AUDIT REPORT

SCHELLER-HESS YODER AND ASSOCIATES
NON-SUPERVISED LOAN CORRESPONDENT
PORTLAND, OREGON

2004-SE-1002
JANUARY 9, 2004

OFFICE OF AUDIT, REGION X
SEATTLE, WASHINGTON

Issue Date January 9, 2004
Audit Case Number 2004-SE-1002

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

Frank E. Baca

FROM: Frank E. Baca, Regional Inspector General for Audit, 0AGA

SUBJECT: Scheller Hess-Yoder and Associates
Non-Supervised Loan Correspondent
Portland, Oregon

We completed an audit of Scheller Hess-Yoder and Associates (SHYA), doing business as Advanced Mortgage Resources in Portland, Oregon. We selected SHYA for review because of their high default and claim rates. Our report contains two findings with recommendations requiring action by your office.

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 recommendations without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

We appreciate the courtesies and assistance extended by the management and staff of Scheller Hess-Yoder & Associates.

Should you or your staff have any questions, please contact me at (206) 220-5360.


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Executive Summary

We completed an audit of Scheller Hess-Yoder and Associates (SHYA), doing business as Advanced Mortgage Resources (AMR) in Portland, Oregon. SHYA is a non-supervised loan correspondent approved by HUD to originate FHA-insured loans under HUD's Single Family Direct Endorsement Program.

The audit objectives were to determine if (1) SHYA acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration (FHA) loans, and (2) SHYA's Quality Control Plan, as implemented, meets HUD requirements. The review covered the period from October 1, 1999 to July 31, 2003. A summary of our review results is provided below.

Independent Branches And Leased Employees

We found that SHYA disregarded HUD/FHA requirements and entered into agreements with outside contractors to act as independent branches or leased employees to originate FHA-insured loans (Finding 1). The agreements between SHYA and these contractors are in violation of HUD/FHA requirements because (1) HUD/FHA prohibits lenders from contracting for customary loan officer functions; (2) the written agreements specify that the loan officers are not employees of SHYA; and (3) the written agreements include provisions that the outside contractors indemnify SHYA for any actions on the contractors' part that were a violation of any applicable statute or regulation. Further, SHYA did not adequately supervise the contractors' employees as required by HUD/FHA. Loan applications completed by the non-SHYA employees contained misleading certifications to HUD that full time SHYA employees processed the applications. HUD/FHA considers the practice of mortgagees using unauthorized branches and non-employees for the origination of insured loans a significant risk to the FHA insurance fund.

Quality Control Requirements

We also found that SHYA disregarded HUD's quality control requirements and its own HUD-approved Quality Control Plan and allowed the person responsible for conducting SHYA's quality control reviews to also process and originate FHA-insured loans (Finding 2). SHYA's quality control reviewer received loan officer commissions on three of the four FHA loans that she originated. Such a conflict of interest on the part of a quality control reviewer is a violation of HUD requirements with respect to the need for an independent quality control review, and limits assurance to HUD that an independent quality control review is performed on SHYA's loans.

Recommendations

We are recommending that (1) SHYA reimburse HUD/FHA for claims paid on one loan originated by an unapproved branch and three loans originated under "employee lease" agreements, (2) SHYA indemnify HUD/FHA against current and future losses on four loans originated under its unapproved branch office agreements and 47 loans originated under "employee lease" agreements, (3) HUD/FHA consider seeking civil monetary penalties against Scheller Hess-Yoder and Associates, its unapproved branch offices, and its "leased employees" for submitting false certifications on the loan applications, and (4) SHYA indemnify HUD/FHA against future losses on one of the four loans originated by its quality control reviewer.

We are further recommending that HUD/FHA determine whether Scheller Hess-Yoder and Associates' deficiencies in its loan origination activities warrant its removal from participation in HUD's Single Family Mortgage Insurance Programs. If HUD determines that Scheller Hess-Yoder and Associates can maintain their approval as a non-supervised loan correspondent, then it should take appropriate monitoring measures to ensure that SHYA (1) discontinues the practice of submitting loans that are originated by "leased employees" or unauthorized branches, and (2) fully implements its Quality Control Plan.

We issued a discussion draft report on September 25, 2003, and discussed the audit results with SHYA's President at an exit conference on October 31, 2003. SHYA provided written comments to the draft report on December 4, 2003, disagreeing with finding one and generally agreeing with finding two. The findings section of this report summarizes and evaluates SHYA's comments. A copy of SHYA's response is included in Appendix B.

Table of Contents

Abbreviations

AMR	Advanced Mortgage Resources
FHA	Federal Housing Administration
HUD	U.S. Department of Housing and Urban Development
ML	Mortgagee Letter
NW	Neighborhood Watch
OIG	Office of Inspector General
QAD	Quality Assurance Division
QCP	Quality Control Plan
SHYA	Scheller Hess-Yoder and Associates
URLA	Uniform Residential Loan Application

Introduction

Background

Scheller Hess-Yoder and Associates (SHYA) doing business as Advanced Mortgage Resources (AMR), was incorporated under the laws of the state of Oregon on July 15, 1992. SHYA received approval from HUD as a Title II non-supervised loan correspondent on May 12, 1999. SHYA's office is located at 6400 SW Canyon Court, Suite 200, Portland, Oregon 97221. As a non-supervised loan correspondent, SHYA originates mortgages for sale to FHA-approved sponsor lenders under the HUD/FHA Single Family Direct Endorsement Program.

In July 2002, HUD's Quality Assurance Division (QAD) performed a monitoring review of SHYA. The results of the review were summarized in the August 14, 2002 findings letter to SHYA. QAD's findings centered on SHYA's lack of an adequate Quality Control Plan (QCP). The following is an excerpt from the findings letter:

> "AMR does not have a QCP that is in conformity with HUD requirements. HUD-approved loan correspondents are required to adopt, maintain and implement such a plan. While HUD does not prescribe specific elements, guidelines are available in HUD Handbook 4060.1 REV-1, Chapter 6. The pertinent elements are outlined in the QCP 'checklist' that was provided to you during the on-site review. For example, AMR's QCP does not contain procedures for written reverification of employment, deposits, gift letter, or other sources of income. The QCP did not contain any procedures for review of 203(k) Rehabilitation Mortgage loans as required by Handbook 4240.4 REV-2, paragraph 1-20 or HUD Mortgagee Letter.
>
> Also, AMR did not submit early-payment default loans for quality control review. HUD Handbook 4060.1, paragraph 6-1(d)(3), requires that mortgagees analyze all HUD/FHA insured loans that go into default within the first six months. Mortgagees can access a list of defaulted loans originated under their mortgagee identification number through Neighborhood Watch Early Warning System. Please refer to Mortgagee Letter 00-20 for further instructions.
>
> Because of the seriousness of this violation, you are requested to forward to this office a copy of your revised quality control plan. Further, please provide evidence of your quality control reviews of early-payment defaults and the assurance that you will conduct these reviews in the future."

By October 1, 2002 SHYA submitted a revised Quality Control Plan that was acceptable to HUD/FHA and the QAD finding was closed.

According to HUD's Neighborhood Watch website, for the past two years SHYA had consistently higher default rates for loans defaulting within 12 months from beginning amortization dates than the overall average rate for the state of Oregon as follows:

Default Rate by Selected Calendar Quarters 6/30/01 – 6/30/03

Quarter Ending	06/30/03	12/31/02	06/30/02	12/31/01	6/30/01
Scheller Hess-Yoder	4.32%	7.77%	7.05%	4.67%	3.70%
Entire State of Oregon	2.20%	2.47%	2.36%	2.43%	2.33%
Relative Comparison	196%	315%	299%	192%	159%

During our audit period of October 1, 1999 to July 31, 2003, SHYA originated 431 FHA-insured single family loans amounting to $58,950,904. As of July 31, 2003, 43 of these loans have gone into default status at least once. SHYA's 10 percent default rate for this period was over three times the default rate for all FHA single-family loans originated in the state of Oregon during the same period. To date, foreclosure action has been initiated on 25 of the 43 defaulting loans. Fourteen of the 25 loans in foreclosure status have gone into claims status, with net losses to HUD of $415,250, for an average net loss of $29,661 per loan. Net losses on the remaining 11 loans in foreclosure status had yet to be determined at the time of our audit.

Audit Objectives, Scope, And Methodology

The audit objectives were to determine if SHYA acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of Federal Housing Administration (FHA) loans, and to determine whether SHYA's Quality Control Plan, as implemented, meets HUD requirements.

