and management supervision over independent contract loan officers, and (3) payment of all operating expenses related to the operation of a mortgage lending business.

In our opinion the deficiencies identified stem primarily from the mortgagees' propensity to pass on the risk associated with FHA-insured loans to others. We also identified other factors that contributed to the use of independent contract loan officers:

- Income reporting requirements need to be defined,
- Misinterpretation of HUD requirements, and
- Increased profitability.

By using independent contract loan officers or non-employees to originate FHA-insured loans, these mortgagees could not, and in fact did not exercise direct control and supervision over their loan origination officers as required by HUD. The lack of direct control and supervision, coupled with quality control deficiencies, contributed to increased default and claim rates and therefore unnecessarily higher risk to the FHA insurance fund.

At First Source's branch office in Midvale, Utah, we saw a significant increase in their default and claim rates from March 2003 to January 2004. Loans currently in default increased 57 percent and claims paid increased 800 percent. At American Union we saw similar significant increases in the same areas, loans currently in default increased 93 percent and insurance claims paid increased 100 percent.

HUD Requirements

Under Section 203 of the National Housing Act (12 U.S.C. 1709), HUD insures mortgages made by private lending institutions. Dependent upon their designation, the institutions have the authority to originate, purchase, sell and/or service HUD FHA-insured mortgages. As a HUD/FHA approved non-supervised loan correspondent, the principal activity is the origination of mortgages for sale or transfer to an approved sponsor under the HUD Single Family Direct Endorsement program. Various HUD Regulations, Handbooks, Notices and Mortgagee Letters govern a non-supervised loan correspondent's participation in the HUD Single Family Mortgage Insurance programs.

Noncompliance With HUD Requirements

Our review of loan origination and quality control activities disclosed the mortgagees not to be in compliance with HUD requirements. Specifically, American Liberty, Aspen, Citywide and First Source use independent contract loan officers to perform loan origination functions that are required by HUD to be performed only by employees. In addition Citywide and First Source established agreements with their independent contract loan officers that do not comply with HUD's requirements. Our review also disclosed noncompliance with HUD requirements in the following areas:

- Implementation of a quality control plan and related activities,
- Execution of control and responsible management supervision over independent contract loan officers, and
- Payment of all operating expenses related to the operation of a mortgage lending business.

We identified similar deficiencies during reviews of three other HUD/FHA approved non-supervised loan correspondents: (1) Clarion, (2) American Union, and (3) Treehouse. The deficiencies relating to the use of independent contract loan officers are discussed below.

Eight Services or Functions Performed by Loan Officer

The Federal Register dated March 1, 1999, addressing HUD regulation 24 CFR § 3500 (RESPA), referred to HUD's letter to the Independent Bankers Association of America, dated February 14, 1995; the letter identified 14 services/functions normally performed in the origination of a loan. Of the 14 services/functions, the loan officer performs eight:

- Obtaining information from the borrower and completion of the mortgage loan application/comparable activity,
- Analysis of the prospective borrower's income and debt and prequalification to determine the maximum mortgage amount the prospective borrower can afford,
- Educating the prospective borrower in the home buying and financing process,
- Collection of financial information (tax returns, banks statements) and other related documents that are part of the application process,
- Providing disclosure (truth in lending, good faith estimate, others) to the borrower,
- Assisting the borrower in understanding and clearing credit problems,
- Maintaining regular contact with the borrower, realtors, lender, between application and closing, and
- Participation in the loan closing.

HUD Mortgagee Letter 95-36 dictates that **customary loan officer functions may not be contracted out**, as mortgagees are held responsible for the quality of loans and compliance with HUD requirements. More specifically, loan origination functions may not be contracted out to third party loan originators, real estate brokers and other similar entities. HUD Mortgagee Letter 00-15 further defines the Department's position that the use of non-employees for the origination of FHA-insured loans increases the risk to the FHA insurance fund.

