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# AUDIT REPORT



MortgageStream Financial Services, LLC  
Greenwood Village, Colorado  
Non-Supervised Direct Endorser

2003-DE-1005

September 15, 2003

Office of Audit, Region 8  
*633 17<sup>th</sup> Street, 14<sup>th</sup> Floor*  
*Denver, Colorado, 80202*

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Issue Date	September 15, 2003
Audit Case Number	2003-DE-1005

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

A handwritten signature in black ink that reads "Robert C. Gwin".

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

SUBJECT: MortgageStream Financial Services, LLC  
Greenwood Village, Colorado  
Non-Supervised Direct Endorser

We completed an audit of MortgageStream Financial Services, LLC, in Greenwood Village, Colorado. We selected MortgageStream Financial Services, LLC for review because of their high default and claim rates. The objectives of our review were to: (1) determine whether the mortgagee complied with HUD regulations, procedures, and instructions in the origination and underwriting 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 two findings with recommendations requiring action by your office. We appreciate the courtesies and assistance extended by the management and staff of MortgageStream Financial Services, LLC, 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 R. Ernest Kite, Assistant Regional Inspector General for Audit, at (303) 672-5452.

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# Executive Summary

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We completed a review of MortgageStream Financial Services, LLC (MortgageStream), a FHA approved non-supervised direct endorser, with a main office located in Greenwood Village, Colorado and branch offices located in Wheatridge and Westminster, Colorado. We did not perform an in-depth on-site review at MortgageStream's branch offices.

We found that MortgageStream did not always exercise due diligence in the origination and underwriting of FHA-insured loans, or perform these functions in accordance with HUD requirements and prudent lending practices. Also, MortgageStream has not adequately implemented its quality control process and is deficient in its overall quality control activities. Furthermore, MortgageStream did not administer or carry out its non-supervised direct endorser activities in conformity with HUD-FHA approval requirements. As a result, six FHA-insured loans, with unpaid balances of \$940,764, are being recommended for indemnification. Lastly, MortgageStream was charging its borrowers an ineligible fee and overcharging its borrowers on two other fees. The reimbursed amount to the borrowers and HUD for these ineligible and overcharged fees total \$141,934.28.

MortgageStream has shown improvement in the areas of: sending FHA-insured loan packages into HUD for endorsement in a timely manner, and making the wire transfer to HUD for the Upfront Mortgage Insurance Premiums. While MortgageStream had problems in these two areas, the majority of the problems occurred within the first year of their existence. MortgageStream has taken positive corrective action to eliminate these concerns.

HUD's Quality Assurance Division performed a Title II monitoring review of MortgageStream during the months of April and May 2002. The findings letter dated June 27, 2002, prepared by the Quality Assurance Division, disclosed that MortgageStream had overcharged its borrowers for credit report fees. In addition, nine FHA-insured loans were indemnified for various infractions of HUD requirements.

MortgageStream's early default and claim rate, in HUD's Denver jurisdiction, exceeds the termination thresholds identified in Mortgagee Letter 2002-20. Consequently, MortgageStream is under review by HUD's Office of Lender Activities and Program Compliance for removal of their ability to originate loans for FHA.

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MortgageStream is a Direct Endorser of FHA-insured loans.

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. As a Direct Endorser, MortgageStream has the authority to originate and underwrite FHA-insured loans for HUD.

Audit Objectives

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

Improvement needed in the origination and underwriting of FHA-insured loans

Our review of loan origination and underwriting activities disclosed that MortgageStream did not always originate and underwrite FHA-insured loans for HUD in accordance with HUD requirements and prudent lending practices. MortgageStream did not exercise due diligence in the verification of the borrower's source of funds and income; in the review of the borrower's liabilities and credit characteristics; in performing verifications of employment and deposits; in documenting gift letters; and in the determination of the borrowers credit worthiness. Furthermore, MortgageStream did not maintain complete case files for loans originated as required by HUD. In our opinion, the deficiencies associated with MortgageStream's loan origination and underwriting activities stem from their noncompliance with HUD requirements and the unsuccessful implementing of their quality control process. These deficiencies led directly to MortgageStream's high default and claim rates and increased the risk to the FHA insurance fund.

Borrowers charged for an ineligible fee and overcharged for two other fees

MortgageStream was charging its borrowers an ineligible loan Commitment "Lock-in" Fee and overcharging its borrowers Document Preparation and Flood Certification Fees. MortgageStream was unable to ensure the accuracy and validity of its loan origination and underwriting processes due to its lack of structured procedures and management controls over its employees.

Insufficient Management and Quality Control Procedures

During our review of the management and quality control activities, we found that MortgageStream has not adequately implemented its quality control process and is deficient in its overall quality control activities. MortgageStream did not timely address findings from its quality control contractor and did not direct its corrective actions to the employees directly affected. Additionally, its contractor did not in all instances, perform an adequate review of MortgageStream's case files, nor did they review loans defaulting within the first six months. In our opinion, the deficiencies associated with MortgageStream's quality

control plan and loan origination and underwriting procedures stem from MortgageStream's noncompliance with HUD's and their own quality control requirements. Therefore, MortgageStream is unable to ensure the accuracy, validity, and completeness of its loan origination and underwriting operations. Because of these deficiencies, we are asking MortgageStream to indemnify HUD for six FHA-insured loans, originated and underwritten by MortgageStream, and asking that MortgageStream repay all borrowers, or HUD if the loan has been foreclosed on, who were overcharged certain fees associated with their loans.

## Recommendations

Based on the results of our review of MortgageStream's loan origination and underwriting functions and their quality control activities, to determine if these procedures are in accordance with FHA approval requirements, we are recommending that MortgageStream's participation in HUD's Single Family Mortgage Insurance Programs be closely monitored for the next year. Furthermore, we are recommending that MortgageStream indemnify HUD for the six FHA-insured loans addressed in this report, having unpaid balances totaling \$940,764, and have MortgageStream pay back all overcharged or ineligible fees associated with FHA-insured loans that they originated and underwrote. The reimbursed amount to the borrowers and HUD for these ineligible and overcharged fees total \$141,934.28. In addition, we are recommending that HUD take any administrative action(s) as deemed appropriate.

Management and employees at MortgageStream were very cooperative and professional during our review. In addition, MortgageStream officials started the process to initiate changes immediately upon being informed about deficiencies. MortgageStream personnel are already in the process of reviewing each FHA-insured loan file to discover which loans had overcharged or ineligible fees and are writing checks to these borrowers. The Board Members of the Partnership that owns MortgageStream hired a technical writer who is in the process of writing policies and procedures for all tasks associated with the origination and underwriting of FHA-insured loans. The Partners are rewriting the Quality Control plan and are hiring a national firm to accomplish their monthly Quality Control reviews. Additionally, they have instituted a plan to accomplish audits of the underwriting functions on a monthly basis.

