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AUDIT REPORT

Pryme Investment and Mortgage Brokers, Inc.
Non-Supervised Loan Correspondent
Murray, Utah

2003-DE-1004

March 27, 2003

Office of Audit, Region 8
633 17th Street, 14th Floor
Denver, Colorado, 80202

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Issue Date
March 27, 2003
Audit Case Number
2003-DE-1004

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

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

SUBJECT: Pryme Investment and Mortgage Brokers, Inc.
Non-Supervised Loan Correspondent
Murray, Utah

We completed an audit of Pryme Investment and Mortgage Brokers, Inc. (Pryme Investment), doing business as Beacon Hill Mortgage, in Murray, Utah. We selected Pryme Investment for review because of their high default and claim rates. The objectives of our review were to: (1) determine whether the mortgagee acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of FHA-insured loans selected for review; and (2) determine whether the mortgagee's quality control plan, as implemented, meets HUD requirements.

Our report contains three findings with recommendations requiring action by your office. We appreciate the courtesies and assistance extended by the management and staff of Pryme Investment and the HUD Denver 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

We completed a review of Pryme Investment and Mortgage Brokers, Inc. (Pryme Investment) a FHA approved non-supervised loan correspondent with a main office located in Murray, Utah and branch office located in Pocatello, Idaho. We did not perform an on-site review at Pryme Investment's branch office. Pryme Investment is a non-supervised loan correspondent approved by HUD-FHA to originate FHA-insured loans under HUD's Single Family Direct Endorsement Program.

We found that Pryme Investment has not adequately implemented its quality control process and is deficient in its overall quality control activities. Furthermore, Pryme Investment did not administer or carry out its non-supervised loan correspondent activities in conformity with HUD-FHA approval requirements. In addition, Pryme Investment did not always originate FHA-insured loans in accordance with HUD requirements and prudent lending practices.

HUD's Quality Assurance Division performed a Title II monitoring review of Pryme Investment during the months of January and February 2001. The findings letter dated April 30, 2001, prepared by the Quality Assurance Division, disclosed that Pryme Investment had not implemented their quality control plan in accordance with HUD Handbook 4060.1 REV-1. In addition, two separate matters were referred to the Real Estate Settlement Procedures Act (RESPA) Division of HUD for resolution. Violations relating to HUD-FHA underwriting requirements were addressed in a separate letter to the responsible sponsor.

HUD Insures Mortgages Made by Private Lending Institutions

HUD insures mortgages made by private lending institutions under Section 203 of the National Housing Act (12 U.S.C. 1709). HUD designates these institutions as supervised mortgagees, non-supervised mortgagees, loan correspondents, investing mortgagees and government institutions. Depending upon their designation, the institutions have the authority to originate, purchase, hold, service or sell FHA-insured mortgages. Specifically, a loan correspondent can only originate loans for an approved sponsor.

Audit Objectives

The objectives of the audit were to determine whether: (1) Pryme Investment acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the FHA-insured loans selected for review; and (2) Pryme Investment's quality control plan, as implemented, meets HUD requirements.

Insufficient Quality Control Process

During our review of quality control activities, we found that Pryme Investment has not adequately implemented its quality control process and is deficient in its overall quality control activities. Pryme Investment did not implement its quality control plan until approximately 43 months after receiving HUD-FHA approval. Pryme Investment did not meet its ten percent sample requirement for quality control reviews for four months. Nor did they review loans defaulting within the first six months or review ten percent of rejected loans. Furthermore, individuals who were not independent of the loan origination process performed quality control reviews. Lastly, Pryme Investment failed to notify HUD of any violations of law or regulation, false statements or program abuses by its employees. In our opinion, the deficiencies associated with Pryme Investment's quality control plan and procedures stem from Pryme Investment's disregard of HUD's and their own quality control requirements. Therefore, Pryme Investment is unable to ensure the accuracy, validity and completeness of its loan origination operations.

FHA Approval Requirements Not Met

Furthermore, Pryme Investment did not administer or carry out its non-supervised loan correspondent activities in conformity with HUD-FHA approval requirements. Pryme Investment failed to report business changes to HUD, such as Chapter 7 bankruptcy. Pryme Investment did not exercise control and responsible management supervision over their employees. Nor did they require exclusivity of their employees. Furthermore, Pryme Investment failed to clearly identify its main office to the public. In our opinion, the deficiencies associated with Pryme Investment's responsibilities as a HUD-FHA approved non-supervised loan correspondent stem from Pryme Investment's disregard of HUD-FHA mortgagee approval requirements. Therefore, Pryme Investment's eligibility as a HUD-FHA approved mortgagee is questionable.

Improvement Needed in the Origination of FHA-Insured Loans

Lastly, our review of loan origination activities disclosed that Pryme Investment did not always originate FHA-insured loans in accordance with HUD requirements and prudent lending practices. Pryme Investment did not exercise due diligence in the verification of the borrower's source of funds and income, and in the review of the borrower's liabilities and credit characteristics. Furthermore, Pryme Investment did not maintain complete case files for loans originated as required by HUD. In our opinion, the deficiencies associated with Pryme Investment's loan origination activities stem from Pryme Investment's disregard of HUD requirements and failure to implement its quality control process, therefore, attributing to the high default and claim rates and increasing the risk to the FHA insurance fund.

Recommendations

Based on the results of our review of quality control activities, operations in accordance with FHA approval requirements, and loan origination activities, we are recommending that Pryme Investment's participation in HUD's Single Family Mortgage Insurance Programs be discontinued. In addition, we are recommending that HUD take any administrative action(s) as deemed appropriate.

If Pryme Investment is allowed to retain their approval as a non-supervised loan correspondent and they continue to participate in HUD's Single Family Mortgage Insurance Programs, then HUD needs to ensure that Pryme Investment has fully implemented its quality control process in conformity with HUD requirements. By doing so, Pryme Investment and HUD will have better assurance as to the accuracy, validity and completeness of its loan origination operations. This will minimize the risk to the FHA insurance fund.

Pryme Investment must also ensure to HUD they have the minimum capital necessary to meet HUD requirements and sufficient operating capital for which to continue as a viable non-supervised loan correspondent. In addition, Pryme Investment must make certain they are reporting business changes to HUD, and they have management controls in place that ensure senior management exercises control and responsible management supervision over its employees. This would also include Pryme Investment requiring exclusivity of its employees and clearly identifying its main office to the public.

Lastly, HUD needs to ensure that Pryme Investment develops and implements a management control process that will ensure all loan origination functions are monitored for compliance with HUD requirements. The management control process must be able to ensure all deficiencies noted in the loan origination process are corrected prior to submission of the loan to the direct endorsement sponsor. Consequently, Pryme Investment and HUD will have better assurance that FHA-insured loans originated by Pryme Investment meet HUD Single Family Direct Endorsement Program requirements. This will further minimize the risk to the FHA insurance fund.

Auditee Comments

The results of the audit were discussed with the president of Pryme Investment during the course of on-site audit work and at the on-site exit meeting. We provided the president with a copy of the draft report for review and comment on February 26, 2003 and requested that any comments be provided by March 14, 2003. On March 17, 2003 the president requested, and was granted, an extension for submission of the comments by March 24, 2003. The president declined to verbally discuss the draft report.

We did not receive the president's comments by March 24, 2003 as agreed, nor were we contacted as to the status of the comments. Therefore, this audit report is being issued without formal comments from Pryme Investment.

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Abbreviations

CFR	Code of Federal Regulations
FHA	Federal Housing Administration
HUD	United States Department of Housing and Urban Development
OIG	Office of Inspector General
RESPA	Real Estate Settlement Procedures Act
URLA	Uniform Residential Loan Application
VOD	Verification of Deposit
VOE	Verification of Employment

Introduction

Pryme Investment and Mortgage Brokers, Inc. (Pryme Investment), also known as Beacon Hill Mortgage, was incorporated on April 21, 1995 under the laws of the State of Utah. Pryme Investment originates Federal Housing Administration (FHA), Veterans Affairs, and conventional mortgages. Pryme Investment received approval from HUD as a Title II non-supervised loan correspondent on April 28, 1997. Pryme Investment has a main office located at 491 West 5300 South, Murray, Utah 84123 and a branch office at 320 West Center Street, Pocatello, Idaho 83204.

As a non-supervised loan correspondent, Pryme Investment's principal activity is the origination of mortgages for sale or transfer to an approved sponsor under the HUD Single Family Direct Endorsement Program. The sponsor is responsible to HUD for the actions of its loan correspondent in originating insured mortgages. The sponsor underwrites the loans originated by the loan correspondent and is required to supervise and perform quality control reviews of its loan correspondent(s). The sponsor must be an approved mortgagee that is also authorized to participate in the HUD Single Family Direct Endorsement Program.

