Department of Veterans Affairs

Office of Inspector General

Audit of Veterans Benefits Administration's Loan Guaranty Program Risk Management

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VA Office of Inspector General
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To Report Suspected Wrongdoing in VA Programs and Operations

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Contents

Executive Summary

Results in Brief

The Office of Inspector General (OIG) conducted an audit to evaluate the effectiveness of risk management within the Veterans Benefits Administration's (VBA) Loan Guaranty (LGY) Program. The audit objective was to determine if LGY Service adequately identified, analyzed, and reduced risks that could prevent the effective achievement of the LGY Program's mission to assist veterans in purchasing and retaining homes.

During fiscal year (FY) 2008, VBA's LGY Program guaranteed veteran home loans totaling $36 billion. For most of these loans, VBA charges veterans funding fees, which Congress establishes through legislation, to help offset losses incurred from managing and selling foreclosed properties. The funding fees vary based on the veteran's type of military service.

Historically, funding fees have generally increased. In 2001 for first time homebuyers, the fees increased to rates ranging from 1.5 to 2.4 percent of the home value, and in 2006 for repeat homebuyers, the fees increased to a rate of 3.35 percent. In FY 2008, funding fees totaled $567 million. To help prevent future increases in veteran funding fees, VBA needs to minimize the losses associated with foreclosed properties.

Recently, VBA's losses have steadily increased from $10.6 million in the 1st quarter of FY 2007 to $32.5 million for the 3rd quarter of FY 2008. During the first 3 quarters of FY 2008 alone, losses totaled about $67.6 million. Strengthening risk identification and analysis of losses related to foreclosed properties underscores how improving risk management could reduce veteran funding fees and help LGY Service better accomplish its mission of assisting veterans to purchase homes.

VBA lacked reasonable assurance that LGY Service appropriately managed risks because the Service did not perform a comprehensive risk assessment. Risk assessments provide significant controls that can provide the basis for determining what actions agencies need to take to address problems that may limit progress toward meeting program objectives.

LGY Service did not perform comprehensive risk assessments because VBA lacks policies and procedures requiring LGY Service to perform risk assessments. VBA relied upon a complement of external and internal risk analysis reviews. However, we found that certain significant risk factors, especially external risks, were not adequately considered as part of these reviews. Without a comprehensive approach to identifying, analyzing, and managing risks, threats to LGY Service's ability to achieve its program objective has the potential of remaining undetected until significant problems arise.

In addition, LGY Service needed to improve the monitoring of a control implemented to mitigate the risk of losses on the sale of foreclosed properties that VA acquires from lenders. Because LGY Service was not monitoring and adjusting the net value percentage (NVP), which LGY Service based on costs that were 9 years old, the control had become less effective. As a result, VA incurred return on sale losses of about $123.5 million dollars during the 21-month period FY 2007 and FY 2008 through June 2008.

Background

The mission of the LGY Program is to assist eligible service members, veterans, and surviving spouses to purchase and retain homes. To accomplish this mission, LGY Service performs three key functions of guaranteeing mortgage loans, managing foreclosed properties, and servicing loans. VA guarantees lenders against losses due to foreclosure on mortgage loans established through the LGY Program. If lenders foreclose on guaranteed loans, VA pays the guarantees, acquires the properties that have the best selling potential, and then a VA contractor manages and sells the properties. A contractor also services VA loans on foreclosed properties by collecting mortgage payments and managing escrow accounts.

Findings

LGY Service needed a more comprehensive risk management program to improve the effectiveness of its risk management and to strengthen risk assessment controls in the areas of identification, analysis, and management (see Appendix B). LGY Service established some risk assessment controls, however, they did not adequately consider many risk factors. To comprehensively manage and control risks, LGY Service needed to improve these risk management controls. A discussion of our results follow.

1. Risk Identification.

To provide managers with the information necessary to identify risks that could impede the efficient and effective achievement of the LGY Program's overall strategic objective, LGY Service needed to establish adequate goals and objectives. A precondition to risk identification, analysis, and management is the establishment of clear and consistent goals and objectives. LGY Service periodically reviewed goals and objectives for continued relevance, ensured goals and objectives complemented and reinforced each other, and regularly reviewed critical objectives. In addition, LGY Service ensured all levels of management were involved and committed to the achievement of goals.

To obtain reasonable assurance that LGY program goals and objectives were achieved, however, certain risk assessments factors needed to be addressed. For example, LGY Service needed to improve its efforts by ensuring program officials establish and compare goals and objectives with industry standards.

<u>Comparing Goals and Objectives with Industry Standards</u>. LGY Service needed to develop program goals and objectives that it can compare with industry standards because of the financial risks involved. VBA's strategic objective for the LGY Program included meeting or exceeding lending industry standards for quality, timeliness, and foreclosure, but VA's FY 2008 Performance and Accountability Report (PAR) did not

compare the LGY Program's five strategic goal measurements with industry standards. The five strategic goal measurements for the LGY Program are the: (1) Foreclosure Avoidance Through Servicing (FATS) ratio, (2) electronic-FATS (E-FATS) ratio, (3) veteran satisfaction survey, (4) lender satisfaction survey, and (5) statistical quality index, which measures the number of correct LGY actions.