If HUD's Office of Lender Activities and Program Compliance allow MortgageStream to retain their approval as a non-supervised direct endorser and to continue to participate in HUD's Single Family Mortgage Insurance Programs, then HUD needs to ensure that MortgageStream has fully implemented its quality control process in conformity with HUD requirements. By doing so, MortgageStream 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.

Lastly, HUD needs to ensure that MortgageStream develops and implements a management control process that will ensure all loan origination and underwriting functions are monitored for compliance with HUD requirements. The management control process must be able to ensure all deficiencies noted in the loan origination and underwriting processes are corrected prior to submission of the loan to HUD for insurance endorsement. Consequently, MortgageStream and HUD will have better assurance that FHA-insured loans originated and underwritten by MortgageStream 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 managing partner of MortgageStream during the course of on-site audit work and at the on-site exit meeting. We provided the managing partner with a copy of the draft report for review and comment on August 13, 2003 and requested that any comments be provided by August 26, 2003.

We received the managing partners comments on September 5, 2003 and their comments are included in this report. Therefore, this audit report is being issued with formal comments from MortgageStream Financial Services, LLC.

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## Abbreviations

CFR	Code of Federal Regulations
CPA	Certified Public Accountant
FHA	Federal Housing Administration
HUD	United States Department of Housing and Urban Development
MCAW	Mortgagee Credit Analysis Worksheet
MIP	Mortgage Insurance Premium
OIG	Office of Inspector General
URLA	Uniform Residential Loan Application

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# Introduction

MortgageStream Financial Services, LLC filed for incorporation on May 9, 2000, in the State of Colorado as a Perpetual Domestic Limited Liability Corporation and was approved as a non-supervised direct endorser by HUD-FHA to originate and underwrite FHA-insured loans under HUD's Title II Single Family Direct Endorsement Program on July 7, 2000.

MortgageStream originates and underwrites Federal Housing Administration (FHA) insured loans and conventional loans. Between February 1, 2001 and January 31, 2003, MortgageStream endorsed 1,165 loans totaling \$189,752,469 under FHA's programs. As of March 7, 2003, ninety-five of the 1,165 FHA-insured loans are currently in default and 32 of the loans have foreclosure action initiated on them. Furthermore, HUD has paid claims on 14 of the 1,165 loans, totaling \$1,447,410.10.

MortgageStream has a main office located at 7000 E. Belleview Suite #250, Greenwood Village, Colorado 80111. In addition, MortgageStream has two other branches in the Denver metropolitan area.

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## Audit Scope, Objectives, and Methodology

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

## Sample of 20 FHA-insured loans

During our audit, we performed tests for compliance with HUD's requirements for the origination and underwriting of FHA-insured loans. We reviewed a sample of 20 FHA-insured loans that had defaulted within the first eighteen months of origination. We interviewed as many of the borrowers of our 20 sample loans as we could locate. We also discovered that during our audit period MortgageStream had 75 loans submitted late for endorsements; 873 loans had either one or both of their Front and/or Back Ratios too high; and 113 loans appear to have had their Upfront Mortgage Insurance Premium (MIP) submitted late. We additionally selected a sample of 10 FHA-insured loans that were sent into HUD for endorsement late to review. Lastly, we selected 10 of MortgageStream's most recently completed loans to review for overcharges on Credit Reports, since this was a discrepancy noted by HUD's Denver Division of Quality Assurance during a review of MortgageStream in 2002.

## Background and Criteria

We interviewed HUD's management and staff to obtain background information on MortgageStream. Specifically, we gathered information from HUD's Quality Assurance

MortgageStream's default rate, as of April 2003, was 8.82%

Division and the Denver Homeownership Center concerning MortgageStream's business operations. We also reviewed HUD's handbooks to obtain FHA requirements.

We explained to MortgageStream's management why they were selected for review, namely their very high compare ratios against other lenders in the state of Colorado. MortgageStream's current default rate, as of April 30, 2003, was 8.82%, while other lenders in Colorado had an average current default rate of 2.55%. We explained to MortgageStream's management that the default and compare ratio information was obtained from HUD's databases, mainly Neighborhood Watch.

We provided a copy of this report to the Managing Partner of MortgageStream.

HUD Data Systems Used

In addition, we relied, in part, on data maintained by HUD in the Single Family Data Warehouse, Neighborhood Watch, and Single Family Insurance System. We did not perform a detailed analysis of the reliability of these systems.

Review of FHA Case Binders and MortgageStream's loan case files

In order to accomplish our audit objectives we reviewed the FHA Case Binders and MortgageStream's loan case files for our 20 sample loans. We also reviewed MortgageStream's loan case files for our 10 late endorsement sample and our 10 credit report overcharge sample.

Audit Scope

Our audit generally covered the period of February 1, 2001 through January 31, 2003. This period was expanded to include the most current data while performing our review. Therefore, where applicable, the audit period was expanded to include current data through April 30, 2003. We conducted our fieldwork from May through June 2003.

Generally Accepted Government Auditing Standards

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

# Lack of Due Diligence in the Origination and Underwriting of FHA-Insured Loans

MortgageStream Financial Services, LLC (MortgageStream) did not comply with HUD requirements and prudent lending practices in the origination and underwriting of FHA-insured loans for our sample of 20 loans. MortgageStream did not exercise due diligence in the verification of the borrower's source of funds and income; review of the borrower's liabilities and credit characteristics; and analysis of the borrower's ability to pay. As a direct result of these deficiencies, MortgageStream was approving mortgagors who were not qualified for FHA-insured loans. MortgageStream's deficiencies in loan origination and underwriting activities are directly related to their: (1) misunderstanding and noncompliance with HUD requirements; (2) unsuccessful implementing of their quality control process; and (3) lack of written management controls. MortgageStream relied solely on the experience of its employees and did not accomplish effective underwriting to ensure all HUD requirements were complied with. These deficiencies all contributed to MortgageStream's high default and claims rates and increased HUD's risk to the FHA insurance fund.

We are recommending that: MortgageStream indemnify HUD for the six FHA-insured loans, with a total unpaid balance of \$940,764, that MortgageStream should not have sent to HUD for endorsement; HUD review a sufficient number of all FHA-insured loans originated and underwritten by MortgageStream to ensure compliance with HUD regulations and directives; MortgageStream write and implement written policies and procedures for the origination and underwriting of FHA-insured loans; and MortgageStream write and implement a comprehensive Quality Control Plan.

## HUD Requirements

Section 203 of the National Housing Act (12 U.S.C. 1709) states that 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.

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.

