AUDIT REPORT

KEYSTONE MORTGAGE AND INVESTMENT COMPANY

PHOENIX, ARIZONA

2004-LA-1001

March 24, 2004

OFFICE OF AUDIT
PACIFIC/HAWAII REGION
LOS ANGELES, CALIFORNIA

Issue Date March 24, 2004
Audit Case Number 2004-LA-1001

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

Margarita Maisonet, Acting Director, Departmental Enforcement Center, CV

Joan S. Hobbs

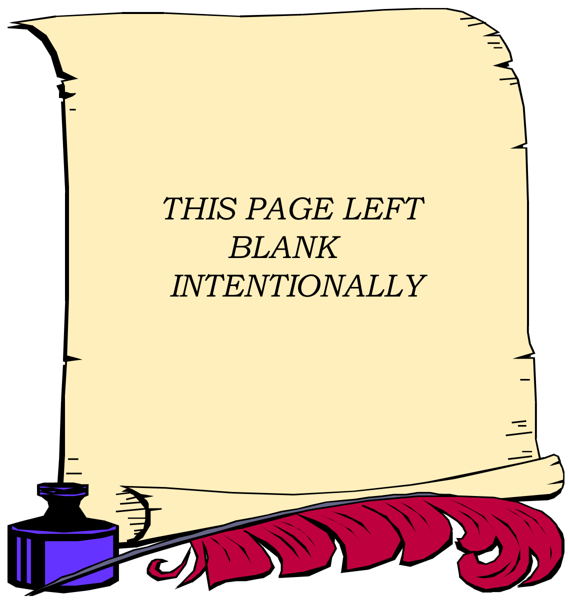
FROM: Joan S. Hobbs, Regional Inspector General for Audit, 9DGA

SUBJECT: Keystone Mortgage and Investment Company
Non-Supervised Loan Correspondent
Phoenix, Arizona

We completed an audit of Keystone Mortgage and Investment Company (Keystone), a non-supervised loan correspondent mortgagee, based in Phoenix, Arizona. We selected Keystone for audit based on the existence of identified risk factors and indications it originated loans at an office that had its origination approval terminated under HUD's Credit Watch authority. The audit objective was to determine if Keystone originated Federal Housing Administration (FHA) insured mortgages in accordance with prudent lending practices and HUD requirements.

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

If you have any questions, please contact Charles Johnson, Assistant Regional Inspector General for Audit at (602) 379-7243.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Executive Summary

We completed an audit of Keystone Mortgage and Investment Company (Keystone), a non-supervised loan correspondent mortgagee located in Phoenix, Arizona. The objective of our audit was to determine if Keystone complied with prudent lending practices, and HUD regulations, requirements, and instructions in the origination of FHA insured mortgage loans.

48 Loan Files Contained Falsified Documents

Keystone used falsified borrower credit and employment documents to originate FHA loans. Forty-eight of the sixty-five loans we reviewed (74%) contained false or altered documents including:

- Fabricated or altered Internal Revenue Service (IRS) W-2 forms, pay stubs, and verification of employment forms.
- Fabricated or altered credit reference letters showing invalid accounts or inaccurate credit history information.
- False credit reports listing invalid borrower credit history information.

We identified a pattern of apparent mortgagee complicity in the loan origination process that allowed false documents to be used and a serious lack of due professional care by mortgagee personnel. Based upon information obtained during the audit, it appears one Keystone employee was primarily responsible for the false and fabricated documents. Further, Keystone's failure to implement a quality control plan allowed the pervasive use of falsified loan origination documents to continue over a period of at least 3 years. As a result, loans were approved based on false information causing FHA to assume over $5 million in unnecessary insurance risk

Keystone improperly originated FHA loans after HUD terminated the origination approval.

Keystone improperly originated FHA loans at its home office in Phoenix after HUD terminated this office's origination approval under the Credit Watch program. In our opinion, this occurred because Keystone intentionally failed to comply with the requirements of HUD's termination. As a result, FHA was exposed to unnecessary risk on loans originated by a terminated mortgagee office.

Auditee Comments.

Keystone's comments are included as Attachment C and summarized at the end of Findings one and two. Keystone agreed that required quality control reviews were not conducted, yet stated they believe Keystone employees did not cause the use of false documents found in its loan files. Keystone stated it did not originate loans at a Credit Watch terminated office.

OIG Evaluation of Auditee Comments

OIG's evaluation of Keystone's comments is included at the end of Findings one and two. We disagreed with several points in Keystone's comments. As stated in the report, we found a pattern of apparent mortgagee complicity in the loan origination process and a serious lack of due professional care by mortgagee personnel. OIG also found Keystone improperly originated FHA loans at a Credit Watch terminated office.

Recommendation

We recommend that your office take appropriate action against Keystone, up to and including debarment and denial of FHA loan approval authority, for not adhering to HUD's program requirements, and require Keystone to indemnify HUD/FHA against past and future losses on the 48 loans identified in Appendix B.

Audit Results Discussed With Auditee

We discussed the findings with Keystone officials during the audit and at an exit conference held on February 5, 2004. We also provided Keystone and HUD with a copy of the draft audit report for comments on February 9, 2004. We received their written responses on March 8, 2004. Their responses and our evaluations are discussed in the findings, and the full text of their responses is included as Appendix C.

