audit report

Issue Date
June 2, 2006
Audit Report Number
2006-BO-1007

TO: Brian Montgomery, Assistant Secretary for Housing–Federal Housing Commissioner, H

FROM: John Dvorak, Regional Inspector General for Audit, 1AGA

SUBJECT: Capital Mortgage Associates LLC (North Haven, Connecticut), Did Not Always Comply with HUD Requirements Regarding Its Single-Family Loan Originations and Quality Control Plan

HIGHLIGHTS

What We Audited and Why

We audited Capital Mortgage Associates LLC (Capital Mortgage), a nonsupervised loan correspondent approved by the U.S. Department of Housing and Urban Development (HUD) to originate Federal Housing Administration-insured single-family loans. We selected Capital Mortgage based on a lender risk analysis, which showed that the loans it originated had a higher default percentage than those of other lenders in the area. Our objectives were to determine whether Capital Mortgage acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the Federal Housing Administration-insured single-family mortgages selected for review and whether its quality control plan as implemented met HUD requirements.

What We Found

Capital Mortgage did not always comply with HUD requirements regarding its single-family loan originations. It engaged in a prohibited net branch arrangement. There was also material loan origination deficiencies with two of the loans originated from this branch. These deficiencies affected the credit quality of the loans and represented a risk of loss to the Federal Housing

Administration insurance fund. Capital Mortgage also charged ineligible fees to borrowers because it was not fully aware of HUD-allowable fees or written disclosure requirements regarding certain closing fees. This resulted in borrowers paying excessive and/or unreasonable fees. In addition, Capital Mortgage did not establish or implement a quality control plan that met all of HUD's requirements. As a result, it may not identify and correct potential deficiencies in a timely manner, resulting in an unnecessary risk to the Federal Housing Administration insurance fund.

What We Recommend

We recommend that HUD's assistant secretary for housing–federal housing commissioner require Capital Mortgage to (1) revise its branch agreements to comply with HUD requirements or cease originating Federal Housing Administration-insured loans from the affected branch office, (2) refund the ineligible fees, and (3) update and fully implement its quality control plan. We also recommend that the assistant secretary refer Capital Mortgage to the Mortgagee Review Board for consideration of administrative sanctions and/or civil money penalties for the violation of HUD requirements disclosed in this report.

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

Auditee's Response

We provided Capital Mortgage draft finding details throughout the course of the audit. We also provided Capital Mortgage with a draft audit report on May 11, 2006, and held an exit conference on May 16, 2006. Capital Mortgage provided us with formal written comments on May 17, 2006. 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

The National Housing Act as amended established the Federal Housing Administration, an organizational unit within the U.S. Department of Housing and Urban Development (HUD). The Federal Housing Administration provides insurance to private lenders against loss on mortgages financing homes. The basic home mortgage insurance program is authorized under Title II, Section 203(b) of the National Housing Act and governed by regulations in 24 CFR [*Code of Federal Regulations*] Part 203.

There are two types of HUD-approved lenders—supervised and nonsupervised. Additionally, HUD authorizes and approves a separate class of lenders called loan correspondents. The loan correspondent, which can be either a supervised or a nonsupervised lender, can originate and process Federal Housing Administration-insured loans, but the correspondents' sponsor lender must conduct the final underwriting and approval of the loan. The loan correspondent, unless it is a supervised lender, cannot hold, purchase, or service Federal Housing Administration-insured mortgages.

Capital Mortgage Associates LLC (Capital Mortgage) is a nonsupervised loan correspondent. HUD granted Capital Mortgage approval to originate loans in July 1996. Capital Mortgage is a loan correspondent for 26 different sponsoring lenders. Its home office is in North Haven, Connecticut, and it has one approved branch in Miami, Florida. Capital Mortgage also operates several satellite offices, which forward all Federal Housing Administration loans originated to the home office for final loan processing. Capital Mortgage's principal market area is Connecticut. Capital Mortgage originated 98 percent of its loans for properties located in Connecticut.

Based on HUD's latest available data, Capital Mortgage originated 174 Federal Housing Administration loans from October 1, 2003, through March 31, 2006, with a total original mortgage amount of more than $29.4 million. As of March 31, 2006, Capital Mortgage's Federal Housing Administration loan default rate on loans for properties located in Connecticut that went into default within the first two years of origination was 7.21 percent. The average for all lenders originating loans for properties in Connecticut for the same period was 3.44 percent. Capital Mortgage has consistently had a higher default rate during the early loan repayment period as compared to the average for all lenders (see table 1 on the following page).

