



Issue Date  
October 13, 2004

Audit Case Number  
2005-DE-1001

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

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

SUBJECT: Ineffective Loan Origination and Quality Control Processes at First Source  
Financial USA's Midvale, UT, Branch Office

## HIGHLIGHTS

### What We Audited and Why

We audited First Source Financial USA's (First Source) Midvale, UT, branch office. We determined an audit was warranted based on deficiencies we identified in the areas of loan origination and quality control during a prior audit, Use of Independent Contract Loan Officers to Originate FHA [Federal Housing Administration]-Insured Loans, Audit Report 2004-DE-0002, dated April 23, 2004.

Our audit objectives were to determine whether the mortgagee complied with U.S. Department of Housing and Urban Development (HUD) regulations, procedures, and instructions in the origination of insured loans selected for review and to determine whether the mortgagee's quality control plan, as implemented, meets HUD's requirements.

### What We Found

First Source's Midvale branch office did not comply with HUD regulations, procedures, and instructions in the origination of 24 of the 25 loans selected for review. We found employment information that was invalid or questionable

and/or passed through the hands of an interested third party, the selling agent for the transaction. In addition, loans were originated by nonemployees or independent contractors.

For 6 of the 24 loans, HUD's total cost was \$787,188. HUD suffered a loss (\$227,031) on the sale of four of the properties and paid insurance claims (\$183,157) to lenders on two of the properties totaling \$410,188. As of June 30, 2004, the remaining 18 loans have a total unpaid insured mortgage balance of \$2,205,329, which represents a continuing or imminent insurance risk.

First Source has a quality control plan that complies with HUD requirements. However, the quality control plan was not implemented, and related quality control reviews were not performed at the Midvale, Utah, branch office. The lack of implementation of a quality control plan has contributed to higher default and claim rates and, therefore, unnecessarily high risk to the Federal Housing Administration insurance fund.

### **What We Recommend**

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner take appropriate action in line with the recommendations made in the two findings of this audit report.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

### **Auditee's Response**

We provided the discussion draft of the audit report to First Source on August 31, 2004, and requested their comments by September 17, 2004. Per First Source's request, we granted an extension to September 30, 2004. First Source provided its written response on September 29, 2004, and generally disagreed with the findings. First Source stated it surrendered its approval to originate insured loans on September 13, 2004. The complete text of the auditee's response along with our evaluation of that response can be found in Appendix B of this report.

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## BACKGROUND AND OBJECTIVES

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First Source Financial USA's (First Source) main office in Henderson, NV, was incorporated in February 1998 as a State of Nevada for-profit corporation. First Source operated a branch office located in Midvale, UT, which originated Federal Housing Administration, Veterans Administration, and conventional mortgage loans.

The Midvale branch office received its approval from the U.S. Department of Housing and Urban Development (HUD) as a Title II non-supervised loan correspondent on April 24, 2001. We reviewed the branch office's loan origination and quality control activities at the branch office located at 1225 Fort Union Boulevard, Suite 200, Midvale, UT 84047, and later at the branch office located at 420 West 1500 South, Suite 100, Bountiful, UT 84010. The main office decided to consolidate the Midvale branch office into the Bountiful branch office because of a combination of events (e.g., profits down, unable to secure a permanent branch manager) at the Midvale branch office. We did not perform an onsite review at First Source's main office.

On April 23, 2004, we issued an audit report (2004-DE-0002) on the use of independent contract loan officers to originate insured loans, which included a review of the Midvale branch office. Our review disclosed that the branch office used nonemployees or independent contract loan officers to originate insured loans, contrary to HUD requirements, and entered into agreements with its independent contract loan officers or nonemployees that did not comply with HUD requirements. In addition, our review disclosed noncompliance with HUD requirements in three areas: (1) implementation of a quality control plan and related activities, (2) execution of control and management supervision over independent contract loan officers, and (3) payment of all operating expenses related to the operation of a mortgage lending business.

We determined that an audit of the Midvale branch office was warranted based on the deficiencies identified during the prior audit. The objectives of our review were to determine whether the mortgagee complied with HUD regulations, procedures, and instructions in the origination of insured loans selected for review and to determine whether the mortgagee's quality control plan, as implemented, meets HUD's requirements.

From April 1, 2001 to March 31, 2004, First Source's sponsors endorsed 280 loans<sup>1</sup> with a total mortgage amount of \$34,777,741, originated by the Midvale branch office for properties located in Utah. As of June 30, 2004, of the 280 loans, 23 (8.21 percent) had been in default at one time, and foreclosure action has been taken on 12 (4.29 percent). HUD has paid insurance claims on 11 of the loans totaling \$1,247,235, with losses totaling \$339,759 on the resale of seven related properties.

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<sup>1</sup> The amount contains loans originated by both the Midvale and Bountiful branch offices, as the Bountiful branch office was using the Midvale branch office's institution identification number when originating insured loans.