The FATS ratio is a tool to measure VBA's success in assisting veterans who are facing foreclosure. VBA developed this ratio to identify the extent to which foreclosures would have been greater had VBA not pursued alternatives to foreclosures. E-FATS is an electronic comparison measurement of dollars saved through successful loan interventions to dollars spent by VA. Unlike LGY Service, the lending industry does not use the FATS or E-FATS ratios. In addition, these ratios do not provide any information as to whether VBA is meeting or exceeding loan industry standards. The lending industry uses other standards such as the timeliness of loan underwriting and closing to measure performance.

<u>Identifying General, External, and Internal Risks</u>. LGY Service needed to identify all types of risks that may threaten VBA's ability to operate an effective and efficient program. LGY Service managers cannot adequately analyze or manage risks they do not identify. LGY Service needed to implement a more comprehensive program to ensure it identifies and addresses general, external, and internal risk factors.

General Factors. LGY Service addressed general risk factors such as discussing risks at senior level conferences, considering the results of findings from audits and evaluations, and communicating employee-identified risks to senior managers. However, LGY Service did not address the general risk factors of determining risk rankings on a scheduled and periodic basis; communicating to staff how LGY Service will identify, rank, analyze, and mitigate risks; and identifying risks as part of short-term and long-term forecasting and strategic planning.

For example, LGY Service managers needed to improve communications with appropriate staff on how risks needed to be identified and mitigated. Without this communication, staff members in the best position to address program vulnerabilities may not fully understand the importance of identifying and mitigating risks that could jeopardize the efficient accomplishment of LGY's mission.

External Factors. LGY Service also addressed external risk factors such as considering technological advancements and interacting with parties outside the federal government. For example, LGY Service identified an external risk that lenders and veterans may discontinue participation in the program if they are not satisfied. To address this specific risk, LGY Service developed procedures to perform lender and veteran satisfaction surveys and established satisfaction rate goals. However, LGY Service did not adequately address other external risk factors such as business and economic risks; the changing needs of Congress, VA officials, and the public; new legislation or regulations; possible natural catastrophes or criminal actions; and risks associated with major suppliers or contractors. The following example highlights one of the external risks.

Considering Business and Economic Risks. LGY Service did not identify or effectively plan to mitigate the business and economic risks caused by a depressed housing market and reduced property values. By establishing a structured risk management program, LGY Service would be in a better position to mitigate risks. These risks include incurring excessive property maintenance costs from the long-term retention of properties and losses on the sale of properties. In FY 2007, VA sold just over 6,000 properties with a total value of about $621.8 million for $565.9 million. As a result, VA's return on sales was a loss of about $55.9 million. With the recent downturn in the housing market, the risk of additional losses on the return on sales remains high.

Internal Factors. LGY service also did not adequately identify internal risk factors. For example, LGY Service did not adequately address the risks associated with heavy reliance on contractors to perform critical agency operations. The recent dramatic changes in the national housing market has made it imperative that LGY Service effectively monitor the performance of contractors that perform the critical operations of managing and selling VA-owned foreclosed properties.

Improving the identification of general, external, and internal risks will help ensure LGY Service addresses risks that may threaten the efficient accomplishment of LGY's mission. To significantly strengthen the analysis and management of program risks, LGY Service needs to ensure a more comprehensive risk management program is in place to enhance its efforts to address risks that have significant potential to negatively impact program performance.

2. Risk Analysis.

LGY Service staff needed to improve the analyses of program risks. LGY Service had established criteria for rating risks as low, medium, or high; analyzing identified risks relevant to program objectives; and estimating the significance of risks. However, LGY Service needed to improve analyses by developing a formal process to analyze risks, involving management and employees in risk analyses, estimating the likelihood and frequency of risks, and determining how to best manage or mitigate risks.

Involving Management and Employees in Risk Analyses. LGY Service managers and employees in the best position to analyze program risks, were not sufficiently involved in risk analyses. Instead, VA relied on three consulting groups to analyze LGY Program controls. VA's Internal Control Service (ICS) used one firm to analyze the risks associated with controls related to VA's overall financial statements, which included the LGY Program financial results. In addition, LGY Service's Portfolio Loan Oversight Unit (PLOU) used two firms to analyze the risks associated with existing PLOU controls.

However, these firms did not analyze other risks such as those arising from business, political, and economic changes or expectations of Congress, VA officials, and the public. These types of risks could jeopardize the accomplishment of LGY program objectives more than the types of risks analyzed by the firms.

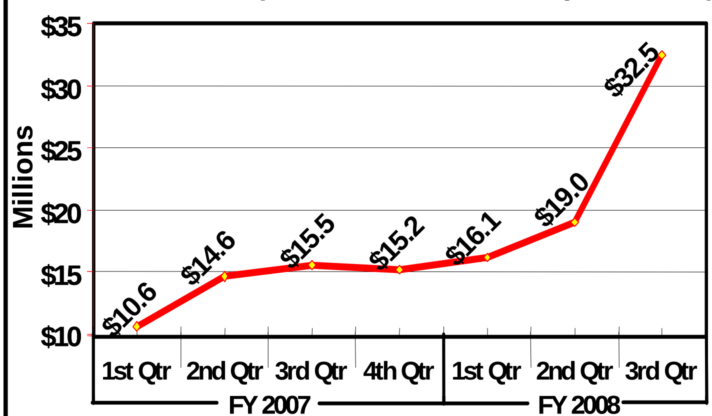
3. Risk Management.