To accomplish our audit objectives, we:

- Reviewed the FHA case files for a sample of 32 of the 33 FHA-insured loans originated by SHYA that had gone into default at least once as of January 9, 2003, at the beginning of our audit work. The FHA case file for one of the 33 defaulting loans was not available for review. The 32 loans reviewed were from the universe of 330 originated by SHYA with beginning amortization dates for the three-year period from October 1, 1999 to November 1, 2002. The results of the detailed testing apply only to the 32 loans selected and cannot be projected to the entire universe of 330 loans.

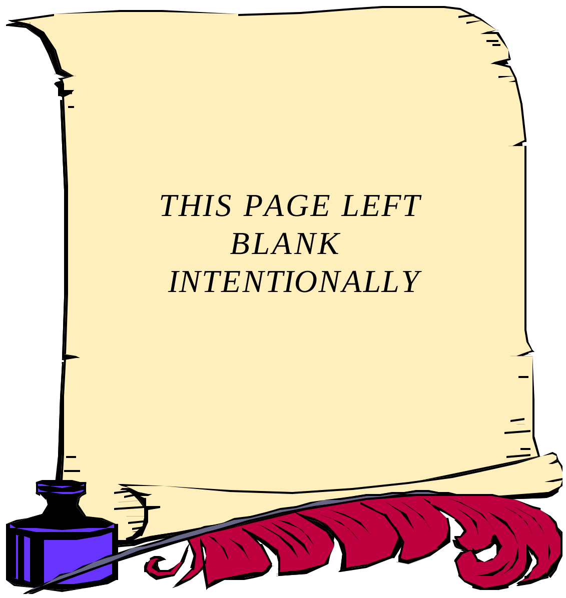
- Examined records at SHYA including loan origination files, loan origination logs, loan pipeline reports, payroll records, and personnel files.

- Conducted interviews with SHYA officials and employees.

- Interviewed available borrowers as needed.

Initially, our audit covered the period October 1, 1999 to November 1, 2002. This period was expanded to include the most current data while performing our review. Thus, we expanded the audit period to include loans originated by SHYA that were endorsed as of July 31, 2003.

We performed the audit in accordance with Generally Accepted Government Auditing Standards.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Scheller Hess-Yoder and Associates Allowed Unapproved Branches and Non-Employees to Originate Insured Loans

Contrary to HUD/FHA requirements, Scheller Hess-Yoder and Associates (SHYA), doing business as Advanced Mortgage Resources (AMR), acted as a conduit for loans originated by unapproved branches and independent loan officers who were not SHYA employees. SHYA disregarded HUD/FHA requirements and entered into agreements with outside contractors to act as independent branches or leased employees to originate FHA-insured loans. The agreements between SHYA and these contractors are in violation of HUD/FHA requirements because (1) HUD/FHA prohibits lenders from contracting for customary loan officer functions; (2) the written agreements specify that the loan officers are not employees of SHYA; and (3) the written agreements include provisions that the outside contractors indemnify SHYA for any actions on the contractors' part that were a violation of any applicable statute or regulation. Further, SHYA did not adequately supervise the contractors' employees as required by HUD/FHA. Additionally loan applications completed by the non-SHYA employees contained certifications to HUD that full time SHYA employees processed the applications. HUD/FHA considers the practice of mortgagees using unauthorized branches and non-employees for the origination of insured loans a significant risk to the FHA insurance fund.

HUD/FHA Prohibits Unauthorized Branch Offices and Requires Close Supervision of Mortgagee Employees

HUD Handbook Requirements for Loan Correspondents

According to HUD Handbook 4060.1 REV-1:

- Lenders (including loan correspondents) must be approved by HUD to originate, purchase, hold or sell HUD/FHA insured mortgages (Paragraph 1-2).
- Lenders must submit applications to HUD for each branch office submitting loans for insurance (Paragraph 1-2 A).
- Lenders are required to pay a $300 application fee and a $200 annual recertification fee for each branch office (Paragraph 2-3).
- Each branch office of a loan correspondent must have a net worth of $25,000 (Paragraph 2-4 D).

- A lender is fully responsible for the actions of its branch office (Paragraph 2-16).

- A lender must pay all of its own operating expenses. This includes the compensation of all employees of its main and branch offices. Compensation may be on the basis of a salary, salary plus commission, and commission only. Other operating expenses that must be paid by the mortgagee include, but are not limited to, equipment, furniture, office rent, overhead, and other similar expenses incurred in operating a mortgage lending business (Paragraph 2-17).

- Lenders must 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 work performed (Paragraph 2-13).

- All employees of the mortgagee except receptionists, whether full time or part time, must be employed exclusively by the mortgagee at all times, and conduct only the business affairs of the mortgagee during normal business hours (Paragraph 2-14).

Mortgagee Letter Requirements

Mortgagee Letter 95-36 (ML 95-36) prohibits lenders from contracting out for customary loan officer functions.

Mortgagee Letter 00-15 (ML 00-15) makes it clear that HUD/FHA considers the practice of mortgagees using unauthorized branches and non-employees for the origination of insured loans a significant risk to the FHA insurance fund. Accordingly, ML 00-15 provides further guidance and clarification regarding the Department's requirements for FHA-approved mortgagee branch offices and employee agreements, stating, in part:

"The Department has learned that some HUD/FHA approved mortgagees are engaged in the practice of taking on an existing, separate mortgage company or broker as a branch and allowing that separate entity to originate insured mortgages under the approved mortgagee's HUD Mortgagee Number. Some mortgagees refer to this arrangement as a 'net branch.' This, however, constitutes a prohibited net branch arrangement…"

and

"As part of on-site mortgagee monitoring reviews, the Department has obtained 'employment' agreements executed by HUD/FHA approved mortgagees and their 'net branches.' A number of the provisions in these agreements violate Departmental branch requirements. For example, there are provisions that:

- require all contractual relationships with vendors such as leases, telephones, utilities, and advertising to be in the name of the 'employee' (branch) and not in the name of the HUD/FHA approved mortgagee.
- require the 'employee' (branch) to indemnify the HUD/FHA approved mortgagee if it incurs damages from any apparent, express, or implied agency representation by or through the 'employee's' (branch's) actions.
- require the 'employee' (branch) to issue a personal check to cover operating expenses if funds are not available from an operating account.

These provisions violate Paragraphs 1-2, 2-13, 2-17, and 3-2B of the Mortgagee Approval Handbook 4060.1 Rev-1. Taken as a whole, such provisions seem designed to maintain a clear separation between the HUD/FHA approved mortgagees and their so-called 'branches,' which is inconsistent with the close supervisory control over all employees mandated by the handbook.

The Department believes that the origination of insured mortgages by lenders that have not received HUD/FHA approval increases the risk to the FHA insurance funds and to the public. Accordingly, mortgagees found to be in violation may be subject to the full range of HUD sanctions." (emphasis added)

SHYA Submitted Loans Originated by Entities That Were Not HUD Approved

Contrary to HUD/FHA regulations and without obtaining HUD's approval, SHYA allowed two independent entities to originate FHA-insured loans using SHYA's approved mortgagee name and FHA lender identification number. SHYA entered into an "Independent Contractor Agreement Associate Loan Officer" with a mortgage broker doing business as The Mortgage Source. According to the agreement, the broker would represent SHYA for all real estate loans generated. SHYA also entered into an "Independent Contractor Agreement Branch Office" with an independent contractor doing business as P&L Financial Services Inc. Under this agreement, P&L Financial Services would operate and manage a branch office of SHYA. These agreements effectively create branch offices of SHYA; however, SHYA did not submit required branch office notifications to HUD for the two branches. Consequently, HUD could not effectively monitor the performance of the SHYA branches because it is not aware of who is actually responsible for originating the branches' loans.

These agreements are also in direct violation of HUD/FHA requirements because neither the broker nor the contractor are exclusive employees of SHYA. Both agreements specifically state that the broker/contractor is not a partner, agent, or employee of SHYA. The contracts further state that the broker/contractor is not eligible to participate in any of SHYA's employee benefit programs, and is not covered by any SHYA insurance program, including workers' compensation. The contracts also make the broker/contractor responsible for all expenses, insurance, and taxes.

Both contracts include indemnification agreements to protect SHYA from any liability associated with the actions of the broker/contractor. Mortgagee Letter 00-15 expressly prohibits these indemnification agreements. Such indemnification agreements put the FHA insurance fund at risk because they are structured to transfer any liability associated with improper loan origination practices from the HUD-approved lender to a non-approved entity that HUD has no knowledge of.