Six Services or Functions Performed by Loan Processor

The loan processor traditionally performs the remaining six services/functions:

- Initiating/ordering verifications of employment and verifications of deposits,
- Initiating/ordering requests for mortgage and other loan verifications,
- Initiating/ordering appraisals,
- Initiating/ordering inspections of engineering reports,
- Ordering legal documents, and
- Determining whether the property is located in a flood zone or ordering such service.

The above six services/functions performed by a loan processor were recognized by HUD in Mortgagee Letter 95-36 as origination functions that do not materially affect underwriting decisions. Therefore, the **loan processor function can be contracted out** without increasing the risk to the FHA insurance fund.

Use of Independent Contract Loan Officers

Contrary to HUD requirements, our review of loan origination and quality control activities disclosed American Liberty, Aspen, Citywide and First Source to be using independent contract loan officers to perform loan origination functions that are required by HUD to be performed only by employees. We identified approximately 1,334 FHA-insured loans, with a beginning amortization date between April 1, 2001 and March 31, 2002, which were originated by independent contract loan officers or non-employees during the audit period.

The same deficiency was identified during our reviews at Clarion, American Union and Treehouse. For these three mortgagees, we identified approximately 4,722 FHA-insured loans that were originated by independent contract loan officers or non-employees during the audit period.

Combined, for these seven mortgagees, 802 of their approximately 811 (99 percent) loan officers were independent contractors or non-employees. To illustrate, the ratio of independent contract loan officers to employee was approximately 50 to one at American Union, who had a total of 200 independent contract loan officers and only four employees. The employees held management and administrative positions. At Aspen all staff were independent contractors. While at First Source even its branch office manager/loan officer was an independent contractor.

The mortgagees' participation in the loan origination process was limited to the issuance of the FHA case number, performance of loan processing services/functions by employees/contractors, and disbursement of the loan commission check for an administrative fee. American Liberty, Aspen, Citywide and First Source pay their independent contract loan officers a commission for each FHA-insured loan closed and report commissions paid to their independent contract loan officers on IRS form 1099-MISC. Clarion's, American Union's and Treehouse's participation in the loan origination process was limited as well and they too reported their independent contract loan officers commission for each FHA-insured loan closed on IRS form 1099-MISC.

The use of independent contract loan officers to originate FHA-insured loans places the mortgagees in direct conflict with HUD's requirements that certain loan origination procedures are to be performed only by employees. The mortgagees cannot effectively ensure the accuracy, validity, and completeness of their loan origination operations, as the independent contract loan officers are not under direct control and supervision of the mortgagee. Therefore, an environment is created where potential deficiencies in the loan origination process go undetected and increase the susceptibility of the FHA insurance fund to risk.

Agreements Established Not In Compliance

Per Mortgagee Letter 95-36, HUD is explicit that customary loan origination functions may not be contracted out, as the mortgagees are held responsible for the quality of loans and compliance with HUD requirements. Furthermore, in Mortgagee Letter 00-15, HUD provides examples of provisions, they identified during reviews of employment agreements established by mortgagees that violate HUD requirements, such as:

> "Require the 'employee'…to indemnify the HUD/FHA approved mortgagee if it incurs damages from any apparent, express, or implied agency

representation by or through the 'employee's'…actions."

We found five mortgagees, Citywide, First Source, Clarion, American Union and Treehouse, had established agreements with their independent contract loan officers, which were not in compliance with HUD requirements. The agreements defined the loan officers as independent contractors and/or contained provisions indemnifying the mortgagees from any risk associated with the loans originated by the independent contract loan officers.

Provisions within established agreements that define loan officers as independent contractors and require indemnification clearly violate HUD requirements. Furthermore, the mortgagees' desire for risk avoidance is evident, implying the mortgagees' willingness to relinquish their fiduciary responsibilities regarding the FHA-insured loan origination process.

