Issue Date	
September 30, 2004	
Audit Case Number	
2004-KC-1801	

TO: John Weicher, Assistant Secretary for Housing - Federal Housing Commissioner, Chairman, Mortgagee Review Board, H

//signed//

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

SUBJECT: Survey of NovaStar Home Mortgage's Use of Net Branches

INTRODUCTION

We surveyed NovaStar Home Mortgage's (NovaStar) use of net branches to determine whether it is complying with applicable requirements in its use of net branches. We determined that it was not fully complying with applicable U.S. Department of Housing and Urban Development (HUD) requirements in its use of net branching at the time of our review. We found the agreements used in its branch offices contained language prohibited by HUD. We also determined that NovaStar improperly used independent contract loan officers in the origination of Federal Housing Administration mortgages. NovaStar is currently updating its branch agreements and as of June 1, 2004, is no longer allowing the employment of independent contract loan officers. These changes should help ensure that NovaStar complies with HUD requirements in its use of net branches.

During our survey, we interviewed appropriate headquarters and field staff. In addition, we reviewed HUD Handbooks, Mortgagee Letters, and the Code of Federal Regulations to obtain an understanding of the regulatory guidance pertaining to net branching. We also interviewed NovaStar's main office staff and branch office staff, and reviewed and evaluated its quality control processes and policies and procedures. We conducted limited testing of NovaStar data and HUD's Single Family Data Warehouse. However, due to time constraints and the expectation of minimal added benefit, we did not determine the reliability of the data provided by NovaStar. We used these data solely to identify loans that were originated by contractors. We verified the results of this effort with NovaStar.

The survey period was January 1 through December 31, 2003. This period was expanded to include the most current data when applicable. We conducted the survey in accordance with generally accepted government auditing standards.

In accordance with HUD Handbook 2000.06, REV-3, within 60 days, please provide us for each recommendation without a management decision, a status report on (1) the corrective action taken, (2) the proposed corrective action and the date to be completed, or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after the report is issued for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or you staff have any questions, please contact me at (913) 551-5870.

SUMMARY

NovaStar did not comply with applicable HUD requirements in its use of net branches. We found that the limited liability company agreements, employment agreements, and lease/sublease agreements used in its branch offices contained language prohibited by HUD. We also determined that NovaStar improperly used independent contract loan officers in the origination of Federal Housing Administration mortgage loans. As a result, HUD lacks assurance that NovaStar has the capability to successfully originate Federal Housing Authority-insured loans and, therefore, assumes an increased risk.

NovaStar has initiated actions to correct these deficiencies by eliminating all limited liability company agreements, as well as removing the prohibited language from the employment and lease/sublease agreements. Also, as of June 1, 2004, NovaStar is no longer allowing the employment of independent loan officers.

BACKGROUND

NovaStar Mortgage created NovaStar Home Mortgage, a retail branch organization, to allow established loan originators the opportunity to maintain a high degree of independent thought, while obtaining the benefits of being affiliated with a large, financially sound organization. NovaStar was approved by HUD on March 22, 2001, as a nonsupervised loan correspondent. As such, its principal activity is the origination of mortgages for sale or transfer to an approved sponsor.

Only a small portion (4.5 percent) of NovaStar's business is the origination of Federal Housing Administration loans. During the 2-year period of January 1, 2002, through December 31, 2003, NovaStar originated 57,720 loans, of which 2,580 were Federal Housing Administration loans, including 61 that defaulted within the first year. The following chart depicts Novastar's Federal Housing Administration loan activity and all Federal Housing Administration activity during this same timeframe.

	Total Loans	Defaulted Loans	1st Year Default Rate
NovaStar	**2,580**	**61**	**2.36%**
Overall	**2,370,440**	**64,261**	**2.71%**

FINDING 1

Branch Office Agreements Contained Prohibited Language

NovaStar's branch office agreements contained language strictly prohibited by HUD. Its management did not take appropriate actions to ensure that HUD requirements were followed for the origination of loans. As a result, HUD lacks assurance that NovaStar has the capability to successfully originate insured loans and, therefore, assumes an increased risk on those loans originated by NovaStar.

We reviewed the following agreements between NovaStar and its branch offices to determine whether they complied with HUD requirements:

- Limited liability company agreements
- Employment agreements
- Leases/sublease agreements

We found deficiencies with each of the agreements. The limited liability company agreement stated that once a branch office was established, ". . .the branch manager may be required to contribute cash capital from time to time on a monthly basis in an amount equal to the most recent month's fixed expenses to maintain sufficient working capital and reserves for the Company's business." The agreement also stated, "NovaStar shall receive compensation for its services provided to the company. Such compensation shall include distributions twice per month for Office Expenses, but only to the extent such expenses exceed the total of all fees, yield spread premium and other compensation received by NovaStar for all Closed Loans for that month, minus NovaStar's Fee." Paragraph 2-17, "Operating Expenses," of HUD Handbook 4060.1, REV-1, states that a mortgagee is required to pay all of its operating expenses. The operating expenses that must be paid by the mortgagee include but are not limited to equipment, furniture, office rent, overhead, and other similar expenses incurred in operating a mortgage lending business.