The agreement with The Mortgage Source states "Independent Contractor agrees to indemnify and hold Company harmless for any loss, damage, fees, or costs incurred by reason of Independent Contractor's misrepresentation, fraud, or violation of any statute or regulation, violation of any rules, regulations or policies of Company, or violation of any other applicable statute or regulation."

The contract with P&L Financial Services contains similar language, stating "Commissioned Contractor agrees to indemnify and hold Company harmless for any loss, damage, fees, or costs incurred by reason of Commissioned Contractor's misrepresentation, fraud, or violation of any statute or regulation, violation of any rules, regulations or policies of Company, violation of any other applicable statute or regulation, or actions of Commissioned Contractor that result in claims made against Company."

Both contracts required the contractors to pay a loan processing fee to SHYA with each loan package submitted for processing. The processing fees to SHYA were $300 per loan for the Mortgage Source and $395 per loan for P&L Financial. The contracts also allowed SHYA to earn a portion of the fees (loan origination fee, yield spread premiums, and service release premiums) generated by loans originated by the contractors. According to its agreement, The Mortgage Source receives 80 percent of the fees from its closed loans with the remaining 20 percent going to SHYA. According to its contract, P&L Financial receives 60 to 80 percent of fees from its closed loans, with the remaining 20 to 40 percent going to SHYA.

Under its agreement, The Mortgage Source originated four FHA-insured loans totaling $448,704. One of the four loans went into foreclosure and claim status, leading to the payment of an insurance claim by HUD. P&L Financial Services originated eight FHA-insured loans totaling $895,896 under its branch agreement. Four of these eight loans were refinanced with new FHA-insured mortgages originated by P&L Financial under its "Employee Lease Agreement." Although both agreements establish branch office arrangements between the two contractors and SHYA, HUD was never notified of the existence of the branches, and all loans originated by them were under SHYA's lender number. This arrangement allowed the branches to operate without providing HUD assurance that the branches had adequate financial reserves and oversight, thereby putting the FHA fund at risk.

SHYA Submitted Loans Originated by Loan Officers That Were Not SHYA Employees

SHYA ignored HUD requirements that lender employees be employed exclusively by the lender, and entered into agreements with loan officers that were not SHYA employees to produce loans. In August 2000, SHYA replaced its branch office agreement with P&L Financial Services with a "Employee Lease Agreement." Under the terms of this agreement, P&L Financial Services "leased" its owner and employees to SHYA to originate single family loans. SHYA entered into similar contracts in which the owners of two other companies, LS Financial Corp. and Diverse Lending Inc., were "leased" to SHYA to originate loans.

According to the agreements, SHYA is the customer and each of the three companies is a provider. All three contracts make it clear that the provider is not an employee of SHYA stating: "…nothing in this agreement shall be construed to make Provider a partner, agent, or employee of Customer. Provider agrees to be responsible for paying any and all required Federal, State or Local taxes or insurance incurred by it's employees actions." The contracts with LS Financial Corp. and Diverse Lending Inc. also specify that the provider is responsible for any and all employee benefits.

Compensation for the contractors is in the form of commissions based upon a split of loan origination and other fees between the contractor ("leased employee") and SHYA that are generated at loan closing. According to its contract, P&L Financial earns from 70 to 80 percent of fees earned on closed loans with the remainder going to SHYA. The contracts for both LS Financial Corp. and Diverse Lending allowed the contractors to earn 70 percent of the loan fees generated, with the remainder also going to SHYA.

As with the above branch agreements, all three employee lease contracts contain language to protect SHYA against any consequences of detrimental actions on the parts of the provider's employees stating: "Provider agrees to indemnify and hold Customer harmless for any loss, damage, fees or costs incurred by reason of Providers employee's misrepresentation, fraud, or violation of any statute or regulation, violation of any rules, regulations or policies of Customer, violation of any other applicable statute or regulation, or actions of Provider that result in claims made against the Customer."

All three contracts contain language that SHYA would provide direct supervision of the provider's employees in the course of day-to-day operations. However, we found inadequate supervision of the leased employees as SHYA did not perform ongoing reviews of the leased employees' performance. Further, although SHYA's president told us that the loans generated by the leased employees receive the same quality control review as the loans produced by SHYA's own employees, prior to the October 2002 closeout of findings of a review conducted by HUD's Quality Assurance Division, SHYA did not have an adequate quality control plan in place. Thus all loans originated by the leased employees up to then did not receive an adequate quality control review.

Under these agreements, the owner of LS Financial Corp. originated five FHA loans totaling $616,042 and the owner of Diverse Lending Inc. originated six FHA loans totaling $770,900. HUD/FHA paid a claim on one of the loans originated by LS Financial. Two of the six loans originated by Diverse Lending have gone into default at least one time, and one of these went into foreclosure and claim status, leading to the payment of an insurance claim by HUD. Under its employee lease agreement, the owner of P&L Financial Services originated 60 loans totaling $7,707,872, one of which was actually originated by the owner's assistant even though the P&L Financial Services owner signed the mortgage documents as the originating loan officer and as an employee of SHYA. Eight of these 60 loans were refinanced with new FHA-insured loans originated by P&L Financial. Nine of the 60 loans originated by P&L Financial have defaulted at least once, with four of the nine loans going into foreclosure status and one going into claim status.

Loan Files Contained Improper Certifications

Lenders are required to submit a completed Uniform Residential Loan Application (URLA), signed and dated by all borrowers and the lender, and the Addendum to the URLA (form HUD- 92900-A) containing signed Lender's Certifications for each insured loan. Section II B of the Lender's Certification states "The information contained in the Uniform Residential Loan Application and this Addendum was obtained directly from the borrower by a **full-time employee of the undersigned lender or its duly authorized agent** and is true to the best of the lender's knowledge and belief." (emphasis added)

During the review of the 32 FHA case files of defaulting SHYA loans, we found five loans that the contractors, who by contract are neither full-time employees or agents of SHYA, certified that they were SHYA employees on the URLA and/or the HUD-92900-A as follows:

> Loan Number 569-0512568 – the owner of Diverse Lending signed both the URLA and HUD-92900-A as an employee of SHYA.
>
> Loan Number 569-0495611 – the owner of The Mortgage Source signed both the URLA and HUD-92900-A as an employee of SHYA.
>
> Loan Number 431-3486696 – the owner of P&L Financial signed both the URLA and HUD-92900-A as an employee of SHYA.
>
> Loan Number 431-3502928 – the owner of P&L Financial signed the URLA as an employee of SHYA and a SHYA employee signed the HUD-92900-A.
>
> Loan Number 431-3570514 – the owner of P&L Financial signed the URLA as an employee of SHYA and a SHYA employee signed the HUD-92900-A.

We also found the following three loans originated by P&L Financial in which a regular SHYA employee "signed for" the owner of P&L Financial on the URLA and a SHYA employee signed the HUD-92900-A:

Loan Number 431-3516559
Loan Number 431-3544957
Loan Number 561-7356616

Auditee Comments

1. At the exit conference, OIG audit staff "effectively ignored" information provided by SHYA in their initial response. Also, the "Final Audit Report…completely ignores every single piece

of information, documentation, and explanation…" SHYA had provided in their October 24, 2003 written comments, at the exit conference, and in an October 31, 2003 letter.

2. It instructed the Mortgage Source to cease all FHA loan originations in a letter sent July 14, 2001 that was inadvertently dated July 14, 2000. The last loan originated by The Mortgage Source was endorsed on October 9, 2001. However, SHYA agrees to indemnify HUD against four loans originated by The Mortgage Source.

3. The branch office agreement between SHYA and Phillip Jack (P & L Financial Services, Inc.) never came to fruition. A branch office was never created or opened and the agreement never enforced by either party. Instead, Mr. Jack worked out of SHYA's main office. As such, HUD should re-consider its recommendation that SHYA indemnify HUD against future losses on four loans.

4. Regardless of the language of the Employee Lease agreements, which were drafted with tax consequences in mind, every person that worked under these agreements was *in fact* an employee of SHYA under Oregon law. These loans were processed in the same manner as any other SHYA loan, and the originators were supervised the same as any other SHYA employee. In addition, HUD itself has allowed the use of Independent Contractor agreements. Further, SHYA had previously received acknowledgement from a HUD Single Family official that the Employee Lease Agreement was acceptable for use under FHA. Evidencing this was a fax sent to the HUD official on July 30, 2002, which was mistakenly dated July 30, 2000. Shortly after the fax was sent, the Compliance Officer telephoned the SHYA owner and informed him that the agreement was acceptable for use under FHA. However, in accordance with representations made by HUD-OIG staff, SHYA has complied with HUD's technical requirement.