Table 1. Comparison of early payment loan default percentages, Capital Mortgage and all lenders originating loans in Connecticut

Quarter end date	Loan defaults (%)		Compare ratio (%)*
	Capital Mortgage	All Lenders in Connecticut	
Mar. 31, 2006	7.21	3.44	210
Dec. 31, 2005	7.81	3.33	235
Sept. 30, 2005	7.84	3.30	238
June 30, 2005	7.34	3.04	241
Mar. 31, 2005	5.76	3.01	191
Dec. 31, 2004	5.58	2.82	198
Sept. 30, 2004	6.36	2.43	262
June 30, 2004	6.10	2.38	256
Mar. 31, 2004	4.98	2.44	204
Dec. 31, 2003	5.15	2.38	216
Sept. 30, 2003	4.48	2.49	180
June 30, 2003	4.57	2.69	170
Mar. 31, 2003	3.51	3.05	115

* A compare ratio is the percentage of originations that went into default or were claim terminated divided by the percentage of originations that went into default or were claim terminated for the selected geographic area. Compare ratio is the value that reveals the largest discrepancies between the subject's default and claim percentage and the default and claim percentage to which it is being compared.

The audit objectives were to determine whether Capital Mortgage acted in a prudent manner and complied with HUD regulations, procedures, and instructions in the origination of the Federal Housing Administration-insured single-family mortgages selected for review and whether its quality control plan as implemented meets HUD requirements. We also assessed other general aspects of Capital Mortgage's operations as they relate to continued lender approval.

RESULTS OF AUDIT

Finding 1: Capital Mortgage Engaged in a Prohibited Net Branch Arrangement

Capital Mortgage operated a branch office under a prohibited branch arrangement. There was also material loan origination deficiencies with 2 of the 17 loans reviewed. These two loans were originated from this branch. Capital Mortgage used this branch because the relationship was financially beneficial to both parties. By using a prohibited branch arrangement, Capital Mortgage does not have direct control and supervision over those involved with the origination of loans. The lack of direct control and supervision, coupled with quality control deficiencies, increases the risk to the Federal Housing Administration insurance fund in the form of defaults and claims.

Prohibited Branch Arrangement

Capital Mortgage maintains several offices that it has not registered as approved branch offices in HUD's data systems. Capital Mortgage considers these branches to be satellite offices because it forwards all Federal Housing Administration loans originated at these locations to the HUD-approved home office for final loan processing. However, one branch, operating under the name of Integrated Finance Services, was created as a separate entity, and it pays all of its own operating expenses. This is the only branch arrangement that Capital Mortgage established in this manner.

HUD permits the use of satellite offices under certain conditions.[1] One of the conditions is that the satellite offices be staffed with employees of the approved lender. Another condition is that the lender pays all of the operating expenses of its satellite offices. Thus, the branch arrangement with Integrated Finance Services is in violation of HUD requirements, and loans originated by this branch constitute third-party originations. This arrangement is also known as a prohibited "net branch" because the approved lender is taking on a separate mortgage company or broker as a branch and allowing that separate entity to originate insured mortgages under the approved lender's HUD lender number.[2]

[1] HUD Mortgagee Letter 94-39.
[2] HUD Mortgagee Letter 00-15.

Service Agreements Violate HUD Requirements

In July 2004, Capital Mortgage entered into services agreement contracts with two loan officers. One of the provisions in these contracts required the loan officers to establish a separate entity as a mortgage broker (Integrated Finance Services). Another provision requires the separate entity to pay for any expenses that it may incur. In addition, the separate entity is required to indemnify Capital Mortgage from any risk associated with the loans originated by the independent contract loan officers. These provisions in the agreements violate HUD branch requirements.[3] HUD regulations also prohibit lenders from contracting out customary loan officer functions.[4]

Following the execution of the services agreement for each loan officer in July 2004, Capital Mortgage originated 53 Federal Housing Administration loans between August 2004 and December 2005. The branch in question originated 26 loans (49 percent). See appendix C for the loans originated from this branch. This branch produced the largest volume of Federal Housing Administration loans for Capital Mortgage.

The branch (Integrated Finance Services) received Internal Revenue Service 1099 forms for all commissions earned for originating loans. Businesses use 1099 forms for payments for services performed by people not treated as its employees (such as subcontractors).

The agreements between Capital Mortgage and the independent contract loan officers were financially beneficial to both parties. For Capital Mortgage, it was financially beneficial because it reduced operating costs and increased loan officer retention. For the independent contract loan officers, it was financially beneficial because they received higher commissions for loan originations. However, HUD prohibits this type of branch arrangement.

Material Origination Deficiencies Identified

Of the 17 loans selected for a detailed loan origination analysis, two had material deficiencies that affected the credit quality of the loans and represented a loss risk to the Federal Housing Administration insurance fund. Both of these loans were originated from the branch in question, but only one of the loans poses a risk to the Federal Housing Administration insurance fund because the borrower paid the

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[3] Mortgagee Approval Handbook, 4060.1 REV-1, CHG-1, paragraphs 2-13, 2-14, and 2-17.
[4] HUD Mortgagee Letter 95-36.

other loan[5] in full in during our audit. However, the repaid loan had a material origination deficiency that went undetected. Appendix D contains a detailed narrative for these loans, and the loan that poses a risk is summarized below.