## RESULTS OF AUDIT

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### Finding 1: Improvement Needed in the Origination of Insured Loans

First Source's Midvale branch office did not comply with HUD regulations, procedures, and instructions in the origination of 24 of the 25 loans selected for review. We found employment information that was invalid or questionable and/or passed through the hands of an interested third party, the selling agent for the transaction. In addition, loans were originated by nonemployees or independent contractors. Lastly, the branch office was not maintaining the entire case file pertaining to loan origination. For 6 of the 24 loans, HUD's total cost was \$787,188.<sup>2</sup> HUD suffered a loss (\$227,031) on the sale of four of the properties and paid insurance claims (\$183,157) to lenders on two of the properties totaling \$410,188. As of June 30, 2004, the remaining 18 loans have a total unpaid insured mortgage balance of \$2,205,329, which represents a continuing or imminent insurance risk.

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#### Invalid Employment Information

A mortgagee is required by HUD to establish the anticipated amount of income and the likelihood of its continuance to determine the borrower's ability to repay the mortgage debt.<sup>3</sup> This entails a verification of a borrower's income for the most recent 2 full years and assurance that the borrower's income can be reasonably expected to continue for at least 3 years.<sup>4</sup> The credit report and verification forms are not to pass through the hands of the applicant, a real estate agent, or other interested third party. The Request for Verification of Employment is to be delivered directly to the applicant's employer and must be returned directly to the mortgagee.<sup>5</sup>

Of the 25 loans we reviewed, we identified 23 loans where employment income information collected by First Source's Midvale branch office, which was used to support a borrower's ability and willingness to repay a mortgage, was invalid or questionable. We contacted the employers for both the borrower and coborrower(s) for all 25 loans. Our reverifications of employment disclosed nonemployment; differences in employment dates; and/or differences in type of income, pay rates, or number of hours worked. A number of the loans included borrower employment outside the United States, which we determined was not plausible when compared to other documentation in the case files. The sponsor

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<sup>2</sup> The total includes amounts associated with insurance claims paid for conveyance and expenses incurred while HUD owned the properties and insurance claims paid for pre-foreclosure or assignment.

<sup>3</sup> Section 2, Effective Income, of HUD Handbook 4155.1.

<sup>4</sup> Paragraph 2-6, Stability of Income, and paragraph 2-7, Salaries, Wages, and Other Forms of Effective Income, of HUD Handbook 4155.1.

<sup>5</sup> Paragraph 3-6, Credit Report and Verifications, of HUD Handbook 4000.2.

(underwriter) would not have been aware of these deficiencies unless he or she had repeated the verifications of employment for each of the 23 loans.

We also found verification forms and/or supporting documentation (e.g., paystubs, W-2s) that passed through the hands of an interested third party, the selling agent, for 5 of the 25 loans. This deficiency was apparent from the various employment documents in the case files and should have been addressed by First Source and/or the applicable sponsor (underwriter) for the 5 loans.

The following two loans are an illustration of some of the deficiencies we identified.

Case Number 521-4957688

Our reverification of employment for the borrower disclosed employment outside the United States, which would not have been plausible when compared to other documentation in the case file. According to the letter confirming employment in Mexico and its translation letter, the borrower was employed in the area of construction from January 3, 1995 to December 19, 2000. However, a Request for Verification of Employment reported that the borrower was employed as a laborer from January 2000 to January 16, 2001, in Utah.

In addition, a paystub used to support the borrower's employment at another Utah firm, passed through the hands of an interested third party, the selling agent for the transaction. The fax header for the paystub included the selling agent's name.

Reverification of employment for the coborrower disclosed nonemployment. According to the Uniform Residential Loan Application (loan application), Request for Verification of Employment, and paystubs, the coborrower was employed as a cook at a restaurant in Utah. Our reverification of employment disclosed the coborrower never worked for the restaurant. The coborrower's income cannot be used for loan qualification. The adjustment to gross monthly income results in a mortgage payment expense to effective income (front ratio) and a total fixed payment to effective income (back ratio) of 49.38 percent. HUD's acceptable front and back ratios are 29 percent and 41 percent, respectively.<sup>6</sup>

In addition, the coborrower's bank statements passed through the hands of an interested third party, the selling agent for the transaction. The fax header on the bank statements included the selling agent's name.

HUD has paid an insurance claim on this loan in the amount of \$122,949 and incurred expenses totaling \$12,114 as a result of acquiring the property. The resale of the property resulted in a loss to HUD of \$51,063.

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<sup>6</sup> Paragraph 2-12, Debt-to-Income Ratios, of HUD Handbook 4155.1.

