



Issue Date	March 11, 2004
Audit Case Number	2004-DE-1002

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

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

SUBJECT: Treehouse Mortgage, LLC, Non-Supervised Loan Correspondent
Denver, Colorado

INTRODUCTION

We have completed an audit of Treehouse Mortgage, LLC, a HUD approved Non-Supervised Loan Correspondent, in Denver, Colorado. We selected Treehouse for review because of their high default and claim rates. The objectives of our review were to determine whether: (1) the mortgagee complied with HUD regulations, procedures, and instructions in the origination of FHA-insured loans; and (2) the mortgagee's quality control plan, as implemented, met HUD requirements.

During our audit, we performed tests for compliance with HUD's requirements for the origination of FHA-insured loans. We reviewed a sample of 20 FHA-insured loans that had defaulted within the first twenty-four months of origination. We reviewed Treehouse's quality control plan to determine if it complied with HUD requirements. We conducted the audit in accordance with Generally Accepted Government Auditing Standards.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without a management decision, 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.

SUMMARY

Our review identified two findings. Contrary to FHA requirements, Treehouse used contract loan officers that were not HUD-approved to originate FHA insured loans. Treehouse also did not have a formal written quality control plan and was deficient in its overall quality control activities.

Treehouse contracted with several independent loan officers to originate FHA insured loans. Treehouse paid the contract loan officers a commission on each FHA loan. Because these loan officers worked as independent contractors, Treehouse management were not able to oversee their performance with the same level of control as their own employees. HUD considers proper oversight and control of the loan origination process as key to reducing FHA mortgage insurance risks.

During our fieldwork, Treehouse implemented changes over the use of contract loan officers. Two of the three remaining contract loan officers were converted to full time employees. The third contract loan officer will no longer originate FHA insured loans. These changes have brought Treehouse into compliance with HUD requirements.

Treehouse did not comply with HUD quality control requirements for over two years. Treehouse's quality control plan was informal and inadequate. In addition, Treehouse did not perform required quality control reviews on all defaulted loans or meet HUD's minimum sampling requirements. Treehouse also did not submit any written reports to senior management that identified deficiencies noted in the files reviewed or the responsible employees. Treehouse's non-compliance with HUD requirements prevented management from taking corrective actions on deficiencies noted or ensuring the completeness, accuracy, and validity of their loan origination files.

Prior to our on-site review, Treehouse management hired an independent consultant to develop a new comprehensive quality control plan that would be in full compliance with HUD requirements. Using this new quality control plan, Treehouse management reviewed all FHA insured loans currently in default and ten percent of all FHA insured loans originated. If Treehouse continues to follow this new quality control plan, as written, it should provide adequate assurance to management that their origination operations comply with HUD directives.

BACKGROUND

HUD approved Treehouse as a Title II non-supervised loan correspondent on May 4, 2000 and granted them the authority to originate HUD-FHA insured loans. From September 2000 through August 2003, Treehouse endorsed 356 FHA insured loans with a total mortgage amount of \$58,267,190. Of these 356 FHA insured loans, HUD has paid claims on eight of the loans for a total of \$1,075,382.46.

We selected Treehouse Mortgage for review due to its high default and high claim rates. Treehouse's default and claims rate is significantly higher (146%) than the average for all

lenders in the state of Colorado. At September 2003, Treehouse had a default claim rate of 3.80% while other lenders in Colorado had an average default rate of 2.60%. At August 31, 2003, HUD's records show that thirteen insured loans had defaulted within the first two years. As of October 2003, six of these FHA insured loans were in default and four of these loans had been submitted to HUD for insurance claim.

The primary objectives of our review were to determine if their loan origination procedures and activities comply with HUD requirements; and establish whether their Quality Control Plan, as implemented, meets HUD requirements.

We completed a review of Treehouse's operations using loans originated between September 1, 2000 and August 31, 2003. Our on-site review was conducted during the months of November and December 2003 and January 2004. Treehouse's loan origination operations were reviewed and policies and procedures were measured against those stated by members of management and Treehouse employees.

Finding 1

Use of Contract Loan Officers

Treehouse Mortgage was using contract loan officers to perform customary loan officer functions that can only be performed by full time employees of the mortgagee. Federal regulations and HUD directives specifically state that there are certain loan officer functions that may not be contracted out to third party loan originators, real estate brokers, and other similar entities. The mortgagee cannot exercise the same level of control and supervision over contract loan officers that it can over its full time employees. Therefore, the mortgagee lacks the same level of assurance that the loan origination functions accomplished by contract loan officers are completely in accordance with federal regulations and HUD directives.