LGY Service needed to improve the management of program risks. For example, LGY Service did not adequately address the risk management responsibilities and activities of establishing mechanisms to anticipate and react to risks presented by changes, using an approach based on how much risk can be prudently accepted, taking responsibility for setting tolerable risk levels, addressing condition changes at the appropriate VA level, and implementing and monitoring controls to manage or mitigate specific risks.

LGY Service needed to improve the monitoring of a control implemented to mitigate the risk of losses on the sale of foreclosed properties that VA acquires from lenders. LGY Service uses net value percentage (NVP), which is calculated based on historical VA costs of managing foreclosed properties, as a control to help ensure VA does not acquire foreclosed properties that may result in return on sale losses. To optimize the effectiveness of the NVP control, LGY Service must update the NVP annually. Annually updating the NVP has become especially important due to the recent dramatic downturn in the national housing market. As of August 2008, LGY Service was using a NVP based on the 1999 costs of managing foreclosed properties. Because LGY Service was not monitoring and adjusting the NVP, which was based on costs that were 9 years old, the control had become less effective.

For the 21-month period FY 2007 and FY 2008 through June 2008, the Property Management Oversight Unit (PMOU) provided LGY Service seven quarterly reports showing that VA's property management contractor's return on sales ranged from 78.4 to 94.9 percent. As shown in Figure 1, VA incurred losses ranging from $10.6 million in the 1st quarter of FY 2007 to $32.5 million for the 3rd quarter of FY 2008. In the first 3 quarters of FY 2008, VBA lost about $67.6 million. VA's total losses during the entire 21-month period were $123.5 million. Because LGY Service did not annually update the NVP, we could not determine the portion of the $123.5 million return on sale losses that VA could have avoided.

Figure 1. VA Return On Sales of Foreclosed Properties Loss Per Quarter (FY 2007 and FY 2008 through June 2008)



Conclusion

LGY Service needed to improve the management of program risk to provide a systematic, organized, and structured analysis of operations by performing sustained comprehensive assessments of the risks that could limit VBA's ability to improve veterans' purchase and retention of homes. Overall, LGY Service needed to improve risk assessment controls relating to risk identification, risk analysis, and risk management. LGY Service did not perform comprehensive risk assessments because VBA had not established policies and procedures requiring LGY Service to perform a comprehensive risk assessment. Instead, LGY Service relied upon a complement of external and internal risk analysis reviews that were not coordinated or sufficiently comprehensive to fully identify and manage all potentially significant risks.

In addition, LGY Service needed to improve the monitoring of a control implemented to mitigate the risk of losses on the sale of foreclosed properties that VA acquires from lenders. Because LGY Service was not monitoring and adjusting the NVP, which LGY Service based on costs that were 9 years old, the control had become ineffective. Without a comprehensive approach to risk management, threats to LGY Service's ability to achieve the program goals and objectives have the potential to go undetected until significant problems arise.

Recommendations

1. We recommended the Under Secretary for Benefits establish policies and procedures requiring LGY Service to implement a comprehensive risk management program that includes adequate mechanisms for identifying, analyzing, and managing risks.

2. We recommended the Under Secretary for Benefits ensure LGY Service establish policies that define the decision authority to make NVP changes based on annual analyses of the potential financial impact and projected changes in financial risk tolerance levels.

Management Comments and OIG Response

The Under Secretary agreed with our findings and recommendations and provided acceptable implementation plans (see Appendix C). We will follow up on the implementation of the Recommendation 1 planned improvement actions. The completed actions for Recommendation 2 are acceptable and we consider this recommendation closed.

(original signed by:)

BELINDA J. FINN
Assistant Inspector General
for Auditing

Introduction

Purpose

The OIG conducted an audit to evaluate the effectiveness of risk management within VBA's Loan Guaranty (LGY) Program. The audit objective was to determine if LGY Service adequately identified, analyzed, and reduced risks that could prevent the effective achievement of the LGY Program's mission to assist veterans in purchasing and retaining homes.

Background

Loan Guaranty Program. The mission of the LGY Program is to assist eligible service members, veterans, and surviving spouses to purchase and retain homes. To accomplish this mission, LGY Service performs three key functions of guaranteeing mortgage loans, managing foreclosed properties, and servicing loans.

<u>Guaranteeing Mortgage Loans</u>. In FY 2008, VBA's LGY Program guaranteed $36 billion in home loans. For veterans who are eligible for mortgage loans through the LGY Program, VA guarantees lenders against losses due to foreclosure. The guaranty provides private mortgage lenders an incentive to offer mortgage loans to veterans without requiring a down payment. VBA issues certificates of eligibility to veterans enabling them to apply to a VA-approved mortgage lender for a guaranteed home loan. To help keep veterans in their homes, LGY Service provides supplemental servicing for VA guaranteed home loans if veterans experience payment difficulties.