Deficient Quality Control

Chapter 6 of HUD Handbook 4060.1 REV-1 provides the general requirements along with mortgagee type specific requirements for quality control plans and related activities. Per paragraph 6-1, General, as a condition of HUD/FHA approval, a mortgagee is required to have and maintain a quality control plan for the origination of FHA-insured loans. In addition, paragraph 6-3, General Quality Control Plan Requirements for Loan Origination, requires quality control reviews to be performed within 90 days of loan closing.

Our review of quality control activities at the five Salt Lake City mortgagees disclosed noncompliance with HUD requirements. We found that all five of the mortgagees had quality control plans. However, the quality control plans were either missing required elements and/or had not been implemented. In addition, we found that quality control reviews were not performed in accordance with HUD requirements. We found similar deficiencies in quality control activities at two previously audited mortgagees, American Union and Treehouse.

The following table summarizes the deficiencies we identified in our review of the five Salt Lake City mortgagees' quality control plans and their implementation, and performance of quality control reviews.[5]

Quality Control Deficiencies

	Mortgagee Name	Plan	Implementation	Reviews
1	American Liberty	X	X	X
2	Aspen	X	X	X
3	Citywide	X	X	X
4	First Source		X	X
5	Jefferson	X	X	X

To illustrate, we reviewed the quality control plan for Aspen and found that it did not contain all of the required elements required under Chapter 6 of HUD Handbook 4060.1 REV-1, as well as, the plan had not been implemented. When we requested access to Aspen's quality control reviews, management informed us that only one or two loans had been reviewed, and the reviews were not documented.

A review of First Source's quality control plan[6] disclosed that, although it contained all of the required elements, no quality control reviews had been performed at the branch office. First Source's branch manager began to review loans originated by one loan officer upon notification by a sponsor that employment information was questionable.

Without proper establishment of a quality control plan and procedures, the mortgagees are unable to ensure the accuracy, validity and completeness of their loan origination operations resulting in increased risk to the FHA insurance fund.

Control and Supervision Not Exercised

Paragraph 2-13, Control and Supervision of Employees, of HUD Handbook 4060.1 REV-1, requires a mortgagee to exercise control and responsible management supervision over their employees. The requirement regarding control and supervision must include, at a minimum, regular and

[5] American Liberty, Aspen, First Source and Jefferson had their quality control plans reviewed by monitors from HUD's Quality Assurance Division during the performance of Title II origination reviews prior to our on-site reviews.

[6] The quality control plan for First Source's Midvale, Utah branch office was obtained from the main office located in Henderson, Nevada. The HUD Quality Assurance Division performed a monitoring review at First Source's main office during September 2002, which included a review of their quality control plan.

ongoing reviews of employee performance and of work performed. This implies direct control and supervision by the mortgagee over its employees.

American Liberty, Aspen, Citywide, First Source, American Union and Treehouse did not exercise control and responsible management supervision over their independent contract loan officers. The mortgagees did not actively participate in the loan origination process performed by their independent contract loan officers. The only oversight of the loan origination process on part of senior management at the mortgagees is when: (1) a loan processor identifies a deficiency during the accomplishment of his/her responsibilities, (2) loan proceeds are disbursed after closing, and/or (3) quality control reviews are performed of loans after closing. Our review of quality control activities (discussed previously) at the mortgagees disclosed various deficiencies at these six mortgagees.

We found that Citywide has devised a form that is completed in part[7] by the loan processor prior to the loan being submitted to the sponsor (underwriter) for underwriting. However, the form is really a checklist that confirms certain actions have been performed and certain documents are contained in the loan origination file. The form does not constitute a check to ensure the propriety of information contained in the loan origination files.

Senior management at American Liberty, Aspen, Citywide and First Source acknowledged the lack of ongoing management supervision over their independent contract loan officers. For example, the president of Aspen, made a statement during a meeting that it is clear there is no ongoing management supervision, as evidenced by his infrequent visits to the main office during our on-site review.

The mortgagees also acknowledged their reliance on their sponsors as their checks and balance for the propriety of information contained in their loan origination files. This is evident in the case of First Source. As discussed previously, First Source's branch manager began to review loans originated by one loan officer upon notification by a sponsor that employment information was questionable.