Table of Contents

CFR	**Code of Federal Regulations**
FHA	**Federal Housing Administration**
HUD	**The Department of Housing and Urban Development**
OIG	**Office of Inspector General**

Introduction

Section 203 (b) (1) of the National Housing Act, as amended, authorizes HUD to provide mortgage insurance for single-family homes. A mortgagee that originates, purchases, holds or sells FHA insured loans, must be formally approved, by HUD. Mortgagees must follow the statutory and regulatory requirements of the National Housing Act and HUD instructions, guidelines, and regulations when originating insured loans. Mortgagees that do not follow these requirements are subject to administrative sanctions.

Keystone is a loan correspondent mortgagee and therefore may originate loans. However, the loans must be sent to a HUD-approved Direct Endorsement sponsor for underwriting approval prior to loan closing, and submission to HUD for insurance endorsement. The loan origination process includes taking the initial loan application, initiating the appraisal assignment, obtaining the credit report, and procuring verifications of deposit and employment. Based on the information gathered by the loan correspondent, the sponsor mortgagee underwrites the loan and makes a decision as to whether the borrower represents an acceptable credit risk for HUD. Since the sponsor bases its underwriting approval, in large part, on information gathered by the loan correspondent, it is critical that the loan correspondent exercises due care and follows prudent lending practices when originating the loan.

Keystone has a home office located in Phoenix, Arizona, and one branch office located in Mesa, Arizona. In January 2002, HUD terminated the FHA loan origination approval of Keystone's home office based on Keystone's high default rate. In February 2002, shortly after the home office was terminated, Keystone obtained approval from HUD to originate FHA loans at a new branch office in Mesa, Arizona.

Audit Objectives

The objective of our audit was to determine if Keystone complied with prudent lending practices and HUD regulations, requirements, and instructions when originating FHA insured single-family mortgages.

Audit Scope and Methodology

We performed our audit during the period February 2003 through October 2003. We selected Keystone for audit based on several risk factors, including a high number of defaults, indications false borrower social security numbers were used, and information indicating the mortgagee originated loans at an office that had been terminated under HUD's Credit Watch termination authority.

To accomplish our audit objectives, we:

- Selected and performed in depth reviews on 24 FHA insured loans originated by Keystone during the period March 2001 through May 2002.

- Selected and performed limited reviews on 41 additional Keystone FHA insured loan files primarily originated between May 2001 and October 2003. These loans were reviewed because the documents used in these files were similar to a pattern of falsified loan origination documents identified in the initial sample.

- Interviewed Keystone management and employees.

- Interviewed FHA borrowers, purported borrower employers, and creditors to verify information submitted to HUD/FHA as part of the FHA loan files reviewed.

- Verified purported borrower wage information.

- Reviewed Keystone's quality control plan and determined if the plan was properly implemented.

Since Keystone is a loan correspondent and therefore must use a HUD-approved sponsor mortgagee to underwrite its FHA loans, our review did not focus on the adequacy of loan underwriting. Although we did note deficiencies related to the sponsors' underwriting in some cases, these will not be addressed as part of this audit report.

The audit primarily covered loans originated during the period from March 2001 through October 2003. During this period, Keystone originated 268 FHA insured loans for amounts totaling approximately $30 million within the state of Arizona. We conducted our review in accordance with generally accepted government auditing standards.

Keystone Used Falsified Documents When Originating FHA Insured Loans

Forty-eight of the sixty-five loans we reviewed, totaling approximately $5 million, were originated and approved based upon falsified borrower information - falsified credit reports, false credit history letters from utility companies, and/or falsified employment documents such as pay stubs, W-2s, and verification of employment forms. This occurred because Keystone apparently allowed the documents to be included in the files and failed to exercise due care during the loan origination process. The scheme was allowed to continue over a period of at least three years because Keystone management failed to implement a quality control plan to monitor its loan origination activities and assure compliance with HUD requirements. As a result, loans were approved based on false information, causing FHA/HUD to assume unnecessary insurance risks. Four of these forty-eight loans have resulted in insurance claims to HUD/FHA and three others are currently in foreclosure.

Loan Origination Requirements

Mortgagees must follow the statutory and regulatory requirements of the National Housing Act and HUD instructions, guidelines, and regulations when originating insured loans. HUD Handbook 4060.1 REV-1, Mortgagee Approval Handbook, requires that mortgagees conform to generally accepted practices of prudent mortgagees and demonstrate responsibility in order to maintain approval for participation in FHA insurance programs. This would include exercising due care when obtaining borrower credit and income verifications, and being alert to situations involving obvious use of falsified documents.

As part of the loan origination process, mortgagees are required to obtain a credit report for each borrower. The credit report is used as a guide in the underwriting process to evaluate the borrower's attitude toward credit obligations. If the credit report shows the borrower has made payments on previous or current obligations in a timely manner, the underwriter will find the borrower represents a reduced risk. If the borrower has not yet established a credit history with traditional credit accounts such as, credit cards, car loans or mortgages, the mortgagee can develop an "alternative" credit history using utility payment records, rental payments, automobile insurance payments, or other similar non-traditional credit sources. The mortgagee itself may obtain this alternative credit information, or the mortgagee may elect to use a credit-reporting agency to develop and provide a non-traditional mortgage credit report (reference HUD Handbook 4155.1 REV-5, Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties).

The mortgagee must also obtain documentation evidencing the borrowers' history of employment and income. The anticipated amount of income and likelihood of its continuance must be established to determine the borrower's capacity to repay the mortgage debt.

The underwriter's evaluation of a borrower's credit and income history (previously obtained during the loan origination process) is used as a basis for determining if the borrower represents an acceptable credit risk under HUD guidelines, and accordingly, whether or not the loan should be approved.