HUD Handbook 4000.4, REV-1, Single Family Direct Endorsement Program requires mortgagees to develop HUD/FHA insured loans in accordance with accepted sound lending practices, ethics, and standards. It also provides that mortgagees must obtain and verify

information with at least the same care that would be exercised if originating a mortgagee when the mortgagee would be entirely dependent on the property as security to protect its investment.

MortgageStream is a Direct Endorser and as such, its principal activities are the origination and underwriting of FHA-insured mortgages. MortgageStream does not service its own loans and immediately sells all loans it originates and underwrites to its investors.

Deficiencies in following HUD requirements and prudent lending practices

MortgageStream did not always follow HUD requirements and prudent lending practices in the origination and underwriting of FHA-insured loans. We selected and reviewed a sample of 20 FHA-insured loans originated and underwritten by MortgageStream with a beginning amortization date between February 1, 2001 and January 31, 2003. All of the sample loans had defaulted within the first two years of origination. Eighteen of the loans had defaulted within the first twelve months of origination, one within thirteen months, and one within eighteen months.

Deficiencies in Loan Origination and Underwriting

Our review of the loan documents, contained in the FHA Case Binders obtained from HUD and from files maintained at MortgageStream, relating to loans originated and underwritten by MortgageStream, disclosed various deficiencies. MortgageStream did not exercise due diligence in the verification of the borrower's source of funds and income; review of the borrower's liabilities and credit characteristics; and analysis of the borrower's ability to pay. We found significant origination and underwriting deficiencies in all 20 loans reviewed, as shown below:

<u>Deficiencies</u>	<u>Number of Loans</u>
High Front and Back Ratios	20 of 20 loans
Insufficient Compensating Factors	16 of 20 loans
Unsupported Verification of Assets	9 of 20 loans
Gift Letter not signed by borrower	10 of 20 loans
Overstated income	5 of 20 loans
Insufficient funds to close	2 of 20 loans
Discrepancies with Appraisal	1 of 20 loans
Overcharged Doc Prep Fees	8 of 20 loans
Overcharged Flood Certification Fees	13 of 20 loans
Ineligible Commitment Fee	9 of 20 loans
Earnest Money not properly documented	5 of 20 loans

Six FHA-insured loans recommended for indemnification

While all 20 sample FHA-insured loans reviewed had documentation deficiencies, six of the 20 sample FHA-insured loans reviewed, with a total unpaid balance of \$940,764, are being referred to HUD for indemnification. Two of the six loans, 052-1736486 and 052-1981100, are being referred because the loans did not have the required buydown documentation in the files; two of the loans, 052-1764645 and 052-1868240, are being referred because the borrowers did not have sufficient funds to close the loan; one of the loans, 052-1950228, is being referred because the loan was insured for an amount which is greater than the maximum allowable mortgage amount; and one of the loans, 052-1890731, is being referred because the lender did not accomplish the required face-to-face interview for first time homebuyers.

### **HUD Buydown Requirements Not Met**

HUD's Buydown Requirements

HUD Handbook 4155.1, Chapter 3, Section 2-14 states that interest rate buydowns are designed to reduce the borrower's monthly payment during the early years of the mortgage and are permitted only on purchase actions. The lender must establish and document that the eventual increase in mortgage payments will not adversely affect the borrower and likely lead to default. One of the following two criteria must be documented: 1) Potential for increased income that would offset the scheduled payment increases; or 2) A demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses. Two of the six loans being referred for indemnification were buydown loans.

Two loans did not have documentation to explain the buydowns

FHA case number 052-1736486 and FHA case number 052-1981100 did not have the required buydown documentation contained in their FHA Case Binders. The case binders did not have the required documentation stating how the borrowers would be able to make increased payments in the future. The Underwriter did not document any of the criteria that the borrower must meet according to HUD Handbook 4155.1. See Appendix A for details on these two FHA-insured loans.

### **Borrower's Funds to Close Insufficient**

HUD's Funds to Close requirements

Section 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. The cash investment in the property must equal the difference between the amounts of the insured mortgage, excluding any Upfront Mortgage Insurance Premium, and the total cost to acquire the property, including prepaid expenses. Acceptable sources of these funds are; earnest money deposits, savings and checking accounts, and gift funds. The gift donor and the borrower sign a gift letter that includes a statement that no repayment is required.

Two loans did not have sufficient documentation to show funds to close

FHA case number 052-1764645 and FHA case number 052-1868240 did not have sufficient documentation in the FHA case binders to show that the borrowers had enough funds to close the loan. It is the Underwriters responsibility to ensure that the borrower has sufficient funds to close on a FHA-insured mortgage. This analysis is accomplished by comparing the information contained in the Uniform Residential Loan Application (URLA), such as earnest money deposits, monies in bank accounts, and/or gift letter funds, and the information the Underwriter inputs into the Mortgage Credit Analysis Worksheet (MCAW). See Appendix A for details on these two FHA-insured loans.

#### **Insured Mortgage Amount Exceeds Appraisal Value**

HUD's maximum mortgage amount requirements

Mortgagee Letter 98-29 states that the formulas used to compute the maximum mortgage amount is to be based on a fixed percentage of the property's sales price (or appraised value, if less) exclusive of closing costs. Accordingly, the property's sales price (or appraised value, if less) exclusive of any borrower-paid closing costs will be multiplied by a percentage that is determined by both the sales price (or value, if less) and the average closing cost for that State. Maximum Loan-to-Value Percentages for Low Closing Costs States, such as Colorado, is:

- 97.15 percent: For properties with values/sales prices in excess of \$125,000.

Additionally, HUD Handbook 4000.4 REV 1, Chapter 3, Paragraph 3, Section 3G, Underwriter's Review of Appraisal, specifies that the mortgagee's Underwriter is to review the appraisal to determine whether or not the appraiser's conclusions are acceptable. If the appraisal is found to be acceptable, the property is eligible for HUD

mortgage insurance. The review consists essentially of the following:

- 1) Verification (as possible from available data) that the factual information submitted is correctly reported;
- 2) Determination of the plausibility and consistency of the conclusions based upon data presented in the report;
- 3) Determination of the consistency of the reported conclusions by comparison with other data conclusions reported in similar cases recently processed; and
- 4) Compliance with underwriting instructions in HUD Handbooks 4145.1 and 4150.1. If the Underwriter concludes that the appraisal report findings are inconsistent, or are otherwise unacceptable, he may contact the appraiser or return the case to the appraiser for reconsideration.

The Underwriter may also add comments or corrections to modify or amend the report by using the "Direct Endorsement Underwriter/HUD Reviewer Analysis of Appraisal" form (Form HUD 54114). Comments or corrections must be supported by HUD valuation policy and adequately documented. This includes the adjusting of value, the removal or addition of repair requirements, and the overall determinations of property approval and rejection. However, it does not include using the Chief Underwriter's prerogative described in HUD Handbook 4125.1; this is only available to HUD staff. The appraisal report itself should not be "marked up" or changed in any way by the DE Underwriter.