The limited liability company agreement also stated, ". . .the members and their affiliates may engage or invest in any activity, including without limitation those that might be in direct or indirect competition with the Company." Paragraph 2-14, "Conducting Mortgagee Business," of HUD Handbook 4060.1, REV-1, states that all employees of the mortgagee, except receptionists, whether full or part time, must be employed exclusively by the mortgagee at all times and conduct only the business affairs of the mortgagee during normal business hours.

In addition, the employment agreements between NovaStar and the branch offices contained provisions indemnifying the mortgagee from any risk associated with the loans originated by the independent contract loan officer. The agreement stated, ". . .an employee shall indemnify and hold NovaStar and its affiliated corporations, and their respective officers, directors, agents, employees, and insurers harmless from and against any and all claims, losses, damages, etc. arising on account of (1) any intentional misconduct or misrepresentation made by Employee, and/or (2) any violation of this agreement, and (3) any third party claim for personal injury or property damage, any other civil liability, or any fines or penalties imposed by any state or federal regulatory agency to the extent caused by the actions or conduct of Employee outside the course and scope of Employee's employment." In Mortgagee Letter 95-36, "Mortgagee Approval – Single Family Loan

Production," HUD specifies 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. Furthermore, in Mortgagee Letter 00-15, "Prohibited Branch Activities," HUD provides examples of provisions identified during reviews of employment agreements, which violated departmental branch requirements, and one of these provisions includes an indemnification clause.

The lease/sublease agreements also contained indemnification language and assignment of responsibility language, which is strictly prohibited by HUD. The previous versions of the lease agreements also contained an "assignment of lease" and a "consent of landlord" agreement, which is how some of the responsibility was assigned to NovaStar. The assignment of lease contained a clause that indemnifies NovaStar from any loss, cost, or expense relating to the failure to fulfill obligations under the lease. Mortgagee Letter 00-15, "Prohibited Branch Activities," prohibits the use of indemnification agreements. The consent of landlord contained a clause that leaves the branch manager primarily obligated as the tenant under the lease. Paragraph 2-17 of HUD Handbook 4060.1, REV-1, states that a mortgagee is required to pay all of its operating expenses. The operating expenses that must be paid by the mortgagee include but are not limited to equipment, furniture, office rent, overhead, and other similar expenses incurred in operating a mortgage lending business.

We believe that the deficiencies in the branch agreements occurred because NovaStar's management did not take appropriate actions to ensure that HUD requirements were followed for the origination of insured loans. NovaStar's management developed the limited liability company agreements, as well as the lease agreements, to increase NovaStar's capital structure and help offset losses from the branch offices that were not successful. The employment agreement that contained the HUD-prohibited language was developed by NovaStar management to be used in conjunction with the limited liability company agreement. All of these agreements were developed to alleviate some of the risk from NovaStar for its branch offices.

When improper net branching practices are followed, HUD lacks assurance that a mortgagee has the proper accountability and control over the origination of insured loans. HUD also lacks assurance that the mortgagee has the capability to successfully originate insured loans and, therefore, assumes an increased risk.

NovaStar has initiated actions to correct the deficiencies by eliminating all limited liability company agreements, as well as removing the prohibited language from the employment and lease/sublease agreements. Once the deficiencies are corrected, NovaStar will be more responsible for its branch office operations and more compliant with HUD regulations.

AUDITEE COMMENTS

NovaStar believes its agreements were designed to comply with HUD requirements, but has taken efforts to remove all potentially prohibited provisions from the agreements. Excerpts of NovaStar's comments follow. Appendix B contains the complete text of comments.

". . . In establishing the Limited Liability Company Agreements and related arrangements, NHMI obtained the advice of competent legal counsel for purposes of complying with

HUD/FHA requirements. NHMI believes that the agreements and arrangements complied with HUD/FHA requirements. Nevertheless, on its own initiative, based on changes to company policies and procedures, NHMI eliminated the Limited Liability arrangements. . ..”