[7] The loan processor completes the remaining areas of the form after the loan has been funded.

Prior to the sponsor's notification, reviews had not taken place.

The procedures established by the mortgagees treat their loan officers as independent contractors in order to comply with IRS income reporting requirements for contractors. Thus, the mortgagees' requirement for direct control and supervision as required by HUD is negated as the loan officers work independently. Without ongoing management supervision, coupled with deficiencies in quality control (discussed previously), the mortgagees are unable to ensure the accuracy, validity and completeness of their loan origination operations resulting in increased risk to the FHA insurance fund.

Unallowable Operating Expenses Charged

Per paragraph 2-17, Operating Expenses, of HUD Handbook 4060.1 REV-1, a mortgagee is required to pay all of its operating expenses. The operating expenses that must be paid by the mortgagee include, but are not limited to, equipment, furniture, office rent, overhead, and other similar expenses incurred in operating a mortgage lending business.

Contrary to HUD requirements, interviews and reviews of agreements with employees and contractors at American Liberty and Citywide disclosed the mortgagees require their independent contract loan officers to pay for various operating expenses required to be paid by the HUD/FHA approved mortgagee. We identified similar deficiencies during our reviews of Clarion, American Union and Treehouse.

To illustrate, American Liberty charges their independent contract loan officers and loan processors for the following operating expenses associated with the origination of FHA-insured loans:

- Unapproved marketing materials,
- Rental space fee of $300 for an office (includes a desk, chair, computer and phone), and
- Rental space fee of $100 for a desk (includes a chair, computer and phone).

However, American Liberty does provide office supplies and other office equipment.

Citywide's independent contract loan officers are charged the following operating expenses associated with the origination of FHA-insured loans:

- Marketing materials,
- Rental space fee up to a $1,000 per month depending on office size, and
- Loan Prospector and Desktop Underwriter usage.

However, Citywide does provide their independent contract loan officers with a telephone, office supplies, office equipment, computer, and receptionist/clerical assistance.

Impact of Use of Contract Loan Officers

Our review of HUD/FHA approved mortgagees in Utah and Colorado, disclosed a number of the mortgagees to be using independent contract loan officers to originate FHA-insured loans. HUD requires customary loan officer functions to be performed only by employees. By using independent contract loan officers, the mortgagees do not have direct control and supervision over their loan officers as required by HUD.

Furthermore, we identified deficiencies in the mortgagees' quality control processes. The lack of direct control and supervision coupled with quality control deficiencies increase the risk to the FHA insurance fund in the form of defaults and claims.

To illustrate, during our review we saw a significant increase in the default and claim rates associated with First Source's branch office in Midvale, Utah. As of March 2003, seven of the 207 FHA-insured loans originated, with a beginning amortization date between April 1, 2001 and March 31, 2003, were currently in default and one loan had an insurance claim paid. As of January 2004, the number of loans currently in default for the same 207 FHA-insured loans had risen to 11 and the number of insurance claims paid had risen to nine. This represents a 57 percent increase for loans currently in default and an 800 percent increase for insurance claims paid. We also saw increases in the current default rates and/or insurance claims paid at American Liberty, Aspen, Citywide and American Union.

In the case of American Union, as of October 2001, 43 of the 1,492 FHA-insured loans originated, with a beginning amortization date between September 1, 1999 and August 31, 2001, were currently in default and six loans had insurance claims paid. As of January 2002, the number of loans currently in default for the same 1,492 loans had risen to 83 and the number of claims paid had risen to 12. This represents a 93 percent increase for loans currently in default and a 100 percent increase for insurance claims paid.

If First Source and American Union had not used independent contract loan officers to originate FHA-insured loans, allowing for direct control and supervision, coupled with the performance of required quality control reviews, the increase in the current default rate and insurance claims paid could have been prevented. As discussed previously, upon notification by a sponsor, First Source's branch manager began to review loans originated by a particular loan officer. The branch manager found a number of the loans associated with the loan officer to be currently in default or had an insurance claim paid. The loan officer was terminated as a result of deficiencies identified during the review of the loans.

