



U.S. Department of Housing and Urban Development  
**Office of Inspector General, Rocky Mountain**

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OFFICE OF INSPECTOR GENERAL FOR AUDIT

Audit Memorandum  
No. 2001-DE-1801

June 1, 2001

MEMORANDUM FOR: Ronald C. Bailey, Director, Denver Homeownership Center, 8AHH

*Ronald C. Bailey*

FROM: Robert Gwin, District Inspector General for Audit, 8AGA

SUBJECT: Clarion Mortgage Capital, Inc., Centennial, Colorado

### INTRODUCTION

We completed a review of Clarion Mortgage Capital, Inc. (Clarion), Centennial, Colorado. The objectives of the review were to determine if Clarion:

- Was fulfilling loan correspondent requirements relating to the functions of its loan officers; and,
- Had management controls pertaining to its loan officer functions concerning FHA mortgage insurance loan origination, and that such controls ensured that FHA loan origination files were properly established and processed.

We reviewed Clarion's loan officer processing and accounting procedures for FHA insured loans originated between January 1, 1997 and October 31, 2000. We accomplished the objectives by evaluating Clarion's: management controls over its loan officer functions; accounting procedures for the loan origination income and expenses; and procedures for the development of FHA loan origination files. We reviewed records relating to FHA loan originations, which were maintained by Clarion, and interviewed Clarion personnel as well as independent Clarion contract loan officers. In addition, we reviewed applicable HUD records and files and interviewed pertinent HUD staff within the Denver Homeownership Center.

We conducted the onsite work during November and December 2000. Additional information was subsequently obtained from HUD. The results of the site work were discussed with Clarion officials during our site review. The draft audit memorandum was presented to Clarion officials for their review and comment during an exit conference on April 30, 2001. Their written

response is included as Appendix A. We conducted our review in accordance with Generally Accepted Government Auditing Standards.

## **BACKGROUND**

Clarion Mortgage Capital, Inc. was incorporated under the laws of the State of Colorado on September 10, 1996 and commenced operations on September 11, 1996. The primary business activity of the company is loan origination and brokerage. Clarion was approved by HUD as a Loan Correspondent on November 21, 1996. Clarion, as a Loan Correspondent, was authorized to complete the origination functions for FHA loans. Clarion negotiated agreements with HUD-approved Sponsors to underwrite the loans.

Clarion's main office is located at 9034 East Easter Place, Suite 204, Centennial, Colorado. Clarion also has obtained HUD approval for four branch offices, as of June 2000, in the following locations: Tustin, California; La Grange, California, Grapevine, Texas, and San Antonio, Texas. In addition, Clarion has contracted with independent loan officers to perform the loan origination functions.

HUD insured loan statistics shows a total of 3,155 FHA loans originated by Clarion during the audit period of January 31, 1997 through October 31, 2000. HUD's latest default statistics, for Clarion for the two-year period ending January 31, 2001, identified 44 loans defaulting within the first two years, out of a total of 2,330 loans originated by Clarion. Clarion's default rate of 1.89 is lower than the rest of the country that has a default rate of 3.79.

## **RESULTS OF REVIEW**

We reviewed Clarion's management controls over the loan officer origination functions and the accounting procedures for the origination of FHA mortgages. Clarion had adequate management controls over these functions.

### **Finding: Improper Loan Originating Functions by Independent Contract Parties.**

Our review of Clarion's management controls over its loan origination functions and the accounting procedures for the origination of FHA mortgages showed Clarion not to be in compliance with HUD requirements in two areas:

- Clarion used independent contracted loan officers to originate FHA loans, in Clarion's name, instead of using regular company employees; and,
- Three of the four designated HUD-approved branch offices were only offices of independent contract loan officers.

Clarion has been using independent contract loan officers to perform all loan origination functions for Clarion including those functions that are required by HUD regulations to be performed by only Clarion employees. Based upon an October 1997 meeting with HUD representatives, Clarion made several operating changes to comply with the guidance provided by HUD. The HUD representatives, involved in the meeting, stated that the contract loan

officers would be considered employees if Clarion executed a memorandum of understanding, with each loan officer, requiring that he or she work exclusively for Clarion. Clarion executed a memorandum of understanding with each contract loan officer requiring exclusivity to Clarion. Therefore, Clarion considered the loan officers to be employees and their loan origination activities to be in harmony with HUD requirements.

HUD needs to provide clarifying instructions to Clarion detailing the requirements for processing loan origination packages by contract loan officers who are under independent contracts with Clarion and by Clarion employees. This would also include guidance on the establishment and use of branch office for processing loan originations.