For the loan that poses a risk (case number 061-2767801), the underwriter approved the loan for the borrower whose total debt-to-income ratios significantly exceeded program guidelines without the support of adequate compensating factors. HUD uses the ratios to determine whether it can reasonably expect the borrower to meet the expenses involved in homeownership and otherwise provide for the family. When the underwriter approved the loan, the maximum mortgage payment expense-to-effective income ratio was set at 29 percent, and the maximum total fixed payment-to-effective income ratio was 41 percent.[6] The borrower's ratios were 42.4 and 50.5 percent, respectively. The underwriter did not document any strong compensating factors supporting the approval of the loan. The loan went into default after only one payment because of excessive obligations, and HUD paid a claim in March 2006. The sponsoring lender is ultimately responsible for the underwriting and the actions of its loan correspondents.

Similar Underwriting Deficiencies Found During Last Lender Review

In November 2000, HUD's Quality Assurance Division performed a lender review of Capital Mortgage. Of the 21 loans reviewed, five had serious underwriting violations relating to excessive debt ratios without significant compensating factors that would justify approval of the loan. Because Capital Mortgage's sponsors are ultimately responsible for the final approval of the loan and the actions of its loan correspondents, HUD required the sponsors to enter into indemnification agreements with HUD for each of these loans.

Conclusion

Capital Mortgage's relationship with this separate entity represents a prohibited branch arrangement and prohibited third-party originations. In addition, there was material loan origination deficiencies with two loans originated from this entity. HUD regulations require lenders to exercise direct control and supervision over their employees and pay all operating expenses, including the expenses of their

[5] The loan that was paid in full was case number 061-2837347, and HUD terminated the Federal Housing Administration insurance status.

[6] "Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties," 4155.1 REV-5, section 2-12.

branches. HUD regulations also prohibit lenders from contracting out customary loan officer functions. The lack of direct control and supervision, coupled with quality control deficiencies (see finding 3), increases the risk to the Federal Housing Administration insurance fund in the form of defaults and claims. Because of the violations, Capital Mortgage is subject to a range of HUD sanctions.[7]

Recommendations

We recommend that HUD's assistant secretary for housing–federal housing commissioner

1A. Require Capital Mortgage to revise its branch agreements to comply with HUD requirements or cease originating Federal Housing Administration-insured loans from the affected branch office.

1B. Refer Capital Mortgage to the Mortgagee Review Board for consideration of administrative sanctions and/or civil money penalties for the violation of HUD requirements disclosed in this finding.

[7] HUD Mortgagee Letter 00-15.

Finding 2: Capital Mortgage Charged Borrowers Ineligible Fees

Capital Mortgage charged ineligible fees totaling $3,875 to borrowers on 12 of the 17 loans reviewed. This occurred because Capital Mortgage was not fully aware of HUD-allowable fees and written disclosure requirements regarding certain closing fees. Capital Mortgage also relied on the sponsoring lenders for the fee listings on the settlement statements. As a result, borrowers paid for excessive and/or unreasonable fees.

Improperly Disclosed Commitment Fees

Capital Mortgage and its sponsors received ineligible commitment fees for eight loans totaling $2,695 (see appendix E). These charges were ineligible because the lenders did not provide the required written disclosures to the borrowers. HUD requires that any lock-in or commitment agreement for which a fee is charged be in writing and guarantee the rate and/or discount points for a period of not less than 15 days before the anticipated closing date.[8] Because the lenders did not provide the required written disclosures, borrowers may not have been guaranteed a rate and/or discount points for a period of at least 15 days before closing. In addition, borrowers were not protected from abusive practices such as charging a fee for a commitment signed the day of closing, not honoring a commitment as agreed to, or not providing something of value in exchange for the fee.

Other Ineligible Fees

Capital Mortgage and its sponsors charged borrowers other ineligible fees for four additional loans totaling $1,180 (see appendix E). The ineligible fees included underwriting fees, tax-related servicing fees, courier fees, and document preparation fees. HUD rules prohibit underwriting and tax-related servicing fees. Two loans included document preparation fees payable to the lender, not a third party. Lenders can only charge a document preparation fee if a third party prepares the documents and the lender does not control the entity. The lender may not charge these fees if it prepares documents itself. One loan included a courier fee on a purchase transaction. Courier fees are only allowable on refinance transactions. When HUD endorsed these loans, its rules prohibited lenders from charging the fees described above to borrowers. Lenders could only collect fees from HUD's list of customary and reasonable fees.[9]

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[8] "Mortgagees Handbook, Application through Insurance (Single Family)," 4000.2 REV-3, paragraphs 1-9A and 5-2P, and HUD Mortgagee Letter 94-7.
[9] Ibid., section 5-2.