Federal Register (March 1, 1999) Part IV Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 identifies 14 services or functions normally performed in the origination of a loan by the loan correspondent. Mortgage Letter 95-36 states that mortgagees may not contract out the customary loan officer functions, as mortgagees are held responsible for the quality of loans and compliance with HUD requirements¹. In addition, such services and functions as these may not be contracted out to third party loan originators, real estate brokers, and other similar entities. In other words, customary loan officer functions are to be performed by employees of the mortgagee.

¹ Functions not to be contracted (1) analyzing the prospective borrower's income and debt and prequalifying the prospective borrower (2) educating the prospective borrower in the home buying and financing process; (3) advising the borrower about the different types of loan products; (4) providing disclosure forms to the borrower; (5) assisting the borrower with credit problems; (6) maintaining regular contact with the borrower, and other related parties to the loan application, and (7) gather any additional information as needed.

HUD Handbook 4060.1, REV-1, requires mortgagees to exercise control and responsible management and supervision over their employees. The requirement regarding control and supervision must include, at a minimum, regular and ongoing reviews of employee performance and of work performed. This handbook further requires a mortgagee to maintain adequate office space in a location conducive to performing mortgage-lending business. A mortgagee's employees may not use their signatory authority to bind the mortgagee in a home, car, or similar space that is not a part of the mortgagee's office. In addition, a mortgagee is required to pay all of its operating expenses incurred in operating a mortgage lending business. This includes the compensation of employees of its main and branch offices.

Treehouse Mortgage used both loan officer employees and contract loan officers to accomplish the required loan origination functions for FHA-insured loans. Treehouse Mortgage, relying on advice from their law firm, entered into a Loan Officer Service Agreements with several of their loan officers.

The Loan Officer Service Agreement contained an "Exclusivity Clause" stating that the contract loan officers would not originate loans for any other mortgage company, other than Treehouse. The agreement contained several paragraphs in direct violation of HUD directives. One provision stated the loan officer would indemnify and hold harmless the mortgagee from all damages, costs, and expenses, including attorney fees, incurred by the mortgagee, resulting from any violation of the provisions of agreement. Several other paragraphs stated that the loan officer is not a Treehouse employee.

Treehouse allowed the contract loan officers to perform all loan origination functions, including those that employees of the mortgage company are required to perform. The contract loan officers operated from their own residences and paid their own operating and overhead expenses.

Treehouse misunderstood and misapplied HUD's requirements concerning the use of non-employees to originate FHA insured loans. Treehouse's contracted law firm represented another mortgagee in the Santa Ana Homeownership Center's region who was using a similar loan officer service agreement. This mortgagee submitted the agreement to the Santa Ana Homeownership Center for their approval, was granted approval for its use, and was told that it met HUD requirements. Consequently, Treehouse modified this same agreement to meet Colorado law and used this agreement with several loan officers originating FHA insured loans.

Because contract loan officers work independently and are not under the direct supervision of the mortgagee, Treehouse cannot effectively ensure the accuracy, validity, and completeness of its loan origination operations. Treehouse's operations are small and because of this, management is directly involved in the supervision and control of its loan officers who are full time employees. This cannot be said about contract loan officers' performance because they operate out of remote locations removed from Treehouse's offices. In addition, potential deficiencies in the loan origination packages could go undetected, thus leaving the FHA insurance fund at risk. HUD requires

mortgagees to perform ongoing reviews of employees' performance. With Treehouse's use of independent contractor loan officers, working from their homes, and Treehouse's lack of an effective quality control program, the FHA insurance fund is even more vulnerable to risk.

Treehouse Mortgage has already stopped the practice of using contract loan officers to originating FHA-insured loans. At the time of our review, there were only three loan officers that were still functioning as contract loan officers. Two of these three contract loan officers are now full time loan officer employees under the direct control and supervision of management. The third loan officer can no longer originate FHA-insured loans.

AUDITEE COMMENTS

Treehouse, in their written comments, which are included in their entirety in Appendix A, basically concurred with our finding and recommendations. Management has already initiated corrective action to address the problem. All loan officers are now IRS Form W-2 employees.

Treehouse, in their written comments, included a note to HUD stated that they believe that large mortgagees in Colorado are still operating using contract loan officers, which makes it impossible for smaller mortgagees to compete with the larger mortgagees.

OIG EVALUATION OF AUDITEE COMMENTS

The positive steps taken by Treehouse Mortgage, LLC to discontinue the practice of using contract loan officers to originate FHA insured loans will help to alleviate the condition addressed in our finding.