Case Number 521-5064063

Our reverification of employment for the borrower disclosed nonemployment. According to the loan application, letter of confirmation of employment, and tax returns, the borrower was employed as an assistant manager for a business that provides multiple services (e.g., accounting, auditing, tax return preparation). Our reverification of employment disclosed that the borrower never worked for the business. The borrower's income cannot be used for loan qualification. The adjustment to gross monthly income results in a front ratio and a back ratio of 66.41 percent.

We question the validity of the coborrower's self-employment. According to the loan application and tax returns, the coborrower was self-employed as a translator. We were unable to confirm the coborrower's employment, given the limited information available in the case file.

Further, there were potential liabilities for both the borrower and coborrower that were not taken into consideration during loan approval. The case file contained tax returns for both the borrower and the coborrower that were completed on January 28, 2002, 1 day before closing on January 29, 2002. The tax returns for 1999 and 2000 submitted by the borrower were incomplete and did not detail whether the borrower was subject to a refund or had a Federal tax liability. The tax returns for 2000 and 2001 for the coborrower disclosed a Federal tax liability of \$1,448 and \$1,421, respectively.

HUD has paid an insurance claim on this loan in the amount of \$162,835 and incurred expenses totaling \$18,109 as a result of acquiring the property. The resale of the property resulted in a loss to HUD of \$51,945.

Appendix C of this audit report contains a schedule of each of the 25 loans reviewed. Appendix D includes a narrative case presentation for case number 521-4957688 discussed above. We provided the narrative case presentations for all 25 loans reviewed to applicable HUD program staff and to First Source. The narrative case presentations are available upon request.

### **Use of Independent Contract Loan Officers**

HUD is explicit that customary loan origination functions may not be contracted out as the mortgagees are held responsible for the quality of loans and compliance with HUD requirements.<sup>7</sup> Furthermore, HUD has identified provisions of agreements between a mortgagee and its loan officers that violate HUD requirements, such as

“Require the ‘employee’ ...to indemnify the HUD...approved mortgagee if it incurs damages from any apparent, express, or

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<sup>7</sup> Mortgagee Letter 95-36.

implied agency representation by or through the  
'employee's'...actions."<sup>8</sup>

Contrary to HUD's requirement, for all 25 loans reviewed, the assigned loan officer was a nonemployee or independent contractor who performed loan origination functions that HUD specifically requires mortgagee employees to perform. Further, the branch manager of the Midvale office was an independent contractor.

We found that First Source established agreements with its branch manager and its loan officers that defined them as independent contractors. Further, the branch manager's agreement contained a provision indemnifying First Source from any risk associated with the branch manager's responsibilities.

First Source compensates its independent contractors for each insured loan closed. The compensation is calculated based on the gross loan commissions (loan origination fee plus the yield spread,<sup>9</sup> if applicable) actually received by First Source at closing less a broker fee multiplied by a commission split based upon the loan type and the independent contractor. Commissions paid by First Source to its independent contractors are reported on IRS form 1099-MISC. First Source does not issue an IRS form 1099-MISC if the independent contractor has incorporated.

The following is an illustration of a loan officer who was not an employee or an independent contractor of First Source at the time of loan application.

Case Number 521-5056202

The loan officer for case number 521-5056202 was not an employee or an independent contractor for First Source at the time the initial loan application was completed on August 8, 2001. The loan officer did not begin to work for First Source as an independent contract loan officer until January 2, 2002. We did not find evidence in the case file or in HUD's systems that the loan had been transferred to First Source from another mortgagee.

The Midvale branch manager informed us that a number of loans in default had been originated by the same loan officer. We found a number of the loans in default had been originated by a relative of the loan officer, and we brought this to the attention of the branch manager, who acknowledged the fact and explained that he was not aware of the other loan officer until he began to review the loans in default. The branch manager stated further that the loan officer had allowed other people (nonemployees) to complete the loan applications, but he did not become aware of this practice until he began to go through the loan files in detail.

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<sup>8</sup> Mortgagee Letter 00-15.

<sup>9</sup> The yield spread is points paid by the lender for loans carrying interest rates above the par rate (interest at zero points).

During its monitoring review in September 2002, HUD's Quality Assurance Division found that the main office also allowed nonemployees to originate and process insured loans.

By using nonemployees or independent contractors to originate insured loans, First Source could not, and in fact did not exercise direct control and supervision over its loan origination activities as required by HUD. The lack of direct control and supervision, coupled with quality control deficiencies (Finding 2) resulted in unnecessarily high risk to the Federal Housing Administration insurance fund.

### **Incomplete Case Files**

A mortgagee is required to retain the entire case file pertaining to loan origination, either in hard copy or microfilm form, for at least 2 years from the date of endorsement for auditing purposes. Upon request, mortgagees must make legible hard copies of the material available to HUD staff.<sup>10</sup>

During our review, First Source was not maintaining the entire case file as required. The audited financial statements for the fiscal year ending December 31, 2003, contained one finding relating to HUD loan origination and settlement compliance. According to the finding, 3 of the 45 loan files selected for review could not be located by First Source.