HUD's Quality Assurance Division performed a Title II monitoring review of Pryme Investment during the months of January and February 2001. The results of the Quality Assurance Division's review detailed in the finding letters dated April 30, 2001 to Pryme Investment and its sponsor Security National Mortgage Company are briefly discussed below:

Quality Control Plan
Pryme Investment had not implemented its quality control plan in accordance with HUD guidelines as required by HUD Handbook 4060.1 REV-1. Pryme Investment had disclosed to the Quality Assurance Division staff that they had just implemented their quality control reviews. Reports to management on findings identified during the quality control review process were not available. We identified similar and additional deficiencies in Pryme Investment's quality control process during our review. These deficiencies are discussed in detail under Finding 1 Insufficient Quality Control Process of this audit report.

Yield Spread Premiums and Servicing Release Premiums
Pryme Investment was not disclosing yield spread premiums and servicing release premiums they received on the HUD-1 Settlement Statements as required under RESPA. This issue was referred to the RESPA Division of HUD for further review and resolution.

Loan Applications Taken by Non-Employee
The spouse of a real estate agent was receiving one half of a loan officer's origination fee for translation services provided during the initial loan application process. The one half of the origination fee was not disclosed on the HUD-1 Settlement Statements as required under RESPA and the spouse was not an employee of Pryme Investment. This issue was referred to the RESPA Division of HUD for further review and resolution.

HUD/FHA Underwriting Requirements
During the monitoring review, the Quality Assurance Division identified various violations of HUD's underwriting requirements by Pryme Investment's sponsor Security National Mortgage Company for seven FHA-insured loans. Due to the seriousness of the violations

identified (e.g., analysis of borrower income, verification of source of funds), the Quality Assurance Division made a request for indemnification for four of the FHA-insured loans reviewed should HUD pay a claim on the loans. The remaining three loans contained violations (e.g., compensating factors for a temporary interest rate buydown, borrower's explanations for derogatory credit items) that did not warrant indemnification. Based on Security National Mortgage Company's explanations, HUD required Security National Mortgage Company to sign an indemnification agreement for three of the four FHA-insured loans.

We noted similar violations of underwriting requirements during our review. These violations are discussed in detail under the Issues Needing Further Study and Consideration section of this audit report.

From March 1, 2000 through February 28, 2002, Pryme Investment's sponsors endorsed 1,016 loans with a total mortgage amount of $120,937,077. As of November 8, 2002, of the 1,016 FHA-insured loans, 98 loans are currently in default and foreclosure action has been initiated on 108 of the loans. Furthermore, HUD has paid claims on 46 of the loans, totaling $5,669,826.25, with losses totaling $1,100,357.

Audit Objectives and Methodology

The objectives of the audit were to determine whether: (1) Pryme Investment acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the FHA-insured loans selected for review; and (2) Pryme Investment's quality control plan, as implemented, meets HUD requirements.

Our audit approach was to identify and evaluate the management controls in place over the key areas of operations of Pryme Investment's FHA-insured loan originations and within HUD Single Family Direct Endorsement Program requirements. Our review methodology included the review of a sample of 20 FHA-insured loans originated by Pryme Investment. We selected our sample of 20 FHA-insured loans from the universe of 1,016 FHA-insured loans originated by Pryme Investment with a beginning amortization date between March 1, 2000 and February 28, 2002. The results of our detailed testing apply only to the 20 FHA-insured loans selected and cannot be projected to the universe of 1,016 FHA-insured loans.

The sample included FHA-insured loans that we identified with a combination of the following characteristics (See also Appendix A.):

- Loan is currently in default or had a claim filed,
- Default status and default reason (e.g., 42 - Delinquent 90 days or more and 7 - Excessive obligations),
- Low number of payments prior to default;
- Gift letter source, and
- Number of defaults by the direct endorsement sponsor.

To accomplish the audit objectives, we examined records and related documents of Pryme Investment. We also reviewed applicable HUD records relating to Pryme Investment's non-supervised loan correspondent activities. We conducted interviews with officials and employees of Pryme Investment and the HUD Quality Assurance Division. Furthermore, we conducted inspections of selected FHA-insured properties and interviewed available mortgagors.

HUD Data Systems Used

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

Audit Scope

Our audit generally covered the period of March 1, 2000 through February 28, 2002. 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 through December 31, 2002. We conducted our field work from June through December 2002.

Generally Accepted Government Auditing Standards

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

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Insufficient Quality Control Process

Pryme Investment has not adequately implemented its quality control process and is deficient in its overall quality control activities. Pryme Investment did not implement its quality control plan until approximately 43 months after receiving HUD-FHA approval. Pryme Investment did not meet its ten percent sample requirement for quality control reviews for four months. Nor did they review loans defaulting within the first six months or review ten percent of rejected loans. Furthermore, individuals who were not independent of the loan origination process performed quality control reviews. Lastly, Pryme Investment failed to notify HUD of any violations of law or regulation, false statements or program abuses by its employees. In our opinion, the deficiencies associated with Pryme Investment's quality control plan and procedures stem from Pryme Investment's disregard of HUD's and their own quality control requirements. Therefore, Pryme Investment is unable to ensure the accuracy, validity and completeness of its loan origination operations.

HUD Handbook 4060.1 REV-1

HUD Handbook 4060.1 REV-1 includes the requirements for a mortgagee's quality control plan for the origination and servicing of FHA-insured mortgages. Chapter 6 of HUD Handbook 4060.1 REV-1 provides the general requirements along with mortgagee type specific requirements for quality control plans.

Deficient Quality Control Procedures

Pryme Investment has not adequately implemented its quality control process. More specifically, Pryme Investment did not implement its quality control plan until approximately 43 months after receiving HUD-FHA approval to originate FHA-insured loans as a non-supervised loan correspondent. In addition, Pryme Investment was deficient in its overall quality control activities. Pryme Investment did not meet the ten percent sample requirement for quality control reviews for four months. Pryme Investment did not review loans defaulting within the first six months, nor did they review ten percent of rejected loans. Individuals who were not independent of the loan origination process performed quality control reviews. As well as, Pryme Investment failed to notify HUD of any violations of law or regulation, false statements or program abuses by its employees. These deficiencies are discussed below.

Quality Control Plan Implemented 43 Months After HUD-FHA Approval

Per paragraph 6-1, General, of HUD Handbook 4060.1 REV-1, as a condition of HUD-FHA approval as a non-supervised loan correspondent, Pryme Investment is required to have and maintain a quality control plan for the origination of FHA-insured mortgages. The quality control plan must be sufficient in scope to enable the mortgagee to evaluate the accuracy, validity and completeness of its loan origination operations.

Contrary to HUD requirements, Pryme Investment's quality control plan was not implemented until approximately 43 months after they were approved as a non-supervised loan correspondent. Furthermore, actual quality control reviews did not begin until 47 months after receiving HUD-FHA approval. Pryme Investment was under the impression that their sponsors were responsible for performing quality control reviews.

The lack of a quality control plan and implementation of the plan through the performance of quality control reviews prevented Pryme Investment from evaluating the accuracy, validity and completeness of its loan origination operations. Therefore, potential deficiencies in the loan origination process were not identified and corrected for a significant period of time.

Ten Percent Sampling Requirement Not Met

In accordance with paragraphs 6-1, General, and 6-3, General Quality Control Plan Requirements for Loan Origination, of HUD Handbook 4060.1 REV-1, quality control reviews are to be performed within 90 days of the loan closing. The mortgagee is required to review either: (1) the lesser of ten percent of all loans closed on a monthly basis, or (2) a random sample that provides a 95 percent confidence level with two percent precision. If fewer than ten loans are originated monthly, the ten percent sampling requirement can be performed on a quarterly basis.

Accordingly, Pryme Investment's quality control plan requires a review of loans no later than ninety days after the closing date using a random selection of "…no less than 10% of all loans closed by retail branches, third party originators and correspondents."

We queried HUD's Single Family Data Warehouse for all loan origination activity between April 1, 2001 and May 31, 2002. We used this period as it coincided with the quality control audit reports provided by Pryme Investment for review. We tallied the number of loans closed each month during the period and determined the number of loans to be reviewed based on Pryme Investment's ten percent sample requirement. We then compared the monthly ten percent sample requirement to the number of loans reviewed each month by Pryme Investment during the period. We found the number of loans reviewed for November 2001, December 2001, January 2002 and February 2002 fell short of the ten percent sample requirement.

The failure to meet sampling requirements for review prevents Pryme Investment from evaluating the accuracy, validity and completeness of its loan origination operations. Therefore, potential deficiencies in the loan origination process were not identified and corrected.

Loans Defaulting Within the First Six Months and Loans Rejected Not Reviewed

Paragraphs 6-1, General, and 6-3, General Quality Control Plan Requirements for Loan Origination, of HUD Handbook 4060.1 REV-1, also requires the mortgagee to analyze all loans, which go into default within the first six months and review of ten percent of total loans rejected. In addition, the quality control plan is to include procedures for expanding the scope of the review where a pattern of deficiencies or fraudulent activity is disclosed.

During our review, we noted that Pryme Investment did not review loans that defaulted within the first six months. Nor did they review ten percent of loans that were rejected. Pryme Investment was unaware of the requirement to review all loans defaulting within the first six months, even though their quality control plan contains the following statement:

> "Additionally, all loans, which go into default within the first six payments, will be selected for review."