Repeat Finding

In November 2000, HUD's Quality Assurance Division performed a lender review of Capital Mortgage. It found that Capital Mortgage charged borrowers similar fees not permitted (including commitment fees) on 9 of the 21 loans reviewed. HUD required Capital Mortgage to refund the charges totaling more than $3,700.

Conclusion

Borrowers paid for excessive and/or unreasonable fees because Capital Mortgage and its sponsors charged ineligible fees. These charges occurred because Capital Mortgage was not fully aware of the HUD-allowable fees and relied on the sponsoring lenders for the fee listings on the settlement statements. Capital Mortgage should refund these fees to the respective parties. It also needs to develop a process to ensure that it only charges and collects customary and reasonable costs from borrowers and that it provides the required written disclosures for loan transactions.

Recommendations

We recommend that HUD's assistant secretary for housing–federal housing commissioner require Capital Mortgage to

2A. Refund $3,875 in ineligible fees. If the loan is in default, refund the amount to the servicer for a principal reduction. If the holding lender files a claim, refund the amount to HUD.

2B. Establish procedures to ensure that it only charges and collects customary and reasonable costs from borrowers and that it provides the required written disclosures regarding certain closing fees.

Finding 3: Capital Mortgage's Quality Control Plan and Its Implementation Were Deficient

Capital Mortgage did establish or implement a quality control plan that met all of HUD's requirements. This occurred because the quality control staff at Capital Mortgage was not fully aware of all of HUD's quality control plan requirements. The failure to implement a quality control plan and perform sufficient reviews prevents Capital Mortgage from ensuring the accuracy, validity, and completeness of its loan origination operations. As a result, Capital Mortgage may not identify and correct potential deficiencies in a timely manner, resulting in an unnecessary risk to the Federal Housing Administration insurance fund.

Deficient Quality Control Plan

Capital Mortgage's quality control plan is missing important and required elements typically found in a sound quality control plan, some of which include the following:

- Performing site reviews of its branches;
- Performing quality control file reviews for all loans going into default within the first six payments;
- Obtaining new credit reports for all borrowers whose loans are included in a quality control review (except streamline refinances or loans processed using an automated underwriting system);
- Performing desk reviews of the property appraisals for all loans chosen for a quality control review (except streamline refinances and HUD real estate owned properties) and additional field reviews by licensed appraisers on 10 percent of the loans selected during the sampling process;
- Determining conditions requiring occupancy reverification; and
- Including all elements listed in section 6-7 of the "Mortgagee Approval Handbook," 4060.1 REV-1, CHG-1, which apply to the functions of Capital Mortgage.

Capital Mortgage's quality control plan did not require reviews of its branches, and it had not completed any site reviews of its branches. This deficiency, in particular, is a weakness in the plan that allowed the prohibited branch arrangement deficiency to go undetected (see finding 1). Also, in response to our initial quality control plan review, Capital Mortgage added that it would use HUD's Neighborhood Watch system to identify and review all loans that were in default status. However, HUD requires that lenders review all loans going into default within the first six payments.[10] The difference between Capital Mortgage's plan and HUD requirements is that the Neighborhood Watch system would not show the loans that went into default within the first six payments in current default status listing if borrowers brought their loans current.

[10] "Mortgagee Approval Handbook," 4060.1 REV-1, CHG-1, paragraph 6-6D.

Poor Quality Control Implementation

Capital Mortgage's implementation of its quality control plan has several major deficiencies. Capital Mortgage did not complete the following:

- Perform quality control file reviews for 10 percent of the Federal Housing Administration loans it originated on at least a quarterly basis;
- Perform quality control file reviews within 90 days of loan closing for randomly selected loans;
- Perform quality control file reviews for all loans going into default within the first six payments;
- Order new credit reports for each borrower whose loan was included in a quality control review (except for non-Federal Housing Administration streamline refinance or automated underwriting system loans); or
- Require field reviews of appraisals by licensed appraisers.

HUD requires that lenders perform quality control reviews within 90 days of closing on at least a quarterly basis. Capital Mortgage had only completed four quality control loan reviews since January 2004, did not complete three of the four reviews within the required 90 days after closing, and conducted two of the four reviews on January 30, 2006, in response to our audit. The quality control reports indicated that the review was primarily a desk review that required a simple checklist of required documents to be in the file with proper signatures and dates. Capital Mortgage noted only minor findings, such as missing truth-in-lending and lead paint disclosures, and a large unexplained bank deposit by the borrower. However, there is no indication that corrective action was completed. We did not find any new credit reports or any indications of field reviews of appraisals by licensed appraisers.