We reviewed First Source's loan files for 14 of the 25 selected loans for completeness. Copies of documents used during the loan origination process were missing, incomplete, and/or unsigned. The yield spread was not disclosed on the Good Faith Estimate for 8 of the 14 loans. One file did not include the coborrower's credit report.

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

### **HUD Assumed an Unnecessarily High Risk**

HUD assumed an unnecessarily high risk when insuring the loans originated by First Source's Midvale branch office. Of the 25 loans selected for review, we identified 23 loans for which employment information was invalid or questionable. Therefore, the borrower and/or coborrower(s) would not have met HUD requirements for loan approval. We also identified one loan where the loan officer was not an employee or an independent contractor of First Source at the time of loan application.

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<sup>10</sup> Paragraph 5-10, Retention of Mortgagee's Origination File, of HUD Handbook 4000.2 REV-2.

For 6 of the 24 insured loans, HUD's total cost was \$787,188. HUD suffered a loss (\$227,031) on the sale of four of the properties and paid insurance claims (\$183,157) to lenders on two of the properties totaling \$410,188. As of June 30, 2004, the remaining 18 loans have a total unpaid insured mortgage balance of \$2,205,329, which represents a continuing or imminent insurance risk. Of the 18 loans, 6 (33.33 percent) had been in default at one time and foreclosure action had been taken on 4 (22.22 percent). Two of the loans were delinquent after 4 months and 1 loan was delinquent after 1 month.

### **Disregard for HUD Requirements**

The deficiencies associated with First Source's Midvale branch office loan origination activities stem from its disregard for HUD's requirements. First Source's failure to implement a quality control process also contributed to the deficient loan origination activities. As discussed in Finding 2 of this audit report, the failure to establish a quality control process led to First Source's inability to ensure the accuracy, validity, and completeness of its loan origination operations. Quality control reviews were not performed at the branch office. Therefore, potential deficiencies in the loan origination process were not identified and corrected.

Lastly, there was a lack of control and management supervision by the main office over the branch office and the branch office over its employees and contractors. First Source only reviews the loan origination process when a loan processor identifies a deficiency during the accomplishment of his or her duties and/or when the branch office receives the check for the loan proceeds after closing and forwards it to the main office for disbursement. Neither review constitutes a reverification of information for quality and validity.

First Source relies on its sponsors to ensure the propriety of information used to approve a loan for Federal Housing Administration-insurance.

### **Recommendations**

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

- 1A. Pursue a referral to the Mortgage Review Board to include sanctions (e.g., letter of reprimand, probation, suspension, withdrawal) against First Source's main office for the deficiencies relating to insured loan origination activities at the Midvale branch office.
- 1B. Pursue reimbursement for the losses incurred and/or insurance claims paid relating to the 6 insured loans not originated in accordance with HUD requirements totaling \$410,188. Refer to Appendix C for the mortgagee responsible for remedy.

- 1C. Pursue indemnification for the 18 insured loans not originated in accordance with HUD requirements totaling \$2,205,329. Refer to Appendix C for the mortgagee responsible for remedy.
- 1D. For recommendations 1B and 1C, pursue civil money penalties from the appropriate entity for
- Invalid documents used in originating the Federal Housing Administration-insured loans.
  - Allowing employment information to pass through the hands of an interested third party (the selling agent).
  - Invalid certification that the loan application contained information obtained directly from the borrower by a full-time employee of the mortgagee, and
  - Using nonemployees or independent contractors to originate insured loans.

At the close of our onsite audit work, the main office informed us that it would be ending its Federal Housing Administration-insured loan origination activities at all offices. If First Source should decide not to end these activities, then HUD needs to

- 1E. Require First Source to develop and implement an internal control process to ensure that all loan origination functions are monitored for compliance with HUD requirements. The internal control process must also ensure that any deficiencies noted in the loan origination process are corrected before the loan is submitted to the sponsor for underwriting.
- 1F. Review First Source's implementation of recommendation 1E and ensure that First Source's loan origination procedures and internal control process are fully implemented in conformity with HUD requirements.

## Finding 2: Quality Control Plan Not Implemented

First Source has a Quality Control Plan that complies with HUD requirements. However, the plan was not implemented, and related quality control reviews were not performed at the Midvale, UT, branch office. Further, First Source did not meet HUD's requirements for reporting withdrawn or denied applications in accordance with the Home Mortgage Disclosure Act. The lack of implementation of a quality control plan has contributed to higher default and claim rates and, therefore, unnecessarily high risk to the Federal Housing Administration insurance fund as illustrated in Finding 1 of this report.