<u>Managing Foreclosed Properties</u>. During the period August 2003–August 2008, VA contracted with Ocwen, a property management company, to manage and sell VA-owned foreclosed properties. In July 2008, VA awarded a new contract to Countrywide Home Loans (CHL). VA-owned foreclosed properties are available for sale to the public. After VA accepts conveyance of the properties, the contractor is responsible for managing and selling the properties. The contractor offers the properties for sale for cash or by offering VA financing. As of September 30, 2007, VA had an inventory of 6,975 foreclosed properties and 4,696 properties in the process of foreclosure. During FY 2007, VBA's property management contractor sold 6,073 foreclosed properties. The costs of managing the sold properties totaled $98.7 million, averaging about $16,300 per property.

<u>Servicing Loans</u>. Since November 2000, VA has contracted with CHL to provide servicing on loans made by VA. CHL collects mortgage payments and manages loan escrow accounts, including the payment of property taxes and insurance. During FY 2007, VA paid CHL about $3 million to service over 12,000 loans. The average cost of servicing a loan was about $250.

Reviews of the Loan Guaranty Program. During the 4-year period 2004–2007, Office of Management and Budget (OMB), the Government Accountability Office (GAO), and VA's Internal Control Service (ICS) reviewed the LGY Program.

<u>Office of Management and Budget Evaluation</u>. In 2004, OMB reviewed the LGY Program using its questionnaire-driven methodology called Program Assessment Rating Tool (PART). The PART contains 25 questions pertaining to a program's design and purpose, strategic planning capability, quality of performance measurements, financial oversight, and reporting of accurate and consistent performance data. The LGY Program's PART score of 35 percent was the second lowest score received by VA's 10 major programs, which include medical care, research, compensation, pension, and burial. The LGY Program also received a PART rating of "results not demonstrated." In addition, OMB made three improvement recommendations related to developing and reporting meaningful program performance measurements. As a result of the 2004 review, OMB recommended that LGY Service: (1) develop analyses of how results of new measures are used and impact program performance, (2) develop the capability to begin reporting on the new long-term performance measures that meaningfully reflect the purpose of the program, and (3) develop the capability to report on mortgage delinquencies earlier than the requirement of 105 days delinquent.

<u>Government Accountability Office Audit</u>. More recently, GAO issued *Department of Veterans Affairs Actions Needed to Strengthen VA's Foreclosed Property Management Contractor Oversight* (GAO Report 08-60, November 2007). The report identified a substantial number of property management deficiencies, such as failure to make needed repairs, which may reduce property marketability. GAO also reported that VA's automated Property Management System did not include real-time property maintenance and repair information, including expense data, and VA's contract did not include sufficient authority to impose penalties for unsatisfactory performance. GAO recommended that VA take several steps in designing, negotiating, and awarding a new contract for property management.

<u>Internal Control Service Review</u>. In 2006, VA's Office of Business Oversight established ICS to assess the departmental network of risk management and control processes. ICS reviews focus on gaining assurance for accurate financial reporting on material weaknesses. The ICS reviews do not provide a comprehensive assessment of program risks because they only analyze risks associated with established controls. They do not analyze other risks, such as those arising from business, political, and economic changes or expectations of Congress, VA officials, and the public.

In 2007, ICS, in conjunction with VA's contracted accounting firm, reviewed LGY controls as part of its assessment of major program internal controls for compliance with OMB Circular A-123, Appendix A. In July 2008, ICS issued their draft report for its review of the LGY Program. The report identified no internal control weaknesses but observed that LGY Service needed to improve the timeliness of recording appraisals in VA's automated appraisal system.

Results and Conclusions

Loan Guaranty Service Needs a Comprehensive Risk Management Program

VBA lacked reasonable assurance that LGY Service appropriately managed risks because the Service did not perform a comprehensive assessment of risks that could limit the effective and efficient achievement of its mission. The national housing market has recently experienced a significant downturn. For example, in calendar year (CY) 2007, the national housing market had about a 14.6 percent decline in the number of homes sold and an approximate 79.0 percent increase in home loan foreclosures.[1] In this market environment, during FY 2007, VBA's LGY Program guaranteed $25 billion in home loans and sold 6,073 foreclosed properties. In addition, instead of a positive return on sales of foreclosed properties, the sales resulted in significant losses. VBA lost about $55.9 million during FY 2007 and about $67.6 million during the first 3 quarters of FY 2008, for a total of $123.5 million.

LGY Service also did not effectively monitor a control mechanism established to mitigate the risk of VA losses on the sale of foreclosed properties that VA acquired from lenders. Because LGY Service did not calculate the net value percentage (NVP) annually as required, we cannot determine its true impact on VA's return on sales total losses of $123.5 million.