HUD also requires that lenders perform quality file reviews for 10 percent of all Federal Housing Administration loans it originates on at least a quarterly basis.[11] Capital Mortgage's sampling methodology states that it uses a 10 percent random sampling each month to include all Federal Housing Administration, U.S. Department of Veterans Affairs, and/or conventional loans and that a minimum of one loan from each is included. If Capital Mortgage selects a 10 percent sample from all loans originated, its sampling methodology is inadequate because it is not ensuring that it is selecting at least 10 percent of just Federal Housing Administration loans. This is especially important since Capital Mortgage originates substantially more conventional loans than Federal Housing Administration or U.S. Department of Veterans Affairs loans.

In addition, HUD requires that lenders obtain new credit reports for all borrowers whose loans are included in a quality control review (except streamline refinances

[11] "Mortgagee Approval Handbook," 4060.1 REV-1, CHG-1, paragraph 6-6C.

or loans processed using an automated underwriting system) and that licensed appraisers perform additional field reviews on 10 percent of the loans selected during the sampling process.[12] According to Capital Mortgage's quality control plan, Capital Mortgage requires ordering only a sample of new credit reports during the quality control process. Also, it only performed appraisal reviews on a case-by-case basis.

Repeat Finding

This is a repeat finding from a HUD review. In November 2000, the HUD Quality Assurance Division completed an on-site review of the operations of Capital Mortgage. It found that Capital Mortgage did not have a comprehensive quality control plan that complied with HUD requirements. HUD required Capital Mortgage to take corrective action.

Conclusion

Capital Mortgage did not establish or implement a quality control plan that meets all of HUD's requirements. Although Capital Mortgage has taken some initial action with regard to this finding, it needs to address the remaining deficiencies to ensure the accuracy, validity, and completeness of its loan origination operations. Also, a failure to comply with quality control plan requirements may result in sanctions and the imposition of civil money penalties by the Mortgagee Review Board.

Recommendations

We recommend that HUD's assistant secretary for housing–federal housing commissioner

3A. Require Capital Mortgage to update its quality control plan to ensure that all the minimum HUD requirements are included.

3B. Ensure that Capital Mortgage fully implements the new plan.

3C. Refer Capital Mortgage to the Mortgagee Review Board for consideration of administrative sanctions and/or civil money penalties for the repeated violation of HUD requirements disclosed in this finding.

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[12] "Mortgagee Approval Handbook," 4060.1 REV-1, CHG-1, section 6-6E.

SCOPE AND METHODOLOGY

Our audit primarily covered the period of October 1, 2003, through September 31, 2005, and included loans originated by Capital Mortgage during this period. We extended the audit period as necessary through March 31, 2006. We conducted our audit work from December 2005 through April 2006. We primarily carried out our audit work at the home office of Capital Mortgage in North Haven, Connecticut, and the local HUD Hartford (Connecticut) field office. We focused the audit on Capital Mortgage's loan origination and quality control operations.

To achieve our objectives, we identified, obtained, and reviewed relevant rules, regulations, and guidance pertaining to the origination of single-family mortgages, including the *Code of Federal Regulations*, HUD handbooks, mortgagee letters, and the *United States Code*. We also obtained and analyzed critical documents from the loan origination files maintained by Capital Mortgage and HUD. We interviewed appropriate lender and HUD officials. In addition, we obtained an understanding of controls significant to the audit objectives and considered whether the lender designed and placed specific control procedures in operation.

We relied on information from HUD's data systems. We reviewed existing information about the data and performed sufficient tests to determine whether the data were reliable. Based on our assessments, we determined that the data was sufficiently reliable for our purposes.

We selected a nonrepresentative sample of nine Federal Housing Administration-insured loans that defaulted within the first two years of origination and eight loans that exhibited other significant problems for a detailed loan origination analysis. This method allowed us to focus on certain loans that had a greater inherent risk to the Federal Housing Administration insurance fund and/or of noncompliance or abuse. Thus, the results of our detailed testing only relate to the 17 loans reviewed.

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

INTERNAL CONTROLS

Internal control is 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.

Relevant Internal Controls

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

- Controls over program operations - Policies and procedures that management has implemented to reasonably ensure that the HUD single-family insurance program meets its objectives and that unintended actions do not result.
- Controls over the validity and reliability of data - Policies and procedures that management has implemented to reasonably ensure that valid and reliable data (including computer-processed data) are obtained, maintained, and fairly disclosed in reports and HUD computer systems.
- Controls over compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that the single-family program implementation is consistent with laws, regulations, and provisions of contracts or grant agreements.

We assessed the relevant controls identified above.

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

Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

- Controls over program operations - Capital Mortgage did not develop or implement a quality control program in accordance with HUD requirements (see finding 3).
- Controls over compliance with laws and regulations - Capital Mortgage engaged in a prohibited net branch arrangement (see finding 1). Capital Mortgage also did not follow other HUD requirements when originating the loans reviewed (see finding 2).