Risk Associated With Originations Passed On

In our opinion the use of independent contract loan officers disclosed during our review of HUD/FHA approved mortgagees in Utah and Colorado stems primarily from the mortgagees' propensity to pass on the risk associated with FHA-insured loans to others. This is not only illustrated by the establishment of agreements by a number of the mortgagees with their independent contract loan officers that include indemnification provisions, but also the mortgagees reliance on their sponsors as the checks and balance for the propriety of information contained in their loan origination files. We identified other factors that contributed to the use of independent contract loan officers by the mortgagees to originate FHA-insured loans as well:

- Income reporting requirements need to be defined,
- Misinterpretation of HUD requirements, and

- Increased Profitability.

Income Reporting Requirements Need To Be Defined

Income Reporting Requirements Need To Be Defined
The lack of clarity in HUD requirements has created an environment that inadvertently contributes to the use of independent contract loan officers. HUD's requirements do not dictate whether income is reported on IRS form 1099-MISC or IRS form W-2. However, HUD's requirements are explicit, as discussed previously, that customary loan officer functions may not be contracted out. In addition, HUD requires ongoing management supervision and control over employees, which is negated by using independent contractors to originate FHA-insured loans.

The lack of defining requirements for income reporting, in effect, allows the mortgagees to pay/report income of loan officers involved in the origination of FHA-insured loans on IRS form 1099-MISC. The IRS requires that form 1099-MISC be used to report amounts paid to independent contractors. It is apparent that the mortgagees interpret being able to use IRS form 1099-MISC for reporting income to mean the use of independent contract loan officers to originate FHA-insured loans is allowable.

In 1996, the Internal Revenue Service (IRS) issued Technical Advice Memorandum (TAM)[8] 9648003 concerning the classification of loan officers for employment tax purposes. The IRS reviewed the practice of treating loan officers as independent contractors for tax purposes considering IRS Code Section 3508, which defines a qualified real estate agent as a statutory non-employee for employment tax purposes. The IRS concluded in the TAM that IRS Code Section 3508 does not apply to loan officers as they are not independent contractors, but are employees. Therefore, mortgagees have a potential liability for failure to withhold payroll taxes (e.g., federal income tax, Social Security tax and Medicare tax) under IRS Code, which could impact the ability of a mortgagee to meet HUD's net worth requirements.

[8] A TAM is guidance provided by the IRS' Office of Chief Counsel in response to technical or procedural questions. The guidance provided represents the final position of the IRS, but only for the issue(s) relating to a specific case. Therefore, pursuant to 26 USC 6110(k)(3) of the IRS Code, the guidance cannot be used or cited as precedent.

Misinterpretation of HUD Requirements

Misinterpretation of HUD Requirements

We found that misinterpretation of HUD requirements contributed to the use of independent contract loan officers. Senior management at American Liberty took the position that HUD program staff, in fact, approved the use of independent contractors to originate FHA-insured loans.

During a Title II monitoring review by HUD's Quality Assurance Division, senior management at American Liberty was contemplating making the switch from IRS form W-2 employees to IRS form 1099-MISC independent contractors. According to senior management, the HUD monitor approved the use of independent contract loan officers or use of IRS form 1099-MISC for income reporting purposes. Therefore, loan officers and loan processors became independent contractors, while remaining staff stayed employees (e.g., receptionist, accountant and senior management). Furthermore, senior management at American Liberty explained that loan officers have to be independent contractors in order to meet IRS requirements for 1099 income reporting.

Contrary to the assertion made by American Liberty management, we were advised the HUD monitor did not approve the use of independent contract loan officers. However, the HUD monitor did correctly inform American Liberty management that HUD requirements do not stipulate whether income is reported on IRS form 1099-MISC versus IRS form W-2.