As a condition of HUD/FHA approval, HUD requires mortgagees, including loan correspondents, to maintain a written Quality Control Plan for the origination of FHA insured mortgages. The plan must provide for independent testing/sampling and evaluation of the significant information gathered for use in the mortgage credit decision. It must be sufficient in scope to enable the mortgagee to evaluate the accuracy, validity and completeness of its loan origination operations. Among other things, the Quality Control Plan must provide for written re-verification of the borrower's employment and ordering a new credit report to identify any discrepancies. Mortgagees may choose to review the lesser of 10% of all loans closed on a monthly basis, or a random sample that provides a 95% confidence level with 2% precision (reference HUD Handbook 4060.1 REV-1, Chapter 6).

Keystone did not adhere to the above HUD requirements. Specifically, Keystone failed to exercise due care when originating FHA insured loans and failed to implement a quality control plan.

We Reviewed 65 Loan Files

In total, we reviewed 65 FHA insured loan files. We initially selected a sample of 24 loans for in-depth review of the loan origination process. This initial review identified the use of false non-traditional credit documents associated with three specific credit sources. Based on this identified pattern, we selected for review 41 additional Keystone loan files where these three specific credit sources were used.

48 Loan Files Contained Falsified Documents

Of the 65 loan files reviewed, 48 (74%) contained false borrower credit and/or employment documents. False credit documents included credit reports and letters purportedly from creditors listing invalid accounts or inaccurate credit history information. False employment documents included fabricated or altered IRS W-2 forms, borrower pay stubs, and verification of employment forms. In many of the loan files involving false employment, the borrower's income or length of employment was overstated. In other cases, the borrower never worked for the purported employer or the borrower worked as a contract laborer rather than as a full time employee as claimed. The falsified documents in Keystone's files were apparently intended to enhance the appearance of the borrower's credit and employment history, and thereby unduly influence the loan underwriting process in order to obtain loan approval. Those loans identified which involved the use of false employment and/or credit documents are detailed in Appendix B.

Keystone Failed to Exercise Due Care and Responsibility

A close review of the 48 loan files involving false origination documents identified a pattern evidencing apparent mortgagee complicity in the falsification, involving primarily one Keystone employee, and a serious lack of due care by mortgagee personnel involved in the loan origination process. Specifically:

All but two of the 48 loan files containing false documents involved the <u>same Keystone employee.</u>

Nearly all of the loan files containing false documents were tied to the same Keystone employee. This employee was the loan officer for 37 of the 48 loans involving the use of false documents and participated in the origination of nine more of these loans, acting as the loan processor or closely supervising the origination process for loan officers in-training.

This employee had extensive prior experience as an underwriter and loan officer, yet claimed to have had no knowledge of the false documents used throughout the loan files. Loan officers in training who worked under this Keystone employee stated they questioned this employee about suspicious documents they found in the loan files, and the employee would either ignore the questions or become angry and confrontational. One of the loan officers in-training working under this employee stated on one occasion she observed the employee using white out to alter a verification of employment form.

The same four credit sources were shown on falsified alternative credit documents in 42 different Keystone loan files.

Forty-two of the forty-eight loan files containing false documents involved falsified credit references (letters and account history statements) from the same four utility companies - COX cable, Qwest telephone, SRP power and/or Southwest Gas. References for these same sources were used even for borrowers that did not reside in areas serviced by these utility companies. Keystone used these false credit documents to obtain alternative credit reports by faxing the falsified letters and account history statements to a credit reporting company who, without verification, would use the falsified accounts to create a credit report. In many instances, the credit reference letters and account statements were purged from Keystone's loan files, leaving only the credit reports with the false account information.

False credit and employment documents found throughout Keystone's loan files were nearly identical.

The 48 loans involving false documents were originated over a three year period and were associated with 1) many different borrowers, sellers and realtors, 2) properties located in different areas, and 3) borrowers living in different areas prior to purchasing their new homes. Yet many of the loan files contained nearly identical false credit and employment documents. In fact, it appears falsified documents in many of the loan files were fabricated using the same template. In these cases, the formatting of the falsified documents was the same, and even random ink markings on the documents were identical. The only common link identified between these loan files was the involvement of one Keystone employee. Examples of these commonalities include:

- The same W-2 form (photocopy) was included in five separate loan files. The borrower name and employer information in each case was altered to make it appear as though it belonged to the borrowers for each loan. However, it was obvious that the documents were created from the same original photocopy. In all five cases, characters consistent with page header information typically printed by a fax machine appeared in the same position respective to the form. These five W-2 forms also contained several random ink markings that were also identically positioned respective to the form, confirming that each of the five falsified W-2 forms was fabricated using one original form as a template.

- Nine additional instances were noted where loan files contained one or more documents which were used as templates to create false employment forms that were used in other loan files. This included pay stubs and additional W-2s. In several loan files we identified false employment documents matching those found in up to seven other Keystone loan files.

- For six loans the same borrower credit history document with COX Cable was used to create false account history statements. Similar use of templates to create false documents was found for other alternative credit letters including letters from SRP power and Qwest Telephone.

- Many of the false documents were altered in a similar manner. For example, in nine cases, income amounts shown on borrower W-2 forms were overstated by even dollar amounts. In six separate loan files the borrower's annual income was overstated by exactly \$10,000 and in other cases the overstatement was exactly \$4,000, \$5,000 or \$6,000. Also, in many cases the borrower's personal information and other altered text on the false documents was printed in a similar manner indicating the documents were altered by the same source using the same method.