Insured loan amount exceeds the maximum loan to value amount

The mortgage amount on FHA case number 052-1950228 was financed for an amount that is greater than the maximum loan to value amount allowed by HUD. Consequently, this loan does not meet the qualifications for FHA-insured loans and should not be sent to HUD for insurance. See Appendix A for details on this FHA-insured loan.

#### **Face-To-Face Interview Not Accomplished**

HUD's face-to-face interview requirements

HUD Handbook 4155.1 Chapter 3, Section 2 states: Face-to-face interviews must be conducted by the lender with all

first-time borrowers who make less than a ten percent downpayment (loan-to-value exceeding 90 percent) unless the borrower receives pre-purchase counseling on the responsibilities of homeownership from a HUD-approved housing counseling agency. The lender must ask sufficient questions to elicit a complete picture of the borrower's financial position, source of funds for the transaction and intended use of the property. All information must be verified.

Additionally, HUD Handbook 4155.1, Chapter 2, Section 2-1, states that the purpose of mortgage credit analysis is to determine the borrower's ability and willingness to repay the mortgage debt, and thus, limit the probability of default or collection difficulties. Four major elements are typically evaluated in assessing a borrower's ability and willingness to repay the mortgage debt: 1) Stability and Adequacy of Income; 2) Funds to Close; 3) Credit History; and 4) Qualifying Ratios and Compensating Factors.

Lack of Face-to-Face Interview by Lender

The borrower for FHA case number 052-1890731 was a first time homebuyer and no employees of MortgageStream ever conducted a face-to-face interview. Without the required interview and the completion of an initial URLA, a proper credit check would not have been conducted prior to closing. This loan should not have been sent to HUD for insurance because a determination as to the buyers credit worthiness was not accomplished prior to closing. See Appendix A for details on this FHA-insured loan.

### **Total Unpaid Balances for the Six Loans**

Unpaid balance of \$940,764 for six questionable loans

The current unpaid value of these six loans is \$940,764. Additionally, all twenty sample FHA-insured loans are currently in default or claims and their total unpaid value, as of March 11, 2003, is \$3,151,529.82.

Deficient Management Controls and ineffective Quality Control Program

According to Generally Accepted Government Auditing Standards, management controls include the systems to measure, report, and monitor program performance. Management controls include; controls over program operations; controls over the validity and reliability of data; controls over compliance with laws and regulations; and controls over the safeguarding of resources. Because MortgageStream had not developed nor written loan origination and underwriting procedures, and had not

developed a comprehensive written Quality Control plan, they were not always in compliance with HUD regulations and directives. MortgageStream relied solely on their employee's experience and some rudimentary checklists to ensure compliance with HUD regulations and directives. Consequently, the requirements of HUD Handbooks 4004.4 and 4155.1 and Mortgagee Letter 98-29 were not always being complied with in the origination and underwriting of FHA-insured loans.

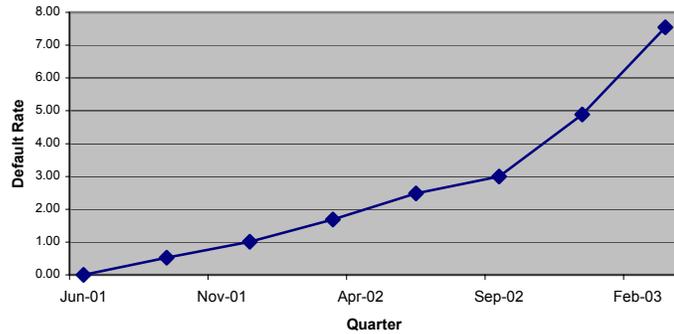
Additionally, MortgageStream's Quality Control plan was not adequately developed. MortgageStream contracts out the accomplishment of their quality control monthly reviews to a local company. Our review showed that the contractor did not always identify deficiencies in MortgageStream's procedures. In addition, management received reports from their contractor on a monthly basis but they did not address the findings in a timely manner, nor did they address the solutions to the individuals affected.

We reviewed several case binders that were reviewed by the contractor. We found deficiencies that were not identified by the contractor. For example, the contractor should have identified the inflated and ineligible fees that we discovered. Additionally, the contractor gave a finding on almost every case file they reviewed that Page 1 of the Initial 92900 Addendum was missing from the file. However, we found copies of this document in all the files. The contractor also wrote up that signatures were illegible therefore, they could not address findings to specific individuals. However, it appears that they did not attempt to obtain copies of each employee's signature.

MortgageStream's Current Default and Claims Rate is increasing

Because of MortgageStream's lack of management controls and ineffective Quality Control program, their default rates are steadily climbing and this puts the FHA Insurance fund at jeopardy. As of March 31, 2003, MortgageStream's Current Default and Claim Rate have climbed to 7.54%. See Chart below for MortgageStream's default and claim rate over the last eight quarters:

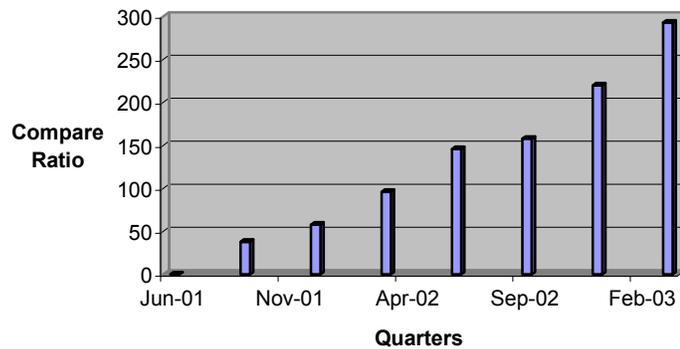
**MortgageStream's Default Rates by Quarters**



MortgageStream's Compare Ratio

Additionally, MortgageStream's Compare Ratio, which is a comparison of their default rate with the default rate of other lenders in Colorado, has also steadily climbed over the last eight quarters. See chart below:

**MortgageStream's Compare Ratios**



HUD has notified MortgageStream that their early default and claim rate in HUD's Denver jurisdiction exceeds the termination thresholds identified in Mortgagee Letter 2002-20 and that HUD may terminate their approval to originate HUD/FHA insured single family mortgage loans in HUD's Denver jurisdiction.

Late Upfront MIPs and Late Endorsement problems corrected

Two areas that were identified as potential problems, based on data obtained from Neighborhood Watch, were late Upfront MIPs and late Endorsements. HUD requirements are that the Upfront MIP must be received at HUD within 15 days of closing; while the entire loan package must be

received at HUD for endorsement within 60 days of closing. HUD's database indicated that MortgageStream had problems in both of these areas; however, upon closer review it was noted that MortgageStream had corrected both of these problem areas. MortgageStream was approved as a non-supervised direct endorser in 2000 and the majority of the late Upfront MIPs and Endorsements occurred in 2001, with a much smaller number in 2002 and virtually none in 2003.