5. In its January 5, 2004 response to our email notifying SHYA of a modification to the finding recommendations, SHYA claimed that OIG had no intention whatsoever of taking into consideration anything that SHYA had to contribute, say, or provide in support of its position relating to the audit.

OIG Evaluation of Auditee Comments

1. HUD-OIG staff fully considered all information provided by SHYA. In its response, SHYA mistakenly refers to the formal Draft Audit Report as the Final Audit Report, even though the transmittal letter and every page of the Draft Audit Report clearly identified it as a draft report. Although we issued a Discussion Draft Audit Report on September 25, 2003, the transmittal letter sent with the Discussion Draft explained that it was to be used for discussion at the exit conference, and that subsequent to the exit conference we would issue a formal draft report for SHYA's written comments. In addition, at the exit conference OIG staff fully discussed with SHYA representatives all issues they wanted to go over regarding their response to the Discussion Draft Audit Report.

2. SHYA agreed to indemnify The Mortgage Source loans identified in the audit finding.

3. SHYA's comments are not consistent with what P&L Financial Services (Mr. Phillip Jack) told HUD-OIG audit staff. Mr. Jack indicated that the Independent Contractor Agreement (and subsequently the Employee Lease Agreement) were the only agreements with SHYA that he worked under.

4. SHYA's citations of Oregon law do not appear to conflict with HUD requirements regarding the use of branch offices or non-employees by lenders. The issues raised by the finding are matters of substance, not merely semantics or form. For example, the provision in these individuals' agreements that shifts liability to the employees or net branches could have material financial implications for HUD. Also, the SHYA contractors indicated to us that they had little if any supervision by SHYA.

HUD did not allow a lender to have a similar type of employee agreement such as used by SHYA, as alluded to in SHYA's response. In the case mentioned by SHYA, HUD had required a lender to revise its employee agreement to meet HUD requirements, most notably to revise the provision that tried to shift liability for indemnification to the employee.

The HUD official that SHYA claims approved the Employee Lease Agreement emphatically told us that she never gave SHYA permission to use these Agreements, nor has she ever received a fax from SHYA regarding the matter. The copies of fax documentation that SHYA provided are incomplete, and in our opinion do not provide support or convincing evidence for their contention that HUD approved the agreements.

5. As noted above, the HUD-OIG staff fully considered all information provided by SHYA in response to our draft findings.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board:

1A. Require Scheller Hess-Yoder and Associates to indemnify HUD/FHA against future losses and reimburse HUD/FHA for the $78,781 claim paid on Loan # 569-0495611 that was originated under the branch office agreement with The Mortgage Source.

1B. Require Scheller Hess-Yoder and Associates to indemnify HUD/FHA against current and future losses on the two currently insured loans with no claims paid, that were originated by The Mortgage Source and the two currently insured loans originated by P&L Financial under their branch office agreements. These loans are identified in Appendix C of this report.

1C. Require Scheller Hess-Yoder and Associates to indemnify HUD/FHA against future losses and reimburse HUD/FHA for: (1) the $63,623 claim paid on Loan # 431-3570514 originated by P&L Financial; (2) the $105,451 claim paid Loan # 569-0514841 originated by LS Financial and (3) the $18,755 claim paid on Loan # 569-0512568 originated by Diverse Lending. All three loans were originated under leased employee agreements.

1D. Require Scheller Hess-Yoder and Associates to indemnify HUD/FHA against current and future losses on the two currently insured loans with no claims paid that were originated by of LS Financial Corp., the four currently insured FHA loans with no claims paid that were originated by Diverse Lending Inc., and the 41 currently insured loans with no claims paid that were originated by P&L Financial under their leased employee agreements. These loans are identified in Appendix D of this report.

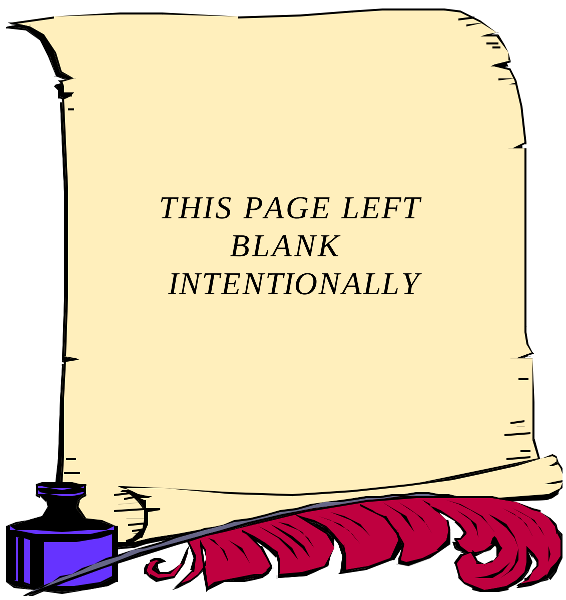
1E. For each loan, identified in Appendix A that was originated by the unapproved branches and leased employees, consider seeking civil monetary penalties against Scheller Hess-Yoder and Associates for submitting false certifications on the loan applications.

1F. Consider seeking civil monetary penalties against the owner of:

- Diverse Lending for false certifications on the loan application forms for FHA loan number 569-0512568;
- The Mortgage Source for false certifications on the loan application forms for FHA loan number 569-0495611;
- P&L Financial for false certifications on the loan application forms for FHA loan numbers 431-3486696, 431-3502928, 431-3570514, 431-3516559, 431-3544957, and 561-7356616.

1G. Determine whether Scheller Hess-Yoder and Associates' deficiencies in its loan origination activities warrant its removal from participation in HUD's Single Family Mortgage Insurance Programs. Consider taking appropriate administrative sanctions.

1H. If HUD determines that Scheller Hess-Yoder and Associates can maintain their approval as a non-supervised loan correspondent, take appropriate monitoring measures to ensure that Scheller Hess-Yoder and Associates discontinues the practice of submitting loans that are originated by "leased employees" or unauthorized branches.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SHYA is Not in Full Compliance With HUD/FHA Quality Control Requirements

Scheller, Hess Yoder & Associates did not fully implement its Quality Control Plan (QCP), which they revised as a result of a previous review by HUD's Quality Assurance Division (QAD). Specifically, in July 2002 a review by the QAD found that SHYA's QCP was inadequate, and required the lender to submit a revised QCP that meets HUD/FHA guidelines. By October 1, 2002 SHYA submitted a revised QCP that was acceptable to HUD and the finding by QAD was closed. However, we found that SHYA disregarded HUD's quality control requirements and its own QCP by allowing the person responsible for conducting SHYA's quality control reviews to also process and originate FHA-insured loans. In addition, the quality control reviewer received loan officer commissions on three of the four FHA loans that she originated. Such a conflict of interest on the part of a quality control reviewer is a violation of HUD requirements with respect to the need for an independent quality control review, and limits assurance to HUD that an independent quality control review is performed on SHYA's loans.

The Quality Control Reviewer Cannot Process FHA-Insured Loans

To ensure that loans are originated and approved in accordance with HUD/FHA rules and regulations, HUD requires lenders to perform regular quality control reviews. These reviews must provide for independent evaluation of the significant information gathered for use in the mortgage credit decision making and loan servicing process for all loans originated or serviced by the mortgagee.

HUD Handbook 4060.1 Chapter 6 Quality Control Plan Paragraph 6-1 states: "Mortgagees must establish a written Quality Control Plan which utilizes a program of internal or external audit or provides for an independent review by the mortgagee's management/supervisory personnel who are knowledgeable and have no direct loan processing, underwriting or servicing responsibilities."

This requirement for an independent review is reflected in SHYA's Quality Control Plan. According to the job description for the quality control reviewer from Section III, Paragraph C of the QCP, "The reviewer's job does not involve processing FHA loans. He or she reports directly to the

President of the company. The quality control reviewer's job does not include personnel matters."

