



Issue Date	December 17, 2008
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Audit Report Number	2009-KC-1002
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TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing
Commissioner, H

FROM: *//signed//*
Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: Clarion Mortgage Capital Did Not Fully Comply with HUD’s or Its Own
Quality Control Requirements

HIGHLIGHTS

What We Audited and Why

We reviewed the Leawood, Kansas, branch office of Clarion Mortgage Capital, a Federal Housing Administration (FHA)-approved loan correspondent. Our audit objective was to determine whether Clarion Mortgage Capital followed U.S. Department of Housing and Urban Development (HUD) requirements for implementing a quality control program.

We audited Clarion Mortgage Capital because it had 87 percent more defaulted loans than the national average and a default-to-claim rate of 13.79 percent. Clarion Mortgage Capital’s Leawood, Kansas, branch office originated 376 FHA-insured loans between July 2006 and June 2008.

What We Found

Clarion Mortgage Capital did not fully comply with HUD’s or its own quality control process. It did not ensure that its quality control contractor reviewed loans within the proper timeframes. Also, it did not document on-site quality control reviews of the branch office and document corrective actions taken to address deficiencies identified in the quality control reports.

What We Recommend

We recommend that the Assistant Secretary for Housing – Federal Housing Commissioner verify that Clarion Mortgage Capital has fully implemented a quality control program that complies with HUD requirements.

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

Clarion Mortgage Capital agreed with our conclusions and to take corrective actions. We provided the draft report to the lender on December 2, 2008, and requested a response by December 16, 2008. It provided written comments on December 12, 2008.

The complete text of the auditee's response can be found in appendix A of this report.

TABLE OF CONTENTS

Background and Objectives	4
Results of Audit	
Finding: Clarion Mortgage Capital Did Not Fully Comply with HUD's or Its Own Quality Control Requirements	5
Scope and Methodology	7
Internal Controls	8
Appendixes	
A. Auditee Comments	9
B. Criteria	12

BACKGROUND AND OBJECTIVES

Clarion Mortgage Capital was founded in 1996 as an affiliation of mortgage professionals based in Greenwood Village, Colorado. It has branch operations in five states. The Leawood, Kansas, branch office became a nonsupervised Federal Housing Administration (FHA)-approved lender on June 20, 2001. Clarion Mortgage Capital is an FHA loan correspondent that performed loan origination tasks such as taking the initial borrower application, ordering the property appraisal, conducting asset and employment verifications, and obtaining credit reports.

The branch office originated FHA loans but various FHA-approved sponsoring lenders underwrote the loans and submitted them to FHA for insurance. Sponsors are FHA-approved direct endorsement lenders that underwrite loans originated by loan correspondents. Sponsors are responsible to HUD for the loan origination actions of their loan correspondents.

From July 1, 2006, through June 30, 2008, Clarion Mortgage Capital's branch in Leawood, Kansas, originated 376 FHA-insured loans, totaling more than \$44.27 million. During this same period, 33 of the loans (8.78 percent) were at least 90 days delinquent.

Our audit objective was to determine whether Clarion Mortgage Capital followed HUD requirements for implementing a quality control program.

RESULTS OF AUDIT

Finding: Clarion Mortgage Capital Did Not Fully Comply with HUD's or Its Own Quality Control Requirements

Clarion Mortgage Capital did not ensure that its quality control contractor reviewed loans within the proper timeframe. Also, it did not document on-site quality control reviews of the Leawood, Kansas, branch office or the corrective actions taken to address deficiencies in the quality control reports. These issues occurred because Clarion Mortgage Capital did not effectively monitor its quality control contractor. Also, the lender's managers were not aware of all HUD quality control requirements. As a result, Clarion Mortgage Capital could not ensure the accuracy, validity, and completeness of its loan origination operations, resulting in an increased risk to the FHA insurance fund.

Quality Control Reviews Not Adequate and Documentation Not Always Accomplished

Clarion Mortgage Capital did not fully comply with HUD's or its own quality control requirements. HUD Handbook 4060.1, REV-2, establishes several basic elements that are required in all quality control programs. Appendix B provides the detailed HUD quality control requirements.

Specifically, Clarion Mortgage Capital did not

- Follow HUD's requirements and ensure that its quality control contractor reviewed loans within 90 days from the end of the month in which the loan closed. The lender did not complete 8 of the 30 quality reviews within this time span.
- Follow its own quality control requirements and ensure that its contractor reviewed loans within 90 days of closing. The contractor did not complete 17 the 30 quality controls reviews within the required timeframe.
- Document on-site quality control reviews of the branch office.
- Document corrective actions taken to address deficiencies identified in the quality control reports.