#### Current corrective actions by Auditee

The Board Members of the Partnership that owns MortgageStream has already taken steps to correct several of the deficiencies identified in this review. They have hired a technical writer to write polices and procedures for all tasks associated with the origination and underwriting of FHA-insured loans. The Partners are also having their auditors rewriting the Quality Control plan and are in negotiations to hire a national company to accomplish their monthly Quality Control reviews. Additionally, the Partners are instituting a plan to have their auditors accomplish their own audits of the underwriting functions of MortgageStream on a continual basis.

#### Auditee Comments

MortgageStream, in their written comments, have basically concurred with our finding and recommendation. Management at MortgageStream has already initiated positive changes in the form of:

- Replacing the Managing Partner responsible for oversight of business operations;
- Hiring a senior underwriter with significant direct endorser experience;
- Hiring a technical writer to assist in developing a comprehensive written policies and procedures manual;
- Engaging a new external quality control firm to accomplish monthly quality control reviews;
- Contracting with a CPA firm to perform file reviews on loans that default as well as other randomly selected files; and
- Develop and implement an improved quality control manual for internal use.

However, MortgageStream also stated that they do not believe that the auditors had all the information relating to the loans recommended for indemnification and would like

to review the cases with HUD program staff for further clarification and final disposition.

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**OIG Evaluation of  
Auditee Comments**

The positive steps planned by and/or already initiated by MortgageStream management will greatly help alleviate the conditions addressed in our finding.

Additionally, we reviewed HUD's FHA Case Binders and MortgageStream's Loan Files, provided to us by MortgageStream management, to make our analysis, finding, and recommendation on the FHA cases for indemnification.

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**Recommendations**

At the time of the writing of this report, MortgageStream is under review by HUD's Office of Lender Activities and Program Compliance for removal of their ability to originate loans for FHA.

Whether or not MortgageStream's is allowed to continue originating and underwriting FHA-insured loans, we recommend that the Assistant Secretary for Housing-Federal Housing Commissioner:

- 1A. Indemnify the following six FHA-insured loans for the reasons previously stated:
- 052-1736486
  - 052-1981100
  - 052-1764645
  - 052-1868240
  - 052-1950228
  - 052-1890731

If HUD determines that MortgageStream can maintain their approval as a non-supervised Direct Endorser, or before they are reinstated if removed, we recommend the Assistant Secretary for Housing-Federal Housing Commissioner:

- 1B. Require the Denver HOC review a sufficient number of FHA-insured loans originated and underwritten by MortgageStream to ensure compliance with HUD regulations and directives.

- 1C. Require MortgageStream to develop and implement a management control process in writing that will ensure all loan origination and underwriting functions are monitored for compliance with HUD requirements. This management control process will need to include a comprehensive Quality Control plan that will ensure compliance with all HUD regulations and directives.
  
- 1D. Review MortgageStream's implementation of recommendation 1C and ensure MortgageStream's loan origination and underwriting procedures and management control process are fully implemented in conformity with HUD requirements.

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## Unallowable and Excessive Fees Charged to the Borrowers

MortgageStream was charging borrowers an ineligible Commitment “Lock-in” Fee and overcharging the borrowers on the Document Preparation and Flood Certification Fees. MortgageStream lacked an effective system to ensure the accuracy and validity of certain fees charged to borrowers associated with FHA-insured loans. MortgageStream needs to implement better management controls over its loan origination fees to include written policies and procedures that will ensure fees charged to borrowers are authorized by HUD and are only for the actual cost of the fees. Based upon our review and discussion with MortgageStream officials, auditors, employed by the Partnership that owns MortgageStream, reviewed every FHA-insured loan originated by MortgageStream since its inception and found 937 FHA-insured loans with ineligible and/or overcharged fees totaling \$141,934.28.

Accordingly, MortgageStream has initiated procedures to refund the overpayment of fees to the individual borrowers or to HUD in the case of properties foreclosed and conveyed to HUD.

Code of Federal Regulations and HUD Regulations

Section 203.27 of Title 24 of the Code of Federal Regulations lists all of the fees that are chargeable to the borrower, by the lender, in connection with obtaining an FHA-insured loan.

Mortgage Letter 94-7 states the conditions for commitment or lock-in fees. Commitment Fees are allowable, however, the lender must guarantee the rate, and or discounts points for no less than 15 days before the anticipated closing date. Also the mortgagee may collect from the mortgagor the commitment fee however the fee may not exceed reasonable and customary amounts.

HUD Handbook 4000.2 REV-2 states the requirements for fee charges. The mortgagee is not permitted to impose the cost of a service on the buyer for more than what the service actually cost.

Sample Selection of 20 FHA-insured loans

By accessing default information on MortgageStream, from HUD’s databases, we selected and reviewed a sample of 20 FHA-insured loans with a beginning amortization date between February 1, 2001 and January 31, 2003. All of the loans had defaulted within the first two years of their origination.

Our review of a sample of 20 loans originated by MortgageStream disclosed several deficiencies, such as: charging an ineligible fee and overcharging certain other fees to its borrowers. The fees that are either ineligible or overcharged consist of:

1. Commitment lock-in fee
2. Document preparation fee
3. Flood certification fee

Unallowable Commitment Fee charged to the borrower

In accordance with Mortgagee Letter 94-7, commitment or lock-in fees are acceptable. The rate and/or the discount points must be guaranteed by the lender for no less than 15 days before the anticipated closing date. The mortgagee is required to ensure that the date on the commitment documentation is at least 15 days before the closing date. Also, the mortgagee may collect from the mortgagor the commitment fee; however, the fee may not exceed reasonable and customary amounts.

We used the 20 sample FHA insured loans to complete a review of commitment fees charged to the borrower. MortgageStream was not able to locate two of the case binders from the 20 sample FHA insured loans. Of the remaining 18 reviewed sample loans, 16 of the files showed commitment fee charges when the commitment lock-in date was less than the required fifteen days before the anticipated closing date. There were eight borrowers that were charged the commitment fee from the sample. The fee amounts were charged inconsistently ranging from \$100 to \$300. The number of days between the lock-in confirmation date and the closing date vary from zero days to nine days. MortgageStream did not ensure that the commitment date was at least 15 days before the anticipated closing date, as stated in Mortgagee Letter 94-7.

The total amount of the ineligible commitment fees that were charged to the borrowers in the sample reviewed was \$1,080. Auditors, employed by the Partnership that owns MortgageStream, reviewed every FHA-insured loan originated by MortgageStream since its inception and found 622 FHA-insured loans with ineligible commitment fees totaling \$68,091.35.