With regards to rejected loans, Pryme Investment's quality control plan contains the following statement:

> "A random selection of no less than 10% of all loans rejected by this company will be selected for review."

Of the 1,016 FHA-insured loans originated during the audit period, 66 (6.5 percent) defaulted within the first six months. Our review of quality control audit reports covering the period April 2001 to May 2002 did not include any loans that had defaulted within the first six months. Nor did they include ten percent of loans that were rejected.

The failure to complete the review of early default loans and loans rejected prevents Pryme Investment from evaluating the accuracy, validity and completeness of its loan origination operations. Therefore, deficiencies in the loan origination process were not identified and corrected.

Quality Control Reviews Performed by Loan Processor and Loan Officer

Per paragraph 6-1, General, of HUD Handbook 4060.1 REV-1, the quality control plan is to provide for the independent evaluation of the significant information gathered for use in the mortgage credit decision making and loan servicing process for all loans originated or serviced. The quality control reviews are to be performed by mortgagee management/supervisory personnel who are knowledgeable and have no direct loan processing, underwriting or servicing responsibilities.

At the time of our review, the president of Pryme Investment was performing the quality control reviews of loans originated by both the main and branch offices. In the past, Pryme Investment had a separate person to perform quality control reviews. However, due to a decline in volume, the president could not justify the cost to employ a separate person to perform quality control reviews.

Our review of Pryme Investment's production report covering the period February 1, 2000 to June 19, 2002 found the individual performing the quality control reviews was not independent of the loan process. In fact, the individual was listed as the loan processor for a total of 70 of the 2,176 loans targeted for FHA insurance per Pryme Investment's production report.

In addition, the production report disclosed the president as the loan originator for approximately 714 loans targeted for FHA insurance. According to the president, verification of information (e.g., employment and assets) is performed by the loan processors, and in some cases by the loan officers. The president is responsible for follow-up and resolution of deficiencies identified during the quality control review process. The internal quality control reviews performed by the loan processor and the president of Pryme Investment do not meet HUD requirements for independent evaluation.

Therefore, Pryme Investment cannot ensure that the quality control reviews performed by the former loan processor and the president were accurate and deficiencies identified were resolved given the lack of independence from the loan origination process.

Program Abuses Not Reported to HUD

In accordance with paragraph 6-1, General, of HUD Handbook 4060.1 REV-1, mortgagees are required to notify the HUD Regional Office, the HUD Area Office or the HUD Regional Office of Inspector General of any violation of law or regulation, false statements or program abuses by the mortgagee, its employees or any other party to the transaction. Furthermore, the mortgagee is required to initiate immediate corrective action when discrepancies are found and to document the corrective actions taken.

Pryme Investment did not notify HUD of any violations of law or regulation, false statements or program abuses by its employees in the origination of FHA-insured loans. Sponsors who expressed concern that a number of loans were first payment defaults had contacted the president of Pryme Investment. The president reviewed the loan files in question and found the same loan officers had originated the loans. The president had difficulty contacting/locating employers and a number of the borrowers used “mattress funds.”

Consequently, the loan officers were terminated for their questionable activities. The president did not have documentation to support the loan file reviews and based the termination decision on a “feeling” the loan officers were not trustworthy. According to the president, the loan officers are probably originating “bad” loans for another mortgage company.

We inquired whether the president had reported the questionable activities of the loan officers to HUD as required. The president was not aware of the reporting requirement of HUD. However, the president did verbally report the loan officer’s activities to the Utah Department of Financial Institutions.

Our sample of 20 FHA-insured loans included 13 loans originated by the loan officers in question. As of November 8, 2002, HUD has paid $1,005,679.66 in claims for eight of the loans, and has sustained a loss of $167,937 in the subsequent resale of three of the properties. The remaining loans were in default.

By not reporting the questionable activity to HUD, there is a risk the loan officers are still originating FHA-insured loans for other approved mortgagees, thus, increasing the risk to the FHA insurance fund.

Impact of Not Meeting HUD Quality Control Requirements

As shown by the discussions above, Pryme Investment has implemented its quality control plan and procedures contrary to HUD's requirements and its own established requirements. Under HUD's Single Family Direct Endorsement Program, the mortgage loan is underwritten and closed without prior HUD review or approval. Therefore, it is imperative that Pryme Investment implements its quality control policies and procedures in accordance with HUD and its own requirements. Without proper establishment of a quality control plan and procedures, Pryme Investment is unable to ensure the accuracy, validity and completeness of its loan origination operations.

Disregard of HUD Requirements

In our opinion, the deficiencies associated with Pryme Investment's quality control plan and procedures stem from Pryme Investment's disregard of HUD's and their own quality control requirements. Furthermore, Pryme Investment transferred the responsibility of quality control to its sponsors.

During our review we found that Pryme Investment did not perform regular and ongoing reviews of loan officer performance and work performed as required by HUD. Pryme Investment relied solely on its sponsors as its checks and balance for the propriety of information contained in the loan origination files.

In summary, as shown by the discussions above, Pryme Investment's quality control process did not meet HUD's requirements nor its own requirements for approved non-supervised loan correspondents under the HUD Single Family Direct Endorsement Program. The HUD Quality Assurance Division identified similar deficiencies, as discussed in the finding, in Pryme Investment's quality control process during their Title II monitoring review of Pryme Investment during the months of January and February 2001.

Therefore, given the repetitive nature of the finding, removal of Pryme Investment's approval to participate in HUD's Single Family Mortgage Insurance Programs, may be warranted. Additionally, HUD may want to consider other administrative action(s) as deemed appropriate.

If Pryme Investment is allowed to maintain their approval as a non-supervised loan correspondent, then HUD needs to ensure that Pryme Investment has fully implemented its quality control process in conformity with HUD requirements. By doing so, Pryme Investment and HUD will have better assurance as to the accuracy, validity and completeness of its loan origination operations, thus, minimizing the risk to the FHA insurance fund.

Auditee Comments

Pryme Investment did not provide formal comments to the audit report.

Recommendations

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

1A. Determine whether Pryme Investment's deficiencies relating to quality control warrant removal from participation in HUD's Single Family Mortgage Insurance Programs. Based upon the deficiencies discussed above relating to Pryme Investment's quality control process, consider taking any appropriate administrative action(s), such as:

- Debarment,
- Limited Denial of Participation, and/or
- Civil Money Penalties.

If HUD determines that Pryme Investment can maintain their approval as a non-supervised loan correspondent, then HUD needs to:

1B. Require Pryme Investment to fully establish and implement an adequate quality control process and related reviews.

1C. Review Pryme Investment's implementation of recommendation 1B and ensure Pryme Investment's quality control process is fully implemented in conformity with HUD requirements.

HUD-FHA Approval Requirements Not Met

Pryme Investment did not administer or carry out its non-supervised loan correspondent activities in conformity with HUD-FHA approval requirements. Pryme Investment failed to report business changes to HUD, such as Chapter 7 bankruptcy. Pryme Investment did not exercise control and responsible management supervision over their employees. Nor did they require exclusivity of their employees. Furthermore, Pryme Investment failed to clearly identify its main office to the public. In our opinion, the deficiencies associated with Pryme Investment's responsibilities as a HUD-FHA approved non-supervised loan correspondent stem from Pryme Investment's disregard of HUD-FHA mortgagee approval requirements. Therefore, Pryme Investment's eligibility as a HUD-FHA approved mortgagee in the origination of FHA-insured loans is questionable.

HUD Requirements

Under HUD's Single Family Mortgage Insurance Programs, mortgagees are eligible if certain qualifications are met to originate, purchase, hold or sell HUD-FHA insured mortgages. Various HUD regulations, Handbooks, Notices and Mortgagee Letters govern the programs.

HUD regulation 24 CFR § 202 establishes the requirements for mortgagee approval. HUD Handbook 4060.1 REV-1 supplements the HUD regulations and provides general and special approval requirements for mortgagees to obtain and maintain their approval for participation in the HUD-FHA mortgage insurance programs.

General and Special Approval Requirements to Obtain and Maintain HUD-FHA Approval

Chapter 2 of HUD Handbook 4060.1 REV-1 provides the general approval requirements all mortgagees must meet to be approved for participation in HUD-FHA mortgage insurance programs. The special approval requirements defined by mortgagee type are delineated in Chapter 3. As a non-supervised loan correspondent, Pryme Investment is not only required to meet the general approval requirements, but must also meet the special approval requirements defined for loan correspondents.

Mortgagee Approval Requirements Not Met

Pryme Investment has not followed HUD-FHA requirements for obtaining and maintaining their approval as a non-supervised loan correspondent. More specifically, we noted non-compliance with HUD-FHA approval requirements in the following areas:

- Failed to report business changes to HUD,

- Senior management did not exercise control and responsible management supervision over their employees,
- Did not require exclusivity of its employees, and
- Failed to clearly identify its main office to the public.

These four areas are discussed below.