“. . . The Employment Agreements and related arrangements were established by NHMI based on the advice of competent counsel for purposes of complying with HUD/FHA requirements, and NHMI believes that the agreements and arrangements complied with HUD/FHA requirements.” “On its own initiative, based on changes in company policies and procedures, and prior to the HUD IG review, NHMI had started the process of revising the Employment Agreements to remove the language cited as being inappropriate by the HUD IG. . ..”

“In establishing the Lease/Sublease Agreements and related arrangements, NHMI obtained the advice of competent legal counsel for the purposes of complying with HUD/FHA requirements. NHMI believes that the agreements and arrangements complied with HUD/FHA requirements. Nevertheless, on its own initiative, based on changes to company policies and procedures, and prior to the HUD IG review, NHMI started the process of revising the Lease/Sublease Agreements and related arrangements. . ..”

OIG EVALUATION OF AUDITEE COMMENTS

We commend NovaStar for taking steps to remove the prohibited language from the branch office agreements. If fully implemented, this should correct the deficiencies noted in these agreements.

RECOMMENDATIONS

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

1A. Verify that NovaStar follows through and corrects all the deficiencies identified in its branch office agreements. At a minimum this should include:

- Removal of all limited liability company agreements.
- Removal of prohibited language from employment agreements.
- Removal of prohibited language from lease/sublease agreements.

FINDING 2

NovaStar Allowed Independent Contract Loan Officers To Originate Federal Housing Administration Loans

NovaStar improperly allowed independent contract loan officers, or Internal Revenue Service Form 1099 contractors, to serve as loan officers on 122 loans during fiscal year 2003. NovaStar's management did not take appropriate action to ensure that staff followed HUD requirements when originating loans. As a result, HUD lacks assurance that NovaStar has the capability to successfully originate insured loans, and therefore, HUD assumes a greater risk.

Mortgagee Letter 95-36, "Mortgagee Approval - Single Family Loan Production," states that customary loan officer functions may not be contracted out, as mortgagees are held responsible for the quality of loans and compliance with HUD requirements. More specifically, loan origination functions may not be contracted out to third party originators, real estate brokers, and other similar entities. HUD Mortgagee Letter 00-15, "Prohibited Branch Activities," further defines HUD's position that the use of non-employees for the origination of insured loans increases the risk to the insurance fund.

NovaStar provided information showing that independent contract loan officers originated 122 Federal Housing Administration loans during 2003 (see appendix A). Initially during the audit, we used NovaStar's data to identify 33 loans that were originated by independent contract loan officers. When we notified NovaStar officials of these findings, they responded that their desire was to provide a different and more comprehensive list of loans originated by independent contract loan officers. The new list of independent contract loan officers contained 122 violations.

We conducted limited testing of the data provided by NovaStar, but due to time constraints and the expectation of minimal added benefit, we did not perform additional work to determine the reliability of the data. We verified the 122 exceptions with NovaStar. However, since we did not verify the reliability of the data we used, we cannot conclude whether there are more exceptions than the 122 identified in appendix A.

NovaStar management is aware that independent contract loan officers are prohibited from originating Federal Housing Administration-insured loans. We believe that the use of independent contract loan officers in the origination of insured loans occurred because NovaStar's management did not take appropriate action to ensure that staff followed HUD requirements during the origination of insured loans.

When improper net branching practices are followed, HUD lacks assurance that a mortgagee has the capability to successfully originate insured loans, and therefore, HUD assumes an increased risk.

NovaStar has initiated actions to correct the deficiencies identified by eliminating all independent contract loan officers. A memorandum from NovaStar management dated April 1, 2004, details that effective June 1, 2004, NovaStar will no longer pay anyone who remains as an Internal Revenue Service Form 1099 contractor. Once the deficiencies are corrected, NovaStar will be more responsible for its branch office operations and more compliant with HUD regulations.

AUDITEE COMMENTS

NovaStar disagrees with our conclusion that it inappropriately used contract loan officers to perform loan origination functions, but has made efforts to eliminate all contract loan officer arrangements. Excerpts of NovaStar's comments follow. Appendix B contains the complete text of comments.

". . . HUD/FHA requirements do not mandate that loan officers be compensated on a W-2 basis, nor do they prohibit the compensation of loan officers on a 1099 basis. No HUD Handbook or Mortgagee Letter provides that compensation of loan officers on a 1099 basis is prohibited. In fact, during the 4th Annual FHA Mortgage Conference. . .the Director of FHA's Office of Lender Activities and Program Compliance stated that paying FHA loan officers using IRS Form 1099 is permitted under FHA program rules."