HUD Requirements The Federal Register, dated March 1, 1999, Part IV, addressed Title 24 of the Code of Federal Regulations, Part 3500. The Federal Register included the Real Estate Settlement Procedures Act Statement of Policy 1999-1, which stated that HUD identified 14 services or functions normally performed in the origination of a loan. Mortgagee Letter 95-36 stated that customary loan officer functions may not be contracted out. The Mortgagee Letter listed loan origination functions which may be contracted out. However, it stated that such functions must be contracted out to a commercial provider of the types of services being requested, and may not be contracted out to third party loan originators, real estate brokers and other similar entities.

HUD Mortgagee Letter 95-36 states that a branch office could be located in either commercial or non-commercial space; however, there must be at least one employee working exclusively for the mortgagee. Mortgagee Letter 00-15 requires a HUD/FHA approved mortgagee to pay all of its operating expenses including the compensation of all employees of branch offices, office rent, and other similar expenses incurred in operating a mortgage lending business.

HUD Handbook 4060.1, para. 2-13, Control and Supervision of Employees, states that Mortgagees are required to exercise control and responsible management supervision over their employees. The requirement regarding control and supervision must include, at a minimum, regular and ongoing reviews of employee performance and of work performed.

Clarion's Operations At the time of our review, Clarion was using independent contract loan officers to carry out the required loan origination functions. The contract, which independent loan officers signed, stated that Clarion assumed no responsibility over them for the direction, supervision and control of their loan origination activities.

The procedures in place at the time of our review provided that the contract loan officers would perform all functions relating to the origination of an insured mortgage. The contract loan officer signed the loan closing documents on behalf of Clarion. The loan origination package would then be forwarded to a Sponsoring Mortgagee, who was a HUD-approved Direct Endorsement Mortgagee. The Direct Endorsement Mortgagee would review the loan package for completeness and conformity with HUD requirements and then process the loan for FHA mortgage insurance.

The contract loan officer attended the closing for a loan and then met with Clarion to receive his or her loan origination commission. The contract loan officer provided the closing disbursements check, received from the title company at closing, and the loan origination documents package to Clarion accounting personnel. The accounting personnel reviewed the document package for completeness. If no problems were identified, the commission was calculated and disbursed to the contract loan officer.

As part of a quality control procedure, Clarion did contract with a separate entity to perform a review of 10 percent of all completed loan origination packages for compliance with HUD requirements.

Clarion obtained HUD approval to operate four branch offices. Two were for offices in California and two in Texas. At the time of our review, only one of the branch offices was functioning as a branch office within HUD guidelines. This office, located in Tustin, California, had regular employees of Clarion and the office overhead and rent was paid directly by Clarion. The other three branch offices were actually offices or residences of loan officers under contract with Clarion. None of the office operating costs was being paid by Clarion.

HUD Requirements Not Met Clarion's procedures of using independent contract loan officers to perform all loan origination functions is at variance with HUD requirements. Certain loan functions are to be performed by only employees of the mortgagee and not by third party contractors. HUD required the mortgagee to have control and supervision of the employees and to monitor their loan origination activities.

The independent contractors, while working exclusively for Clarion, perform all loan origination activities for Clarion including those required to be performed by Clarion's own employees. The contractors operate from their residences or commercial space. Each of the contractors pays their own operating or overhead expenses that are funded from the loan origination commissions from Clarion. None of the contractors' expenses are paid directly by Clarion. The loan officer contract stated that Clarion assumed no responsibility over the loan officer for the direction, supervision and control of the loan origination activities.

Clarion Considers Their Operations Satisfactory to HUD Clarion officials considered their operation to be in conformity with HUD requirements. While the loan officers are under separate contracts with Clarion, Clarion considers the contract loan officers to be Clarion employees. Clarion pays its contract loan officers a fee that is based upon 85 percent of the loan origination revenue for each closed loan package the contractor processes. The fee, while higher than what other mortgagees would pay, is made to cover the operating and overhead expenses of the contract loan officers.

In addition, Clarion monitors and evaluates the loan origination activities of the contract loan officers through its independent evaluation of each closed loan package. Clarion uses an independent company to perform a review of 10 percent of all loan origination packages closed for Clarion by its contract loan officers. The review determines whether the closed loans met HUD requirements.

In like manner, Clarion performs a review of each closed loan when the contract loan officer submits a request for their particular loan commission. Before Clarion pays the loan commission, Clarion through the use of a checklist ensures that the required forms were completed by the loan officer.