LGY Service did not perform comprehensive risk assessments because VBA lacks policies and procedures requiring LGY Service to perform the risk assessments. Instead, VBA relied on OMB, GAO, and ICS reviews. However, these reviews were not coordinated or sufficiently comprehensive for LGY to fully identify and manage all potentially significant risks. Without a comprehensive approach to identifying, analyzing, and managing risks, threats to LGY Service's ability to achieve the program objective of helping veterans purchase and retain a home has the potential of remaining undetected until significant problems arise. LGY Service needed to improve risk assessment controls in the areas of risk identification, risk analysis, and risk management. (See Appendix B)

1. Risk Identification.

To provide managers with the information necessary to identify risks that could impede the efficient and effective achievement of the LGY Program's overall strategic objective, LGY Service needed to establish adequate goals and objectives. A precondition to risk identification, analysis, and management is the establishment of clear and consistent goals and objectives.

[1]The 14.6 percent decline in home sales was calculated using home sales data from the U.S. Census Bureau and the National Association of Realtors. The 79 percent increase in home loan foreclosures was reported in a Realty Trac® press release and *USA Today*, January 29, 2008.

LGY Service addressed some risk assessment factors pertaining to goals and objectives. For example, LGY Service periodically reviewed goals and objectives for continued relevance, ensured goals and objectives complimented and reinforced each other, regularly reviewed critical objectives, and ensured all levels of management are involved and committed to the achievement of goals.

However, LGY Service did not address other risk assessment factors pertaining to the element of goals and objectives such as linking LGY Program goals and objectives to VBA's objectives and strategic plans, establishing goals and objectives for key operational and support activities, comparing goals and objectives with industry standards, establishing measurement criteria for each goal and objective, and identifying what must occur or happen to meet VBA's objectives.

The following examples address factors LGY Service needed to improve.

<u>Linking Goals and Objectives to Strategic Plans</u>. To fully support VBA's strategic objective for the LGY Program, LGY Service needed to establish additional goals and objectives that are linked to the strategic objective. VBA's strategic objective for the LGY Program is to:

> *Improve the ability of veterans to purchase and retain a home by meeting or exceeding lending industry standards for quality, timeliness, and foreclosure avoidance.*

To help improve the ability of veterans to retain their homes and avoid foreclosure, LGY Service established a FATS ratio goal. However, LGY Service did not establish goals or objectives for helping improve veterans' ability to purchase a home.

<u>Establishing Goals for Key Activities</u>. LGY Service needed to establish goals for the key functions of managing foreclosed properties and servicing loans. During FY 2007, VBA's property management contractor sold 6,073 foreclosed properties. The costs of managing these properties totaled about $98.7 million, averaging $16,300 per property. These costs included expenses for property maintenance, repairs, and taxes. Also during FY 2007, VBA's loan servicing contractor serviced over 12,000 home loans. The costs of servicing these loans totaled about $3 million which averaged about $250 per loan. The costs associated with managing properties and servicing loans create significant business risks that LGY Service goals and objectives did not address. These business risks include increased costs that could occur from maintaining a large inventory of foreclosed properties, retaining foreclosed properties for extended periods, or contractor overcharges for property management and loan servicing.

<u>Comparing Goals and Objectives with Industry Standards</u>. VBA's strategic objective for the LGY Program included meeting or exceeding lending industry standards for quality, timeliness, and foreclosure avoidance. However, VA's FY 2008 PAR did not compare the LGY Program's five strategic goal measurements with industry standards. The five strategic goal measurements for the LGY Program are the: (1) FATS ratio, (2) E-FATS

ratio, (3) veteran satisfaction survey, (4) lender satisfaction survey, and (5) statistical quality index, which measures the number of correct LGY actions.

The FATS ratio is a tool to measure VBA's success in assisting veterans who are facing foreclosure. VBA developed this ratio to identify the extent to which foreclosures would have been greater had VBA not pursued alternatives to foreclosures. E-FATS is an electronic comparison measurement of dollars saved through successful loan interventions to dollars spent by VA. Unlike LGY Service, the lending industry does not use the FATS or E-FATS ratios. In addition, these ratios do not provide any information as to whether VBA is meeting or exceeding loan industry standards.

The lending industry uses other standards such as the timeliness of loan underwriting and closing to measure performance. LGY Service needed to develop program goals and objectives that it can compare with industry standards because of the financial risk involved. If VBA does not meet or exceed lending industry standards, lenders may elect not to underwrite VA guaranteed home loans for veterans.

Identifying General, External, and Internal Risks. LGY Service needed to identify all types of risks that may threaten VBA's ability to operate an effective and efficient program. LGY Service managers cannot adequately analyze or manage risks they do not identify. LGY Service needed to implement a more comprehensive program to ensure it identifies and addresses general, external, and internal risk factors.

General Factors. LGY Service addressed certain general risk identification factors such as discussing risks at senior level conferences, considering the results of findings from audits and evaluations, and communicating employee-identified risks to senior managers. However, LGY Service did not address the general risk identification factors of determining risk rankings on a scheduled and periodic basis; communicating to staff how LGY Service will identify, rank, analyze, and mitigate risks; and identifying risks as part of short-term and long-term forecasting and strategic planning. The following example highlights a factor LGY Service needed to improve.