"HUD Handbook 4060.1 provides simply that "Mortgagees are required to exercise control and responsible management supervision over their employees. The requirement regarding control and supervision must include, at a minimum, regular and ongoing reviews of employee performance and of work performed. . .." "In Mortgagee Letter 95-36, HUD announced that mortgagees could contract out certain functions, but advised that underwriting and customary loan officer functions may not be contracted out. Thus, the focus of the HUD/FHA requirements is that the mortgagee conduct functions with its staff that is supervised. IRS tax rules do not address control and supervision of loan officers for FHA purposes - the rules address only tax issues. If HUD desired to adopt IRS tax rules for purposes of defining staff requirements for mortgagees it could have done so. HUD has not done so. Thus, the issue for FHA purposes is whether a mortgagee exercises appropriate control and supervision over staff, and IRS rules have no bearing on this issue. . .."

"We understand that HUD is in the process of considering changes to its requirements to provide greater guidance in this area. Specifically, the Office of Inspector General. . .issued an Audit Report . . .on April 23, 2004 (the "Audit Report") regarding the review of eight FHA mortgagees that, according to the Audit Report, used independent contract loan officers to originate FHA loans." ". . .the Office of Inspector General recommends that HUD (a) "issue appropriate guidance and specific instructions to HUD's Homeownership Centers and to FHA approved mortgagees requiring the use of mortgagee employed loan officers versus independent contractors or non-employees to originate FHA-insured loans" and (b) "require mortgagees to report their originating loan officer's income on IRS form W-2, which would include the withholding of federal income tax, Social Security tax and Medicare tax. . .." "Thus, the Audit Report acknowledges the absence of a requirement that loan officers be compensated on a W-2 basis, or that HUD rules equate compensation of a loan officer on a 1099 basis as being inconsistent with employee status. Further, the Audit Report emphasizes the need for HUD to provide further guidance to mortgagees in this area. In fact, the Audit Report notes that the Office of Housing – Single Family has drafted a proposed rule to define a lender employee. . .."

". . .Under existing requirements, NHMI exercised appropriate control and supervision over loan officers. Loan officers involved in the origination of FHA-insured loans were required to follow the same policies and procedures regarding the origination of FHA-insured loans and were under the same quality control requirements of NovaStar regardless of whether they were independent contract loan officers or W-2 employees of NovaStar."

"Finally, on its own initiative, based on changes in company policies and procedures, and prior to the HUD IG review, NHMI eliminated the loan officer arrangements cited as being inappropriate by the HUD IG. . .."

OIG EVALUATION OF AUDITEE COMMENTS

We commend NovaStar for taking steps to eliminate all independent contract loan officers. This should prevent any future occurrences.

NovaStar commented that Federal Housing Administration staff provided verbal instructions during a mortgage conference, indicating that mortgagees are allowed to pay loan officers using Internal Revenue Service Form 1099. While we cannot ascertain what instructions may have been given at a mortgage conference, mortgagees must follow HUD's written requirements (i.e. handbooks and mortgagee letters); and HUD's written requirements specifically prohibit mortgagees from using independent contract loan officers (non-employees) for loan origination functions. Because Internal Revenue Service Form 1099 is used to report miscellaneous income for payments for services performed for a trade or business by people not treated as employees (e.g., independent contractors), NovaStar's use of Form 1099 to compensate the 122 loan officers demonstrates that these loan officers were not NovaStar employees.

NovaStar also referred to an Office of Inspector General report issued April 23, 2004, that addresses the use of independent contract loan officers. NovaStar believes this report acknowledges that HUD does not require mortgagees to compensate loan officers on a W-2 basis. However, the April 23rd report does draw the conclusion that other mortgagees improperly used independent contract loan officers, or non-employees, to perform loan origination functions. The report also concludes that this was caused, in part, by mortgagee misinterpretation of HUD's requirements. HUD regulations do not currently specify whether compensation to loan officers is to be reported on Internal Revenue Service Form 1099 or Form W-2. However, Form 1099 is used to report miscellaneous income for payments or services performed by independent contractors. Form W-2 is used to report wages and other compensation paid to employees. Therefore, because NovaStar compensated these 122 loan officers on a Form 1099 basis, we concluded they were not employees.

NovaStar also emphasized that it exercised appropriate control and supervision over its contract loan officers by placing them under the same quality control requirements as it own employees. However, this is not the issue expressed in our report. NovaStar violated HUD requirements by allowing contract loan officers, instead of mortgagee employees or commercial providers, to perform customary loan officer functions.

Mortgagee Letter 95-36 states that customary loan officer functions may not be contracted out, as mortgagees are held responsible for the quality of loans and compliance with HUD requirements. More specifically, loan origination functions may not be contracted out to third party originators, real estate brokers, and other similar entities. In addition, Mortgagee Letter 00-15 further explains HUD's position that the use of non-employees for the origination of insured loans increases the risk to the insurance fund. Therefore, we maintain that NovaStar improperly allowed its independent contract loan officers to perform functions prohibited by HUD and in doing so, increased the risk to the insurance fund.