Clarion considered their use of contract loan officers to be acceptable by HUD. Representatives of HUD's Denver Homeownership Center, Quality Assurance Division, met with Clarion officials on October 6, 1997. The understanding between the HUD representatives and Clarion was that a contract loan officer would be considered an employee of Clarion if a memorandum of understanding, requiring exclusivity by the loan officer, was signed. Clarion added a memorandum of understanding to each loan officer contract. The memorandum of understanding stated that: the contract loan officer would abide by all HUD regulations; the loan officer would direct all originated loans through Clarion while working with Clarion; and, the contract would be terminated if the loan officer originated loans as an employee of a company other than Clarion.

In an October 15, 1997 letter to Clarion, HUD requested that copies of the signed memorandum of understanding be provided to HUD within 15 days. The letter further stated that once the signed copies were received, HUD would consider the issue resolved. Clarion submitted copies of the signed agreements to HUD at the end of October 1997. The understanding between Clarion and the HUD representatives does not coincide with HUD's official position on employee requirements.

HUD Clarification Is Needed While we recognize that Clarion officials have been acting in good faith, their business structure is not in full compliance with HUD requirements. HUD needs to provide clarifying instructions to Clarion on HUD requirements for processing loan origination packages by contract loan officers and by Clarion employees. This will need to include a determination as to whether loan officers under independent contracts with Clarion are actually employees of Clarion and thereby are permitted to perform those loan origination activities which are to be performed by only Clarion employees. Guidance will also need to be included on the establishment and use of branch offices for processing loan originations.

### Clarion's Response

Clarion officials provided their written response on May 11, 2001. The entire response is included in Appendix A. The response states, in part, "Clarion believes it is in full compliance with FHA program requirements, having gone so far as to obtain prior HUD approval for the key components of its loan origination procedures." Therefore, they disagree with the report conclusion that Clarion's loan origination arrangements are improper or not in compliance with HUD requirements and with recommendation 1A. They explain that HUD agreed that their loan officers are "employees" as this term is used in the FHA program requirements; that Clarion assumes full responsibility for the quality of all their loans; and, that they have supervisory and management controls over their loan officers.

The response further states, "Clarion asserts that it has complied with the letter and spirit of Mortgage Letter 95-36, in all respects." Clarion pays a high commission, which they consider to be indirect payment of overhead costs. However, Clarion is willing to change their procedures

and directly pay the overhead for all branch offices, which they will do to address concerns expressed in the draft audit memorandum.

Clarion suggests that there is no need to refer this matter to HUD's Denver Homeownership Center, as it previously has provided the clarification to Clarion that such a referral would be seeking, and Clarion requests that this matter be closed without further proceedings.

#### OIG's Evaluation of Clarion's Response

Clarion's position focuses entirely on the fact that Clarion considers its contract loan officers to be "employees" of Clarion and is in harmony with HUD requirements. Clarion maintains that it has more than required supervisory and management controls over its contract loan officers. Clarion's supervision and management controls as detailed in their response deals with the selection and initial oversight of contract loan officers and in the post loan closing reviews of the contract loan officer loan origination activities. While HUD regulations require direct supervision of employees, Clarion does not provide any supervision of the loan officers in their loan origination activities prior to loan closing. This is supported by Clarion's loan officer contracts which state Clarion assumes no responsibility over the loan officer for the direction, supervision and control of the loan origination activities.

We recognize in the audit memorandum that Clarion obtained guidance from a HUD representative and has basis for considering their operations to be in compliance with the HUD requirements. However, during the audit work, various parties expressed different interpretations of the applicable HUD requirements. Therefore, HUD needs to make a determination of the actual meaning of the applicable requirements and provide this information and any related guidance to Clarion. This needs to include a determination as to whether independent contract loan officers are considered to be actual employees of Clarion.

#### Recommendations

We recommend that the Denver Homeownership Center:

- 1A. Provide clarifying instructions to Clarion for complying with HUD regulations concerning loan origination requirements and what functions are to be performed by Clarion employees and contract loan officers. This will need to include a determination as to whether independent contract loan officers are considered to be actual employees of Clarion. In addition guidance and instructions will need to be provided to Clarion for the proper establishment and use of a branch office.
- 1B. Review Clarion's implementation of recommendation 1A and ensure that Clarion's loan origination procedures and operations are in conformity with HUD's requirements.