Separate Communication of Minor Deficiencies

We reported minor internal control and compliance issues verbally to the auditee on January 19, 2006, and March 21, 2006.

FOLLOWUP ON PRIOR AUDITS

This was the first HUD Office of Inspector General audit of Capital Mortgage. However, in November 2000, HUD's Quality Assurance Division performed a lender review of Capital Mortgage (review file number 11345). The purpose of the review was to ensure that practices and procedures employed by Capital Mortgage were consistent with HUD regulations and polices governing Federal Housing Administration single-family programs. The HUD review resulted in six findings. HUD and Capital Mortgage resolved and closed the findings, but three of the findings resurfaced during our audit.

HUD found five loans that the lender approved with total fixed payment-to-effective income ratios exceeding HUD guidelines without significant compensating factors. HUD required Capital Mortgage's sponsor lenders to indemnify HUD should HUD pay a claim on these loans. This HUD finding relates to our finding 1.

HUD also found that Capital Mortgage charged borrowers fees not permitted (including commitment fees) on 9 of the 21 loans reviewed, totaling $3,732. HUD required Capital Mortgage to refund the charges. This HUD finding relates to our finding 2.

Finally, HUD found that Capital Mortgage did not have a written comprehensive quality control plan that complied with HUD requirements. HUD required Capital Mortgage to submit a plan that was in compliance. This finding relates to our finding 3.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/
2A	$3,875

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 polices or regulations.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

05/17/2006 15:32 FAX 203 288 6307 CAPITAL MORTGAGE 002/003

Capital MORTGAGE

100 Broadway
North Haven, CT (800) 272-4844

Timothy Bannon
Michael Motulski, CPA
US Department of Housing and Urban Development
20 Church Street, 19th Floor
Hartford, CT 06103

Re: Capital Mortgage Associates LLC

Dear Tim and Mike,

Thanks again for all your help and advice with the Audit. As per our conversation we have listed some additional information we feel that is relevant in our case:

Comment 1

(a) Page 1: States we used a prohibited branch agreement and independent contract loan officers. The loan officers did not receive 1099's from Capital. We paid them for services rendered to the company in the capacity as an employees with form W-2's.

Comment 2

(b) Page 2 What We Recommend: In regards to any ineligible fees charged we believe that the lenders should be responsible for any fees paid to them.

Comment 3

(c) Page 4: Please review the default average for New Haven County as compared to the national average.

Comment 4

(d) Page 6 Finding 1: We don't believe we have paid independent loan officers for the origination of FHA loans. Mike and Lou were still and still are W-2 Employees of Capital. Mike and Lou are employees of Capital for many years and wanted to open an office up. We helped them do this and also helped get them mortgage broker license. This was not an "existing separate mortgage company". We had an attorney draw up the agreement and at that time felt it was not in violation any HUD rules. We are paying Mike and Lou as employees for any services rendered to Capital in the capacity as an employee with form W-2's. We do not and have not paid them individually with 1099's. This arrangement began mid 2004 and prior to this they were working out Capital's main office and paid only as employees. We feel that the internal control of the files then and now go through the same Quality Control as all of our files. The files have Capital's disclosures and are kept in the same place as all capital loans.

Ref to OIG Evaluation	Auditee Comments

Comment 4 (e) Page 7: We don't feel Lou and Mike are independent loan officers and they were not paid with form 1099's. Neither loan officer received a form 1099, rather they both received form W-2's and Integrated Financial received a form 1099.

Comment 4 (f) Page 8 Conclusion: We do not pay independent contract loan officers for HUD loans.

Comment 5 (g) Page 10 Finding 2: We feel any ineligible fees charged should be the responsibility of the person who receives them. This was a repeat finding and concerns us that these Lenders can list us as payees on the HUD and can in turn charge us the exact fee in an attempt to shift responsibility. Please be advised these fees are dictated to us by the lenders and or Lawyers.

Comment 6 (h) Page 12 Finding 3: This was a repeat finding and please be advised that last audit the Quality Controls were done by Steve's old partner and since then we have updated them several times. We have sent them to our Sponsors and Warehouse lines and have complied with all of their reviews. We are currently pursuing contracting out the Quality Control. HUD must realize that Capital does not have any correspondence with lenders in regards to loan default, late loan payments, ect. Capital can utililize Neighborhood Watch to track such issues but we can be off months from notice to lender from HUD, since the system is updated quarterly.

Again, thank you again for all your attention to this mater. We sincerely appreciate your help.

Sincerely

Steven Kroop
Managing Member

Robert Criscuolo CPA, PFS
Member

OIG Evaluation of Auditee Comments

Comment 1 We acknowledge that the loan officers received W-2 forms from Capital Mortgage for certain non-loan origination services rendered to the company such as training and accept that Integrated Finance Services actually received the 1099 forms from Capital Mortgage for commissions on loans originated from this branch. We clarified this in the report on page 7.