Those borrowers and employers we interviewed stated that they provided the correct employment and credit documents to Keystone. This is corroborated by our review of Keystone's loan files. For example, in one instance Keystone's loan file contained an Arizona Public

Service (APS) electric bill provided by a borrower, yet its file also contained a false letter from SRP, a different power company. In this same case, documents in Keystone's loan file, including pay stubs and its own employee's notes, showed the borrower was a contract laborer paid without any tax withholdings. Yet, Keystone included a false W-2 form in the file showing the borrower was an employee with tax withholdings, and not a contract laborer. This false information was submitted to its sponsor for underwriting approval. It is apparent that Keystone had the correct credit and employment information in this case, but chose to use falsified information in order to obtain loan approval.

In summary, Keystone failed to exercise due care when obtaining borrower credit and income verifications and failed to prevent the persistent use of falsified documents. Based on the facts discussed above, it appears one Keystone employee was responsible for including the false documents in the loan files to obtain underwriting approval. Because the underwriting process intended to limit HUD's insurance risk was unduly influenced by inaccurate credit and employment information in 48 of Keystone's loans, HUD was exposed to unnecessary risk.

Failure to Implement a Quality Control Plan

Keystone management failed to implement a quality control plan as required by HUD. As a result, the rampant use of false credit and employment documents discussed above was allowed to continue undetected by management over a period of at least three years. When we first requested documentation on recent quality control reviews, Keystone provided a one page document listing two loans that were supposedly reviewed. Upon further review, we found this list had been created only after OIG requested this, and no prior reviews had actually been conducted. Keystone management stated they will ensure the required quality control reviews are conducted in the future.

Auditee Comments

Keystone agreed that the required quality control reviews were not performed, and stated an Executive Vice President for Keystone was fired because no loan files were subjected to independent review. Keystone also stated a contractor was hired since September of 2003 to perform quality control reviews.

Keystone stated they believe no employees caused or allowed fraud in the loan files. Keystone stated there is a possibility the falsified documents were created by an unknown party that produces false documents "on the street" for a fee, rather than by a Keystone employee. However, based on the strength of the information and documentation presented in our report, Keystone terminated the loan officer associated with the falsified loans.

Keystone stated credit documents cited as false in the audit report might have been valid.

OIG Evaluation of Auditee Comments

We agree with Keystone (as discussed in our audit report), that it did not conduct independent quality control reviews as required by HUD. Further, Keystone's response stated a senior loan officer was assigned to its quality control function. This is prohibited by HUD Handbook 4060.1, which requires that quality control staff have no direct loan processing responsibilities. It should be noted that this loan officer was the same individual that participated in originating 46 FHA loans using false documents.

Keystone noted it might have been difficult to detect the use of false documents. We disagree. In fact, Keystone's primary FHA loan officer claims she had indications false documents were being used and states in a letter "When HUD first came to me to question several items of documentation in the file and advised me that many of them were false I was not surprised or alarmed because many times while originating loans over the past 3 years I had my own suspicions". This letter indicates that only "very questionable" documents were rejected, and also states "…I am aware that I am responsible for the documentation in the file and I agree that me and Keystone had some responsibility to ensure that what was in the loan file was true and exact, I feel this is where I failed". Also, as noted in the audit report, other Keystone employees questioned the legitimacy of the loan documents. It is apparent Keystone, at a minimum, failed to resolve obvious use of falsified documents and thus failed to exercise due professional care when originating FHA insured loans.

Keystone claimed the falsified documents found in its files may have been created by an unknown third party rather than by a Keystone employee. However, the audit report does not conclude as to who physically created the false documents, but rather the report outlines a Keystone employee's apparent complicity in using the false documents within FHA loan files. As stated in the audit report, the only common link identified between the files, often containing identical false documents, was a single Keystone employee. In our opinion, it would have been virtually impossible for the falsified documents to be used without the knowledge of this employee.

Another comment in Keystone's response appeared to imply borrower utility bills we concluded were falsified may have been valid, yet only appeared false because they were not associated with the borrowers' current address. This point is not valid. Through direct verification with creditors (COX, Qwest, SRP and Southwest Gas) we confirmed the purported accounts were not valid or not associated with the borrower.

Recommendations

We recommend the Assistant Secretary for Housing – Federal Housing Commissioner and Chairman, Mortgagee Review Board:

1A. Require Keystone to indemnify HUD/FHA for any losses already incurred, and against future losses, on the 48 loans identified in Appendix B that were originated using false documents.

1B. Seek civil monetary penalties against Keystone for each loan identified in Appendix B that was originated using falsified documents.

1C. Take appropriate action against Keystone up to and including removal from participation in HUD's Single Family Mortgage Insurance Programs.

1D. If HUD determines that Keystone can maintain their approval as a non-supervised loan correspondent, take appropriate monitoring measures to ensure Keystone Mortgage implements a quality control plan that meets HUD requirements.

We recommend the Acting Director, Departmental Enforcement Center:

1E. Debar the Keystone employee apparently responsible for use of the falsified documentation.

Keystone Originated Loans at a Credit Watch Terminated Office

Keystone originated FHA insured loans at its Phoenix home office after HUD terminated this office's origination approval agreement pursuant to HUD's Credit Watch termination authority. In our opinion, Keystone intentionally failed to comply with the requirements of HUD's termination notice. Further, it appears Keystone circumvented HUD's Credit Watch termination by obtaining HUD approval for a new branch office, and using this office to submit loans to HUD for insurance, when in fact, the loans were originated at least in part through the terminated office. As a result, HUD's Credit Watch Termination was effectively bypassed and FHA was exposed to unnecessary risk on loans originated by a terminated mortgagee office that had not taken the remedial steps needed to strengthen its loan origination controls and obtain reinstatement of its loan origination approval.