### Excessive Fees on Document Preparation

In accordance with Section 203.27 of Title 24 of the Code of Federal Regulations, the mortgagee may collect from the mortgagor expenses incurred during the loan origination process. However, the lender may not exceed reasonable and customary charges and no more than the amount actually paid by the mortgagee.

When reviewing the 20 sample FHA-insured loans and invoices from the document systems company for document preparation fees, we noted that MortgageStream was overcharging the borrowers \$85. The invoice from the document preparation vender indicated that for each case the charge was \$60; however, the HUD-1 showed that the borrowers were charged \$145. There were a total of eight borrowers that were overcharged from the sample of twenty loans.

The total amount of the excessive document preparation fee that was charged to the borrowers in the sample reviewed is \$680. Auditors, employed by the Partnership that owns MortgageStream, reviewed every FHA-insured loan originated by MortgageStream since its inception and found 731 FHA-insured loans with overcharged document preparation fees totaling \$66,085.79.

### Excessive Fees on Flood Certifications

As previously stated above, in accordance with Section 203.27 of Title 24 of the Code of Federal Regulations, the lender may not exceed reasonable and customary charges and no more than the amount actually paid by the mortgagee.

When reviewing the 20 sample FHA insured loans and invoices from the flood certification company, it was noted that MortgageStream Financial was overcharging the borrowers \$9. The invoice from the flood certification vendor indicated that for each case the charge was \$20; however, the HUD-1 showed that the borrowers were charged \$29. There were a total of thirteen borrowers that were overcharged from the sample of twenty loans.

The total amount of the excessive flood certification fee that was charged to the borrowers in the sample reviewed was \$117. Auditors, employed by the Partnership that owns MortgageStream, reviewed every FHA-insured loan originated by MortgageStream since its inception and

found 862 FHA-insured loans with overcharged flood certification fees totaling \$7,757.14.

Disregard of HUD Requirements

In our opinion, the deficiencies associated with MortgageStream's excessive fees and unallowable fees are due to the lack of written policies and procedures. MortgageStream relies solely on the past experience of their employees to perform the loan origination and underwriting functions. MortgageStream's management controls do not adequately ensure that all employees are adhering to HUD regulations in the origination and underwriting of FHA insured loans.

MortgageStream does not have a set schedule of fees that employees can reference too for the correct fee amount. Management needs to provide supplemental guidance and/or training to employees concerning the fees and charges associated with FHA-insured loans. This would help to eliminate employees arbitrarily listing amounts for fees and charges that are inflated. MortgageStream may need to establish a process to ensure that the fees charged on the HUD-1 are accurate.

MortgageStream progress on previous findings

Overall MortgageStream Financial did not use due diligence when computing the amounts charged to the buyers and ensuring HUD regulations were being met. In addition, MortgageStream was not aware of the commitment/lock-in requirements.

HUD's Quality Assurance Division performed a non-supervised Title II monitoring review of MortgageStream Financial Services, LLC during the months of April and May 2002. The findings letter dated June 27, 2002, and the Approval/Recertification Tracking System (AARTS) dated October 25, 2002, prepared by the Quality Assurance Division, disclosed that MortgageStream Financial Services, LLC had 304 loans in which the borrowers were overcharged credit report fees and MortgageStream was required to make restitution totaling \$10,404 to the borrowers.

We discussed the overcharging of the three fees; commitment fee, document preparation fee and flood certification fee, with the officers at MortgageStream, and they stated that they have already begun to identify the borrowers that they overcharged. MortgageStream has also

hired a technical writer and are in the process of writing policies and procedures for the loan origination and underwriting processes to ensure borrowers are not overcharged.

MortgageStream's corrective actions

Based upon our review and discussion with MortgageStream officials, MortgageStream has completed its review of all their FHA-insured loans and the total dollar value of all overcharged and ineligible fees is \$141,934.28. MortgageStream is in the process of writing checks to reimburse the borrowers or HUD if the property has been foreclosed and conveyed to HUD.

**Auditee Comments**

MortgageStream concurs with our finding and recommendation and has already reviewed all of their lender files and identified borrowers who have been overcharged fees. They are waiting directions from HUD for proper disposition. MortgageStream has also published a fee schedule to assist their closing department in monitoring all fees charged on mortgage loans in the future.

**OIG Evaluation of Auditee Comments**

MortgageStream, in their written comments, have concurred with our finding and recommendation. Management at MortgageStream has already initiated positive steps to rectify the conditions identified in this finding and to repay borrowers and HUD for overcharged and ineligible fees.

**Recommendations**

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

- 2A. Ensure that MortgageStream implements adequate procedures to ensure employees verify fees charged to borrowers are correct and in accordance with HUD regulations, and that the Mortgagee furnishes evidence of these changes to HUD in a timely manner of the report issue date.
- 2B. Once MortgageStream has established and implemented the appropriate adjustments in their written policies and procedures, HUD should review the implemented changes to ensure that the controls

and procedures are adequate and that HUD requirements are being met.

- 2C. Verify that MortgageStream makes reimbursement to the borrowers of all fees that were overcharged or ineligible. HUD should receive the payment if foreclosure and conveyance is complete on any of the properties.

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# Management Controls

In planning and performing our audit, we considered the management controls of MortgageStream Financial Services, LLC 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.

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## Management Controls Assessed

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

- Loan origination process,
- Loan underwriting process, and
- Quality control plan.

## Assessment Procedures

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

- Review of established procedures formulated by MortgageStream in originating and underwriting FHA-insured loans,
- Interviews with officials and employees of MortgageStream and other related parties and entities,
- Examination of records and related documents for FHA-insured loans originated between February 1, 2001 and January 31, 2003,
- Review of records and files maintained by HUD's Quality Assurance Division in connection with the oversight of the HUD-FHA approved Direct Endorser MortgageStream, and
- Interviews with applicable officials and employees of HUD's Quality Assurance and Processing and Underwriting Divisions relating to activities associated with MortgageStream.

## 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 MortgageStream's management controls over its loan origination and quality control procedures for the origination and underwriting of FHA-insured loans showed MortgageStream as not complying with HUD requirements. Based on our audit, we believe significant weaknesses exist in the following three areas:

- Loan origination and underwriting processes (Finding 1),
- Operating in accordance with FHA approval requirements (Findings 1 and 2), and
- Quality Control process (Findings 1 and 2).

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

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# Follow Up on Prior Audit Reports

This is the first HUD Office of Inspector General for Audit review of MortgageStream. The mortgagee's last independent audit report for the year ending December 31, 2002 did not contain any findings.