RECOMMENDATIONS

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

2A. Take appropriate administrative action(s) against NovaStar, such as requiring it to pay civil money penalties for the 122 loans improperly originated by independent contract loan officers.

MANAGEMENT CONTROLS

Management controls include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

We determined that the following management controls were relevant to our survey objective:

- Controls over the origination of Federal Housing Administration loans.

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

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

- Branch agreements do not comply with Federal requirements (see finding 1).

FOLLOWUP ON PRIOR AUDITS

This is the first Office of Inspector General audit of NovaStar.

Appendix A

SCHEDULE OF CONTRACTOR ORIGINATED MORTGAGES

Mortgagor Last Name	Loan Amount	Property State	Property Zip Code	Mortgagor Last Name	Loan Amount	Property State	Property Zip Code
[redacted]	$136,984.00	IN	47711	[redacted]	$103,331.00	UT	84302
[redacted]	$260,245.00	NJ	07003	[redacted]	$75,741.00	KY	40208
[redacted]	$176,506.00	CA	95350	[redacted]	$116,909.00	KY	40330
[redacted]	$87,975.00	KY	40216	[redacted]	$93,021.00	KY	41017
[redacted]	$77,140.00	IN	47557	[redacted]	$91,839.00	NY	12144
[redacted]	$72,623.00	NY	13045	[redacted]	$138,837.00	NV	89122
[redacted]	$183,126.00	MD	20715	[redacted]	$115,090.00	KY	41018
[redacted]	$84,330.00	NY	12144	[redacted]	$95,030.00	KY	40502
[redacted]	$45,675.00	OK	74447	[redacted]	$48,500.00	OK	74110
[redacted]	$170,000.00	NJ	07731	[redacted]	$284,960.00	NY	11378
[redacted]	$142,759.00	MN	55412	[redacted]	$99,216.00	NY	14080
[redacted]	$80,860.00	KY	40515	[redacted]	$183,500.00	CO	80026
[redacted]	$166,109.00	CA	95204	[redacted]	$67,434.00	KY	41723
[redacted]	$193,612.00	CO	80205	[redacted]	$119,059.00	KY	40505
[redacted]	$68,359.00	KY	42633	[redacted]	$142,055.00	KY	40299
[redacted]	$54,150.00	OK	74437	[redacted]	$96,747.00	KY	40505
[redacted]	$94,902.00	OK	74073	[redacted]	$114,622.00	VA	22553
[redacted]	$86,899.00	WA	99202	[redacted]	$108,145.00	KY	40422
[redacted]	$86,997.00	FL	32808	[redacted]	$95,742.00	KY	40391
[redacted]	$102,483.00	CO	80247	[redacted]	$110,269.00	NV	89110
[redacted]	$142,675.00	OR	97080	[redacted]	$114,500.00	AR	72120
[redacted]	$89,320.00	OK	74445	[redacted]	$80,859.00	KY	40475
[redacted]	$83,750.00	IN	47331	[redacted]	$88,305.00	KY	40069
[redacted]	$96,485.00	NV	89101	[redacted]	$132,686.00	CO	80012
[redacted]	$180,897.00	KY	40291	[redacted]	$132,000.00	CO	81001
[redacted]	$82,348.00	KY	40403	[redacted]	$76,670.00	KY	40214
[redacted]	$121,000.00	FL	32818	[redacted]	$76,670.00	KY	40272
[redacted]	$284,951.00	NY	11720	[redacted]	$94,530.00	KY	40258
[redacted]	$95,503.00	KY	40272	[redacted]	$143,350.00	CT	06238
[redacted]	$76,500.00	FL	32792	[redacted]	$124,747.00	AR	72022
[redacted]	$104,979.00	KY	41018	[redacted]	$130,985.00	NY	12189
[redacted]	$212,000.00	MA	01841	[redacted]	$240,000.00	NY	11413
[redacted]	$96,831.00	NY	12601	[redacted]	$198,940.00	NY	11691
[redacted]	$157,435.00	UT	84116	[redacted]	$65,163.00	NY	12047
[redacted]	$135,892.00	NY	11951	[redacted]	$89,500.00	OK	74129
[redacted]	$50,300.00	NV	89103	[redacted]	$139,806.00	KY	40241
[redacted]	$118,475.00	IL	60440	[redacted]	$131,929.00	FL	34235
[redacted]	$156,576.00	OR	97206	[redacted]	$68,000.00	NY	12020
[redacted]	$172,321.00	NY	11738	[redacted]	$120,920.00	CO	80247
[redacted]	$95,655.00	OR	97408	[redacted]	$117,246.00	NV	89701
[redacted]	$148,326.00	KY	40514	[redacted]	$136,360.00	OK	73162
[redacted]	$128,735.00	UT	84106	[redacted]	$194,000.00	CO	80233
[redacted]	$166,840.00	CA	95207	[redacted]	$58,652.00	NY	12885
[redacted]	$89,666.00	KY	40356	[redacted]	$71,113.10	OK	73109
[redacted]	$104,288.00	KY	41018	[redacted]	$238,564.00	NY	11722
[redacted]	$144,809.00	KY	41048	[redacted]	$136,285.00	CO	80128