These recommendations will be controlled under the Departmental Automated Audit Management System. Within 60 days please furnish to this office, for each recommendation in this report, 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 not necessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

We appreciate the courtesies and assistance extended by the personnel of Clarion Mortgage Capital, Inc. and the Denver Homeownership Center. Should you have any questions, please contact Ernest Kite, Assistant District Inspector General for Audit, at (303) 672-5452.

# Auditee's Comments



**Clarion Mortgage Capital**

*A Call to Action*

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303-843-0777 Fax: 303-843-0999

May 11, 2001

Robert Gwin  
District Inspector General for Audit, 8AGA  
U.S. Department of Housing and Urban Development  
Office of Inspector General, Rocky Mountain  
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RE: Clarion Mortgage Capital, Inc.  
Denver, Colorado

Dear Mr. Gwin:

Thank you for the opportunity to respond to your draft audit memorandum of Clarion Mortgage Capital, Inc, reviewing certain of our company's FHA-insured mortgage loan origination and loan officer activities.

Let me say at the outset that Clarion's goal is to be an exemplary partner with FHA in providing homeownership opportunities through the FHA mortgage insurance program. We designed our loan production system to provide low cost loans to our borrowers, while still fully complying with all applicable FHA loan origination and loan officer requirements and providing the highest quality FHA-insured loans.

As you noted in your report, we consulted with the HUD/Denver Homeownership Center in October, 1997, in order to be sure that we complied with FHA program requirements and we modified our program at the suggestion of HUD, and in manner requested by HUD, to be sure we complied. As a result, HUD already has fully approved our loan origination and loan officer arrangements.

As you also pointed out, our default rate is well below average, and by every indication we are exceeding FHA loan quality standards.

Finally, as you also confirmed in your report, Clarion's management controls over loan officer origination functions and accounting procedures for the origination of FHA mortgages are adequate.

Under all of these circumstances, we respectfully disagree with the conclusion in your memorandum that Clarion's loan origination arrangements are "improper" or "not in compliance with HUD requirements," and with your recommendation that the Denver



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Homeownership Center provide “clarifying instructions to Clarion for complying with HUD loan origination requirements.” We provide further details below.

**I. Issues Concerning Clarion’s Use Of Loan Originator “Independent Contractors.”**

The HUD Denver Homeownership Center expressly has agreed that Clarion’s FHA loan originators are Clarion “employees” as this term is used in the FHA program requirements. For HUD/FHA purposes, HUD has agreed, they are Clarion employees and are not to be considered “independent contractors.” This conclusion is a sound one.

Perhaps we did not explain it to the OIG team as clearly as we would have liked, but Clarion does, unequivocally, assume full responsibility for the quality of the Clarion loans it originates through Clarion loan originators. What Clarion does not do is directly control in all respects the methods and means these originators use daily to originate loans. This distinction, between the measure of freedom Clarion gives its loan originators to use the most economical and efficient methods to originate loans, and the strict supervisory and management control that Clarion exercises over the quality of the FHA loans Clarion originates through its loan officers, is critical to an understanding of Clarion’s origination procedures.

Among the significant supervisory and management controls exercised by Clarion over Clarion loan officers and the quality of the Clarion FHA loans they originate are the following:

1. Clarion thoroughly interviews prospective loan originators to determine if they are competent, experienced, and ethical loan originators.
2. The first two loan packages originated by a new originator are audited in detail. Clarion compares the findings of these two initial quality control audits with the claimed experience of the loan originator.
3. Clarion has engaged an experienced quality control company, National Lender Services, to perform ongoing quality control audits of ten percent of all loans originated by Clarion’s loan originators.
4. As an FHA-approved loan correspondent, the underwriting of loans is performed by our sponsors. Whenever, in our Sponsor’s opinion, a Clarion loan originator has not properly performed his or her loan origination responsibilities, Clarion immediately responds and implements appropriate remedial measures.
5. After loan closing and funding, Clarion engages in a thorough review of each loan to ensure that it meets all FHA program requirements. If any defects are found at this stage, the originator is immediately notified and appropriate remedial measures taken.

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6. If an originator is found to have engaged in any material violations of Clarion's loan quality and ethical standards, the originator's agreement immediately is terminated.
7. A Clarion loan originator may originate loans only for Clarion. The relationship is exclusive.
8. Clarion frequently corresponds with its originators to provide updates on FHA program requirements, regulatory compliance and Clarion's internal procedures. In this way, our originators are provided with the most current guidance available on matters affecting loan quality.