HUD's Quality Assurance Division performed a non-supervised Title II monitoring review of MortgageStream during the months of April and May 2002. The findings letter dated June 27, 2002, and the Approval/Recertification Tracking System (AARTS) dated October 25, 2002, prepared by the Quality Assurance Division, disclosed that MortgageStream had not originated and underwritten nine FHA-insured loans in accordance with HUD requirements. These nine cases were indemnified. In addition, 304 loans were overcharged credit report fees and MortgageStream was required to make restitution totally \$10,404.61 to the borrowers.

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# Details of FHA-Insured Loans for Indemnification

Following is a narrative of each of the six loans recommended for indemnification. The narratives highlight only the most egregious of the deficiencies noted in the FHA Case Binders. The deficiencies noted are the ones that should have prevented the loan from being sent to HUD for endorsement. However, all of the cases had other origination and underwriting deficiencies besides the specific violations noted in the narratives discussed below.

## **HUD Buydown Requirements Not Met**

### *FHA Case Number: 052-1736486*

HUD sent MortgageStream a letter on December 6, 2001 stating that the file for FHA case number 052-1736486, whose unpaid loan balance as of March 11, 2003 was \$130,443, and whose current loan default status is foreclosure started, was selected for review by the Denver Homeownership Center and that several deficiencies noted needed to be corrected by MortgageStream. A second request was sent to MortgageStream on January 22, 2002 requesting that MortgageStream send a reply or further disposition would occur. HUD never received a reply from MortgageStream addressing the deficiencies noted in the file. This loan's file did not contain any of the required documentation associated with buydown loans.

### *FHA Case Number: 052-1981100*

The borrower for FHA case number 052-1981100, whose unpaid loan balance as of March 11, 2003 was \$139,726, and whose current loan default status is delinquent, was interviewed by the OIG on June 11, 2003. The borrower stated in the interview that he never interviewed with anyone at MortgageStream about this loan and all his paperwork was processed through his realtor with no contact with a loan officer from MortgageStream. This loan's file did not contain any of the required documentation associated with buydown loans.

## **Borrower's Funds to Close Insufficient**

### *FHA Case Number: 052-1764645*

The borrower on FHA case number 052-1764645, whose unpaid loan balance as of March 11, 2003 was \$218,271, and whose current loan default status is property conveyed to insurer, did not have sufficient funds to close. The MCAW states that the funds required to close are \$6,811.20, however documentation in the file only shows funds to close of \$6,591.90. The dollar amount input into the MCAW by the Underwriter for gift funds was \$7,000.00, making the cash reserves after closing \$188.80. The gift letter itself however, shows a gift amount of \$4,591.90. The cash reserves, using the \$4,591.90 gift amount, should have been shown as -\$2,219.30. This means that the borrower did not have sufficient funds to close when calculating the funds to close using the correct gift amount. There is an earnest money deposit of \$2,000.00 on the MCAW that is not counted towards the assets available. If the amount of \$2,000.00 were added, the borrowers would still not have sufficient funds to close. The total of all assets

available for closing should have been shown as -\$219.30. The gift letter was overstated on both the MCAW and the URLA.

FHA Case Number: 052-1868240

The borrower on FHA case number 052-1868240, whose unpaid loan balance as of March 11, 2003 was \$172,298, and whose current default status is delinquent, did not have sufficient funds to close. The MCAW states that the required funds to close are \$5,483.38, however documentation in the file only shows funds to close of \$4,250.00. The MCAW also states that the assets available are \$5,000.00, however there is insufficient documentation in the file to support this amount. The file shows a money order for \$4,250.00 was given to the title company for closing. The earnest money deposit on the MCAW is stated as \$1,000.00; however, there is insufficient documentation in the file to support this dollar amount.

The only funds properly documented in the file, which can be used for closing, are the \$4,250.00 dollars given to the title company. Using this dollar amount, the borrower is deficient \$1,203.38 dollars needed to close. There is a letter in the file that state that the borrower has saved a total of \$5,000.00 over the past four months, however, the borrowers only gave the title company \$4,250.00 as earnest money. This amount is insufficient to cover the funds required to close.

**Insured Mortgage Amount Exceeds Appraisal Value**

FHA Case Number: 052-1950228

The appraised value for FHA case number 052-1950228, whose unpaid loan balance as of March 11, 2003 was \$180,541, and which has already been foreclosed on, was \$182,000. The contract sales price and the amount insured by HUD was for \$185,000, which is \$3,000.00 dollars more than the appraised value. The loan should not have been insured for more than the appraisal amount.

The actual market value price of the property listed on the Uniform Residential Appraisal Form is \$182,000. The Conditional Commitment Direct Endorsement Statement of Appraised Value, accomplished and signed by the Underwriter, shows the estimated value as \$185,000. The loan to value amount as stated on the MCAW is \$179,727, based on the contract sales price of \$185,000 times the 97.15% prescribed in Mortgagee Letter 98-29. The correct loan to value amount should be \$176,813, based on the actual appraised amount of \$182,000 times the 97.15% prescribed in Mortgagee Letter 98-29. This is a difference of \$2,914.00. The Underwriter did not submit any documentation stating their disagreement with the appraiser's conclusion or their reasons for increasing the value of the property. The amount of this loan, which is insured by FHA, exceeds the allowable maximum loan to value amount by \$2,914.00.

**Face-To-Face Interview Not Accomplished**

*FHA Case Number: 052-1890731*

MortgageStream personnel did not conduct a face-to-face interview with the borrower for FHA case number 052-1890731, whose unpaid loan balance as of March 11, 2003 was \$99,483, and whose current loan default status is first legal action to commence foreclosure. The URLA was signed and dated by a MortgageStream Underwriter on October 25, 2001, which is the closing date of the loan. The URLA states that the application was taken during a face-to-face interview.

However, in an interview conducted by the OIG on June 9, 2003, the borrower stated that the loan was denied by another mortgage company on the actual day of closing and was then subsequently picked up by MortgageStream on that same day. The borrower indicated that a face-to-face interview with a MortgageStream employee never occurred even though the borrower, as a first time homebuyer, is required to have a face-to-face interview with an employee of the lender. Additionally, a MortgageStream representative was not present at the time of loan closing. The borrower indicated that she has never had any personal contact with a MortgageStream employee. The borrower also stated that most of the paperwork from MortgageStream was simply faxed to her on the day of closing for signature.

Additionally, other deficiencies were noted in this FHA case file. As stated earlier, the closing date of this loan was October 25, 2001. The credit report contained in the FHA case binder is dated December 10, 2001, which shows that the credit report was received after the loan closed. Without a credit report, MortgageStream would not have been able to make a determination as to whether the borrower had the ability to make monthly housing payments.