Mortgagor Last Name	Loan Amount	Property State	Property Zip Code
[redacted]	$157,219.00	NY	12528
[redacted]	$64,621.00	KY	41071
[redacted]	$189,442.00	CA	95621
[redacted]	$63,002.00	KY	40511
[redacted]	$141,875.00	KY	40517
[redacted]	$88,015.00	FL	32808
[redacted]	$62,000.00	OK	74033
[redacted]	$68,400.00	NY	12944
[redacted]	$91,278.00	KY	40508
[redacted]	$148,896.00	CA	95206
[redacted]	$154,696.00	CO	80017
[redacted]	$37,473.00	KY	40004
[redacted]	$83,686.00	OK	74011
[redacted]	$123,069.00	NV	89108
[redacted]	$54,000.00	NV	89130

Mortgagor Last Name	Loan Amount	Property State	Property Zip Code
[redacted]	$76,630.00	NY	12804
[redacted]	$139,055.00	MT	59714
[redacted]	$77,779.00	NY	12047
[redacted]	$137,837.00	MT	59714
[redacted]	$87,975.00	NY	10950
[redacted]	$102,087.00	UT	84015
[redacted]	$89,370.00	NY	12208
[redacted]	$133,375.00	NC	28625
[redacted]	$123,931.00	MT	59714
[redacted]	$304,195.00	NY	11735
[redacted]	$350,610.00	NY	11435
[redacted]	$71,357.00	OK	73119
[redacted]	$131,950.00	MT	59714
[redacted]	$102,007.00	OK	74873
[redacted]	$105,000.00	NY	12065

AUDITEE COMMENTS

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JUL 2 8 2004

July 27, 2004

Ronald J. Hosking
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General
Region 7 Office of Audit
Gateway Tower II – 5th Floor
400 State Avenue
Kansas City, KS 66101-2406

Re: NovaStar Home Mortgage, Inc. Audit Discussion Draft

Dear Mr. Hosking:

Thank you for the opportunity to respond to the Discussion Draft in connection with the Audit of NovaStar Home Mortgage, Inc. (NHMI) conducted by your office. Based on the discussions with your office, NHMI is surprised by the Discussion Draft. In particular, while NHMI was advised that the results were a "clean audit," the Discussion Draft cites violations of HUD/FHA requirements, and recommends that the Mortgagee Review Board take appropriate action(s) against NHMI, such as requiring that NHMI pay civil money penalties for "122 FHA loans improperly originated by independent contract loan officers." Specifically, the Discussion Draft asserts as follows in the Summary portion of the Discussion Draft:

> NovaStar Home Mortgage did not comply with applicable HUD requirements in its use of net branches. We found that the Limited Liability Company agreements, employment agreements, and lease/sublease agreements used in its branch offices contained language prohibited by HUD. We also determined that NovaStar improperly used independent loan officers in the origination of FHA mortgage loans. As a result, HUD lacks assurance that NovaStar Home Mortgage has the capability to successfully originate FHA-insured loans and therefore assumes an increased risk.
>
> NovaStar Home Mortgage has initiated actions to correct these deficiencies by eliminating all Limited Liability Company agreements as well as removing the prohibited language from the employment and lease/sublease agreements. Also, as of June 1, 2004 NovaStar Home Mortgage is no longer allowing the employment of independent loan officers.

Summary Comments

First, NHMI believes that the HUD IG does not have sufficient reason to lack "assurance that NHMI has the capability to successfully originate FHA-insured loans and therefore assumes an increased risk." The Discussion Draft itself provides that during the period from January 1, 2002 through December 31, 2003 NovaStar's first year default rate on FHA loans was 2.36%, while the first year default rate for all FHA loans during the period was 2.71%. I believe this demonstrates that NHMI has the capability to successfully originate FHA-insured loans.