SHYA's Quality Control Reviewer Originated FHA-Insured Loans

SHYA's Pipeline report shows that the same person who is responsible for performing its quality control reviews originated the following four FHA-insured loans:

FHA Case Number[1]	Loan Amount	Endorsement Date
431-3668869	$171,800	12/04/01
431-3563723	$177,393	05/17/01
569-0538696	$132,914	05/03/02
569-0559116	$136,867	02/11/03

Our review of the loan documents found that the quality control reviewer signed the initial loan applications as the interviewer for all four of the above loans, and the lender's certification for loan number 431-3563723. The quality control reviewer told us that she performed all of the duties as the loan officer for these loans. The reviewer also disclosed that she received a commission fee for originating and processing three of the four loans. No commission was paid to her on one loan because the borrower was also a SHYA loan officer.

In addition to originating the four loans, the quality control reviewer also performs another loan processing duty: she and SHYA's loan processing manager are responsible for inputting loan and borrower information into the lender's automated underwriting system.

In our opinion, HUD does not have adequate assurance that SHYA is processing loans in conformance with FHA requirements because the quality control reviewer's loan origination and processing duties compromises her independence when performing quality control reviews.

[1] Loan Numbers 431-3668869, 431-3563723, and 569-0538696 have been terminated and are no longer insured by the FHA

Auditee Comments

SHYA stated that it now understands that HUD's prohibition against having the same person review and process FHA loans includes the originating of FHA-insured loans. As such, SHYA has taken action to ensure the Quality Control person is not involved in any aspect of originating and processing FHA loans. SHYA further agreed to indemnify HUD against any future losses attributable to the loan originated by the individual that performed Quality Control reviews.

OIG Evaluation of Auditee Comments

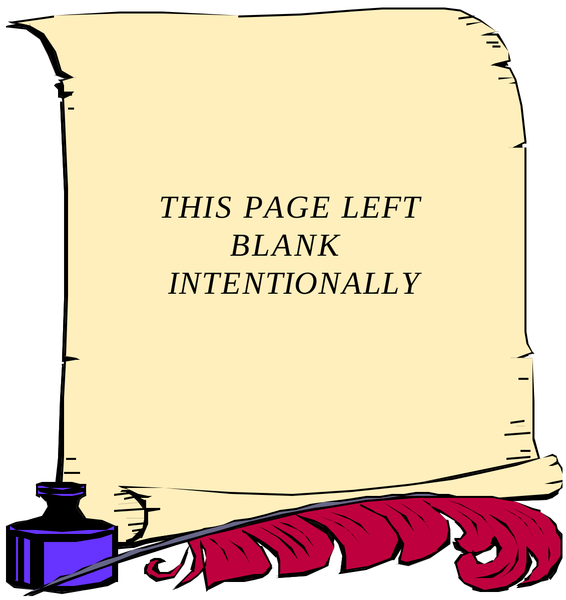
SHYA's response is substantially responsive to the finding.

Recommendations

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner, Chairman, Mortgagee Review Board:

2A. Require Scheller Hess-Yoder and Associates to indemnify HUD/FHA against future losses on FHA loan number 569-0559116.

2B. Take appropriate monitoring measures to ensure that Scheller Hess-Yoder and Associates fully implements its Quality Control Plan.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Management Controls

In planning and performing our audit, we considered the management controls of SHYA 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 processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

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

- Program Operations. Policies and procedures that management has in place to reasonably ensure that the loan origination process is in compliance with the HUD/FHA program requirements, and that the objectives of the programs are being met.

- Quality Control Plan. Policies and procedures that management has in place to reasonably ensure implementation of HUD/FHA quality control requirements.

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 are obtained, maintained, and fairly disclosed in reports.

Based on our review, we believe that SHYA's management controls have significant weaknesses and regarding HUD requirements in the following areas:

- SHYA violated HUD/FHA requirements regarding FHA's loan origination process by submitting loans originated by unapproved branches and non-employees (Finding 1).

- SHYA violated HUD/FHA's quality control process requirements because its quality control reviewer also processed insured loans (Finding 2).

We also found that SHYA does not ensure that policies and standards relating to loan origination are known by SHYA employees. Our interviews with SHYA employees in general indicate that they are not always aware of nor do they possess copies of documents such as written job descriptions, written loan origination policies and procedures, or the SHYA quality control plan.

Schedule of Questioned Costs and Funds Put to Better Use

Recommendation Number	**Type of Questioned Cost**		**Funds Put To Better Use 3/**
	Ineligible 1/	**Unsupported 2/**	
1A.		$ 78,781	
1B.			$ 512,850
1C.	$82,387	$105,451	
1D.			$6,339,706
2A.			$ 136,867
Totals	**$82,378**	**$184,232**	**$6,989,423**

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 policy or regulations. The amount shown is for two net claims. A net claim is the total claim paid by HUD less any proceeds from HUD's sale of the insured property.

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. The amount shown is for two gross claims. A gross claim is the amount of the claim paid by HUD prior to any recovery from the sale of the property by HUD. At the time of the audit, the properties were not yet sold by HUD.

3/ Funds put to better use are costs that will not be expended in the future if our recommendations are implemented, for example, costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

The table on the following page shows a breakdown of the above schedule by the description of each individual category of questioned cost.

Recommendation Number	Description of Cost	Ineligible 1/	Unsupported 2/	Funds Put To Better Use 3/
1A.	Gross Claim Paid on Loan # 569-0495611 Originated by The Mortgage Source		$ 78,781	
1B.	Total Loan Amount of 2 Currently Insured FHA Loans Originated by The Mortgage Source			$ 282,864
1B.	Total Loan Amount of 2 Currently Insured FHA Loans Originated by P&L Financial as Branch Office			$ 229,986
1C.	Net Loss on Claim Paid on Loan # 431-3570514 Originated by P&L Financial	$63,623		
1C.	Gross Claim Paid on Loan # 569-0514841 Originated by LS Financial		$105,451	
1C.	Net Claim Paid on Loan # 569-0512568 Originated by Diverse Lending	$18,755		
1D.	Total Loan Amount of 41 Currently Insured FHA Loans Originated by P&L Financial as Leased Employee			$5,581,416
1D.	Total Loan Amount of 4 Currently Insured FHA Loans Originated by Diverse Lending			$ 499,492
1D.	Total Loan Amount of 2 Currently Insured FHA Loans Originated by LS Financial			$ 258,798
2A.	Loan Amount of Currently Insured FHA Loan #569-0559116 Originated by SHYA Quality Control Reviewer			$ 136,867

Totals		**$82,378**	**$184,232**	**$6,989,423**

Auditee Comments

The auditee comments, dated December 4, 2003 and January 5, 2004 are attached to this appendix. The attachments to the December 4, 2003 comments are voluminous and impractical to include in this appendix. A hard copy file of the auditee comments and all the attachments are kept at the HUD-OIG Office in Seattle and are available upon request.

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December 4, 2003

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HUD/OIG AUDIT
SEATTLE, WA

U.S. Department of Housing and Urban Development
Office of the Inspector General for Audit
Northwest/Alaska Region 10
Attention: Frank E. Baca
909 First Avenue, Suite 126
Seattle, WA 98104-1000

[ADVANCED]

RE: Mortgagee Review: Scheller Hess-Yoder and Associates, dba Advanced Mortgage Resources

Dear Mr. Baca:

As you are aware, this firm represents Scheller Hess-Yoder and Associates, dba Advanced Mortgage Resources (SHYA) in the above referenced matter. On October 24, 2003, we provided you with SHYA's response to your Discussion Draft Audit Report dated September 25, 2003, in anticipation of the forthcoming Exit Conference. A copy of HUD's Draft Audit Report is attached hereto as **Exhibit A**. A copy of SHYA's response is attached hereto as **Exhibit B**.

In SHYA's response, we addressed the findings and issues you identified in your Draft Audit Report with the good will and intent of resolving this matter with as little inconvenience and conflict for all parties involved. SHYA's response provided forthright explanations to many of the issues discussed in your Draft Audit Report, and in fact, SHYA even agreed to indemnify HUD on multiple points.

On October 31, 2003, an Exit Conference was held at the office of Lew Delo, SHYA's local counsel in Portland. Attending this meeting were you, Ed Schmidt, Tess Lirio, Steve Salveson, and myself. At the meeting, you stated that HUD was there to merely answer any questions Mr. Salveson or myself may have had. Notwithstanding the fact that we had provided three (3) separate copies of SHYA's response to you, Mr. Schmidt, and Ms. Lirio, addressing all of HUD's findings, questions, and concerns well in advance of the Exit Conference, we also presented you with copies of Oregon Code 59.840, et seq., showing that independent contractors *are* allowed under Oregon Law, and that Mortgage Brokers *are required* to closely monitor and supervise them. A copy of Oregon Code 59.840, et seq. is attached hereto as **Exhibit C**.