### Plan Not Implemented and Reviews Not Performed

As a condition of HUD approval, First Source is required to have and maintain a quality control plan that is sufficient in scope to evaluate the accuracy, validity, and completeness of its loan origination operations. The evaluation of loan origination operations is to occur within 90 days of a loan closing and encompass a review of either the lesser of 10 percent of all loans closed on a monthly basis or a random sample that provides a 95 percent confidence level with 2 percent precision. If fewer than 10 loans are originated monthly, the 10 percent sampling requirement can be performed quarterly. The evaluation requirements also include an analysis of all loans that default within the first 6 months and a 10 percent review of loans rejected.<sup>11</sup>

Our review disclosed that First Source has a Quality Control Plan that is sufficient in scope. However, it was not implemented. First Source also did not perform quality control reviews—to include analysis of all loans that default within the first 6 months and 10 percent review of loans rejected—at the Midvale branch office.

Further, we found that First Source did not meet HUD's requirements for reporting withdrawn or denied applications when it made credit decisions in accordance with the Home Mortgage Disclosure Act.<sup>12</sup>

### Similar Deficiencies Noted at Main and Other Branch Office

HUD's Quality Assurance Division performed a Title II monitoring review of First Source's main office in Henderson, NV, during September 2002. The monitoring review identified similar deficiencies in the main office's implementation of its quality control plan. First Source failed to implement a quality control plan acceptable to the Secretary of HUD and to perform quality

<sup>11</sup> Chapter 6 of HUD Handbook 4060.1.

<sup>12</sup> Paragraph 3-13g, Home Mortgage Disclosure Act, of HUD Handbook 4155.1 and Mortgagee Letter 95-03.

control reviews within 90 days of closing and of loans that went into default within the first 6 months of loan closing.

We found the deficiencies in the area of quality control to be prevalent at the Bountiful, UT, branch office also.

### **Impact of Not Meeting HUD Quality Control Requirements**

As illustrated above, First Source has not implemented its quality control process in accordance with HUD requirements and its own established requirements at its Midvale branch office. Under HUD's Single Family Direct Endorsement Program, a mortgage loan is underwritten and closed without prior HUD review or approval. Therefore, it is imperative that First Source implement its quality control process in accordance with HUD's and its own requirements. Without proper establishment of a quality control process, First Source is unable to ensure the accuracy, validity, and completeness of its loan origination activities. The lack of implementation of a quality control process has contributed to higher default and claim rates and, therefore, unnecessarily high risk to the Federal Housing Administration insurance fund (see Finding 1).

### **Disregard for HUD Requirements**

The deficiencies associated with First Source's quality control process stem from its disregard for HUD's and its own requirements. In addition, the main office failed to provide adequate guidance and assurance that the Midvale branch office, to include the Bountiful branch office, is operating in accordance with HUD requirements. Further, First Source transferred its responsibility for quality control to its sponsors.

We found that First Source did not perform regular and ongoing reviews of loan officer performance and work performed as required by HUD. First Source relied solely on its sponsors to ensure the propriety of information used to support the approval of a borrower for an insured loan.

In addition, the main office in Henderson, NV, did not provide adequate guidance and assurance that the Midvale branch office was operating in accordance with HUD requirements. As discussed above, the main office was reviewed by the HUD Quality Assurance Division in September 2002. The monitoring review identified deficiencies similar to those identified during our review of the Midvale and Bountiful branch offices.

It is apparent that the deficiencies identified and resulting remedies implemented at First Source's main office were neither communicated nor enforced or implemented at the Midvale and Bountiful branch offices, indicating a breakdown in the internal control process. There was little or no ongoing management supervision by the main office over the branch offices.

During our entrance conference in September 2003, with the president and other key management from First Source's main office we were informed that the Midvale branch office was responsible for performing the quality control reviews of loans it originates and would have any related documentation. The main office had a contract with a company to perform quality control reviews of only main office generated loans. We asked the Midvale branch manager for the quality control review reports and were informed that he was not aware of HUD's quality control requirements and quality control reviews had not been performed. As a remedy for the deficiency, the main office informed us that quality control reviews for all branch office loans would be performed out of the main office as well as by the contractor.

When we resumed our review in May 2004, at the Bountiful branch office we again made a request for quality control review reports for loans originated by the Midvale branch office. We were not provided with the quality control review reports. We made additional requests to the main office and the branch office for the quality control review reports. Management at the main office informed us that the branch manager was responsible for performing the quality control reviews and if they are not available then they were not completed. The Bountiful branch manager was not aware of HUD's quality control requirements and did not have any quality control review reports to provide. The branch manager suggested that we contact the management at the main office.

During our final attempt to obtain access to the quality control review reports on June 10, 2004, management at the main office informed us that First Source was surrendering its HUD approval. First Source's management cited the expenses associated with Federal Housing Administration loans, mainly from the reviews performed by their contractor had contributed to First Source's decision to surrender its approval.