Business Changes Not Reported

1. Business Changes Not Reported

Paragraph 2-21, Reporting Business Changes, of HUD Handbook 4060.1 REV-1, requires mortgagees to notify HUD within 10 days of all corporate changes including: corporation conversions, mergers, consolidations, successions, liquidations, termination, and changes in their charter provisions, name, location, control of ownership, character of business, executive officers or branch managers. With regards to bankruptcy, mortgagees are required to submit a statement of net worth within 30 days of commencement of voluntary or involuntary bankruptcy.

During our review, we identified two instances where Pryme Investment failed to report significant business changes to HUD: (1) discontinuance of loan origination operations at its main and branch offices, and (2) filing of Chapter 7 bankruptcy.

As discussed earlier, the president had begun the process of shutting down loan origination activities at Pryme Investment with a target date of June 30, 2002. The correspondence log maintained by the HUD Lender Approval and Recertification Division disclosed they had not received any verbal or written notification from Pryme Investment as required.

In addition to failing to report a discontinuance of loan origination operations, Pryme Investment failed to report to HUD the filing of Chapter 7 bankruptcy on August 1, 2002. Again, the correspondence log maintained by the HUD Lender Approval and Recertification Division disclosed they had not received any verbal or written notification from Pryme Investment as required.

According to available public records, the Chapter 7 bankruptcy was subsequently dismissed on October 4, 2002. The public records included the following excerpt:

> "Assets available for distribution: No"

This business change is significant in that Pryme Investment is required to meet certain net worth, liquidity, and warehouse line of credit requirements to be approved for participation in Title I or Title II programs as prescribed under HUD regulations 24 CFR § 202.7 and 24 CFR § 202.8.

Review of the bankruptcy filing disclosed that Pryme Investment filed Chapter 7 bankruptcy due to the "…danger of being subject of significant judicial judgments and liens…." Pryme Investment had a negative net worth of $1,623,988.82, based on the reported assets of $105,466.35 and liabilities of $1,729,455.17 as of August 1, 2002. In addition, the company sold over half of its assets, which consisted mainly of office equipment and furniture.

The fair market value of the remaining assets listed with the bankruptcy court was stated at $48,978.73, which was much lower than the reported amount in the financial statements to HUD of $257,332 for fiscal year ended December 31, 2001. According to the bankruptcy papers filed, Pryme Investment had a year to date loss on operations of $14,298.72.

This situation puts into question Pryme Investment's eligibility as a HUD-FHA approved mortgagee. Primarily, Pryme Investment lacks the minimum required capital to meet HUD's requirements and to continue operations as an approved loan correspondent.

Control and Supervision Not Exercised

2. Control and Supervision Not Exercised

Paragraph 2-13, Control and Supervision of Staff, 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 ongoing reviews of employee performance and of work performed.

During our review, we found Pryme Investment's senior management did not exercise control and responsible management supervision over its employees. Senior management did not actively participate in the loan origination process performed by its loan officers and loan processors. The only review of loan officer work that takes place prior to submission of the loan file to the sponsor (underwriter) is the completion of the standard checklist by the loan processor. The standard checklist is completed to ensure the loan file contains all the required documents and does not verify the quality or the validity of data in the loan file. Per senior management, the sponsors verify the information and catch any discrepancies. A second checklist is completed after the loan has been underwritten and is ready for closing.

Furthermore, as discussed in Finding 1, Pryme Investment did not implement their quality control plan until approximately 43 months after they received HUD-FHA approval to originate FHA-insured loans as a non-supervised loan correspondent. In addition, individuals that were not independent of the loan origination process performed the quality control reviews.

Exclusivity of Employees Not Required

3. Exclusivity of Employees Not Required

Paragraph 2-14, Conducting Mortgagee Business, of HUD Handbook 4060.1 REV-1, requires employees of the mortgagee, excluding the receptionist, whether full or part time, to be employed exclusively by the mortgagee, at all times, and conduct only the business affairs of the mortgagee during normal business hours.

During our review we found Pryme Investment did not require exclusivity of its employees as required by HUD. A loan officer was allowed to originate FHA-insured loans while being employed by another HUD-FHA approved mortgagee. In addition, this same loan officer along with Pryme Investment loan processors were allowed to process loans for a sponsor.

While on-site, we received information from the HUD Denver Homeownership Center staff that the president of Pryme Investment was no longer originating loans. We discussed the information with the president of Pryme Investment, as it was not shared during other information gathering meetings. The president, as of the beginning of

June 2002, informed us he had begun to closeout all loan origination activities at Pryme Investment. The president reported he no longer participated in the loan origination process as he had taken an account executive position with a Pryme Investment sponsor. The president had planned to shift all remaining loans in process that did not close prior to June 30, 2002 to another HUD-FHA approved loan correspondent. This included loans in process at both the main and branch offices. Also, the remaining loan officers and loan processors would be moving over to the HUD-FHA approved loan correspondent who would be leasing office space at Pryme Investment's main and branch offices. The HUD-FHA approved loan correspondent received authorization for a branch office at Pryme Investment's branch office location on May 30, 2002.

The president made it clear during various discussions that he no longer originated loans for Pryme Investment. The president explained further that his assistant was now a State of Utah licensed loan officer and had begun to originate loans beginning June 2002.

President Continued to Originate FHA-Insured Loans While Being Employed By Other Mortgagee

Contrary to the president's explanations, review of Pryme Investment's records disclosed the president had originated FHA-insured loans during the month of June 2002, while being employed by another mortgagee. In addition, the assistant did not become a licensed loan officer in the State of Utah until June 30, 2002. Furthermore, the assistant disclosed that she was not a loan officer, but an assistant to the president.

Subsequent to our on-site review, the president of Pryme Investment informed us that "the deal fell through" and the sponsor no longer employs him. Along with the president, there are currently two other loan officers at Pryme Investment's main office. The branch office is currently not originating FHA-insured loans.

President Along With Loan Processors Originated Loans for Sponsor

We obtained and reviewed the FHA case binders for two loans included in Pryme Investment's loan production report. Our review of Pryme Investment's loan production report and the documentation contained in the FHA case binders disclosed the president of Pryme Investment as the loan officer for the two loans. As well as, two of Pryme Investment's loan processors participated in the loan origination process for the two loans. The HUD-FHA approved originating mortgagee for the two loans was not Pryme Investment, but a sponsor of Pryme Investment. Both loans were refinances (not streamline) for properties located in Colorado, which is outside of Pryme Investment's area of operations. The following is a summation of documentation found in each of the FHA case binders:

FHA Case Number 052-1346190
The first FHA case binder reviewed disclosed the originating lender as Security National Mortgage Company. The loan officer listed per the "FHA Underwriter Condition Sheet" is the president of Pryme Investment and the processor listed was a former loan processor at Pryme Investment. Various documents contained in the file include references to Beacon Hill Mortgage, also known as, Pryme Investment. For example, the HUD-1 Settlement Statement includes payment from the borrower's fund for the loan origination fee, loan discount, and credit report to Beacon Hill. In addition, the credit report, bank statements, and the VOEs include references to Pryme Investment loan processors.

FHA Case Number 052-1213019
The second FHA case binder disclosed the originating lender as Security National Mortgage Company. The loan officer listed per the "FHA Underwriter Condition Sheet" is the president of Pryme Investment and the processor listed is an employee of Pryme Investment. Various documents contained in the file include references to Pryme Investment loan processors. The name Beacon Hill has been "blacked out" with a marker on various documents as well.

Main Office Not Identified to the Public

4. Main Office Not Identified to the Public
Per paragraph 2-16, Office Facilities, of HUD Handbook 4060.1 REV-1, the mortgagee's main and branch offices facilities are to be clearly identified to the public.

While on-site, we found Pryme Investment's main office was not clearly identified to the public. More specifically, the building contained only a sign reading "The Colonial House" with no identification of Pryme Investment nor the building address displayed. We observed a client who apologized to a loan officer for being late, as they could not find the building.

Business Activities Demonstrate Irresponsibility

Per paragraph 2-23, Ineligible Participants, of HUD Handbook 4060.1 REV-1, for a mortgagee to maintain approval, neither the mortgagee nor any officer, partner, director, principal or employee shall be engaged in business practices that do not conform to generally accepted practices of prudent mortgagees or do not demonstrate responsibility.

Our review of Pryme Investment business activities using available public records revealed that Pryme Investment is alleged to have engaged in business practices that do not conform to generally accepted practices of prudent mortgagees or that demonstrate irresponsibility. Review of the bankruptcy filing disclosed that Pryme Investment had three suits filed against it relating to: (1) fraud and improper loan fees, (2) the performance of a repurchase agreement on ten loans from a sponsor, and (3) the participation in a fraudulent scheme where borrowers lost money.

Impact of Not Meeting FHA Approval Requirements

HUD-FHA has established general requirements, as well as specific requirements that apply to the type of mortgagee for which it seeks approval for participation in the HUD-FHA mortgage insurance programs. As evidenced by the above deficiencies it is clear that Pryme Investment has operated outside of these established requirements. Therefore, Pryme Investment's eligibility as a HUD-FHA approved mortgagee is questionable.