Much to our great dismay and concern, you, Mr. Schmidt, and Ms. Lirio effectively ignored the information, documentation, and explanation contained in SHYA's response to your Draft Audit Report. The only mention made at the meeting to the response was Mr. Schmidt's comments concerning the incorrect endorsement dates *that we had pointed out to HUD*, as well as your statement regarding Beverly Scott's apparent denial of ever having reviewed and approved SHYA's Employee Lease Agreement in 2002. Not only did SHYA's response include ample evidence that Ms. Scott in fact received the Employee Lease Agreement via fax in 2002, but I supplemented this information with a letter to you dated October 31, 2003, providing you with a print-out from HUD's own website showing that the fax

Mr. Frank Baca
December 4, 2003
Page 2

number the Agreement was sent to in 2002 was indeed HUD's. A copy of this supplemental letter is attached hereto as **Exhibit D**.

On November 13, 2003, you issued HUD's Final Audit Report. A copy of HUD's Final Audit Report is attached hereto as **Exhibit E**. This Final Audit Report, virtually identical to the Draft Audit Report save for some minor changes, *completely ignores every single piece of information, documentation, and explanation SHYA had compiled and provided to HUD, from SHYA's response dated October 24, 2003, from the Exit Conference on October 31, 2003, and from my supplemental letter dated October 31, 2003. What SHYA attempted to do in trying to resolve this matter as efficiently and amicably as possible, has been completely thwarted by your office. Every effort made in good faith by SHYA to be totally forthcoming with information, documentation, and explanation has been dismissed and ignored. There is not even any mention of Beverly Scott's apparent denials as to receiving and approving the Employee Lease Agreement back in 2002, even though we have provided documentation to the contrary. It simply appears that absolutely no consideration was paid to SHYA's willingness and effort to cooperate with HUD.*

Once again, our response is arranged to coincide with the numbering/identification of issues in HUD's November 13 Final Audit Report.

COMPANY & PROCEDURAL HISTORY

Scheller Hess-Yoder and Associates, dba Advanced Mortgage Resolutions has been in business for over eleven (11) years, licensed in both Oregon and Washington. The company was approved by the Department of Housing and Urban Development as a Title II non-supervised loan correspondent on May 12, 1999, resulting in a period of over four (4) years without a complaint.

SHYA is a member of the Oregon Association of Mortgage Brokers, and has been a member of the National Association of Mortgage Brokers since 1993. SHYA President Steve Salveson has been given the industry designation of Certified Residential Mortgage Specialist (CRMS), which happens to be the second highest designation available.

SHYA takes pride in being an equal opportunity employer and taking a strong stance against discrimination in any form in hiring and in the conduct of its business.

RESPONSE

HUD's Finding 1: ***Scheller Hess-Yoder and Associates Allowed Unapproved Branches and Non-Employees to Originate Insured Loans.***

SHYA's Response to HUD's Alleged Finding 1:

The Mortgage Source - May 21, 1996 Branch Office Agreement

This matter typifies how SHYA has consistently made every effort to achieve full compliance with HUD rules and regulations by acting on its own accord to correct discovered deficiencies.

Mr. Frank Baca
December 4, 2003
Page 3

The Mortgage Source was a branch office of SHYA's operating out of Washington under an "Independent Contractor Agreement/Associate Loan Officer" dated May 21, 1996, and SHYA understands HUD's position in light of Mortgagee Letter 00-15. However, it is important to note that *SHYA discovered the invalidity of this agreement and arrangement on its own, and instructed The Mortgage Source to cease all origination of FHA loans back in 2001, as evidenced in a memorandum from Stephen Salveson to Alita DeCourcey attached hereto as* **Exhibit F**. While the memorandum was inadvertently dated July 14, 2000, it was actually written and sent on July 14, 2001. As HUD can clearly see, SHYA made certain that The Mortgage Source completely discontinued originating any FHA loans shortly after that date, with the last one being endorsed on October 9, 2001.

Notwithstanding the foregoing, SHYA understands the necessity for complying with HUD rules and regulations, and thus, in the spirit of cooperation and partnership with HUD, agrees to indemnify HUD against any future losses attributable to the following four (4) loans originated by The Mortgage Source:

FHA Case Number	Mortgage Amount	Endorsement Date
569-0470547	$173,343	August 7, 2000
569-0473464	$89,323	January 29, 2001
569-0504938	$109,521	July 16, 2001
569-0495611	$76,517	October 9, 2001

P & L Financial - September 10, 1998 Branch Office Agreement

On page 9 of its Final Audit Report, HUD addresses an "Independent Contractor Agreement Branch Office" between SHYA and an independent contractor, Phillip Jack, doing business as P & L Financial Services, Inc. dated September 10, 1998. HUD goes on to state that this agreement effectively created a branch office of SHYA.

This agreement never came to fruition. A branch office was never created/opened because the agreement was never pursued or enforced by either party. Instead, Mr. Jack worked solely out of SHYA's main office.

For the foregoing reason, SHYA respectfully requests that HUD reconsider its recommendation that SHYA indemnify against future losses on the four (4) loans mistakenly believed originated by P& L Financial under the "Independent Contractor Agreement Branch Office."

P & L Financial - August 4, 2000 Employee Lease Agreement/Diverse Lending – April 23, 2001 Employee Lease Agreement/LS Financial – March 1, 2001 Employee Lease Agreement

Regardless of the language of the above-listed Employee Lease agreements, which were drafted with tax consequences in mind, every single person who worked under these agreements was *in fact* an employee of SHYA under Oregon law: they *all* worked out of SHYA's main office, they were *all closely supervised*, with their work consistently coming under scrutiny by SHYA management, and their loans were processed and closed in the *exact same manner* as any other loan being done by SHYA. The fact that tax purposes were considered in the agreements has no bearing as to the level of supervision and control that was *actually* exerted by SHYA management over these employees.

Mr. Frank Baca
December 4, 2003
Page 4

For example, insight into how Oregon determines employee-employer relationships can be found in Oregon case law where the term "employer" has been understood to mean "a person who is in such relation to another person that the person may control the work of that other person and direct the manner in which it is said to be done." Realty Group, Inc. v. Department of Revenue., 299 Or. 377, 379 (1985). In Realty, the Court examined the question whether brokers' payments to their salespeople were taxable under the definitions of the transit district law. In affirming the Tax Court's decision, the Supreme Court of Oregon paraphrased the Tax Court's conclusion "*that the test of an employment relationship is the right of one party to control the other party's performance of the work to be done, whether or not such control is actually exercised in every particular circumstance.*" Supra at 383. The Court went further stating that "*while an obvious attempt has been made to establish salespersons as independent contractors' by an 'Independent Contractor Agreement' that purported to make salespersons 'solely responsible for determining the manner and means' of performance, nevertheless the brokers retained supervision and the rights to approval or disapproval over important steps in the consummation of real estate sales arranged by a salesperson.*" Supra at 383.

As the Court above stated, the designation given the employee should not be the focus; *the actual control and supervision over that employee* should be the focus. In this respect, a leased employee would be analogous to an independent contractor.

Under Oregon law, a mortgage broker *may* employ independent contractors to do licensed activities. This information was recently confirmed directly via telephone with Mr. Lee Proctor of the State of Oregon Division of Finance & Corporate Securities. Mr. Proctor also cited ORS 59.840(4)(a) as a reference, which is attached hereto as **Exhibit G**.

In addition, HUD itself has allowed the use of Independent Contractor agreements. As recently as September 2002, Shannon O'Toole, Director of HUD's Santa Ana Homeownership Center, reviewed and approved the use of an Independent Contractor Agreement *because* of the supervision and control being exercised over the loan officers. A copy of the Independent Contractor Agreement submitted to Shannon O'Toole is attached hereto as **Exhibit H**. A copy of the letter from Shannon O'Toole approving the Independent Contractor Agreement is attached hereto as **Exhibit I**. Please note that portions of this letter have been redacted to protect client privacy.

Notwithstanding the foregoing, SHYA had previously received acknowledgment from HUD that SHYA's Employee Lease Agreement was acceptable for use under FHA. As HUD is aware, during the week of July 15, 2002, Compliance Officer Beverly Scott from HUD's Single Family Division, Oregon State Office, Northwest Alaska Area, located at 400 Southwest Sixth Avenue, Suite 700, Portland, Oregon, visited SHYA to conduct a review of its operations.