Second, NHMI disagrees with the assertion in the Discussion Draft that NHMI's "management did not take appropriate actions to ensure that HUD/FHA requirements were adhered to for the origination of FHA-insured loans." NHMI is most concerned about compliance with HUD/FHA requirements, sought the advice of competent legal counsel in establishing the policies and procedures cited in the Discussion Draft, and does not believe that the policies and procedures violated HUD/FHA requirements. Further, as acknowledged by the HUD IG in the Discussion Draft, all of the alleged bases for the failure to comply with HUD/FHA requirements were addressed by NHMI at its own initiative in connection with updates and revisions to company policies and procedures prior to the HUD review.

Third, NHMI believes that the referral of NHMI to the Mortgagee Review Board for sanctions is not warranted. This matter should be handled by the Kansas City Homeownership Center; to the extent issues raised by the Discussion Draft remain unresolved.

Comments

Loan Officers. In the Discussion Draft, it appears that the HUD IG concludes that the payment of loan officers on a 1099 basis equates to a violation of FHA requirements. Respectfully, that is not the law. HUD/FHA requirements do not mandate that loan officers be compensated on a W-2 basis, nor do they prohibit the compensation of loan officers on a 1099 basis. No HUD Handbook or Mortgagee Letter provides that the compensation of loan officers on a 1099 basis is prohibited. In fact, during the 4th Annual FHA Mortgage Conference, which was held on October 8 & 9, 2002 in Washington, DC, Phil Murray, the Director of FHA's Office of Lender Activities and Program Compliance, stated that paying FHA loan officers using IRS Form 1099 is permitted under FHA program rules.

HUD Handbook 4060.1 provides simply that "Mortgagees are required to exercise control and responsible management supervision over their employees. The requirement regarding control and supervision must include, at a minimum, regular and ongoing reviews of employee performance and of work performed." ¶ 2-13. In Mortgagee Letter 95-36, HUD announced that mortgagees could contract out certain functions, but advised that underwriting and customary loan officer functions may not be contracted out. Thus, the focus of the HUD/FHA requirements is that the mortgagee conduct functions with its staff that is supervised. IRS tax rules do not address control and supervision of loan officers for FHA purposes—the rules address only tax issues. If HUD desired to adopt IRS tax rules for purposes of defining staff requirements for mortgagees it could have done so. HUD has not done so. Thus, the issue for FHA purposes is whether a mortgagee exercises appropriate control and supervision over staff, and IRS rules have no bearing on this issue.

We understand that HUD is in the process of considering changes to its requirements to provide greater guidance in this area. Specifically, the Office of Inspector General in Denver, Colorado issued an Audit Report to John C. Weicher, Assistant Secretary for Housing – Federal Housing Commission on April 23, 2004 (the "Audit Report") regarding the review of eight FHA mortgagees that, according to the Audit Report, used independent contract loan officers to originate FHA loans. In the Audit Report, the Office of Inspector General recommends that HUD (a) "issue appropriate guidance and specific instructions to HUD's Homeownership Centers and to FHA approved mortgagees requiring the use of mortgagee employed loan officers versus independent; contractors or non-employees to originate FHA-insured loans" and (b) "require mortgagees to report their originating loan officer's income on IRS form W-2, which would include the withholding of federal income tax, Social Security tax and Medicare tax." Audit Report, p. 19. Thus, the Audit Report acknowledges the absence of a requirement that loan officers be compensated on a W-2 basis, or that HUD rules equate compensation of a loan officer on a 1099 basis as being inconsistent with employee status. Further, the Audit Report emphasizes the need for HUD to provide further guidance to mortgagees in this area. In fact, the Audit Report notes that the Office of Housing – Single Family has drafted a proposed rule to define a lender employee. Audit Report, p. 20.

It appears from the Discussion Draft that the intent is to impose on NHMI requirements that are desired by the HUD IG, but not in existence, at this time, at HUD. Under existing requirements, NHMI exercised appropriate control and supervision over loan officers. Loan officers involved in the origination of FHA- insured loans were required to follow the same policies and procedures regarding the origination of FHA- insured loans and were under the same quality control requirements of NovaStar regardless of whether they were independent contract loan officers or W-2 employees of NovaStar.

Accordingly, I believe the recommendation in the Discussion Draft the that the Mortgagee Review Board take appropriate action(s) against NHMI, such as requiring that NHMI pay civil money penalties for "122 FHA loans improperly originated by independent contract loan officers" is not appropriate or supported.

Finally, on its own initiative, based on changes in company policies and procedures, and prior to the HUD IG review, NHMI eliminated the loan officer arrangements cited as being inappropriate by the HUD IG, as acknowledged by the HUD IG in the Discussion Draft.