Disregard of HUD Requirements

In our opinion, the deficiencies addressed above in Pryme Investment carrying out their responsibilities as a HUD-FHA approved non-supervised loan correspondent stem from Pryme Investment's disregard of HUD-FHA mortgagee approval requirements. Pryme Investment did not follow their own established procedures, nor did they have a system in place to ensure HUD-FHA mortgagee approval requirements are being met.

For example, Pryme Investment enters into Associate Agreements (Agreement) with its loan officers. The Agreement defines the loan officer as an employee who "…shall not transact any business in relation to loan origination, selling, funding, closing or consulting with any other business so long as he/she shall remain an employee…." As previously illustrated Pryme Investment did not require exclusivity of its loan officers as defined in its Agreement and required by HUD.

In summary, Pryme Investment did not meet HUD-FHA approval requirements for non-supervised loan correspondents under the HUD Single Family Direct Endorsement Program. Therefore, we recommend that Pryme Investment's approval to participate in the HUD program, as a non-supervised loan correspondent should be discontinued. Additionally, HUD may want to consider other administrative action(s) as deemed appropriate.

If Pryme Investment is allowed to maintain their approval as a non-supervised loan correspondent, then assurances need to be made by Pryme Investment that they have the minimum capital necessary to meet HUD requirements and sufficient operating capital for which to continue as a viable non-supervised loan correspondent.

Furthermore, Pryme Investment must make certain they are reporting business changes to HUD, and they have management controls in place that ensure senior management exercises control and responsible management supervision over its employees. This would also include Pryme Investment requiring exclusivity of its employees and clearly identifying its main office to the public.

Auditee Comments

Pryme Investment did not provide formal comments to the audit report.

Recommendations

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

2A. Determine whether Pryme Investment's deficiencies relating to FHA approval requirements warrant removal from participation in HUD's Single Family Mortgage Insurance Programs. Based upon the deficiencies discussed above relating to Pryme Investment's operations, consider taking any appropriate administrative action(s), such as:

- Debarment,

- Limited Denial of Participation, and/or
- Civil Money Penalties.

If HUD determines that Pryme Investment can maintain their approval as a non-supervised loan correspondent, then HUD needs to:

2B. Ensure that Pryme Investment has the minimum capital necessary to meet HUD requirements and sufficient operating capital for which to continue as a viable non-supervised loan correspondent.

2C. Require Pryme Investment to develop and implement a proper management structure that meets HUD requirements. This would include the following:

- Reporting business changes to HUD as required,
- Exercising of control and responsible management supervision by senior management over its employees,
- Requiring employees to be exclusive, and
- Clearly identifying the main office to the public.

2D. Review Pryme Investment's implementation of recommendation 2C and ensure Pryme Investment's operations comply with FHA approval requirements.

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Improvement Needed in the Origination of FHA-Insured Loans

Pryme Investment did not always originate FHA-insured loans in accordance with HUD requirements and prudent lending practices. Pryme Investment did not exercise due diligence in the verification of the borrower's source of funds and income and review of the borrower's liabilities and credit characteristics. Furthermore, Pryme Investment did not maintain complete case files for loans originated as required by HUD. In our opinion, the deficiencies associated with Pryme Investment's loan origination activities stem from: (1) Pryme Investment's disregard of HUD requirements; (2) Pryme Investment's failure to implement its quality control process; and (3) senior management's lack of control and responsible supervision over Pryme Investment's employees. These deficiencies contributed to the high default and claim rates and increased the risk to the FHA insurance fund.

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 by HUD, the institutions have the authority to originate, purchase, sell or service HUD FHA-insured mortgages.

As a loan correspondent, Pryme Investment's principal activity is the origination of mortgages for sale or transfer to an approved sponsor under the HUD Single Family Direct Endorsement Program. The sponsor is responsible to HUD for the actions of its loan correspondent in originating FHA-insured mortgages. The sponsor underwrites the loans originated by the loan correspondent and is also required to supervise and perform quality control reviews of its loan correspondent(s). The sponsor must be an approved mortgagee that is also authorized to participate in the HUD Single Family Direct Endorsement Program.

Under HUD's Single Family Direct Endorsement Program, the mortgagee underwrites and closes the mortgage loan without prior HUD review or approval. HUD Handbook 4155.1 REV-4 CHG-1 contains the basic mortgage credit underwriting requirements for single family (1-4 units) mortgage loans insured under the National Housing Act.

Fourteen Services or Functions Performed During Loan Origination

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. The services/functions entail but are not limited to the following:

- 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, bank statements) and other related documents that are part of the application process,
- Initiating/ordering verifications of employment (VOEs) and verifications of deposit (VODs),
- Initiating/ordering requests for mortgage and other loan verifications,
- Initiating/ordering appraisals,
- Initiating/ordering inspections of engineering reports,
- Providing disclosures (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,
- Ordering legal documents,

- Determining whether the property is located in a flood zone or ordering such service, and

- Participation in the loan closing.

Underwriter's Loan Approval Subject to Information Gathered

Based on the information contained in the loan package received from the loan correspondent, the underwriter (sponsor) will approve or reject the loan or approve the loan if certain conditions are met. Therefore, it is critical that the loan correspondent exercise due diligence and follows prudent lending practices during the loan origination process.

Deficiencies in Loan Originations

Pryme Investment did not always follow HUD requirements and prudent lending practices in the origination of FHA-insured loans. We selected and reviewed a sample of 20 FHA-insured loans originated by Pryme Investment with a beginning amortization date between March 1, 2000 and February 28, 2002.

Our review of the loan documentation contained in the FHA case binders obtained during the loan origination process by Pryme Investment disclosed various deficiencies. Pryme Investment did not exercise due diligence in the verification of the borrower's source of funds and income, and review of the borrower's liabilities and credit characteristics. Nor did Pryme Investment maintain complete case files for loan originations as required by HUD. The following cases are illustrative of the various deficiencies identified during the review process.

Mortgage Not Adjusted for Inducement to Purchase

Paragraph 2-10, Funds to Close, of HUD Handbook 4155.1 REV-4 CHG-1, requires all funds for the borrower's investment to be verified. An acceptable source of these funds is gift funds. The donor of the gift may not be a person or entity with an interest in the sale of the property, such as the seller, real estate agent or broker, builder or any entity associated with them. Gifts from these sources are considered inducements to purchase and must be subtracted from the sales price. The gift donor and the borrower sign a gift letter that includes a statement that no repayment is required.

The borrower for FHA case number 521-4656299 received a gift of $4,640 from a cousin. Our reverification of the gift funds disclosed the gift was provided by an individual who resides at the residence of the loan officer for the transaction. During an interview, the gift donor disclosed he was not a relative and the borrower had paid back the gift funds. Therefore, the $4,640 was not a gift, but a loan. The gift represents an inducement to purchase as it came from an individual associated with the loan officer for the transaction. The $4,640 was not subtracted from the sales prices as required. The mortgage was over-insured by $4,608.56 and the borrower did not meet the cash investment requirements for the property.

Cash Saved at Home Not Verified Properly

Paragraph 2-10, subparagraph M, Cash Saved at Home, of HUD Handbook 4155.1 REV-4 CHG-1, requires the mortgagee to verify all funds for the borrower's investment. Specifically, borrowers who save cash at home are required to demonstrate the ability to do so. As part of the asset verification process performed by the mortgagee, the borrower is required to explain how the funds were accumulated and the amount of time taken to do so.

As part of the loan origination process, as detailed in the Federal Register dated March 1, 1999, addressing HUD regulation 24 CFR § 3500 (RESPA), the loan correspondent is responsible for collection of financial information (tax returns, bank statements) and other related documents that are part of the application process. The sponsor relies on the information prepared/collected by the loan correspondent in determining the eligibility of the borrower(s) to qualify for the loan.

During our review we identified four FHA-insured loans where the FHA case binder did not include an explanation from the borrower as to how cash saved at home was accumulated and the amount of time taken to do so. The only documentation contained in the FHA case binder was a Monthly Budget and Residual Form – Cash on Hand statement completed by the loan correspondent. The FHA case numbers and the amount deposited per letters from the title company were as follows:

- FHA case binder 521-4850042 - a deposit of $1,000 was made to the title company,

- FHA case binder 521-4707361 - a deposit of $1,000 was made to the title company,

- FHA case binder 521-4724846 - a deposit of $1,000 was made to the title company, and

- FHA case binder 521-4735832 - a deposit of $1,400 was made to the title company.

We have included the above discussion on cash saved at home in the Issues Needing Further Study and Consideration section of the audit report.

False Employment Verifications

Section 2, Effective Income, of HUD Handbook 4155.1 REV-4 CHG-1, requires the mortgagee to establish the anticipated amount of income and the likelihood of its continuance, to determine the borrower's capacity to repay the mortgage debt. Paragraph 2-6, Stability of Income, and paragraph 2-7, Salaries, Wages, and Other Forms of Effective Income, of HUD Handbook 4155.1 REV-4 CHG-1, requires the mortgagee to verify the prospective borrower's income for the most recent two full years and ensure the borrower's income can be reasonably expected to continue for at least three years.