Mortgagee Requirements

A mortgagee must be approved by HUD in order to originate, purchase, hold or sell HUD-FHA insured mortgages (HUD Handbook 4060.1). In accordance with 24 CFR 202.3 and HUD's Mortgagee Letter 99-15, a mortgagee's FHA origination approval agreement may be terminated if the mortgagee's rate of defaults and claims on HUD/FHA insured mortgages endorsed during the preceding 24 months exceeds 200 percent of the default and claim rate for that geographic area, and also exceeds the national default and claim rate.

Keystone originated loans after HUD terminated approval

On January 24, 2002, HUD terminated the FHA loan origination approval of Keystone's home office in Phoenix, Arizona, under the Credit Watch termination authority. This termination was based on Keystone's default and claim rate of 8.10 percent, which was more than twice the HUD Phoenix Office rate of 2.24 percent, and greater than the national rate of 3.07 percent for the 24 months ending June 30, 2001. Nineteen days after HUD terminated Keystone's Phoenix home office approval, Keystone submitted an application to HUD requesting approval of a new branch office in Mesa, Arizona (adjacent to Phoenix). HUD approved this request for a new branch office on February 28, 2002, and assigned it a separate HUD mortgagee identification number. All FHA insured loans originated by Keystone after the credit watch termination date were submitted to HUD using the mortgagee identification number established for this newly created branch office in Mesa.

In reality, Keystone continued to conduct FHA origination activities at its home office in Phoenix after this office's origination approval was terminated. Based on interviews with the president of Keystone, the Mesa office branch manager and a Keystone loan processor, loan officers continued to take borrower FHA loan applications at the home office in Phoenix after the credit watch termination date. Additionally, Keystone staff stated that discussions with borrowers and loan document processing related to FHA loans were routinely performed at the home office after the Credit Watch termination.

A review of six randomly selected loan files closed in mid to late 2002, and review of eight loan files closed between June and October 2003, identified documents in all 14 files indicating the loans were, at least in part, originated at Keystone's home office. For example, we found documents from title companies, miscellaneous fax memos, credit reports, verifications, and appraisal reports all showing the Keystone home office address and/or telephone number and/or fax number. Further, even the legitimacy of the branch office (used for submission of FHA loans to HUD for insurance endorsement) as a viable operating entity is questionable. When we made an unannounced visit to the branch office in February 2003, one year after this office was approved by HUD and had purportedly begun originating FHA insured loans, Keystone's name did not appear on the sign in front of the building, and even the building directory did not list Keystone as a business operating in the center. Accordingly, it appears that the branch office was a front established primarily to allow Keystone to continue loan origination activities at its terminated branch office in violation of HUD's termination notice.

Auditee Comments

Keystone disagreed with the finding and stated that HUD told Keystone they could open a new branch in Mesa and that the Mesa office was not a front established to bypass HUD's Credit Watch termination.

Keystone stated they were not aware the Mesa branch office did not have a business sign.

Keystone acknowledged that loan officers occasionally met with borrowers and received loan-processing documents at the Phoenix location after this office had its origination approval terminated by HUD. Additionally, Keystone stated documents found in its loan files showing the Phoenix office address were generated automatically on "preloaded" computer forms and that the personnel assigned to the Mesa office did not have offices at Keystone's Phoenix location.

OIG Evaluation of Auditee Comments

As stated in the report and affirmed in Keystone's response, Keystone staff conducted face-to-face meetings with borrowers, took loan applications and received loan processing documents at Keystone's Phoenix location after this office was terminated under HUD's Credit Watch program. These activities represent significant elements of the loan origination process and should not have been performed at a Credit Watch terminated branch office. By effectively circumventing HUD's Credit Watch termination, Keystone exposed HUD to unnecessary risk. This is demonstrated by the fact that the pattern of false FHA loan origination documents we identified continued after Keystone opened its new office in Mesa, Arizona.

Keystone's explanation of computer generated forms "preloaded' with the Phoenix office address raises additional doubts as to the legitimacy of the Mesa branch. It appears Keystone did not even change the address on its forms for at least a full year after it supposedly ceased FHA loan origination activities at this location.

Keystone's claim that personnel assigned to the Mesa branch did not have offices at Keystone's Phoenix location is incorrect. On February 21, 2003, we conducted a face-to-face interview with a Keystone loan officer and a Keystone loan processor supposedly assigned to the Mesa branch while they were seated in their office at the Phoenix location. Further, these Keystone employees specifically identified the desks in the Phoenix office as their own and when asked if they had desks in both the Phoenix office and the Mesa Office they responded "yes".

Recommendation

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

2A. Take appropriate administrative sanctions against Keystone for not complying with HUD's Credit Watch termination of its Phoenix office.

Management Controls

In planning and performing our audit, we considered the management controls of Keystone to determine our audit procedures, not to provide assurance on the 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 its business operations. They include the systems for measuring, reporting and monitoring business performance.

Relevant Management Controls

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

- Validity and Reliability of Data – Policies and procedures management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and used during the loan origination process.

- Compliance with Laws and Regulations – Policies and procedures management has implemented to reasonably ensure its loan origination process is carried out in accordance with applicable laws and regulations.

The following audit procedures were used to assess the relevant controls identified above:

- Reviewed Keystone's policies and procedures for originating FHA loans,
- Interviewed Keystone management and staff, and
- Reviewed 65 FHA loan files primarily originated between March 2001 and October 2003.

Significant Weaknesses

A significant weakness exists if management controls do not give reasonable assurance that resource use is consistent with laws, regulations and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained and maintained, and fairly disclosed in reports.