Lastly, First Source relied on its sponsors to ensure the accuracy of the information contained in the loan origination files. The Midvale branch manager did not begin to review loans in default until notified by the Utah Division of Real Estate that an underwriter (sponsor) disagreed with a borrower's income information. The branch manager's review disclosed that a number of the loans in default included questionable coborrower employment information, and the majority of the loans were originated by the same loan officer. As a result of the review, the loan officers were dismissed. The branch manager acknowledged that the reviews he performed did not constitute quality control reviews and if he had performed quality control reviews the deficiencies would have been identified and corrected sooner.

## Recommendations

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

2A. Pursue a referral to the Mortgage Review Board to include

- Sanctions (e.g., letter of reprimand, probation, suspension, withdrawal) against First Source's main office for quality control deficiencies at the Midvale and Bountiful branch offices and
- An assessment of a civil money penalty for failure to implement a quality control plan.

At the close of our onsite audit work, the main office informed us that it would be ending its Federal Housing Administration-insured loan origination activities at all offices. If First Source should decide not to end these activities, then HUD needs to

2B. Require First Source's main office to fully establish and implement an adequate quality control process at its Bountiful branch office.

2C. Review First Source's implementation of recommendation 2B and ensure that First Source's quality control process is fully implemented in conformity with HUD requirements.

## SCOPE AND METHODOLOGY

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Our audit approach was to identify and evaluate the internal controls in place over the key areas of operation of First Source's Federal Housing Administration-insured loan origination activities. Our review methodology entailed the review of 25 insured loans from the universe of 280 such loans originated by First Source with a beginning amortization date between April 1, 2001 and March 31, 2004, for properties located in Utah. The results of our testing apply only to the 25 loans reviewed and cannot be projected to the universe of 280 loans.

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

To accomplish the audit objectives, we examined First Source's records. We also reviewed applicable HUD records relating to First Source's non-supervised loan correspondent activities. We conducted interviews with First Source officials, employees, and independent contractors or nonemployees and the HUD Quality Assurance Division. We also conducted interviews with borrowers (if applicable) and obtained information from their current and past employers.

Our audit generally covered the period of April 1, 2001 through March 31, 2004. Where applicable, we expanded the audit period to include current data. We conducted our field work in September 2003 and in May and June 2004.

We performed our review in accordance with generally accepted government auditing standards.

## INTERNAL CONTROLS

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Internal controls are an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives; Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

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### Relevant Internal Controls

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

- Loan Origination Process – Policies and procedures established by management to ensure Federal Housing Administration-insured loans are originated in accordance with HUD requirements and
- Quality Control Process – Policies and procedures established by management to ensure the quality control plan has been implemented and related reviews are performed in accordance with HUD requirements.

We assessed the relevant controls identified above.

### Significant Weaknesses

A significant weakness exists if internal controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Based on our review, we believe significant weaknesses exist in two areas: (1) the loan origination process (Finding 1) and (2) the quality control process (Finding 2). The deficiencies are discussed in detail in the Results of Audit section of this report.

## FOLLOW-UP ON PRIOR AUDITS

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### **Use of Independent Contract Loan Officers to Originate FHA [Federal Housing Administration]-Insured Loans, 2004-DE-0002**

We reviewed the use of independent contract loan officers to originate Federal Housing Administration-insured loans based on information we received. We reviewed five HUD approved non-supervised loan correspondents, which included First Source's Midvale, UT, branch office. We issued Audit Report 2004-DE-0002, Use of Independent Contract Loan Officers to Originate FHA [Federal Housing Administration]-Insured Loans, on April 23, 2004.

Our review at the branch office disclosed that it used nonemployees or independent contract loan officers to originate insured loans contrary to HUD requirements. The branch office entered into agreements with its nonemployees or independent contractors that did not comply with HUD requirements. Our review also disclosed noncompliance in three areas: (1) implementation of a quality control plan and related activities, (2) execution of control and management supervision over independent contract loan officers, and (3) payment of all operating expenses related to the operation of a mortgage lending business.

We are working with HUD to reach acceptable management decisions for the two recommendations made in the audit report.

## APPENDICES

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### Appendix A

#### SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

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Recommendation Number	Ineligible <sup>1/</sup>	Funds to Be Put to Better Use <sup>2/</sup>
1B	\$410,188	
1C		\$2,205,329

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

<sup>2/</sup> "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

## Appendix B

# AUDITEE COMMENTS AND OIG'S EVALUATION

### Ref to OIG Evaluation

### Auditee Comments



2920 N. Green Valley Pkwy. • Bldg. 3, Suite 312 • Henderson, NV 89014  
Phone (702) 458-1980 • Fax (702) 938-2002 • www.YourFirstSource.com

September 29, 2004

U.S. Department of Housing and Urban Development  
Office of the Inspector General for Audit, Region 8  
UMB Plaza, 1670 Broadway, 24<sup>th</sup> Floor  
Denver, CO 80202-4801

Attn: Robert C. Gwin, Regional Inspector General for Audit

Re: Audit Response

Dear Regional Inspector Gwin,

#### Comment 1

On September 13, 2004, First Source Financial surrendered their FHA approval. This decision was made in part due to FHA placing the onus of originating loans on the lender while limiting the responsibility of the sponsor that performed the underwriting of the file.