Paragraph 3-6, Credit Report and Verifications, of HUD Handbook 4000.2 REV-2, requires the mortgagee to verify information with as much care as would be used if they were entirely dependent on the property as security. Furthermore, the credit report and verification forms are not to pass through the hands of the applicant, a real estate agent, or other interested third party. Specifically, the Verification of Employment (VOE) is to be delivered directly to the applicant's employer and must be returned directly to the mortgagee.

As part of the loan origination process, as detailed in the Federal Register dated March 1, 1999, addressing HUD regulation 24 CFR § 3500 (RESPA), the loan correspondent is responsible for obtaining information from the borrower and completion of the mortgage loan application and initiating/ordering VOEs. The sponsor relies on the information prepared/collected by the loan correspondent in determining the eligibility of the borrower(s) to qualify for the loan.

Our review of FHA-insured loans originated by Pryme Investment disclosed questionable verifications of employment for one borrower and two co-borrowers whose income was used to qualify for the FHA-insured loans.

FHA Case Number 521-4655235
We question the validity of the co-borrower's claimed employment with a store per the final Uniform Residential Loan Applications (URLA) and the VOE for FHA case number 521-4655235.

We spoke with the accountant and manager of the store who confirmed the co-borrower had never been an employee. The accountant and manager alleged that a former employee who is now a real estate agent had provided the false employment verification.

Review of the VOE prepared by the loan processor disclosed the VOE had passed through the hands of a third party, the selling agent for the transaction. The VOE contained a signed statement by the president of Pryme Investment that the VOE is a true and accurate copy of the VOE from the selling agent. Pryme Investment made the following certification on page 1 of form HUD-92900-A (Addendum to the URLA), "The verification of employment and verification of deposits were requested and received by the lender or its duly authorized agent without passing through the hands of any third persons and are true to the best of the lender's knowledge and belief."

Therefore, the final URLA and the VOE contain false information, and certifications made and signed by the loan officer, loan processor and borrower appear to be false, as well.

FHA Case Number 521-4656299
We question the validity of the borrower's claimed employment with a catering service per the initial and final URLAs, the VOE, and related paystubs for FHA case number 521-4656299. We confirmed the address for the borrower's place of employment per the URLAs and the VOE, as the address of a home located in Hyrum, Utah which is approximately 87 miles from the borrower's residence at the time the URLAs were completed and approximately 85 miles from the property the borrower received an FHA-insured mortgage.

We spoke with an occupant of the home and were informed there had never been a catering service operated out of the home. The occupant revealed that the loan officer for the transaction was a former restaurant owner in the area. Per the occupant they do not have a telephone and would not be able to provide any verifications. Furthermore, the paystubs used to support the borrower's employment appear to be the same paystub photocopied multiple times with adjustments made to the dates on the paystubs.

Therefore, the initial and final URLAs, VOE and related paystubs contain false information, and certifications made and signed by the loan officer, loan processor and borrower appear to be false, as well.

<u>FHA Case Number 521-4672443</u>
We questioned the accuracy of a co-borrower's employment with a fast food establishment per the initial and final URLAs and the VOE for FHA case number 521-4672443. Review of the VOE disclosed that the co-borrower had worked at the fast food establishment for approximately 22 months (December 7, 1998 to September 26, 2000). Our confirmation with the human resource department for the fast food establishment disclosed the co-borrower had been employed for only ten months (November 29, 1999 to September 26, 2000), not 22 months as reported per the VOE. In addition, the individual we spoke with at the human resource department informed us that the individual who signed the VOE on behalf of the fast food establishment was never an employee or a manager. The individual also stated they had provided similar information to another individual a few months earlier who had called to verify the co-borrower's employment.

Therefore, the initial and final URLAs and VOE contain false information, and certifications made and signed by the loan officer, loan processor and borrower appear to be false, as well.

Liabilities and Credit Characteristics

Paragraph 2-4, Credit Report Requirements, of HUD Handbook 4155.1 REV-4 CHG-1, requires the mortgagee to separately develop credit information for any open debt listed on the loan application but not included on the credit report.

As part of the loan origination process, as detailed in the Federal Register dated March 1, 1999, addressing HUD regulation 24 CFR § 3500 (RESPA), the loan correspondent is responsible for the analysis of the prospective borrower's income and debt and prequalification to determine the maximum mortgage amount the prospective borrower can afford. This includes obtaining information from the borrower and other sources to resolve derogatory credit information. The sponsor relies on the information prepared/collected by the loan correspondent in determining the eligibility of the borrower(s) to qualify for the loan.

For the following three FHA-insured loans, liabilities disclosed on the initial URLA were omitted from the final URLA and the Mortgage Credit Analysis Worksheet prepared by the loan correspondent. The FHA case binders did not contain any additional information concerning the liabilities. And the liabilities did not appear on the credit report.

- 521-4606569 – The initial URLA disclosed a liability with monthly payments of $350 and an unpaid balance of $8,400. If the liability were to be included, the fixed payment-to-income ratio would have increased from 29.48 percent to 37.98 percent.

- 521-4656299 – The initial URLA disclosed a liability with monthly payments of $387 and an unpaid balance of $11,421. If the liability were to be included, the fixed payment-to-income ratio would have increased from 29.28 percent to 37.99 percent. In addition, the credit report contained a collection account with a current balance of $402. The borrower provided an explanation for the collection. However, the FHA case binder did not include any information as to whether the collection was paid. Nor was the collection taken into consideration when completing the Mortgage Credit Analysis Worksheet.

- 521-4666851 – The initial URLA disclosed a liability with monthly payments of $250. The unpaid balance amount was not disclosed. If the liability were to be included, the fixed payment-to-income ratio would have increased from 32.58 percent to 41.38 percent.

Had these liabilities been fully disclosed, the eligibility of the borrower(s) to qualify for the loan may have been affected. We have included the above discussion on review of liabilities and credit characteristics in the Issues Needing Further Study and Consideration section of the audit report.

Incomplete Loan Files

Paragraph 5-10, Retention of Mortgagee's Origination File, of HUD Handbook 4000.2 REV-2, requires the origination mortgagee to retain the entire case file pertaining to loan origination, either in hard copy or microfilm form, for at least two years from the date of insurance endorsement for auditing purposes. Upon request, mortgagees must make legible hard copies of the material available to HUD staff.

During our review, we found that Pryme Investment was not maintaining the entire case file as required. We were unable to locate the case file for one of the 20 FHA-insured loans selected for review in Pryme Investment's loan/case file database[1] or in the stacks of hard copy files stored in the basement. Of the remaining 19 case files that we were able to locate and review, copies of documents used during the loan origination process were unsigned, missing either the underwriter and/or lender signature. The case files were missing pages of credit reports and loan applications. In addition, we identified one file that did not include a good faith estimate, and two files that did not include gift letters.

The absence of documentation in the case files prohibits Pryme Investment from ensuring the loan origination process was properly documented. In addition, missing and/or incomplete documentation may impede the performance of quality control reviews.

Impact of Loan Origination Deficiencies

The above cases clearly illustrate that HUD assumed unnecessarily high risk when insuring the loans originated by Pryme Investment. These cases have attributed to the high default and claim rates and increased the risk to the FHA insurance fund.

[1] Approximately six to eight months prior to our on-site review beginning in June 2002, Pryme Investment began scanning their closed loan/case files using PaperVision an electronic document management system.

During our review, we saw a significant increase in Pryme Investment's default and claim rates for the 1,016 FHA-insured loans originated with a beginning amortization date between March 1, 2000 and February 28, 2002.

As of April 2, 2002, HUD's Single Family Data Warehouse disclosed 72 of the 1,016 FHA-insured loans were currently in default. As of November 8, 2002, the number of current defaults for the same 1,016 FHA-insured loans had risen to 98. This represents an increase in the current default rate of 36.11 percent from April 2002 to November 2002 for the same FHA-insured loans.

As of November 8, 2002, HUD has paid claims on 46 of the 1,016 loans totaling $5,669,826.25, with losses totaling $1,100,357. Furthermore, HUD has incurred loss mitigation costs totaling $19,166.10 for ten of the 1,016 loans.

Disregard of HUD Requirements

In our opinion, the deficiencies associated with Pryme Investment's loan origination activities stem from Pryme Investment's disregard of HUD requirements as demonstrated in the origination of loans associated with the case illustrations above.

Pryme Investment's failure to implement its quality control process also contributed to the deficient loan origination activities. As discussed in detail in Finding 1 of this audit report, the failure to establish a quality control process has led to Pryme Investment's inability to ensure the accuracy, validity and completeness of its loan origination operations. Quality control reviews were not performed until 47 months after Pryme Investment received their approval as a FHA non-supervised loan correspondent. Therefore, potential deficiencies in the loan origination process were not identified and corrected.