An illustration of misinterpretation of HUD requirements by HUD program staff that conflicted with official policy was found during our review of Treehouse Mortgage. The agreements Treehouse established with its independent contract loan officers did not comply with HUD requirements. Treehouse entered into agreements with its loan officers as a result of advice they had received from their attorneys. Treehouse's attorneys had previously represented another mortgagee residing in the Santa Ana Homeownership Center's (HOC) region. The other mortgagee submitted its proposed loan officer agreement to the Santa Ana HOC, who in turn reviewed and approved it. Our review of the agreement identified various provisions (e.g., indemnification) that violate HUD's requirements. The Denver HOC concurred with our assessment that the agreement conflicts with HUD's requirements that FHA-insured loans be originated by mortgagee employees, and that mortgagees are held responsible for the quality of loans and compliance with HUD requirements.

Increased Profitability

<u>Increased Profitability</u>
An additional factor that contributes to the use of independent contract loan officers by the mortgagees is increased profitability as a result of reduced operating costs and increased loan officer retention. For example, the mortgagees experience reduced operating costs as they avoid:

- Administrative costs associated with withholding of personal income tax (federal and state) for the employee,
- Contribution of one half of an employee's Social Security tax and Medicare tax,
- Contribution to the federal (and some states) unemployment insurance system,
- Contribution to various state employment systems (e.g., disability, education),
- Providing worker's compensation, and/or
- Providing benefits (e.g., retirement, health insurance, vacation and sick leave).

Lastly, the commission structure associated with the use of independent contract loan officers to originate FHA-insured loans allows for retention and increases the overall profitability of the mortgagee. In the past, American Liberty had reported a loan officer's commissions on IRS form W-2 and loan commissions were split 50/50. The loan officers felt the company was making all of the money; thus, retention was low. As a result, American Liberty made the switch to independent contract loan officers and reporting income on IRS form 1099-MISC.

American Liberty attributes its ability to retain loan officers to the use of IRS form1099-MISC for income reporting and to charging the flat administrative fee. Not only does the independent contract loan officer realize more profit, but

American Liberty does as well. American Liberty bills its independent contract loan officers for a portion of the operating expenses (as discussed previously), and has minimal supportive/administrative costs and responsibility.

Furthermore, we noted a number of independent contract loan officers had incorporated and any loan commissions were paid via IRS form 1099-MISC to the corporations. The mortgagees were contracting with corporations to generate FHA-insured loans. Such arrangements could be construed as prohibited branch arrangements and create an unclear path of responsibility and liability. HUD holds its mortgagees responsible for the quality of loans and compliance with HUD requirements.

Summary

Under HUD's Single Family Direct Endorsement program, the mortgagee underwrites and closes the mortgage loan without HUD/FHA review or approval. HUD has established various Regulations, Handbooks, Notices and Mortgagee Letters that govern the program. Given the autonomy of this program it is imperative that approved mortgagees not only understand, but also comply with established requirements.

HUD requirements stipulate that customary loan officer functions may not be contracted out as these functions are to be performed by employees of the approved mortgagee. The practice as we found showed mortgagees to be using independent contract loan officers. The mortgagees did not have direct control and supervision over their loan officers as required by HUD. Again, the lack of direct control and supervision, coupled with quality control deficiencies, increase the risk to the FHA insurance fund.

As a result of our review, we are recommending that HUD/FHA issue appropriate guidance and specific instructions to HUD's Homeownership Centers and to FHA approved mortgagees requiring the use of mortgagee employed loan officers versus independent contractors or non-employees to originate FHA-insured loans. We also recommend that HUD require mortgagees to report their originating loan officer's income on IRS form W-2, which would include withholding of federal income tax, Social Security tax and Medicare tax.

Auditee Comments

The Office of Housing - Single Family concurred with our audit results and agreed with our recommendations. Upon issuance of the audit report they will initiate corrective action on the finding and related recommendations. The Office of Housing - Single Family is aware of the issue discussed in the audit report and has drafted a proposed rule (FR-4761-P-01), which among other things, provides a definition of a lender employee.