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

- Keystone management's policies and procedures, as implemented, were inadequate to ensure valid and reliable data was obtained during the loan origination process (see finding 1).

- Keystone's policies and procedures were inadequate to ensure compliance with HUD requirements and prudent lending practices (see findings 1 and 2).

Follow Up On Prior Audits

This is the first HUD Office of Inspector General audit review of Keystone. Keystone's last independent audit report for the year ending December 31, 2002, did not contain any findings.


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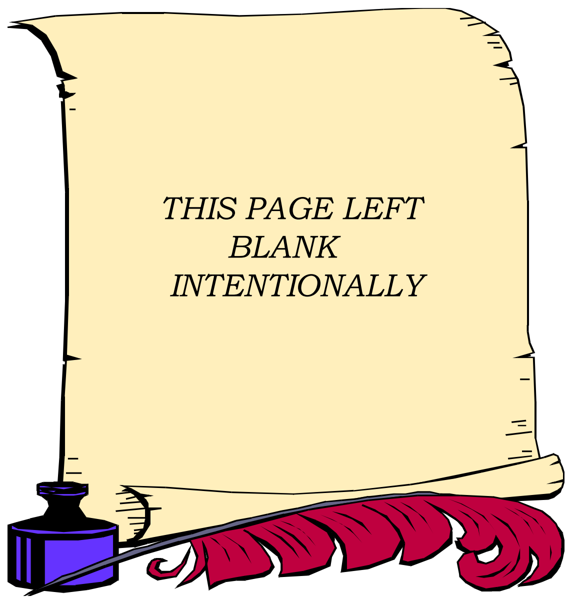
Schedule of Questioned Costs and Funds Put to Better Use

Finding Number	Type of Questioned Cost Ineligible 1/	 Unsupported 2/	Funds Put to Better Use 3/
1	0	0	$4,307,344

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 policies or regulations.

2/ Unsupported costs are costs charged to a HUD-financed of HUD-insured program or activity, and eligibility cannot be determined at the time of the audit. The costs are not supported by adequate documentation, or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

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

			Use of False Documents	
FHA Case Number	Closing Date	Original Mortgage Amount	Employment	Credit
023-0317715	8/23/00	100,320		X
023-0639742 [1]	5/7/01	103,377	X	
023-0710858	6/6/01	100,424		X
023-0712632 [2]	7/6/01	226,796	X	
023-0748637	7/20/01	96,485		X
023-0678638 [2]	7/25/01	105,346	X	X
023-0785681 [1]	8/16/01	85,655	X	X
023-0798111	8/31/01	82,603		X
023-0809788 [1]	9/7/01	88,609	X	X
023-0793297	10/4/01	91,563	X	X
023-0884063	11/5/01	95,895		X
023-0942324	12/5/01	104,043		X
023-0928952	12/11/01	94,208	X	X
023-0923109	12/19/01	109,940		X
023-0787000	1/9/02	95,589	X	
023-0846990	1/17/02	120,115	X	X
023-0924984	1/22/02	118,065		X
023-0925095	1/23/02	128,612	X	X
023-0986059	2/1/02	105,346	X	X
023-0917625	3/19/02	137,390	X	
023-0931758	3/22/02	129,762	X	
023-1135867	4/29/02	114,326		X
023-0927038 [2]	5/22/02	113,739	X	
023-1158658	6/6/02	104,362	X	X
023-1126416	6/7/02	106,915		X
023-1166018	6/13/02	105,346	X	X
023-1162407	6/17/02	86,640	X	X
023-1189366	7/8/02	122,459	X	X
023-1198339	7/12/02	99,113		X
023-1228397	8/26/02	103,377	X	X

Schedule of FHA Loans Originated Using False Documents (Continued)

FHA Case Number	Closing Date	Original Mortgage Amount	Use of False Documents: Employment	Use of False Documents: Credit
023-1212351	8/27/02	104,362	X	X
023-1235612 [1]	8/28/02	102,393		X
023-1234804	9/24/02	107,808	X	X
023-1270801	10/2/02	97,470	X	X
023-1244013	10/10/02	107,539	X	X
023-1422221	12/20/02	102,393	X	X
023-1262597 [2]	12/27/02	103,870	X	X
023-1449511	1/1/03	88,609	X	X
023-1394193	1/3/03	97,470	X	X
023-1449382	2/13/03	87,132	X	X
023-1620555	5/14/03	99,439		X
023-1557814	6/4/03	100,424	X	X
023-1611235	6/11/03	114,527	X	X
023-1730711	7/8/03	112,140		X
023-1731609	7/9/03	93,335	X	X
023-1721472	7/28/03	120,115	X	X
023-1711787	8/7/03	118,342		X
023-1875334	10/3/03	101,408	X	X
Total		5,135,196		

[1] Loans not currently insured by FHA and not refinanced to another FHA loan.

[2] Loans that resulted in insurance claims to HUD with known loss amounts.

Auditee Comments

THE
KEYSTONE
GROUP

KEYSTONE
MORTGAGE &
INVESTMENT
COMPANY

Friday, March 05, 2004

Office of Inspector General
Department of Housing and Urban Development
Pacific/Hawaii Region
Los Angeles CA

RE: Keystone Mortgage and Investment Company, Phoenix AZ 2004-LA-XXXX, February XX, 2004

Dear Sirs and Madams:

Thank you for the opportunity to respond to your preliminary audit findings. We appreciate the professionalism and thoroughness of your team and the time they have invested in preparing this report. Through the cooperative efforts of your staff and our employees we believe that we can improve lending procedures for both HUD and ourselves. As always, we will provide complete cooperation in this ongoing issue and make every effort to ferret out the source(s) of the problem and resolve them to the satisfaction of all parties involved.