The compensating factor that was used on the MCAW was that the borrower is a limited user of credit. This statement is questionable due to the credit history shown in the FHA case binder. According to the credit report, the borrower has had serious delinquency and derogatory public record or collections filed. Also the borrower is not a limited user of credit because all three scoring systems used were able to give an output score for the borrower. The credit report also states that the balances on revolving accounts are too high. On the credit report there were six listing of debts and obligations for the borrower, and of the six listings, five are credit cards. The credit report clearly shows the borrower was more than a limited user of credit. Additionally, the credit report should have been received prior to closing and used by MortgageStream in evaluating the insurability of the borrower's loan.

This file was sent to HUD late for endorsement because MortgageStream was waiting for the credit report to be received.

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## Schedule of Questioned Costs And Funds Put To Better Use

Recommendation Number	Type of Questioned Cost		Funds Put to Better Use <u>3/</u>
	Ineligible <u>1/</u>	Unsupported <u>2/</u>	
1A			<u>\$940,764</u>
2A	<u>\$68,091.35</u>		
2A		\$66,085.79	
2A		\$ 7,757.14	
<b>Totals:</b>	<b><u>\$68,091.35</u></b>	<b><u>\$73,842.93</u></b>	<b><u>\$940,764</u></b>

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State or local policies or regulations.

2/ Unsupported costs are costs charged to a HUD-financed or HUD-insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Funds Put to Better Use are costs that will not be expended in the future if our recommendations are implemented.

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# Auditee's Comments

## **MortgageStream** **FINANCIAL SERVICES, LLC**

September 5, 2003

Mr. Frederick Smith  
Office of Inspector General  
633 17<sup>th</sup> Street, North Tower, 14<sup>th</sup> Floor  
Denver, CO. 80202-3607

Dear Mr. Smith:

Enclosed are MortgageStream Financial Services, LLC's comments to your draft report on the recent audit of our organization's activities.

We have discussed many of the comments and the audit report throughout the course of the audit and during the exit conference. This enclosure summarizes many of those comments and our proposed corrections

and procedural changes. If you have any questions or require any clarification, please do not hesitate to call.

Sincerely,



Stan Sauerwein  
Acting Director (Effective September 1, 2003)  
MortgageStream Financial Services

7000 East Belleview Ave. #250, Greenwood Village, CO 80111, 720-377-3300, 720-377-3301

MortgageStream Financial Services, LLC  
Comments to Inspector General Audit Report

General Comments

MortgageStream Financial Services, LLC would like to extend its thanks to the inspector general's office for a very professional review and analysis of its operation. In particular, we would like to thank Mr. Frederick Smith for many very relevant insights and suggestions for improvements to our system.

The audit report disclosed management weaknesses to the company's board of members. The Board is currently acting on this information to rectify this problem. Effective September 2003, Ms. Kathleen O'Loughlin is removing herself from all management/underwriting of MortgageStream. The Board has hired a senior underwriter with significant direct endorsement experience (resume attached) to replace Ms. O'Loughlin, effective immediately. The Board is also releasing from employment one loan officer it believes has significantly contributed to higher risk loans.

The Board is also addressing weaknesses in the documentation processes and procedures. It is implementing stronger controls and closer monitoring of the company's operations.

A limited synopsis of comments to the audit report findings and solutions follows. We look forward to addressing these changes and enhancements in further detail with the Denver Home Ownership Center personnel.

Origination and Underwriting

The audit report has delineated weaknesses in MortgageStream's origination and underwriting processes. We believe new policy and procedure enhancements will rectify a significant portion of these weaknesses. MortgageStream is currently developing and implementing many of the inspector general's recommendations and guidelines imposed by HUD. MortgageStream believes these additional controls and conditions are warranted in the markets in which it originates the majority of its mortgages. These changes will help achieve a less risky profile of its mortgage portfolios. The following is a synopsis of the new policy & procedure enhancements that we believe will assist MortgageStream to achieve its (and HUD's) goals of quality FHA insured mortgages.

Originating and Underwriting – Policy and Procedure Enhancements

MortgageStream is currently developing a comprehensive written policies and procedures manual for use by the management and staff. This manual will delineate the policies and procedures for origination, processing, underwriting and shipping & endorsement of all loans originated by MortgageStream. MortgageStream is being assisted by a technical writer to develop this manual which will also contain detailed job descriptions and checklists for each employment position.

Quality and Control

Based on the audit report recommendations the company is developing programs and requiring changes to assist in the implementation of an effective system for quality control. A brief synopsis of actions for enhancement follows.

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# Auditee's Comments

## MortgageStream Financial Services, LLC Comments to Inspector General Audit Report

### Quality and Control Enhancements

- 1) MortgageStream is currently in the process of engaging a new external quality control firm. The audit exposed many weaknesses of the current external quality control firm engaged by MortgageStream, and originally recommended by HUD. Our research indicates the new quality control firm is significantly more thorough in its quality control review process. We believe this will generate better information for review by the Board for continued monitoring and action.
- 2) Additionally, MortgageStream is contracting with a CPA firm to perform file reviews above and beyond the HUD requirements. They will be contracted to review any file that enters a default status as well as other randomly selected files. We believe their input will provide additional information to further audit policies and procedures allowing MortgageStream to achieve it's goal of high quality FHA insured loans.
- 3) MortgageStream will develop and implement an improved quality control manual for internal use with appropriate checks, balances and reporting modules to further enhance the internal control as it relates to quality control of originated loans.
- 4) MortgageStream has a published fee schedule to assist the closing department in monitoring all fees charged on mortgage loans. The external and internal quality control reviews will also develop a monitoring program to ensure compliance with the published fee schedule.
- 5) MortgageStream will refund overcharges to customers after it receives direction from the HOC as to which amounts need to be forwarded to HUD and the appropriate mailing address for such remittance to HUD.

### Indemnity Request

MortgageStream is reviewing the loans the inspector general has recommended for indemnifications. We do not believe the auditors had all the information relating to these files. For sake of expediency, we would like to suggest the HUD ownership personnel review these files with the new management of MortgageStream for further clarification and final disposition.

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## Distribution Outside of HUD

The Honorable Susan M. Collins, Chairman, Committee on Government Affairs  
The Honorable Joseph Lieberman, Ranking Member, Committee on Government Affairs  
The Honorable Thomas M. Davis, III, Chairman, Committee on Government Reform  
The Honorable Henry A. Waxman, Ranking Member, Committee on Government Reform  
Sharon Pinkerton, Senior Advisor, Subcommittee on Criminal Justice  
Andy Cochran, House Committee on Financial Services  
Clinton C. Jones, Senior Counsel, Committee on Financial Services  
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Mark Calabria, Committee on Banking, Housing, and Urban Affairs  
W. Brent Hal, U.S. General Accounting Office  
Steve Redburn, Chief Housing Branch, Office of Management and Budget  
Linda Halliday, Department of Veterans Affairs, Office of Inspector General