As is apparent, and as is specifically noted in your draft audit memorandum, Clarion has adequate management controls over its loan origination functions. Clarion exceeds HUD's supervisory requirement of regular reviews of originator performance and work performed. Indeed, under Clarion's origination procedures, Clarion has in place all of the FHA-required management and supervisory controls, and more, that it would have had had in place had Clarion hired these loan originators, rather than as IRS-classified "independent contractors" receiving IRS-form 1099 documents, as IRS-classified "employees" receiving IRS form W-2 documents. The only real difference is in the tax implications to the loan originators and in the use by the IRS of a different name for the relationship.

We do not believe that there is any meaningful distinction with regard to FHA program requirements. We believe the term "employees," as used in HUD Handbook 4060.1, encompasses the use of Clarion's IRS-classified independent contractors, in light of Clarion's rigorous supervisory and management controls over loan quality and the fact that HUD does not, under these requirements, specify the method by which an approved mortgagee must compensate its personnel. Perhaps even more importantly, HUD's Denver Homeownership Center agrees, as it should, as evidenced by its express approval of Clarion's loan origination program including the hiring by Clarion of loan originators that the IRS classifies as independent contractors.

## II. Branch Issues

The draft audit memorandum states that three of the four Clarion branch offices did not conform to FHA requirements because they were staffed by Clarion loan originators that the IRS would classify as independent contractors. It notes the requirement in Mortgagee Letter 95-36 that at least one "employee" work at the branch office, and that the employee work exclusively for the mortgagee.

As noted above, Clarion believes the term "employee" as used in Mortgagee Letter 95-36 is broad enough to encompass an "employee" who is deemed to be an independent contractor for tax purposes and receives an IRS 1099 form instead of a W-2,

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if, as in the Clarion loan origination program, that loan originator is subject to adequate supervisory and management controls and the mortgagee remains fully responsible for its loans. Further, as also noted above, our agreement requires that the originator originate loans exclusively for Clarion.

In this connection, we also note that Mortgagee Letter 95-36 specifically eliminated the "brick and mortar" requirements for branches with the goal of reducing overhead costs and providing greater access to low-income loan applicants. The mortgagee letter eliminated the prior restriction on using non-commercial office space and provided mortgagees with the freedom within broad limits to determine the location and type of branch office facilities they chose to maintain.

Clarion asserts that it has complied with the letter and spirit of Mortgagee Letter 95-36, in all respects. By conducting its loan origination activities in a fully professional manner from branch office facilities located in the homes of its loan originators, it has reduced its overhead and has been able to pass some of these savings to its loan applicants. These branch offices provide a professional working environment and provide high quality loan origination services to Clarion's borrowers.

The draft audit memorandum noted a concern about Clarion's method of paying loan originator operating expenses at its branch offices. The draft audit memorandum correctly noted that Clarion paid 85% of the fees generated to the loan originator, a much higher percentage than what is typically paid. In exchange for this additional compensation, the loan originator pays or reimburses Clarion for some of the expenses of the branch and costs of originating the loan from this amount. We believe that this type of arrangement is fully consistent with applicable FHA requirements.

Nevertheless, we have re-considered Clarion's procedures in light of the concerns expressed in your draft audit memorandum, and in order to help resolve all outstanding issues, Clarion would make the following expense reimbursement procedure changes to its program: Clarion would pay all branch office expenses directly, rather than indirectly from the branch loan originator's commissions. These expenses would include any rent, utilities, and telephone expenses of the Clarion branch office. We believe that such a change might help clarify the fact that Clarion does pay all branch office expenses.

### **III. Conclusion.**

Clarion believes it is in full compliance with FHA program requirements, having gone so far as to obtain prior HUD approval for the key components of its loan origination procedures. Accordingly, Clarion respectfully suggests that there is no need to refer this matter to the HUD's Denver Homeownership Center, as it already previously has provided the clarification to Clarion that such a referral would be seeking, and Clarion requests that this matter be closed without further proceedings. (In the event that this matter is referred, Clarion trusts that HUD will re-affirm its prior conclusion.) Clarion is willing, however, to make the procedural change to its branch office payment and reimbursement process noted above, in order to resolve all outstanding issues.

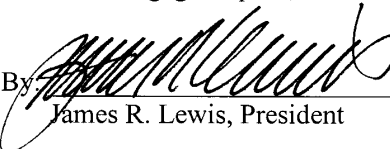
Robert Gwin  
May 11, 2001  
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We thank you, again, for giving us this opportunity to respond to the draft audit memorandum.

Please let us know if you have further questions or comments.

Sincerely,

Clarion Mortgage Capital, Inc.

By:   
James R. Lewis, President

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