Determining Risk Rankings on a Scheduled and Periodic Basis. LGY Service needed to determine relative risk rankings of low, medium, and high on a more consistent and frequent basis. In 2006, VA's Office of Business Oversight established ICS to evaluate VA's network of risk management and control processes. In 2007, ICS reviewed LGY Service's controls and ranked 20 controls as low, medium, or high risk. However, an ICS manager stated that the next review would be in 2010. In addition, LGY Service had performed functional area control reviews. However, LGY Service reviewed only two of six functional areas during FYs 2007 and 2008 (through July 2008). LGY Service did not review the other four functions for periods ranging from 4 to 18 years.

External Factors. LGY Service addressed certain external risk identification factors such as considering technological advancements and interactions with parties outside the Federal Government. For example, LGY Service identified an external risk that lenders and veterans may discontinue participation in the program if they are not satisfied. To address this specific risk, LGY Service developed procedures to perform lender and veteran satisfaction surveys and established satisfaction rate goals.

However, LGY Service did not adequately address the external risk identification factors of considering business and economic risks; the changing needs of Congress, VA officials, and the public; new legislation or regulations; possible natural catastrophes or criminal actions; and risks associated with major suppliers or contractors. The following example highlights a factor LGY Service needed to improve.

<u>Considering Business and Economic Risks</u>. LGY Service did not identify or effectively plan to mitigate the business and economic risks caused by a depressed housing market and reduced property values. By establishing a structured risk management program, LGY Service would be in a better position to mitigate risks. Business risk can be the result of internal or external factors that may be evident in the wider business community. Economic risk is a condition of the economy that negatively affects buying and selling of goods and services.

A depressed housing market and reduced property values are business and economic risks that LGY Service did not identify. For example, VA could incur excessive property maintenance costs resulting from the long-term retention of properties and losses on the sale of properties. In FY 2007, VA sold 6,073 properties with a total value of about $621.8 million for $565.9 million. VA's return on sales was a loss of about $55.9 million. With the recent downturn in the housing market, the risk of additional losses on the return on sales remains high.

Internal Factors. LGY Service did not adequately address internal risk identification factors such as:

1. Business process reengineering or redesign of operating processes,
2. Disruption of information systems processes and availability of backup systems,
3. Qualifications and training of personnel,
4. Heavy reliance on contractors to perform critical agency operations,
5. Major changes in managerial responsibilities,
6. Succession planning and retaining key personnel, and
7. Availability of future funding.

The following example highlights a factor LGY Service needed to improve.

<u>Identifying Business Process Reengineering Risks</u>. LGY Service needed to identify the risks of reengineering the default, servicing, and foreclosure process by transferring these critical functions from Regional Loan Centers (RLCs) to lenders. As of May 2008, LGY Service began the transfer of these functions by providing training to two lenders' employees and granting these lenders access to the VA Loan Electronic Reporting Interface system. However, before beginning the transfer of these functions, LGY

Service did not identify the potential risks of allowing lender employees to perform functions previously performed by VBA employees. Identifying these risks is important because if lenders do not provide veterans every opportunity to avoid foreclosure, veterans could lose their homes, and VBA costs to manage and market these foreclosed properties could increase.

2. Risk Analysis.

LGY Service staff needed to improve the analyses of program risks. LGY Service program officials cannot adequately manage risks if they do not properly analyze risks. Once LGY Service staff identify program risks, they need to perform thorough and complete risk analyses to determine the possible effect on program goals and objectives.

LGY Service considered risk analysis factors such as establishing criteria for rating risks as low, medium, or high; analyzing identified risks relevant to program objectives; and estimating the significance of risks. However, LGY Service needed to improve the analyses of risks in the areas of developing a formal process to analyze risks, involving management and employees in risk analyses, estimating the likelihood and frequency of risks, and determining how to best manage or mitigate risks. The following highlights two factors LGY Service needed to improve.

<u>Involving Management and Employees in Risk Analyses</u>. LGY Service managers and employees, who are in the best position to analyze program risks, were not sufficiently involved in risk analyses. Instead, VA relied on three private consulting firms to analyze LGY Program controls. VA's ICS used one firm to analyze the risks associated with controls related to VA's overall financial statements, which included the LGY Program financial results. LGY Service's PLOU used two firms to analyze the risks associated with existing PLOU controls. However, these firms did not analyze other risks such as those arising from business, political, and economic changes or expectations of Congress, VA officials, and the public. These types of risks could jeopardize the accomplishment of LGY program objectives more than the types of risks analyzed by the firms.

<u>Estimating the Likelihood and Frequency of Risks</u>. LGY Service managers needed to analyze the likelihood and frequency of risks such as increasing home foreclosures, decreasing home values, and potential congressional legislation and its effect on the LGY Program. LGY Service managers did not analyze these types of risks because they relied on contractors' risk analyses, which did not analyze the likelihood and frequency of risks.