Recommendations

We recommend the Assistant Secretary for Housing - Federal Housing Commissioner:

1A. Issue appropriate guidance and specific instructions to HUD Homeownership Centers and to FHA approved mortgagees requiring the use of mortgagee employed loan officers versus independent contractors or non-employees to originate FHA-insured loans.

1B. Require FHA approved mortgagees to report their originating loan officer's income on IRS form W-2, which would include withholding of federal income tax, Social Security tax and Medicare tax.

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Management Controls

In planning and performing our audit, we considered the management controls established by the five HUD/FHA approved non-supervised loan correspondents (mortgagees), American Liberty, Aspen, Citywide, First Source and Jefferson to determine our audit procedures, not to provide assurance on the controls. Management controls are the plan of an organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Management Controls Assessed

We determined the following management controls were relevant to our audit objective:

- Loan origination process and
- Quality control process.

Assessment Procedures

The following audit procedures were used to evaluate the management controls:

- Review of established procedures formulated by the mortgagees in originating FHA-insured loans,
- Interviews with officials and employees of the mortgagees and other related parties and entities,
- Examination of records and related documents for FHA-insured loans originated between April 1, 2001 and March 31, 2003,
- Review of records and files maintained by HUD's Quality Assurance Division in connection with the oversight of the mortgagees, and
- Interviews with applicable officials and employees of HUD's Quality Assurance Division relating to activities associated with the mortgagees.

Significant Weaknesses

A significant weakness exists if management controls do not provide reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained and maintained, and fairly disclosed in reports.

Our review of the mortgagees' management controls over their loan origination and quality control procedures for the origination of FHA-insured loans showed the mortgagees as not complying with HUD requirements. Based on our audit, we believe the following items discussed in the finding are significant weaknesses:

- Use of independent contract loan officers to perform loan origination functions required by HUD to be performed only by employees,

- Implementation of a quality control plan and related activities,

- Execution and control and responsible management supervision over independent contract loan officers, and

- Payment of all operating expenses related to the operation of a mortgage lending business.

The deficiencies are discussed in detail in the finding section of this report.

Follow Up On Prior Audits

This is the first HUD Office of Inspector General for Audit review of the specific use of independent contract loan officers to originate FHA-insured loans.

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Background Information

American Liberty Financial Services
American Liberty was incorporated in March 1996 as a state of Utah for-profit corporation. American Liberty originates Federal Housing Administration (FHA), Veterans Affairs (VA), and conventional mortgage loans. American Liberty received approval from HUD as a Title II non-supervised loan correspondent on May 5, 1998. We reviewed American Liberty's loan origination and quality control activities at the main office located at 310 East 4500 South, Suite 220, Murray, Utah 84107.

HUD's Quality Assurance Division performed a Title II monitoring review of American Liberty during May 2002. The monitoring review identified deficiencies in: (1) implementation of their quality control plan, (2) reporting FHA loan activities in accordance with the Home Mortgage Disclosure Act (HMDA), and (3) availability and completeness of loan origination files.

The mortgagee's last independent audit report for the year ending December 31, 2002 contained one finding:

> "The Company did not submit their annual audit report within 90 days of its fiscal year end. According to 24 CFR Part 202, the Company is required to submit an audit report within 90 days of its fiscal year end."

The audited financial statements for the year ending December 31, 2003 were not due. Therefore, we are unable to discern whether American Liberty had resolved the issue of late submission of their annual audit report.

Aspen Financial, LC
Aspen was incorporated in June 1998 as a state of Utah for-profit corporation. Aspen originates FHA, VA, and conventional mortgage loans. Aspen received approval from HUD as a Title II non-supervised loan correspondent on August 30, 2000. We reviewed Aspen's loan origination and quality control activities at the main office located at 12272 South 800 East, Draper, Utah 84020.