RECOMMENDATIONS

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

1A Obtain written assurances from Treehouse Mortgage that only loan officers who are full time employees of Treehouse will originate FHA insured loans.

1B Conduct sufficient reviews of Treehouse Mortgage's loan origination activities to ensure FHA insured loans are accomplished by only full time loan officer employees.

Finding 2

Non-Compliance with Quality Control Requirements

Treehouse Mortgage, LLC, did not comply with HUD's quality control requirements. Treehouse did not have a formal written quality control plan until October 2003, twenty-six months after receiving HUD-FHA approval. Treehouse failed to review loans defaulting within the first six months and did not review ten percent of rejected loans. In addition, Treehouse did not meet its quality control review sampling requirement of selecting at least ten percent of all FHA-insured loans originated monthly for review. Furthermore, Treehouse did not accomplish quarterly written reports to its senior management for review. Consequently, Treehouse had reduced management controls over its loan origination operations. Furthermore, any identifiable loan origination deficiency could go uncorrected. Accordingly, Treehouse was unable to properly ensure the accuracy, validity, and completeness of their loan origination operations.

Under HUD Regulations², Treehouse is to implement a written quality control plan that assures compliance with the regulations and other HUD issuances regarding mortgage loan origination. HUD Handbook 4060.1 REV-1 details the requirements for Treehouse's quality control plan over the origination of FHA insured mortgage loans. Loan correspondents are required to have a quality control plan in place that is sufficient in scope to enable them to evaluate the accuracy, validity, and completeness of their loan origination operations. Quality control reviews are to be performed within 90 days of loan closing and are to include a specified sampling percentage of originated loans.

Additionally, Treehouse is to analyze all loans that go into default within the first six months and ten percent of total loans rejected. Furthermore, the quality control plan is to include procedures for expanding the scope of the review where a pattern of deficiencies or fraudulent activity exists.

Treehouse did not have a formal written quality control plan until October 2003, twenty-six months after its inception. During this period, Treehouse Mortgage applied an informal quality control plan that was used only to complete cursory reviews of loan origination packages. Treehouse did not review loans that defaulted within the first six months nor did they review ten percent of rejected loans. The lack of a quality control plan prevented Treehouse from fully evaluating the quality of their loan originations. Furthermore, loan processing deficiencies, such as errors and omissions or unacceptable patterns or trends, would not have been readily identifiable or go undetected.

Treehouse is a small business that uses micro-management practices and management is thoroughly involved throughout the loan origination process. Management believed that these practices would be sufficient to ensure the overall quality of the loan origination packages.

² Section 202.5 of Title 24 of the Code of Federal Regulations

Treehouse also relied on reviews conducted by their sponsors as a primary quality control check. The sponsors send reports to Treehouse indicating issues that required attention and Treehouse management would then correct the problems within the file. With the small number of loans originated at Treehouse, management felt this method would address their deficiencies.

Before the Denver OIG review, Treehouse hired an independent consultant to assist with the development of a quality control plan. Management developed a plan that they believe to be in full compliance with HUD requirements. We reviewed the new plan and found it to be comprehensive and in conformity with HUD requirements. If implemented correctly, the plan will provide adequate management control to the loan origination operations at Treehouse Mortgage.

However, after the new quality control plan was completed in October 2003, Treehouse management reviewed all defaulted loans and a ten percent sample of all loans originated for the past two years. The sampling of the reviewed loans did not meet HUD regulations and the time requirements were not satisfied. The quality control manager simply picked random files from storage boxes to complete ten percent of the total loans originated and then reviewed a minimum of one file for each loan officer that had not yet had a file reviewed. The quality control officer did not use a random selection process for selecting the loans to review.

After we discussed the quality control plan with Treehouse management, they have decided to change the manner that they complete their quality control reviews in order to comply with HUD regulations. The quality control manager will use a random number generator to obtain the cases that will be reviewed so sampling requirements will be fulfilled. Also, reviews will be completed quarterly due to the small number of loans originated each month. This will ensure that the quality control reviews will meet the time requirements.

We completed case binder reviews on twenty defaulted loans at Treehouse and compared any deficiencies to those identified by Treehouse management using their new quality control plan. Our review showed that Treehouse's quality control reviews were adequate and appeared to detect all discrepancies that were contained within the files.

AUDITEE COMMENTS

Treehouse, in their written comments, basically concurred with our finding and recommendations. Management has already initiated corrective action to address the problem. Treehouse has developed a Quality Control Plan and will conduct quarterly reviews.