Comment 2 Many of the fees charged were payable to Capital Mortgage. Consistent with HUD's last lender review finding, we are recommending that Capital Mortgage refund the ineligible fees. Although Capital indicated that the ineligible fees were "passed through" by sponsoring lenders our audit scope was limited to a review of the loan origination and quality control operations of Capital Mortgage. Therefore, the finding remained unchanged. Capital Mortgage should address this concern specifically with HUD management officials during the resolution of the recommendations in the report. See also Comment 5 below.

Comment 3 We reviewed the default average for Capital Mortgage and determined that the comparison to other lenders nationwide would not be appropriate because 98 percent of its loans were on properties located in Connecticut. It is more appropriate to compare Capital Mortgage to other lenders originating loans on properties in Connecticut. We made this change to the background section of the report.

Comment 4 We agreed to limit the finding to a discussion on the engagement of the prohibited net branch arrangement and eliminated the discussion on the independent contract loan officers. See Comment 1 above. However, the condition is still in material violation of HUD rules and the recommendations remained substantially unchanged.

Comment 5 Our scope was limited to a review of the loan origination and quality control operations of Capital Mortgage. It is not appropriate for the OIG to address the concern that the sponsoring lenders may also be in violation of HUD regulations at this time. Therefore, the finding and recommendations remained unchanged. Capital Mortgage should address this concern specifically with HUD management officials during the resolution of the recommendations in the report. See also Comment 2 above.

Comment 6 We commend Capital Mortgage for taking some initial actions with regard to the quality control plan finding. The Mortgagee Approval Handbook, 4060.1 REV-1, requires all Federal Housing Administration approved lenders, including loan correspondents, to implement and continuously have in place a quality control plan for the origination and/or servicing of insured mortgages as a condition of maintaining approval. Engaging outside sources to perform the quality control function is acceptable as long as the engagement agreement adheres to HUD's requirements. In addition, it is acceptable to use HUD's Neighborhood Watch system to identify loans that went into early payment default status. The finding and recommendations remained unchanged.

Appendix C

LOANS ORIGINATED BY INDEPENDENT CONTRACT LOAN OFFICERS

Case number	Original mortgage amount	Date endorsed
061-2809953	$124,540	Nov. 3, 2004
061-2822178	$236,292	Jan. 19, 2005
061-2817030	$103,790	Jan. 28, 2005
061-2826498	$189,033	Jan. 28, 2005
061-2835448	$159,608	Feb. 17, 2005
061-2830008	$137,738	Feb. 23, 2005
061-2837347	$192,971	Mar. 10, 2005
061-2831502	$96,628	Mar. 29, 2005
061-2840419	$221,523	Apr. 8, 2005
061-2852288	$160,065	Apr. 22, 2005
061-2841420	$172,550	May 2, 2005
061-2845915	$221,523	May 6, 2005
061-2856136	$201,883	May 13, 2005
061-2855097	$177,219	May 20, 2005
061-2840758	$184,300	May 23, 2005
451-0867364	$278,183	May 27, 2005
061-2854815	$190,246	June 1, 2005
061-2845909	$170,063	June 9, 2005
061-2838313	$182,141	July 12, 2005
061-2867802	$122,084	Aug. 3, 2005
061-2824518	$300,287	Sept. 20, 2005
061-2884347	$251,060	Nov. 1, 2005
061-2898425	$159,253	Nov. 28, 2005
061-2888457	$167,373	Jan. 9, 2006
061-2883834	$195,433	Jan. 10, 2006
061-2918673	$231,420	Jan. 11, 2006

Appendix D

NARRATIVE CASE PRESENTATIONS

Case number:	061-2767801
Original mortgage amount:	$120,434
Section of the Housing Act:	203(b)
Date of loan closing:	June 11, 2004
Status as of March 31, 2006:	Preforeclosure sale completed
Payments before first default:	One
Reason for default:	Excessive obligations
Claims paid by HUD:	$22,119

Summary:

In addition to being originated by an independent contract loan officer (a third-party origination violation – finding 1), the underwriter approved this loan for the borrower, whose total debt-to-income ratios exceeded program guidelines, without the support of adequate compensating factors. The file documented monthly income for the borrower of $3,102, monthly debts of $250, and monthly mortgage payments of $1,317. The mortgage payment-to-effective income ratio was 42.4 percent ($1,317 / $3,102) and exceeded the 29 percent* allowable by HUD. The total fixed payment-to-effective income ratio was 50.5 percent ([$250 + $1,317]) / $3,102) and exceeded the 41 percent* allowable by HUD.