HUD's Quality Assurance Division performed a Title II monitoring review of Aspen during March 2002. The monitoring review identified deficiencies in: (1) implementation of their quality control plan, (2) reporting FHA loan activities in accordance with the HMDA, (3) charging employees a rental space fee, (4) reporting to HUD the name (doing business as Aspen Home Loans) used to transact business, (5) reporting branch offices to HUD, and (6) availability and completeness of loan origination files.

The mortgagee's last independent audit report for the year ending December 31, 2002 did not contain any findings.

Citywide Home Loans
Citywide was incorporated in December 1998 as a state of Utah for-profit corporation. Citywide originates FHA, VA, and conventional mortgage loans. Citywide received approval from HUD as a Title II non-supervised loan correspondent on April 20, 2000. We reviewed Citywide's loan

origination and quality control activities at the main office located at 4001 South 700 East, Suite 250, Salt Lake City, Utah 84107.

HUD's Quality Assurance Division has not performed a Title II monitoring review of Citywide.

The mortgagee's last independent audit report for the year ending December 31, 2002 did not contain any findings.

First Source Financial USA

First Source's main office in Henderson, Nevada was incorporated in February 1998 as a state of Nevada for-profit corporation, and operates a licensed mortgage company in Midvale, Utah. First Source's Midvale branch office originates FHA, VA, and conventional mortgage loans. The Midvale branch office received approval from HUD as a Title II non-supervised loan correspondent on April 24, 2001. We reviewed First Source's loan origination and quality control activities at the branch office located at 1225 Fort Union Boulevard, Suite 200, Midvale, Utah 84047. We did not perform an on-site review at First Source's main office.

HUD's Quality Assurance Division performed a Title II monitoring review of the main office located in Henderson, Nevada during September 2002. The monitoring review of the main office identified deficiencies in: (1) implementation of their quality control plan, (2) independent contractor agreements are not in compliance with HUD's requirements, (3) allowed employees to work at other companies in a related industry, (4) allowed non-employees to originate and process FHA-insured loans, and (5) accepted false documentation that passed through the hands of the borrower. The monitoring review did not encompass loan origination and quality control activities at the Midvale branch office.

The mortgagee's last independent audit report for the year ending December 31, 2002 did not contain any findings.

Jefferson Nationwide Mortgage Corp.

Jefferson was incorporated in February 1998 as a state of Utah for-profit corporation. Jefferson originates FHA, VA, and conventional mortgages. Jefferson received approval from HUD as a Title II non-supervised loan correspondent on June 23, 1999. We reviewed Jefferson's loan origination and quality control activities at the main office located at 8180 South 700 East, Suite 100, Sandy, Utah 84070.

HUD's Quality Assurance Division performed a Title II monitoring review of Jefferson during September 2002. The monitoring review identified deficiencies in: (1) implementation of their quality control plan, (2) reporting FHA loan activities in accordance with the HMDA, and (3) completeness of loan origination files.

The mortgagee's last independent audit report for the year ending December 31, 2002 was prepared assuming that Jefferson would continue as a going concern. The notes to the financial statements disclosed the following:

> "The Company's current liabilities exceeded its current assets by $206,121 and the Company has a stockholder's deficit of $18,487 as of December 31, 2002. These factors create an uncertainty about the Company's ability to continue as a going concern. Management is currently attempting to increase business and lower administrative expenses. The ability of the Company to continue as a going concern is dependent on the results of Management's efforts. The financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern."

Jefferson provided us with their unaudited financial statements for the six-month period ending June 30, 2003. We reviewed the unaudited financial statements and found stockholder's equity had increased from the deficit of $18,487 to a positive $188,508. It appears stockholder's equity is sufficient to meet HUD's net worth requirements for an approved non-supervised loan correspondent. However, we were unable to deduce when the increase in stockholder's equity took place. In addition, we noticed that Jefferson did not record any depreciation expense for the six-month period. We estimated that depreciation expense would have been approximately $40,000.

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