Lastly, Pryme Investment's senior management (as discussed in Finding 2 of the audit report) did not exercise control and responsible supervision over its employees. Senior management did not actively participate in the loan origination process performed by its loan officers. The only review of a loan officer's work that takes place prior to submission of the loan file to the sponsor for underwriting is the completion of a standard checklist. The checklist is completed to ensure the loan file contains all the required documents, but does not verify the quality or validity of data in the loan file. Senior management relied on its sponsors (underwriters) as its checks and balance for the propriety of information contained in the loan files.

Since Pryme Investment did not carry out its loan origination activities in accordance with HUD requirements and prudent lending practices, further participation in the HUD program should be discontinued. Additionally, HUD may want to consider other administrative action(s) as deemed appropriate.

If Pryme Investment is allowed to maintain their approval as a non-supervised loan correspondent, then HUD needs to ensure that Pryme Investment develops and implements a management control process that will ensure all loan origination functions are monitored for compliance with HUD requirements. The management control process must be able to ensure all deficiencies noted in the loan origination process are corrected prior to submission of the loan to the direct endorsement sponsor. Consequently, Pryme Investment and HUD will have better assurance that FHA-insured loans originated by Pryme Investment meet HUD Single Family Direct Endorsement Program requirements, thus further minimizing the risk to the FHA insurance fund.

Auditee Comments

Pryme Investment did not provide formal comments to the audit report.

Recommendations

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

3A. Determine whether Pryme Investment deficiencies in loan origination activities warrant removal from participation in HUD's Single Family Mortgage Insurance Programs. Based upon the loan origination deficiencies discussed above, consider taking any appropriate administrative action(s), such as:

- Debarment,
- Limited Denial of Participation,

- Civil Money Penalties, and/or
- Indemnification.

If HUD determines that Pryme Investment can maintain their approval as a non-supervised loan correspondent, then HUD needs to:

3B. Require Pryme Investment to develop and implement a management control process that will ensure all loan origination functions are monitored for compliance with HUD requirements. Also, the management control process must ensure any deficiencies noted in the loan origination process be corrected prior to submission of the loan to the direct endorsement sponsor for underwriting.

3C. Review Pryme Investment's implementation of recommendation 3B and ensure Pryme Investment's loan origination procedures and management control process are fully implemented in conformity with HUD requirements.

Management Controls

In planning and performing our audit, we considered the management controls of Pryme Investment to determine our audit procedures, not to provide assurance on their management 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 objectives:

- Loan origination process, and
- Quality control plan.

Assessment Procedures

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

- Review of established procedures formulated by Pryme Investment in originating FHA-insured loans,
- Interviews with officials and employees of Pryme Investment and other related parties and entities,
- Examination of records and related documents for FHA-insured loans originated between March 1, 2000 and February 28, 2002,
- Review of records and files maintained by HUD's Quality Assurance Division in connection with the oversight of the HUD-FHA approved non-supervised loan correspondent Pryme Investment, and
- Interviews with applicable officials and employees of HUD's Quality Assurance Division relating to activities associated with Pryme Investment.

Significant Weaknesses

A significant weakness exists if management controls do not give 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 Pryme Investment's management controls over its loan origination and quality control procedures for the origination of FHA-insured loans showed Pryme Investment as not complying with HUD requirements. Based on our audit, we believe significant weaknesses exist in the following three areas:

- Quality control process (Finding 1),
- Operating in accordance with FHA approval requirements (Finding 2), and
- Loan origination process (Finding 3).

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

Follow Up on Prior Audits

This is the first HUD Office of Inspector General for Audit review of Pryme Investment. The mortgagee's last independent audit report for the year ending December 31, 2001 did not contain any findings.

HUD's Quality Assurance Division performed a Title II monitoring review of Pryme Investment during the months of January and February 2001. The findings letter dated April 30, 2001, prepared by the Quality Assurance Division, disclosed that Pryme Investment had not implemented their quality control plan in accordance with HUD Handbook 4060.1 REV-1. In addition, two separate matters were referred to the RESPA Division of HUD for resolution. Violations relating to HUD-FHA underwriting requirements were addressed in a separate letter to the responsible sponsor.

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Issues Needing Further Study and Consideration

In conducting our review, we identified two issues, which were not within the specific objectives of our review, needing further study and consideration by the HUD program management.

HUD Underwriting Requirements Not Followed

As discussed under the Introduction section of the audit report, HUD's Quality Assurance Division performed a Title II monitoring review of Pryme Investment during the months of January and February 2001. The Quality Assurance Division staff had identified various violations of HUD's underwriting requirements by one of Pryme Investment's sponsors. We identified similar and additional violations of underwriting requirements during our review of the 20 FHA-insured loans.

Inducement to Purchase

Paragraph 2-10, Funds to Close, of HUD Handbook 4155.1 REV-4 CHG-1, requires all funds for the borrower's investment to be verified. An acceptable source of these funds is gift funds. The donor of the gift may not be a person or entity with an interest in the sale of the property, such as the seller, real estate agent or broker, builder or any entity associated with them. Gifts from these sources are considered inducements to purchase and must be subtracted from the sales price. The gift donor and the borrower sign a gift letter that includes a statement that no repayment is required.

The borrower for FHA case number 521-4582281 received a gift of $3,000 from the selling agent to the transaction whose relationship per the gift letter was a "long-time friend and co-worker." Regardless of the selling agent's relationship with the borrower, the $3,000 gift represents an inducement to purchase, as the gift donor was the selling agent in the transaction. The $3,000 was not subtracted from the sales price as required. The mortgage was over-insured by $2,356.14 and the borrower did not meet the cash investment requirements for the property.

The eligibility of the borrower to qualify for the loan may have been affected had the inducement to purchase been taken into consideration by the lender. This information is being provided to HUD for consideration and may warrant possible corrective action.

Cash Saved at Home

Paragraph 2-10, subparagraph M, Cash Saved at Home, of HUD Handbook 4155.1 REV-4 CHG-1, requires the mortgagee to verify all funds for the borrower's investment. Specifically, borrowers who save cash at home are required to demonstrate the ability to do so. As part of the asset verification process performed by the mortgagee, the borrower is required to explain how the funds were accumulated and the amount of time taken to do so.

We identified four FHA-insured loans where the FHA case binder did not include an explanation from the borrower as to how cash saved at home was accumulated and the amount of time taken to do so.

- FHA case binder 521-4850042 - a deposit of $1,000 was made to the title company,
- FHA case binder 521-4707361 - a deposit of $1,000 was made to the title company,
- FHA case binder 521-4724846 - a deposit of $1,000 was made to the title company, and
- FHA case binder 521-4735832 - a deposit of $1,400 was made to the title company.

The eligibility of the borrowers to qualify for the loans should have been contingent upon receipt of explanations on how cash saved at home was accumulated and the amount of time taken to do so. This information is being provided to HUD for consideration and may warrant possible corrective action.

Liabilities and Credit Characteristics

As part of the loan origination process, as detailed in the Federal Register dated March 1, 1999, addressing HUD regulation 24 CFR § 3500 (RESPA), the loan correspondent analyzes the prospective borrower's income and debt and prequalification to determine the maximum mortgage amount the prospective borrower can afford. This includes obtaining information from the borrower and other sources to resolve derogatory credit information. Paragraph 2-4, Credit Report Requirements, of HUD Handbook 4155.1 REV-4 CHG-1, requires the mortgagee to separately develop credit information for any open debt listed on the loan application but not included on the credit report.

We identified three FHA-insured loans where liabilities disclosed on the initial Uniform Residential Loan Application (URLA) were omitted from the final URLA and the Mortgage Credit Analysis Worksheet. The liabilities did not appear on the credit report, as well.

- 521-4606569 – The initial URLA disclosed a liability with monthly payments of $350 and an unpaid balance of $8,400.

- 521-4656299 – The initial URLA disclosed a liability with monthly payments of $387 and an unpaid balance of $11,421. In addition, the credit report contained a collection account with a current balance of $402. The borrower provided an explanation for the collection. However, the FHA case binder did not include any information as to whether the collection was paid. Nor was the collection taken into consideration when completing the Mortgage Credit Analysis Worksheet.

- 521-4666851 – The initial URLA disclosed a liability with monthly payments of $250. The unpaid balance amount was not disclosed.

The eligibility of the borrowers to qualify for the loans may have been affected had the liabilities been taken into consideration by the lender. This information is being provided to HUD for consideration and may warrant possible corrective action.

Income Stability
Section 2, Effective Income, of HUD Handbook 4155.1 REV-4, requires the lender to establish the anticipated amount of income and the likelihood of its continuance, to determine the borrower's capacity to repay the mortgage debt. Paragraph 2-9, Self-Employed Borrowers, requires the following documents:

- Signed and dated individual tax returns, including applicable schedules for the most recent two years,

- A year to date profit-and-loss statement and balance sheet, and
- A business credit report on corporations and "S" corporations.