The underwriter used the following compensating factors on the mortgage credit analysis worksheet (form HUD-92900-PUR):

1. Borrower took prepurchasing counseling course.
2. Willingness to pay off debts.
3. Conservative attitude toward accruing new credit since divorce.
4. Contributed 5 percent toward purchase.

Factors 1 and 2 are inadequate and are not included in HUD's list of compensating factors that lenders may use in HUD Handbook 4155.1, REV-5, "Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties." Factor 3 is not an adequate compensating factor because the borrower completed the divorce in September 2003 and the loan closed in June 2004, only nine months later. Finally, factor 4 is not adequate because it should be 10 percent or more according to HUD guidelines.

The loan went into default after only one payment because of excessive obligations. The holding lender completed a preforeclosure sale in October 2005, and HUD paid a claim of $22,119 in March 2006. The sponsoring lender is ultimately responsible for the underwriting and the actions of its loan correspondents.

* Effective with the April 13, 2005, Mortgagee Letter 2005-16, HUD raised the qualifying ratios to 31/43. This policy change was not in effect for these cases. However, the ratios exceed these limits.

NARRATIVE CASE PRESENTATIONS

Case number:	061-2837347
Original mortgage amount:	$192,971
Section of the Housing Act:	203(b)
Date of loan closing:	February 9, 2005
Status as of March 31, 2006:	Terminated/paid-in-full
Payments before first default:	N/A
Reason for default:	N/A
Claims paid by HUD:	$0.00

Summary:

In addition to being originated by an independent contract loan officer (a third-party origination violation – finding 1), we identified a material conflict-of-interest deficiency. An employee of the branch was involved in the processing of this loan for Capital Mortgage and was the real estate agent. This employee may have received both the real estate commissions and the lender origination commissions for originating this loan. This practice violates HUD's conflict-of-interest policies, which prohibit payments to individuals who have received other payments for services related to a transaction. HUD also requires that all employees, except receptionists, work exclusively for the lender at all times, whether full time or part time, and conduct only the business affairs of the lender during normal business hours ("Mortgagee Approval Handbook," 4060.1 REV-1, CHG-1). The same real estate agent/employee is listed as the real estate agent on the purchase and sales agreement and the loan officer on the verification of rent, verification of deposit, request for appraisal, and other miscellaneous correspondence in the loan origination files.

Additionally, the settlement agent is the husband of the real estate agent/employee involved with this loan and is listed as a real estate agent for the same real estate agency according to the company Web site. This may also be a conflict-of-interest violation. There were no affiliated business arrangement disclosures in the origination files.

The underwriter also approved this loan for the borrowers, whose total debt-to-income ratios exceeded program guidelines, without the support of adequate compensating factors. The file documented monthly income for the borrowers of $3,958, monthly debts of $80, and monthly mortgage payments of $1,633. The mortgage payment-to-effective income ratio was 41.3 percent ($1,633 / $3,958) and exceeded the 29 percent allowable by HUD. The total fixed payment-to-effective income ratio was 43.3 percent ([$80 + $1,633] / $3,958) and exceeded the 41 percent allowable by HUD. The underwriter used the following compensating factors:

1. Borrowers have limited use of revolving credit.
2. Borrowers completed a HUD-approved first-time homebuyer program.
3. Borrowers have demonstrated an ability to save.

Factor 2 is inadequate and is not included in HUD's list of compensating factors that lenders may use in HUD Handbook 4155.1, REV-5, "Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties." The borrowers had shown a conservative use of credit (factor 1), but they had not demonstrated the ability to save significantly (factor 3). The borrowers' bank statements for the three months before the closing indicated they had a monthly bank balance of about $5,400. However, the amount was steady from month to month, the borrowers had no additional savings accounts listed, and $4,800 was due from the borrowers at closing. Stronger factors would have been necessary to approve the loan.

The sponsoring lender is ultimately responsible for the underwriting and the actions of its loan correspondents. Although this loan no longer poses a risk to the Federal Housing Administration insurance fund because the borrower paid the loan in full in February 2006 and HUD terminated the Federal Housing Administration insurance status, it represents a material origination deficiency that went undetected.

Appendix E

SCHEDULE OF INELIGIBLE FEES CHARGED TO BORROWERS

Case number	Ineligible fee	Amount
061-2670789	Commitment fee	$225
061-2690080	Commitment fee	$425
061-2703654	Document prep fee	$225
061-2721092	Document prep fee	$190
061-2721092	Tax-related service fee	$69
061-2721092	Underwriting fee	$150
061-2729304	Commitment fee	$225
061-2752944	Commitment fee	$225
061-2767801	Tax service fee	$79
061-2772331	Commitment fee	$450
061-2817030	Commitment fee	$225
061-2822178	Underwriting fee	$442
061-2822178	Courier fee	$25
061-2830355	Commitment fee	$425
061-2837347	Commitment fee	$495
	Total:	**$3,875**