On the following pages, we will address each of your specific findings. Under separate cover we will provide any additional details as to the companies and individuals that might have been a part of these actions that may or may not be known to you.

In every instance, our sincere desire is to find and halt any activity that has or could have caused harm. As always, we will maintain contact with you to provide us guidance so that we may all benefit from this investigation.

All questions and comments can be addressed to Chuck Makula at Keystone Mortgage and Investment Co. Inc. (800) 254-9659 x 102.

Sincerely,

Greg Burckle
VP, Manager Commercial Operations, Keystone Mortgage & Investment Co. Inc

809 NORTH
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BK14116

Keystone Response to Audit Report 2004-LA-XXXX

Introduction

This report contained two findings with recommendations requiring action by your office. We will address each finding with our rebuttal and explanations for each.

Finding #1: Keystone used false documents when originating FHA insured loans

The accusation is that Keystone did not exercise due care when originating FHA loans and failed to implement a quality control plan.

Keystone Mortgage is under the supervision of the Arizona State Banking Commission as well as HUD. Keystone Mortgage has passed all Arizona State audits satisfactorily. The most recent was August of 2002. Keystone passed the HUD audit of January 2002 with satisfactory results but it was noted that the company needed a better QC function. At that time, the management of Keystone wrote a QC manual to be followed for all files selected for audit. An executive vice president and partner in the company, was responsible for those procedures. An executive vice president and partner was to audit 100% of the files originated by the company until such time that adequate QC procedures were in place. He was assisted by a senior loan processor, who had extensive experience in underwriting and processing, having had a senior position with one of the largest lenders in the nation.

The company felt secure in having a senior partner in charge of this function to ensure that quality control was properly accomplished. At no time did any of our investors, who did the actual final underwriting of the files, notify us of any issues, problems or complaints on the veracity of information provided. Our investors were also required to QC files. They provide an independent audit and safety net for all brokers supplying files to them. Our internal QC function also found no issues with these files. At that time, we had no reason to suspect that fraud was being perpetrated by anyone within or outside this organization.

The current HUD audit was begun in January 2003. At that time, the executive vice president and partner was responsible for and had assured the company that the files were all in order. He asserted that he and a senior loan processor had reviewed all of them and found no substantial issues. As always, HUD has free access to any file we have in our possession. We cooperated completely with every request.

In March of 2003, the executive vice president and partner was terminated when it was discovered he had not sent files out for an independent QC. A senior loan processor assumed that QC function. As the current audit progressed, certain anomalies were discovered in the files. We responded by contracting with an outside contractor in June of 2003 to QC files on a 10%

sampling basis. By September of 2003, the contractor had not finished the review of any files. We terminated our relationship at that time and contracted with another person to complete audits of our files on a 10% sampling basis. Since then, we have received several reports with miscellaneous findings. No file was found to have had any fraudulent information.

Our rapport with the HUD auditors has been very good. We are as interested in running a clean operation as HUD is in protecting government assets. The livelihoods of 40 people depend on this and we would never knowingly jeopardize that.

The senior loan processor had been an employee of Keystone for many years. She had always done an outstanding job of processing files and dealing with clients honestly and forthrightly. When she suspected problems with borrowers or Realtors, she refused the business rather than attempt to complete the transaction. She had over 15 years in the business with many in a senior position with one of the largest lenders in the country. As a single mom supporting three children and she worked diligently to accomplish the task at hand. Her living depended on her abilities and her reputation in the industry.

As to the fact that the same individual was involved in the majority of the files, this senior loan processor also originated FHA loans and processed 100% of the FHA loans. She was the primary person responsible for the company's interface to FHA lenders. With her background, skills and experience, she provided valuable training and assistance on FHA issues.

As to the statement that loan officers in training witnessed her fraudulent acts, we must take exception. The policy of this company in no uncertain terms, is that we will NOT tolerate fraud. If employees witnessed this and did not report this to management, we must assume complicity in the deed. If they did not aid and abet the fraudulent act, then the comments are duplicitous. If they saw an employee using whiteout on a form, the question must be asked, "What were they covering"? Was it material to the form or was it incidental to the information being gathered? In either case, management should have been notified immediately.

As far as the same four scores occurring on credit reports on files covering a two year or more periods out of 65 files reviewed, that does not seem out of the ordinary. Who would remember six months later that the same score appeared on a previous file? While we are computer assisted here, we are not computers. If the point is to lay every file we see side-by-side forever to check for fraud, then the HUD guidelines should plainly state that.

As for false alternative documentation used for credit references, the fact that a borrower does not currently live in an area served by a company does not mean that he or she never did. The purpose of an alternative credit letter is to prove they paid their obligations on time, not that they resided in that area. FHA borrowers are not the most stable borrowers; typically minority groups and the ones that can afford houses have often paid bills for other family members. The fact that the bill is not for their current residence does not matter as long as it was in their name and was paid on time.