For FHA case number 521-4672443, income in the amount of $4,210 with qualifying ratios of 29.53 percent and 41.81 percent was used to qualify the borrower and co-borrower, according to the Mortgage Credit Analysis Worksheet. We took a more conservative approach in the calculation of average income to arrive at $3,998 per month resulting in ratios of 30.34 percent and 44.02 percent. The file contained copies of Federal and State of Oklahoma tax returns for 1998 and 1999 signed by the borrower on September 27, 2000 one day after closing. The coversheet from the certified public accounting firm that prepared the tax returns was dated September 25, 2000. The FHA case binder did not include a year to date balance sheet.

The borrower had a Federal income tax liability of $1,885 in 1998 and $4,259 in 1999. The borrower had a State income tax liability of $121 in 1998 and $461 in 1999. The liabilities were not taken into consideration in approving the borrower for the loan.

As of November 8, 2002, HUD has paid a claim totaling $157,067.63.

If the lender had taken a more conservative approach in calculating the borrower's average income and the liabilities were fully disclosed, the feasibility of the borrower's ability to qualify for the loan is questionable. This information is being provided to HUD for their consideration and possible corrective action.

Buydowns

Paragraph 2-14, Temporary Interest Rate Buydowns, of HUD Handbook 4155.1 REV-4, requires the lender to establish that the eventual increase in mortgage payments will not adversely affect the borrower and likely lead to default. The underwriter is required to document which of the following criteria (compensating factors) the borrower meets:

- Potential for increased income that would offset the scheduled payment increases,

- A demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expense,

- The borrowers have substantial assets available to cushion the effect of the increased payments, and

- The cash investment made by the borrower substantially exceeds the minimum required.

During our review we found that temporary interest rate buydowns were used to reduce the borrower's monthly payment during the early years of the mortgage for eight of the 20 FHA-insured loans reviewed. All eight of the FHA-insured loans were approved with qualifying ratios at the buydown rate. The lender did not establish whether the eventual increase in mortgage payments would not adversely affect the borrower and likely lead to default as required for all eight FHA-insured loans.

As of November 8, 2002, three of the eight FHA-insured loans were in default. HUD has paid claims totaling $677,466.65 for five of the FHA-insured loans and incurred a loss totaling $169,039 on the subsequent resale of three of the properties.

	FHA Case Number	Buydown Type	Default or Claim	Claim Amount Paid	Loss on Resale
1	521-4574341	2-1	Default		
2	521-4580172	1-1	Claim	$147,526.52	$38,175
3	521-4606569	1-1	Claim	$148,456.46	$51,327
4	521-4637260	2-1	Default		
5	521-4666851	2-1	Claim	$123,208.16	$79,537
6	521-4672443	2-1	Claim	$157,067.63	
7	521-4708242	2-1	Claim	$101,187.88	
8	521-4832236	2-1	Default		
	Totals			**$677,466.65**	**$169,039**

The eligibility of the borrowers to qualify for the loans may have been affected had the eventual increase in mortgage payments been taken into consideration by the lender. This information is being provided to HUD for consideration and may warrant possible corrective action.

Branch Office Loan Origination Activities

Per paragraph 3-4, Loan Correspondents, of HUD Handbook 4060.1 REV-1, the principal activity requirement for a non-supervised loan correspondent is the origination of mortgages for sale or transfer to a sponsor(s). As discussed in Finding 2 of the audit report, the president of Pryme Investment had at one point begun the process of shutting down loan origination activities at Pryme Investment with a target date of June 30, 2002. Subsequent to our on-site review, the president of Pryme Investment informed us that "the deal fell through" and loan origination activity continued at Pryme Investment's main office. According to the president, the branch office is currently not originating FHA-insured loans. Furthermore, review of the bankruptcy file disclosed the relationship between Pryme Investment and its branch manager was terminated during April 2002.

If Pryme Investment's branch office is no longer originating FHA-insured loans, they are not meeting the principal activity requirement for non-supervised loan correspondents. Therefore, the approval to originate FHA-insured loans through Pryme Investment's branch office is questionable. This information is being provided to HUD for review and any administrative action deemed appropriate.

FHA-Insured Loans Selected for Review

As of
April 2, 2002

	FHA Case Number	Mortgage Amount	Default or Claim	Default Status	Default Reason	# of Payments Prior to Default	Gift Letter Source Per HUD Systems	Sponsor
1	521-4574341	$123,878	Default	42	15	11	Non-profit Religious/Community	Security National Mortgage Co
2	521-4580172	$140,063	Claim	46	2	9	Relatives	Security National Mortgage Co
3	521-4582281	$121,090	Default	68	15	3	Other	Security National Mortgage Co
4	521-4606569	$140,957	Claim	46	7	4	Non-profit Religious/Community	Security National Mortgage Co
5	521-4637260	$139,070	Default	68	6	0	Non-profit Religious/Community	Security National Mortgage Co
6	521-4655235	$138,340	Default	43	15	5	Non-profit Religious/Community	Security National Mortgage Co
7	521-4656299	$141,553	Default	12	6	3	Relatives	Security National Mortgage Co
8	521-4660127	$106,835	Default	68	15	10	Non-profit Religious/Community	Security National Mortgage Co
9	521-4662583	$147,004	Default	43	7	10	Non-profit Religious/Community	Security National Mortgage Co
10	521-4666757	$147,514	Claim	45	6	0	Non-profit Religious/Community	Security National Mortgage Co
11	521-4666851	$117,340	Claim	46	15	3	Non-profit Religious/Community	Security National Mortgage Co
12	521-4672443	$147,017	Claim	45	15	1	Non-profit Religious/Community	Security National Mortgage Co
13	521-4685526	$107,734	Claim	46	6	1	Non-profit Religious/Community	Security National Mortgage Co
14	521-4688907	$141,056	Default	68	7	2	Other	Bank of Utah
15	521-4707361	$97,650	Default	68	15	5	Other	Bank of Utah
16	521-4708242	$95,645	Default	68	15	6	Other	Bank of Utah
17	521-4724846	$128,189	Default	68	15	2	Other	Bank of Utah
18	521-4735832	$131,640	Default	68	6	1	Other	Bank of Utah
19	521-4832236	$128,089	Default	42	3	1	Other	Bank of Utah
20	521-4850042	$133,119	Default	42	7	3	Other	Bank of Utah
	Total	**$2,573,783**						

Default Status
12 – Repayment
42 – Delinquent 90 Days or More
43 – Foreclosure Started
45 – Foreclosure Completed
46 – Property Conveyed to Insurer
68 – First Legal Action to Foreclosure

Default Reason
2 – Illness of Principal Mortgagor
3 – Illness of Mortgagors Family Member
6 – Curtailment of Borrower Income
7 – Excessive Obligations
15 – Other

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Status of FHA-Insured Loans

As of
November 8, 2002

	FHA Case Number	Mortgage Amount	Default or Claim	Default Status	Default Reason	Claim Amount Paid	Loss on Resale	Gift Letter Source Per Mortgagee Records
1	521-4574341	$123,878	Default	68	15			Brother & The Nehemiah Program
2	521-4580172	$140,063	Claim	45	2	$147,526.52	$38,175	Brother
3	521-4582281	$121,090	Default	45	15			Friend
4	521-4606569	$140,957	Claim	46	7	$148,456.46	$51,327	Wife & The Nehemiah Program
5	521-4637260	$139,070	Default	43	6			The Nehemiah Program
6	521-4655235	$138,340	Default	42	15			Brother & The Nehemiah Program
7	521-4656299	$141,553	Default	12	6			Cousin
8	521-4660127	$106,835	Default	45	15			Uncle & The Nehemiah Program
9	521-4662583	$147,004	Claim	13	7	$45,252.29		The Nehemiah Program
10	521-4666757	$147,514	Claim	46	6	$164,138.33	$47,348	Wife & The Nehemiah Program
11	521-4666851	$117,340	Claim	46	15	$123,208.16	$79,537	The Nehemiah Program
12	521-4672443	$147,017	Claim	46	15	$157,067.63		The Nehemiah Program
13	521-4685526	$107,734	Claim	46	6	$117,153.71	$41,052	The Nehemiah Program
14	521-4688907	$141,056	Claim	46	7	$158,679.66		The Nehemiah Program
15	521-4707361	$97,650	Claim	46	15	$101,520.91	$33,474	The Nehemiah Program
16	521-4708242	$95,645	Claim	46	15	$101,187.88		The Nehemiah Program
17	521-4724846	$128,189	Claim	46	15	$138,992.00		The Nehemiah Program
18	521-4735832	$131,640	Default	43	6			The Nehemiah Program
19	521-4832236	$128,089	Default	45	3			The Nehemiah Program
20	521-4850042	$133,119	Default	42	15			The Nehemiah Program
	Total	**$2,573,783**				**$1,403,183.55**	**$290,913**	

Default Status
12 – Repayment
13 – Paid In Full
42 – Delinquent 90 Days or More
43 – Foreclosure Started
45 – Foreclosure Completed
46 – Property Conveyed to Insurer
68 – First Legal Action to Foreclosure

Default Reason
2 – Illness of Principal Mortgagor
3 – Illness of Mortgagors Family Member
6 – Curtailment of Borrower Income
7 – Excessive Obligations
15 – Other

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