Following her visit, Ms. Scott and SHYA President Steve Salveson discussed the validity of SHYA's Employee Lease Agreement. On July 30, 2002, Mr. Salveson faxed a copy of SHYA's agreement along with a cover sheet to Ms. Scott for her review. [A copy of the fax report and cover sheet are attached hereto as **Exhibit J**. Please note that the fax report shows three (3) pages as having been transmitted: those being the cover sheet and the two-page Employee Lease Agreement; however, the date on the cover sheet was mistakenly written as "7-30-00." The true transmittal date is 7-30-02, as shown on the fax report.]

Within a week of receiving the agreement to review, Ms. Scott personally contacted Mr. Salveson via telephone and informed him that the agreement *was acceptable for use under FHA*. SHYA reasonably relied on this representation by Ms. Scott and continued using the Employee Lease agreements up until the recent 2003 audit by HUD. However, as of the date of this letter, SHYA is no longer using the Employee Lease Agreement in accordance with the representations now being made by Ms. Lirio and Mr. Schmidt. Notwithstanding the foregoing, and in the spirit of cooperation and partnership with HUD, SHYA has complied with HUD's technical requirement, thus converting the sole remaining leased employee into a W-2 employee. A copy of this employee's W-4 form is attached hereto as **Exhibit K**.

On pages 10, 11, and 12, the Final Audit Report addresses the fact that certain "leased employees" signed Certifications. Once again, notwithstanding the language of the Employee Lease agreements, these persons were *treated* as full-time employees, were *supervised* as full-time employees, *worked in the main office* alongside all other employees, and, thus, in essence *were full-time employees*. The language of the agreements was effectively superceded by SHYA's actual practices with respect to these employees, a clear example of "substance" over "form." Simply put, this is exactly why these employees had no reservations about signing the Certifications.

HUD's Finding 2: ***<u>SHYA is Not in Full Compliance With HUD/FHA Quality Control Requirements.</u>***

SHYA's Response to HUD's Alleged Finding 2:

SHYA has always exhibited great care and concern regarding the Quality Control of its operations. SHYA performs QC reviews monthly, even exceeding the 10% HUD requirement. For example, in January 2003, five (5) loans closed; SHYA randomly selected one (1) file to audit. A copy of the report to management is attached hereto as **Exhibit L**. In April 2003, fourteen (14) loans closed; thus, two (2) loans were selected for auditing. A copy of the report to management is attached hereto as **Exhibit M**.

With regards to Denice Word, the person who had been assigned to conduct Quality Control reviews, SHYA *did have* a number of safeguards instituted to ensure that the integrity of SHYA's Quality Control reviews were not being compromised: if a file that Ms. Word had originated came up for review, an outside Audit service was to be employed to audit that file. Fortunately, this procedure never had to be utilized.

The fact is that SHYA believed it was in compliance with HUD Handbook 4060.1 Chapter 6-1. The language therein states that the QC person must not have "direct loan *processing*, *underwriting* or *servicing* responsibilities." [emphasis added] However, SHYA now understands that this prohibition also encompasses the *originating* of FHA-insured loans. As a result, SHYA management promptly sent an email to Ms. Word informing her of HUD's requirements and directing her not to originate any future FHA loans whatsoever. A copy of this email is attached hereto as **Exhibit N**. Procedures are now in place to ensure that Ms. Word remain isolated from all aspects of processing, *as well as originating*, FHA loans.

As HUD can see, SHYA took prompt corrective action to ensure that this violation of HUD rules and regulations does not occur in the future. Notwithstanding the foregoing, however, SHYA, in the spirit of cooperation and partnership with HUD, agrees to indemnify HUD against any future losses attributable to the following loan originated by Ms. Word:

Mr. Frank Baca
December 4, 2003
Page 6

FHA Case Number	Mortgage Amount	Endorsement Date
569-0559116	$136,867	February 11, 2003

RELATED ISSUES

SHYA would like to take this opportunity to address some issues that were not readily stated within HUD's Final Audit Report. On page 5, Ms. Lirio's review of thirty-two (32) FHA case files is mentioned briefly. What is notable here is that HUD's copy files for these 32 loans contained various missing or misplaced documents. *SHYA's copy files, however, contained every single one of those required documents, without exception.*

In all transactions, SHYA makes sure to send all required documentation to the lenders. It is the lenders' sole responsibility to ensure that those documents are forwarded to HUD. As a result, this lack of care and compliance on the part of the lenders *should not* be made attributable to SHYA.

SHYA also took immediate and timely steps to address and cure any deficiencies arising out of Beverly Scott's visit in 2002. SHYA updated its Quality Control Plan and, as stated above, even submitted its Employee Lease Agreement to Ms. Scott for her review, which resulted in acknowledgement of its validity and compliance with FHA.

Finally, it is of importance to note that between June 2003 and October 2003, SHYA's comparison ratio dropped significantly for both Oregon and the United States. On page 5 of HUD's Final Audit Report, SHYA's comparison ratio for Oregon on June 30, 2003 is listed as being at 196%. Please note that HUD does not specify whether this number refers to current defaults or defaults within the first two years. In either event, as of October 31, 2003, the ratio for current defaults is at 92% (a significant decrease of 102%) while the ratio for defaults within the first two years is at 108% (a significant decrease of 88%). This is quite a remarkable feat on the part of SHYA. In addition, on June 30, 2003, SHYA's comparison ratio for the United States was at 169% for defaults within the first two years. As of October 31, 2003, this number has dropped to 117%. Another fantastic job on the part of SHYA. Copies of the Neighborhood Watch website printouts are attached hereto as **Exhibit O**. *These figures clearly exemplify SHYA's commitment to improving its quality control procedures, taking immediate corrective action, and ultimately, strengthening its relationship with HUD.*

CONCLUSION

For all the reasons stated above, SHYA respectfully submits that no administrative action is warranted in connection with the findings discussed herein. SHYA has readily responded to the allegations, instituting prompt and broad-ranging remedial actions where necessary or prudent, and agrees to indemnify HUD in those instances where SHYA has readily accepted responsibility.

SHYA reserves the right to supplement this response as more information becomes available. We patiently await your reply. Should you require further information, please do not hesitate to contact me directly at (714) 662-4990 with any questions or concerns.

Mr. Frank Baca
December 4, 2003
Page 7

Very truly yours,

The Law Offices of HERMAN THORDSEN

By: Herman Thordsen
Herman Thordsen, Esq.

enc: as indicated

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January 5, 2004

U.S. Department of Housing and Urban Development
Office of the Inspector General for Audit
Northwest/Alaska Region 10
Attention: Frank E. Baca
909 First Avenue, Suite 126
Seattle, WA 98104-1000

VIA EMAIL ONLY

[ADVANCED]

RE: Modification of Finding 1 Recommendation: Scheller Hess-Yoder and Associates, dba Advanced Mortgage Resources (SHYA)

Dear Mr. Baca:

This letter is in response to Ed Schmidt's email dated December 23, 2003, advising SHYA of the OIG's modification of Finding 1 from the Audit Report "recommendations." Once again, it appears that OIG has either completely ignored or completely discounted every single piece of information, documentation and explanation that SHYA had previously provided in its good faith effort to cooperate with OIG's audit. Based on these modifications, it is apparent that OIG had no intention whatsoever of taking into consideration anything that SHYA had to contribute, say, or provide in support of its position relating to the audit.

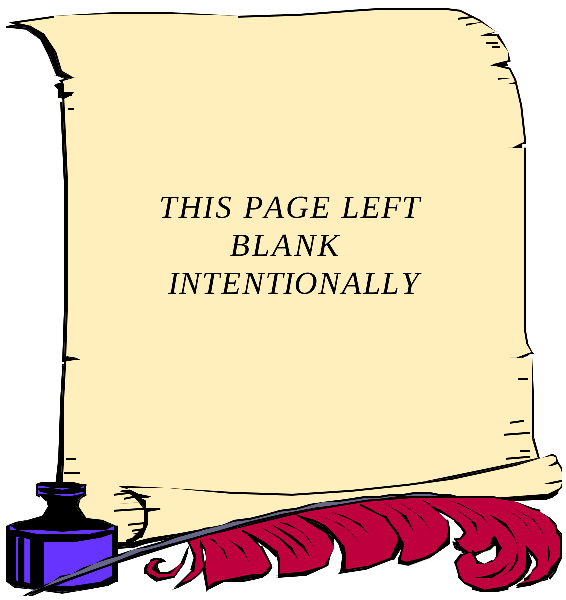
This response incorporates all of our previous communications, comments, and responses regarding OIG's audit of SHYA. SHYA reserves the right to supplement this response as more information becomes available.