In addition, Clarion Mortgage Capital's corporate office provided quarterly quality control reports to branch office managers rather than monthly reports.

Branch office managers could have monitored loan origination deficiencies more effectively if they received more frequent feedback on their loan officers' loan-processing activities.

Contractor Not Monitored and Managers Unaware of All HUD Requirements

Clarion Mortgage Capital's main office, which centrally managed the quality control program, did not effectively monitor its quality control contractor. Senior management officials acknowledged their responsibility to require timely completion and return of quality control reviews from the contractor.

Clarion Mortgage Capital managers were not aware of all HUD quality control requirements. A Clarion Mortgage Capital senior manager stated that management was not aware of the documentation requirements for the on-site branch quality control reviews and corrective actions taken to address deficiencies.

Clarion Mortgage Capital Unable to Ensure Proper Loan Originations

The lender was unable to ensure the accuracy, validity, and completeness of its loan origination operations. As a result, it might not identify potential deficiencies and make needed corrections in a timely manner, resulting in an increased risk to the FHA insurance fund.

Recommendation

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

- 1A. Verify that Clarion Mortgage Capital has fully implemented a quality control program that complies with HUD requirements.

SCOPE AND METHODOLOGY

To accomplish our objective, we reviewed Clarion Mortgage Capital's quality control plan and quality control reports and interviewed its management officials. We also reviewed HUD's and Clarion Mortgage Capital's underwriting policies and procedures.

Our audit period was July 1, 2006, through June 30, 2008. During this period, Clarion Mortgage Capital's quality control contractor completed quality control reviews of 30 loans. We reviewed the quality control reports for all 30 to determine whether the quality control contractor

- Completed the minimum number of loan reviews required.
- Completed quality control reviews within 90 days from the end of the month in which the loan closed (HUD's requirement) and within 90 days of closing (Clarion Mortgage Capital's requirement).
- Completed quality control reviews on early default loans.

In addition, we determined whether Clarion Mortgage Capital's management took prompt and appropriate actions to deal with material findings.

During our audit period, Clarion Mortgage Capital's Leawood, Kansas, branch office originated 376 FHA-insured loans. Of these loans, 33 loans became 90 days delinquent within the first two years. Initially, part of our objective was to determine whether Clarion Mortgage Capital followed HUD requirements for borrower eligibility and creditworthiness, and property eligibility when originating FHA loans. We reviewed the FHA loan binders and/or Clarion Mortgage Capital's electronic loan files for 10 defaulted loans. We evaluated the loan origination and underwriting procedures performed on each loan and identified no reportable deficiencies.

We relied on computer-processed data contained in HUD's Single Family Data Warehouse system. During the audit, we assessed the reliability of the data and found it to be adequate. We also performed sufficient tests of the data, and based on the assessments and testing, we concluded that the data were sufficiently reliable to be used in meeting our objectives.

We performed audit work from September through November 2008 at Clarion Mortgage Capital's branch office at 10740 Nall Avenue, Suite 240, Leawood, Kansas.

We performed our review in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

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

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

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

Relevant Internal Controls

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

- Controls to ensure that the lender implements a quality control program that complies with HUD requirements.

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 Weakness

Based on our review, we believe that the following item is a significant weakness:

- Clarion Mortgage Capital did not have adequate controls in place to ensure that it followed HUD requirements when implementing its quality control program.

Appendix A

AUDITEE COMMENTS



A Call to Action

December 12, 2008

U.S. Dept. of Housing & Urban Development
Office of Inspector General
Attn: Ronald J. Hosking
Region 7 Office of Audit
Gateway Tower ii – 5th Floor
400 State Avenue
Kansas City, Kansas 66101-2406

Subject: Audit of Clarion Mortgage Capital, Inc.
Leawood, Kansas branch office

Dear Mr. Hosking:

This is in response to the audit findings set out in the audit report dated December 2, 2008 which reported the results of your review of Clarion Mortgage Capital, Inc. (CMC) quality control program. We appreciate the information provided during your review and thank you for the opportunity to submit a response to the draft report.

Finding

The auditors found CMC did not fully comply with HUD's or its own quality control process. It did not ensure that its quality control contractor reviewed loans within the proper timeframes.