OIG EVALUATION OF AUDITEE COMMENTS

The positive steps taken by Treehouse Mortgage, LLC to develop and implement a Quality Control Plan and to conduct quarterly reviews, will help to alleviate the condition addressed in our finding.

RECOMMENDATIONS

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

2A Obtain written assurances from Treehouse Mortgage that their quality control plan has been fully implemented, and

2B Evaluate the implementation of Treehouse's quality control plan during HUD's next Quality Control review and evaluate its compliance with HUD requirements.

MANAGEMENT CONTROLS

In planning and performing our survey, we considered the management controls relevant to HUD's FHA loan origination program to determine our survey procedures, not to provide assurance on the controls. Management controls include the plan of 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.

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

- Loan Origination Process; and
- Quality Control Plan

We used the following audit procedures to evaluate the management controls:

- Review of established procedures formulated by Treehouse in originating FHA-insured loans,
- Interviews with officials and employees of Treehouse and other related parties and entities,
- Examination of Treehouse Mortgage's records and related documents for FHA-insured loans originated between August 1, 2000 and September 31, 2003, and
- Review of records and files maintained by HUD's Quality Assurance Division in connection with the oversight of the HUD-FHA approved Loan Correspondent Treehouse.

It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet an organization's objectives.

Our review of Treehouse Mortgage, LLC's management controls over its loan origination procedures for the origination of FHA-insured loans showed Treehouse as not complying with HUD requirements. Based on our audit, we believe weaknesses exist in the following two areas:

- Loan Origination Process (Finding 1); and
- Quality Control Process (Finding 2)

FOLLOW-UP ON PRIOR AUDITS

This is the first review of Treehouse Mortgage, LLC by the Denver Office of Inspector General for Audit.

AUDITEE COMMENTS



Response to Audit Report Findings

Finding 1: Use of Contract Loan Officers

Corrective Action:

All Loan Officers who originate FHA loans are full time employees of Treehouse Mortgage. There are no 1099, or independent contractors, who perform FHA loan origination. Treehouse Mortgage had contacted HUD at an earlier time several years ago and was told that a person who was paid via 1099 was within guidelines. Prior to this audit Treehouse retained a consultant to assist in the formation of a more comprehensive quality control plan. This consultant provided Treehouse with an employment contract that had been submitted, as stated in the findings, to the Santa Ana HOC for analysis. The HOC in Santa Ana said the contract met HUD guidelines. After modifying to comply with Colorado law Treehouse put these contracts into place. Upon further review of the contract, and seemingly inconsistent information from differing HOC's, Treehouse made the decision to only have W2 employees who were under direct control and supervision of management to proceed with the origination of FHA loans.

Note to HUD:

Treehouse Mortgage takes pride in its status as a non-supervised Loan Correspondent. It provides our company the ability to assist consumers by offering them a product, which for many facilitates the dream of home ownership. Treehouse strives to operate a fair and conscious driven business and in doing so try to compensate employees, if possible, at higher standards than is customary in the marketplace. As a small business, we are concerned that the 1099 issue of payment is perpetuating an unequal playing field amongst large corporations and small business making it extremely difficult for Treehouse to maintain an attractive compensation package to prospective employees. Large companies in Colorado are originating FHA loans still utilizing 1099 contractors and in doing so are able to pay a higher percentage of total loan revenue as payment. Treehouse understands the role of HUD in assisting and protecting consumers and that same spirit should be applied to the small business trying to offer FHA products.



Response to Audit Report Findings cont.

Finding 2: Non-Compliance with Quality Control Procedures: Corrective Action:

Treehouse Mortgage now has a HUD acceptable Quality Control Plan in place. As mentioned in the findings, although Treehouse Mortgage did not have the exact auditing “procedures” in place that is ultimately acceptable to HUD, due to the relative low-volume of originations, the management at Treehouse “micro-managed” each file.

Management did consistently check Neighborhood Watch on FHA connection to monitor the default mortgages. There was follow-up and contact kept with most default clients.

Even though Treehouse Mortgage’s auditing procedures did not specifically meet HUD guidelines; Management always understood the importance of monitoring and reviewing its FHA files.

An example of this was that all FHA files were carefully reviewed by our companies’ processor *and* management, Scott LaBarbera and Brian Jewell before they were sent to any DE underwriter. Any deficiencies were discussed individually with loan officers but not documented.

Management now understands that even though there was always high importance placed on the monitoring of FHA files, in order to comply with HUD regulations we must strictly follow our current Quality Control Plan. The reviews will take place on a quarterly basis.

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
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