Very truly yours,

The Law Offices of HERMAN THORDSEN

By: ______________________________
Jozef G. Magyar, Esq.

Cc: Edward Schmidt
Steve Salveson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Loans Originated Under Independent Contractor/Branch Agreements

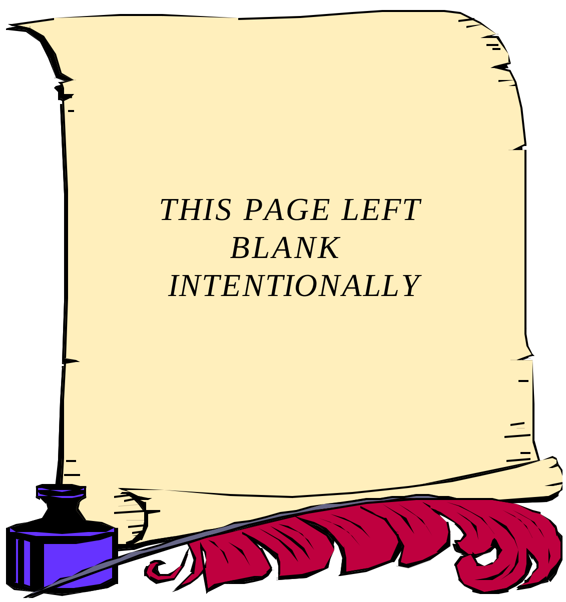
P&L Financial – September 10, 1998 Branch Office Agreement
Currently Insured Loans (Recommendation 1B.)

FHA Case Number	Closing Date	Endorsement Date	Refinanced Case Number (if applicable)	Mortgage Amount *	Loan Status 12/11/03
431-3445026	05/25/00	07/24/00	431-3576415 then to 431-3724006	$107,207	current
569-0476375	07/31/00	09/08/00	569-0523111 then to 569-0566458	$122,779	current
TOTAL P & L: 2 Loans				**$229,986**	

The Mortgage Source - May 21, 1996 Branch Office Agreement
Currently Insured Loans (Recommendation 1B.)

FHA Case Number	Closing Date	Endorsement Date	Refinanced Case Number (if applicable)	Mortgage Amount *	Loan Status 12/11/03
569-0470547	04/28/00	08/07/00	569-0507420 then to 569-0568370	$173,343	current
569-0504938	06/25/01	07/16/01	569-0565814	$109,521	current
TOTAL The Mortgage Source: 2 Loans				**$282,864**	

*Original loan amount or loan amount for the loans refinanced by SHYA.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Loans Originated Under Employee Lease Agreements

P&L Financial – August 4, 2000 Employee Lease Agreement
Current, Defaulting & Foreclosed Insured Loans (Recommendation 1D.)

FHA Case Number	Closing Date	Endorsement Date	Refinanced Case Number (if applicable)	Mortgage Amount *	Loan Status 12/11/03
431-3463115	08/07/00	09/14/00	431-3662646	$ 82,566	current
431-3471163	08/23/00	10/03/00	431-3731427	$131,425	current
431-3474521	08/23/00	01/16/01	431-3674908	$144,591	current
431-3486696	**10/11/00**	**11/07/00**		**$135,230**	**in default**
431-3489482	11/08/00	01/03/01	431-3614638 then to 431-3881503 then to 431-3982601	$120,472	current
431-3502928	**12/08/00**	**01/04/01**		**$173,343**	**foreclosure commenced**
431-3516559	**01/30/01**	**02/21/01**		**$100,916**	**prior default, now current**
431-3516650	02/28/01	03/28/01	431-3789541	$78,828	current
431-3528216	03/13/01	04/23/01	431-3900537	$166,374	current
431-3531868	03/01/01	08/24/01		$168,617	current
431-3544957	**03/30/01**	**03/30/01**		**$142,980**	**prior default, now current**
431-3550707	04/18/01	05/17/01		$161,994	current
431-3596796	07/03/01	11/09/01		$149,651	current
431-3622771	08/15/01	01/28/02		$146,697	current
431-3628404	**09/26/01**	**11/29/01**		**$132,034**	**prior default, now current**

*Original loan amount or loan amount for the loans refinanced by SHYA.

FHA Case Number	Closing Date	Endorsement Date	Refinanced Case Number (if applicable)	Mortgage Amount *	Loan Status 12/11/03
431-3656831	11/15/01	12/07/01		$177,219	current
431-3665906	11/28/01	12/27/01		$157,278	current
431-3686804	12/26/01	02/07/02		$139,806	current
431-3699498	02/05/02	02/20/02		$121,842	current
431-3724297	03/21/02	04/05/02		$100,992	current
431-3735412	06/28/02	08/20/02		$173,093	current
431-3760583	06/26/02	08/16/02		$130,826	current
431-3765408	06/28/02	07/31/02		$142,759	current
431-3771767	07/01/02	07/24/02		$151,620	current
431-3773876	10/17/02	11/21/02		$157,528	current
431-3785317	08/30/02	11/30/02		$151,738	current
431-3826956	11/27/02	02/06/03		$135,351	current
431-3841273	11/22/02	01/13/03		$ 91,083	current
431-3862714	01/29/03	04/18/03		$155,099	current
431-3863834	04/30/03	05/29/03		$138,868	current
431-3866479	03/19/03	06/04/03		$108,300	current
431-3879408	02/28/03	07/01/03		$ 94,906	current
431-3891099	03/18/03	04/01/03		$181,437	current
431-3912958	05/29/03	07/08/03		$156,545	current
431-3922932	05/07/03	06/19/03		$135,091	current
431-3931406	05/28/03	07/01/03		$137,458	current
561-7149449	**10/31/00**	**11/15/00**	**561-7356616**	**$129,462**	**foreclosed**
569-0515506	09/28/01	12/26/01		$108,709	current
569-0531970	02/27/02	05/10/02		$144,338	current
569-0545979	07/31/02	10/08/02		$109,026	current
569-0553171	**12/04/02**	**02/05/03**		**$115,324**	**foreclosure commenced**
TOTAL P&L: 41 Loans				**$5,581,416**	

*Original loan amount or loan amount for the loans refinanced by SHYA.

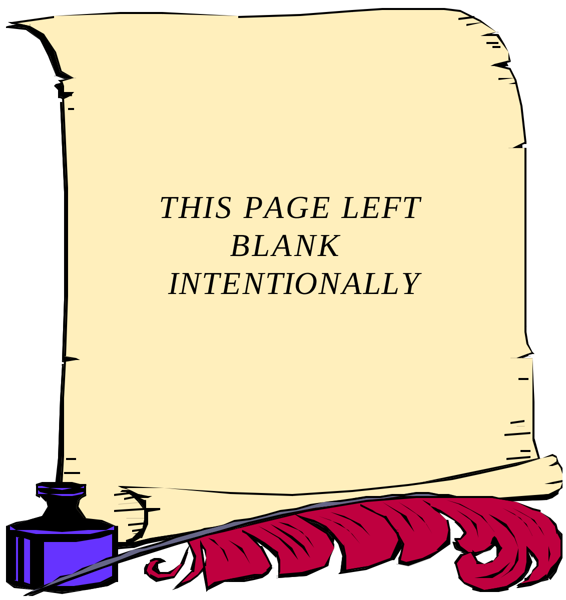
Diverse Lending – April 23, 2001 Employee Lease Agreement
Current & Defaulting Insured Loans (Recommendation 1D.)

FHA Case Number	Closing Date	Endorsement Date	Refinanced Case Number (if applicable)	Mortgage Amount *	Loan Status 12/11/03
431-3569988	04/27/01	06/14/01		$ 91,665	current
431-3688000	12/17/01	02/07/02		$129,369	current
561-7405571	12/03/01	01/11/02		$151,452	**default**
569-0514914	09/17/01	03/11/02		$127,006	current
TOTAL Diverse Lending: **4 Loans**				**$499,492**	

LS Financial – March 1, 2001 Employee Lease Agreement
Current Insured Loans (Recommendation 1D.)

FHA Case Number	Closing Date	Endorsement Date	Refinanced Case Number (if applicable)	Mortgage Amount *	Loan Status 12/11/03
431-3555024	04/09/01	05/29/01		$136,852	current
431-3681270	11/30/01	12/21/01		$121,946	current
TOTAL LS Financial: 2 Loans				**$258,798**	

*Original loan amount or loan amount for the loans refinanced by SHYA.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