Limited Liability Company Arrangement. The Discussion Draft provides that the HUD IG found deficiencies with Limited Liability Company Agreements used by NHMI. In establishing the Limited Liability Company Agreements and related arrangements NHMI obtained the advice of competent legal counsel for purposes of complying with HUD/FHA requirements. NHMI believes that the agreements and arrangements complied with HUD/FHA requirements. Nevertheless, on its own initiative, based on changes to company policies and procedures, NHMI eliminated the Limited Liability Company arrangements. This is acknowledged by the HUD IG in the Discussion Draft. For clarification purposes, NHMI notes the following.

The Discussion Draft provides that the "Limited Liability Company agreement stated that once a branch office was established, 'the branch manager may be required to contribute cash capital from time to time on a monthly basis in an amount equal to the most recent month's fixed expenses to maintain sufficient working capital and reserves for the Company's business'." The term "Company" in the quoted provision refers to the Limited Liability Company, and not NHMI. Thus, the branch manager was not required to contribute to the capital of NHMI.

The Discussion Draft also cites the following provision of Limited Liability Company Agreement: "the members and their affiliates may engage or invest in any activity, including without limitation those that might be in direct or indirect competition with the Company." The Discussion Draft then states that "Paragraph 2-14, Conducting Mortgagee Business, of HUD Handbook 4060.1 REV-1 states that all employees of the mortgagee, except receptionists, whether full or part time, must be employed exclusively by the mortgagee at all times, and conduct only the business affairs of the mortgagee during normal business hours." Again, in the quoted provision, the term "Company" refers to the Limited Liability Company, and not NHMI. The provision was intended to permit NHMI to enter into Limited Liability Company arrangements with more than one party and to otherwise conduct its business.

Pursuant to the Limited Liability Company arrangement, on an ongoing basis NHMI did incur expenses associated with its branch office operations.

Employment Agreements. The Discussion Draft provides that the HUD IG found deficiencies with Employment Agreements used by NHMI. The Employment Agreements and related arrangements were established by NHMI based on the advice of competent counsel for purposes of complying with HUD/FHA requirements, and NHMI believes that the agreements and arrangements complied with HUD/FHA requirements.

On its own initiative, based on changes in company policies and procedures, and prior to the HUD IG review, NHMI had started the process of revising the Employment Agreements to remove the language cited as being inappropriate by the HUD IG, as acknowledged by the HUD IG in the Discussion Draft.

Lease/Sublease Agreements. The Discussion Draft states as follows:

> The "Assignment of Lease contained an indemnification clause that indemnifies NovaStar from any loss, cost, or expense relating to the failure to fulfill obligations under the lease. Mortgagee Letter 00-15, Prohibited Branch Activities, prohibits the use of indemnification agreements. The Consent of Landlord contained a clause that leaves the branch manager primarily obligated as the tenant under the lease. Paragraph 2-17, Operating Expenses, of HUD Handbook 4060.1 REV-1 states that a mortgagee is required to pay all of its operating expenses. The operating expenses that must be paid by the mortgagee include, but

are not limited to, equipment, furniture, office rent, overhead, and other similar expenses incurred in operating a mortgage lending business."

In establishing the Lease/Sublease Agreements and related arrangements NHMI obtained the advice of competent legal counsel for purposes of complying with HUD/FHA requirements. NHMI believes that the agreements and arrangements complied with HUD/FHA requirements. Nevertheless, on its own initiative, based on changes to company policies and procedures, and prior to the HUD IG review, NHMI started the process of revising the Lease/Sublease Agreements and related arrangements. This is acknowledged by the HUD IG in the Discussion Draft. For clarification purposes, NHMI notes the following.

While the ; Assignment of Lease contained a mutual indemnification provision, importantly pursuant to the Assignment NHMI assumed and agreed to perform and fulfill all terms, covenants, conditions and obligations required to be performed and fulfilled by the branch manager, as lessee, under the lease, including the making of all payments due to or payable on behalf of the landlord under the lease as they became due and payable. As NHMI agreed to assume all obligations under the lease, the provision under which the branch manager indemnified NHMI was of no practical consequence. With regard to the Consent of Landlord, the landlord's retention of the right to have the branch manager remain liable simply reflects a technical business reality—landlords often are unwilling to release the original party to a lease even when accepting performance from another party. Again, NHMI assumed all of the branch manager's obligations under the lease.

Based on the foregoing, NHMI believes that referral of this matter to the Mortgagee Review Board for sanctions is not warranted, and that the matter should be handled by the Kansas City Homeownership Center if it is not fully resolved after consideration of these NHMI comments.

Again, NHMI appreciates the opportunity to respond to the Discussion Draft.

Sincerely,

Lance Anderson

Lance Anderson

cc: Carrie Gray
Office of Inspector General

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