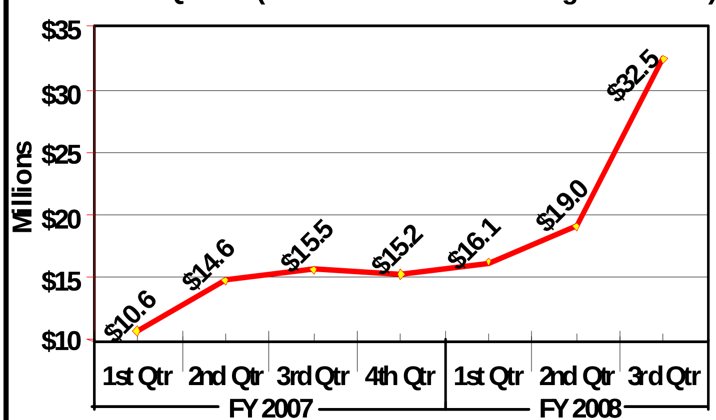
3. Risk Management.

LGY Service needed to improve the management of program risks. In recent years, the importance of LGY Service risk management has increased because the depressed national housing market has the potential to influence the cost-effective accomplishment of certain LGY Program functions such as the management of foreclosed properties. LGY Service did not adequately address the risk management factors of establishing mechanisms to anticipate and react to risks presented by changes, using an approach based on how much risk can be prudently accepted, taking responsibility for setting tolerable risk levels, addressing condition changes at the appropriate VA level, and implementing and monitoring controls to manage or mitigate specific risks. The following example highlights a risk management factor LGY Service needed to improve.

<u>Implementing and Monitoring Controls to Manage or Mitigate Specific Risks</u>. LGY Service needed to improve the monitoring of a control implemented to mitigate the risk of losses on the sale of foreclosed properties that VA acquires from lenders. LGY Service uses a NVP, which is calculated based on historical VA costs of managing foreclosed properties, as a control to help ensure VA does not acquire foreclosed properties that may result in return on sale losses. To optimize the effectiveness of the NVP control, LGY Service must update the NVP annually. Annually updating the NVP has become especially important due to the recent dramatic downturn in the national housing market. As of August 2008, LGY Service was using a NVP based on the 1999 costs of managing foreclosed properties. Because LGY Service was not monitoring and adjusting the NVP, which was based on costs that were 9 years old, the control had become less effective.

For the 21-month period FY 2007 and FY 2008 through June 2008, PMOU provided LGY Service seven quarterly reports showing that VA's property management contractor's return on sales ranged from 78.4 to 94.9 percent. As shown in Figure 2, VA incurred losses ranging from $10.6 million during the 1st quarter of FY 2007 to $32.5 million for the 3rd quarter of FY 2008. In the first 3 quarters of FY 2008, VBA lost about $67.6 million. VA's total losses during the entire 21-month period were $123.5 million. Because LGY Service did not annually update the NVP, we could not determine the portion of the $123.5 million return on sale losses that VA could have avoided.

Figure 2. VA Return On Sales of Foreclosed Properties Loss Per Quarter (FY 2007 and FY 2008 through June 2008)



During FY 2008, VBA's LGY Program guaranteed veteran home loans totaling $36 billion. For most of these loans, VBA charges veterans funding fees, which Congress establishes through legislation, to help offset losses incurred from managing and selling foreclosed properties. The funding fees vary based on the veteran's type of military service. Historically, funding fees have generally increased. In 2001 for first time homebuyers, the fees increased to rates ranging from 1.5 to 2.4 percent of the home value and in 2006 for repeat homebuyers, the fees increased to a rate of 3.35 percent. In FY 2008, funding fees totaled $567 million. To help prevent future increases in veteran funding fees, VBA needs to minimize the losses associated with foreclosed properties.

Conclusion

LGY Service needed to improve the management of program risk to provide a systematic, organized, and structured analysis of operations by performing sustained comprehensive assessments of the risks that could limit VBA's ability to improve veterans' purchase and retention of homes. Overall, LGY Service needed to improve risk assessment controls relating to risk identification, risk analysis, and risk management. LGY Service did not perform comprehensive risk assessments because VBA had not established policies and procedures requiring LGY Service to perform a comprehensive risk assessment. Instead, LGY Service relied upon a complement of external and internal risk analysis reviews that were not coordinated or sufficiently comprehensive to fully identify and manage all potentially significant risks.

In addition, LGY Service needed to improve the monitoring of a control implemented to mitigate the risk of losses on the sale of foreclosed properties that VA acquires from lenders. Because LGY Service was not monitoring and adjusting the NVP, which LGY Service based on costs that were 9 years old, the control had become ineffective. Without a comprehensive approach to risk management, threats to LGY Service's ability to achieve the program goals and objectives have the potential to go undetected until significant problems arise.

Recommendations

1. We recommended the Under Secretary for Benefits establish policies and procedures requiring LGY Service to implement a comprehensive risk management program that includes adequate mechanisms for identifying, analyzing, and managing risks.

2. We recommended the Under Secretary for Benefits ensure LGY Service establish policies that define the decision authority to make NVP changes based on annual analyses of the potential financial impact and projected changes in financial risk tolerance levels.

Under Secretary for Benefits Comments

The Under Secretary agreed with our findings and recommendations. LGY Service will establish new policies and procedures to implement a comprehensive risk management program by March 31, 2010. After a comprehensive risk assessment, LGY will initiate formal A-123 reviews for each of the high-risk LGY functional areas and processes. The A-123 reviews will then be used to conduct annual risk assessments.