Also, much of the documentation needed for FHA loans is available, as we now know, on the street for a price of between $500 and $1000. We have found three companies that purportedly would provide the documents as well as the training to answer a loan officer's questions. One of these is a mortgage company. As your conversations with us have indicated, you are aware of facilities providing such documentation. If this is true, then what if the provider of the documentation caused the watermarks when they created the document for the borrower? What if a template on the perpetrators equipment created the other altered documentation? We granted you access to all our facilities and computers. We want to assist you in stopping this. To the best of our knowledge, you did not find any of the aforementioned templates. Is that because they don't exist here? What if these "watermarks" originated from an outside source? Since these documents were provided over a two-year period, the odds of catching documents with the same extraneous watermarks are indeed slim. Especially since the population of any one type of identifying watermark was small (seven or less of any one type). Virtually the only way this can be noticed is to hold each paper side-by-side or on top of one another to distinguish this.

We now know from your comments and our limited research that these documents can allegedly be purchased on the street. Are the commonalities the result of the vendors distinguishing traits? Did they arrange to provide false telephone verification of employment? Did they change the W-2's? Have you known about this but not informed mortgage companies to watch for this?

That would lend credence to the complaint that many files contained identical false documentation. While this may be evident when you have 46 files in front of you and can hold each piece of paper up to the light to compare, spread that same caseload over two years and ask if it is reasonable to expect that level of QC to be done. If it is, please state that requirement plainly in the HUD guidelines.

While the results of your audit are now apparent, when all these findings are spread through 46 files over a two year period, when no other underwriter or investor in the chain of review caught this, and the documents and training can be bought on the street, the accusation of Keystone or it's employee committing a fraudulent act seems much less tangible.

If this practice is rampant in the industry, or even in Phoenix Arizona, then the responsibility of HUD seems to be to make that evident to the entire industry immediately and take steps to stop it. As of this moment we have not received such a directive from HUD.

So it appears that the primary employee that would be common to the processing and or originating of FHA loans at Keystone would appear on most of the files in question now would be the one you would expect to be on most of the loans.

However, on the strength of the documentation presented to the management of Keystone, we did terminate the employee the day that the local HUD IG office made that information available. While we hope and pray that she is not guilty, we cannot afford even the appearance of impropriety. We have, we are, and we will cooperate with the HUD office to the utmost of our ability.

On the accusation that Keystone failed to implement a quality control plan, we did create a plan, had it implemented by a senior partner now terminated, arranged to do an internal audit after he left, hired an outside firm, and, when that didn't provide results, hired another firm that is now providing regular QC audits.

Our recommendations are that:

1A. Keystone should indemnify HUD only after a thorough investigation of all outside sources and if it was proven that Keystone Mortgage was responsible.

1B. Keystone should not be fined since it has not been proven that Keystone Mortgage was responsible. Also, 40 employees depend on this company to support their families. The publicity alone will damage the company irreparably.

1C. Civil penalties against Keystone are a matter for the courts to decide, if we are proven guilty.

1D. Keystone has already resigned from HUD as a FHA lender. Unless and until the market for fraudulent documents is investigated and corrected, we would prefer not to be a part of that environment.

1E. Any sanctions against anyone in this business should be held in abeyance until they are proven guilty to allow the accused due process.

Finding #2 Keystone originated loans at a credit watch terminated office

We believe this accusation to be patently false.

Keystone Mortgage branch at 809 N. 5th Ave was terminated. As the HUD auditors then explained to us, that did not mean we could not have another office, just not one in Phoenix. We applied for and were granted an originating office in Mesa AZ. We followed HUD guidance on this.

We rented facilities, installed computers, phones, fax lines, and furniture. A manager, senior processor and originator worked there with assistants and another loan officer. Attached are the bills for that period of time paid by the company for the facility and its operation.

These personnel did come to the office in Phoenix from time to time on a non-regular basis. They did not have offices here.

Since this office is centrally located between the west side of Phoenix and Mesa on the east side (20+ miles away) we did allow borrowers to meet loan officers here. If they were dropping off documents for the Mesa branch, we had them delivered the next day to Mesa. Occasionally, other documents would be sent to 809 N. 5th Avenue in error. Those again were dispatched to Mesa the next day. The manager and senior loan officer lived near the office in Mesa. She also worked from home.

When we closed the office, we removed a truckload of furniture, including three desks, chairs, a fax machine, a computer and a copy machine. These were in good working order and had been serviced as required. All equipment, desks, and electronic devices were in good working order when they were returned.

We believe that incidental contact between Mesa and the Phoenix office does not breach the agreement not to originate from 809 N. 5th Ave in Phoenix. As the OIG auditors have stated, that is a matter of interpretation between HUD offices.

We did require employees from Mesa to attend meetings and other functions from time to time. We did not prevent their customers or them from using the facilities here when required. Any documents addressed to this office were the result of automatically generated computer forms pre-loaded with the 809 N. 5th Ave address.

The office we rented was an executive suite. We were not aware of the purported fact that our name did not appear on a sign. We take exception to the accusation that this was a front. We paid the rent, telephone bills, and other expenses associated with this location.

2A. Our recommendation is this accusation be dropped in its entirety.

Additional Comments:

We have cooperated fully with this ongoing investigation. We believe Keystone is the victim of this fraud, not the perpetrator. We believe that no employees did cause or allow fraud in the files.

Additionally, all employees that you have suspected of fraud for any reason have been terminated. Keystone Mortgage does NOT tolerate fraud, not even the appearance of fraud.

Attached under separate cover are comments from the senior processor in question. We are submitting them in their entirety as we received them.

At least one of the ex-employees interviewed by the OIG may have been intimidated by the interviewers.

Attached are the bills paid for the Mesa office.

As always we are always willing to cooperate in any way possible to resolve this issue, provide more information or assist in any other way.

Chuck Makula
President
Keystone Mortgage and Investment Co. Inc.

Attachments

A. Qwest bills
B. Mesa Executive Suites invoices
C. AT&T bills