CMC Response

The time period covered by this audit was a difficult time for the mortgage industry. CMC's quality control contractor was QC-MAC. QC-MAC was going through the same issues the rest of the industry was experiencing. We knew both principals of QC-MAC were undergoing health problems and possible financial difficulties which forced a staff reduction. This resulted in audits not being completed in as timely a manner as previously. CMC was trying to work with them through this difficult time. We understand that ultimately it is the responsibility of the lender to monitor and ensure audits are completed in a timely manner. CMC will monitor quality control contractor activity more closely in the future to ensure loans are reviewed within 90 days of the end of the month in which the loan closed.

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Finding

CMC did not document on-site quality control reviews of the branch office.

CMC Response

CMC will document executive physical annual branch visits using a checklist based on the items listed in the HUD Handbook. This checklist will include confirmation of the following items:

- The office is properly registered with FHA and the address is current;
- Operations are conducted in a professional, business-like environment;
- The office is properly and clearly identified for any walk-in customers; has adequate office space and equipment; is in a location conducive to mortgage lending; and is separated from any other entity by walls or partitions
- The office is sufficiently staffed with trained personnel;
- Office personnel have access to relevant statutes, regulations, HUD issuances and Handbooks;
- Procedures are revised to reflect changes in HUD requirements and personnel are informed of the changes;
- Personnel at the office are all employees of the mortgagee or contract employees performing functions that FHA allows to be outsourced; and
- The office does not employ or have a contract with anyone currently under debarment or suspension, or a Limited Denial of Participation.

Finding


CMC did not document corrective actions taken to address the deficiencies identified in the quality control reports.

CMC Response

The deficiencies identified in the quality control reports were summarized for CMC executive management in quarterly reports. Unless the deficiency was systemic, it would be addressed with the individual loan originator. CMC will modify procedures to provide monthly reports and include the branch managers as well as the executives in the reviews. Receiving more frequent feedback on the loan originators' loan processing activities should allow branch office managers to monitor loan origination deficiencies more effectively. In addition, all corrective actions taken to address deficiencies identified in the quality control reports will be more fully documented.

We hope this information responds fully to the issues identified during your review of our Kansas branch office and our quality control plan. If you need additional information or have questions, please do not hesitate to call me. We look forward to hearing from you soon.

Sincerely,



James R. Lewis
President

Appendix B

CRITERIA

HUD Handbook 4060.1, REV-2, paragraph 7-6A, states that loans must be reviewed within 90 days from the end of the month in which the loan closed.

Clarion Mortgage Capital's quality control plan states that loans must be reviewed within 90 days of the closing of the loan.

HUD Handbook 4060.1, REV-2, paragraphs 7-3G and 7-3G(1), state that lenders' offices, including traditional, nontraditional branch, and direct lending offices engaged in origination or servicing of FHA-insured loans, must be reviewed to determine whether they are in compliance with HUD's requirements. The review must include but not necessarily be limited to confirmation of the following items:

- The office is properly registered with FHA, and the address is current.
- Operations are conducted in a professional, business-like environment.
- If the office is located in commercial space, the office is properly and clearly identified for walk-in customers, has adequate office space and equipment, is in a location conducive to mortgage lending, and is separated from any other entity by walls or partitions (entrances and reception areas may be shared).
- If the office is located in noncommercial space, the office has adequate space and equipment and displays a fair housing poster if the public is received. If it is open to receive the public, it must be accessible to persons with disabilities, including those with mobility impairments. If it is not open to the public but used occasionally to meet with members of the public, alternate means of accommodation may be used to serve persons with disabilities.
- The servicing office provides toll-free lines or accepts collect calls from borrowers.
- The office is sufficiently staffed with trained personnel.
- Office personnel have access to relevant statutes, regulations, and HUD issuances and handbooks, either in hard copy or electronically.
- Procedures are revised to reflect changes in HUD requirements, and personnel are informed of the changes.
- Personnel at the office are all employees of the lender or contract employees performing functions that FHA allows to be outsourced.

- The office does not employ or have a contract with anyone currently under debarment, suspension, or a limited denial of participation.

HUD Handbook 4060.1, REV-2, paragraph 7-3I, states that review findings must be reported to the lender's senior management within one month of completion of the initial report. Management must take prompt action to deal appropriately with any material findings. The final report or an addendum must identify actions being taken, the timetable for their completion, and any planned followup activities.