#### Comment 2

Over the course of the past two years First Source Financial has worked diligently to improve their internal quality control procedures as well as contracting a third party to provide quality control at an additional expense. However, due to the auditing practices of HUD by the time we were made aware that there was an error in our procedures it was too late to correct the problem.

#### Comment 3

Twenty Three (23) of the Twenty Four (24) loans audited were all closed by the same loan officer who was terminated by First Source Financial for suspected fraud. As a result, we have conducted more than one independent audit on the same files you audited and our findings are inconclusive. We are still in the process of reviewing each case and comparing your findings to our independent audit findings and in some cases are completing additional audits with our quality control company which we will forward upon completion.

Please feel free to contact me with any questions or requests for additional information.

Sincerely,

Cathleen Mullin-Scott  
President of Operations

Cc: Joseph N. Giuliano, President & CEO, First Source Financial  
Bobbie Medeiros, Office Manager, First Source Financial

#### BRANCH OFFICES

Peoria, AZ (623) 486-8676 • Phoenix, AZ (602) 288-3366 • Oklahoma City, OK (405) 601-1920 • Midvale, UT (801) 565-0002

## OIG Evaluation of Auditee Comments

**Comment 1** First Source acknowledges that as of September 13, 2004, it surrendered its approval “in part due to FHA [Federal Housing Administration] placing the onus of originating loans on the lender while limiting the responsibility of the sponsor that performed the underwriting of the file.”

Contrary to First Source’s assertion, the sponsor is responsible for the actions of its loan correspondents in originating insured loans. However, if deficiencies identified are a result of the loan correspondent’s procedures and are not identifiable during the underwriting process, then the loan correspondent is responsible.

A loan correspondent is also required to have a quality control process. As discussed in Finding 2 of this report, First Source did not have a quality control process and relied on its sponsors to ensure the propriety of information used to support the approval of a borrower for an insured loan. Five of the 23 insured loans identified with invalid or questionable employment information defaulted within the first six months. If First Source had implemented a quality control process at its Midvale, UT, branch office the deficiencies associated with the loans could have been identified and corrected sooner.

Further, First Source’s President of Operations informed us on June 10, 2004, that a letter to HUD had been prepared where First Source surrendered its HUD approval. The President of Operations cited the expenses associated with Federal Housing Administration-insured loans, mainly from the reviews performed by their quality control contractor had contributed to First Source’s decision to surrender its approval.

**Comment 2** First Source states that it has worked diligently over the past two years to improve its internal quality control procedures as well as contracting a third party to provide quality control at an additional expense. First Source asserts that auditing practices of HUD have made it “too late” to correct “errors” in its procedures.

Contrary to First Source’s assertion, and as discussed in Finding 2 of this report, First Source’s main office was made aware of “errors” in its quality control procedures beginning with a monitoring review of the main office performed by HUD’s Quality Assurance Division in September 2002. First Source has a quality control plan that is sufficient in scope. However, it was not implemented (e.g., quality control reviews were not performed).

We identified the same “errors” in First Source’s quality control procedures during our onsite reviews at both the Midvale and Bountiful, Utah, branch offices. The main office informed us that the branch offices were responsible for quality control reviews. However, our discussions with the branch managers at both offices disclosed they were not aware of HUD’s quality control requirements. In fact, the branch manager at the Bountiful office received a copy of the quality control plan from the main office shortly before our arrival in May 2004.

According to the branch manager, the main office had instructed him to review the plan and become familiar with it before we came onsite. First Source's disregard of HUD's requirements is evident.

**Comment 3** First Source indicates that the same loan officer who was terminated for "suspected fraud" closed 23 of the 24 insured loans audited by the OIG. First Source also states that they have conducted more than one audit of the loans we audited and their findings are "inconclusive."

Contrary to First Source's assertion, we reviewed 25 insured loans originated by First Source. Further, our review of HUD's and/or First Source's files disclosed the terminated loan officer originated 14 of the 25 loans. Of the remaining 11 loans, three different loan officers originated 10 loans. We were unable to identify the loan officer for one loan. Further, 8 of the loans were originated by a relative of the terminated loan officer that the Midvale branch manager acknowledged he was not aware of until he began his reviews of the defaulted loans.

# Appendix C

## SCHEDULE OF DEFICIENCIES AND MORTGAGEE RESPONSIBLE FOR REMEDY

As of June 30, 2004

FHA Case Number	Insurance Status	Streamline Refinance Case Number	Invalid/Questionable Employment	Interested 3rd Party	Nonemployee/ Contractor	Reimburse HUD	Remedy Indemnification	Mortgagee Responsible for Remedy
1	521-4957688	Claim	X	X	X	551,063	5110,103	Irwin Mortgage Corporation
2	521-5021182	Terminated	X		X		5147,094	First Source Financial USA
3	521-5029227	Active	X		X		5157,957	First Source Financial USA
4	521-5029265	Terminated	X		X		397,492	First Source Financial USA
5	521-5030211	Terminated	X		X			First Source Financial USA
6	521-5031512	Terminated	X		X	** 5137,665		First Source Financial USA
7	521-5048547	Terminated	X		X		5115,653	First Source Financial USA
8	521-5054428	Terminated	X	X	X		5129,560	Washington Mutual Bank FA
9	521-5056175	Terminated	X		X		5124,800	First Source Financial USA
10	521-5056202	Terminated	X		*** X		5112,098	First Source Financial USA
11	521-5056890	Terminated	X		X		5113,352	First Source Financial USA
12	521-5057549	Terminated	X		X		5109,021	First Source Financial USA
13	521-5057578	Active	X	X	X		588,414	Washington Mutual Bank FA
14	521-5060706	Terminated	X		X		5120,030	First Source Financial USA
15	521-5064063	Claim	X		X	551,945		Irwin Mortgage Corporation
16	521-5066189	Active	X	X	X		5138,815	First Horizon Home Loan Corporation
17	521-5070466	Terminated	X		X		5158,559	First Source Financial USA
18	521-5082645	Terminated	X		X		5130,195	First Source Financial USA
19	521-5082718	Terminated	X		X			First Source Financial USA
20	521-5091682	Claim	X		X	555,970		First Source Financial USA
21	521-5096299	Active	X		X		5125,460	First Source Financial USA
22	521-5097577	Terminated	X		X		5106,771	First Source Financial USA
23	521-5106735	Active	X	X	X		5119,956	International Home Capital Corporation
24	521-5124109	Claim	X		X	568,054		First Source Financial USA
25	521-5146480	Claim	X		X	545,491		First Source Financial USA
Totals			23	5	25	\$410,188	\$2,205,330	

\* We provided the FHA case numbers for the purchase loans originated by First Source where the mortgage insurance was terminated and then streamline refinanced by another mortgagee. As of June 30, 2004, the streamline refinanced loans were actively insured.

\*\* HUD paid an insurance claim on the streamline refinanced loan (521-5456967) for the purchase loan (521-5031512) originated by First Source.

\*\*\* The insured loan was originated by an individual who was not an employee or an independent contractor of First Source at the time of loan application.

## Appendix D

### NARRATIVE CASE PRESENTATION

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Case Number	521-4957688
Loan Amount	\$114,207
Sponsor (underwriter)	Irwin Mortgage Corporation
Settlement date	01/22/2002
Endorsement date	02/26/2002
Status as of June 30, 2004	Claim

#### Deficiencies

##### Borrower

- Employment outside United States not plausible when compared to information in Federal Housing Administration case binder and the branch office's case file – According to the letter confirming employment in Mexico and its translation letter, the borrower was employed in the area of construction from January 3, 1995 to December 19, 2000. However, the Request for Verification of Employment reported that the borrower worked as a laborer from January 2000 to January 16, 2001, in Utah. Further, the letter confirming employment in Mexico and its translation letter are similar in font style and print quality to the paystubs used to support the coborrower's employment at a restaurant. Our reverification disclosed the restaurant did not employ the coborrower.
- Stability of income in question – The borrower had five different jobs during 2001.
- Paystub passed through the hands of an interested third party, the selling agent – A paystub used to support the borrower's employment at loan application passed through the hands of an interested third party, the selling agent. The fax header for the paystub included the selling agent's name.

##### Coborrower

- Reverification of employment disclosed not employed – According to the loan application, Request for Verification of Employment, and paystubs, the coborrower worked as a cook at a restaurant in Utah at loan application. Our reverification of employment disclosed that the coborrower never worked for the restaurant. The loan application, Request for Verification of Employment, and paystubs contain invalid information. The coborrower's income cannot be used for loan qualification.
- Adjusted income results in ratios that exceed limits – The adjustment to gross monthly income results in a front ratio and a back ratio of 49.38 percent. According to paragraph 2-12, Debt-to-Income Ratios, of HUD Handbook 4155.1, HUD acceptable ratios are 29 percent and 41 percent, respectively.
- Letter confirming employment outside the United States appears invalid – The letter confirming employment in Mexico and its translation letter are similar in font style and print quality to the paystubs used to support the coborrower's employment.
- Bank statements passed through the hands of an interested third party, the selling agent – The coborrower's bank statements passed through the hands of an interested third party, the selling agent. The fax header on the bank statements included the selling agent's name.

HUD has paid an insurance claim on this loan in the amount of \$122,949 and incurred expenses totaling \$12,114 as a result of acquiring the property. The resale of the property resulted in a loss to HUD of \$51,063.