On April 14, 2009, LGY established policy requiring the Service Director to concur in the annual NVP analysis, justification, and recommendation. Calculation of property acquisition and management costs will be completed annually in November for the prior fiscal year. Analysis and publication of the NVP in the Federal Register (if necessary) will occur annually in December. VBA requested closure of this recommendation.

OIG Response

The planned actions for Recommendation 1 are acceptable and we will follow up on their implementation. The completed actions for Recommendation 2 are acceptable and we consider this recommendation closed.

Appendix A

Scope and Methodology

The audit covered LGY Program risk management controls during the 22-month period October 2006–July 2008 and included on-site reviews at eight locations:

VBA Central Office, Washington, DC	PMOU, Nashville, TN
LGY Service, Washington, DC	PLOU, Indianapolis, IN
RLC, Atlanta, GA	ICS, Austin, TX
Loan Management Unit, Nashville, TN	
Administrative and Loan Accounting Center, Austin, TX	

At these locations, we interviewed program officials and staff. We also reviewed policies, procedures, property management and loan servicing contracts, and other key documents related to internal controls and risk management. Documents reviewed included a Grant Thornton Limited Liability Partnership July 2007 report on LGY Program compliance with OMB Circular A-123, Appendix A and a Kearney & Company October 2007 report on PLOU's invoice certification process. We also analyzed PMOU return on sales data for properties acquired through foreclosure.

To assess the effectiveness of LGY Program risk management controls, we used OMB's Circular A-123 and GAO's *Internal Control Management and Evaluation Tool* (August 2001, GAO-01-1008G). The circular requires federal managers to establish and assess the effectiveness of internal controls. The tool assists agencies in implementing or maintaining effective controls and in determining what, where, and how improvements can be made. GAO recommends federal managers use the tool to perform a systematic and structured assessment of the internal control structure.

The audit focused on controls related to the audit objectives. The audit was not intended to form an opinion on the adequacy of VBA controls overall, and the report does not render such an opinion. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Appendix B

Risk Management Controls

Effective risk management controls include the following four main elements. When operating effectively, these elements create a risk control process that minimizes program inefficiencies.

1. Program Goals and Objectives. Goals and objectives are the starting point for risk management and need to be established for operational and support activities. Goals and objectives should be reviewed to assure they have continued relevance and are consistent with industry or business norms. Management also needs to establish measurement criteria for each goal and objective.

2. Risk Identification. Program officials need to implement mechanisms to identify internal and external risks that could impede the achievement of program goals and objectives. Internal risks include relying on contractors to perform critical program operations and risks associated with changes in managerial responsibilities. External risks include business and economic changes and new legislation or regulations.

3. Risk Analysis. Management needs to establish policies and procedures to analyze identified risks and determine the possible effects on program goals and objectives. Appropriate levels of management and employees must be involved in the analysis, and they need to determine the best approach for managing or mitigating the risks.

4. Risk Management. Program officials need to implement mechanisms for managing risks by anticipating and reacting to governmental, economic, industry, business, or regulatory changes. Management needs to give special attention to changes that can have a more dramatic and pervasive effect on the program. Effective risk management will help mitigate risk and provide better assurance that program goals and objectives are successfully accomplished.

LGY Service Controls. LGY Service had established Regional Loan Centers to assist veterans and lenders with guaranteed mortgage loans and three units to monitor, oversee, and control the performance of the three functions of guaranteeing mortgage loans, managing foreclosed properties, and servicing loans.

Regional Loan Centers (RLC). LGY Service has nine RLCs responsible for providing services to both lenders and veterans. RLCs provide training to lenders and real estate professionals to educate and encourage the lenders to offer mortgage loans to veterans with favorable credit terms. RLCs also work with veterans and lenders to arrange alternatives to foreclosure when veterans face financial difficulty.

Loan Monitoring Unit (LMU). The LMU in Nashville, TN monitors VA-approved mortgage lenders' underwriting practices to ensure adherence to VA standards and regulations. This includes monitoring lenders' establishment, underwriting, and closing of guaranteed home loans.

Property Management Oversight Unit (PMOU). The PMOU in Nashville, TN provides oversight of the property management contract. PMOU staff perform contract monitoring, including inspections of foreclosed properties owned by the VA. PMOU staff also review contract invoices to ensure they are accurate, verifiable, and documented. The PMOU staff then approves the invoices for payment.

Portfolio Loan Oversight Unit (PLOU). The PLOU in Indianapolis, IN provides oversight of the loan servicing contract. PLOU staff perform contract monitoring, including the review of pending property rights and foreclosure litigation. PLOU staff also review contract invoices to ensure they are accurate, verifiable, and documented. The PLOU staff then approves the invoices for reimbursement.

In addition, VBA's Administrative and Loan Accounting Center in Austin, TX provides financial management services to LGY Service. These services involve financial oversight and control of the LGY Program, including reviewing voucher accuracy, paying vouchers, reconciling loan accounts, and offering financial advisory services.

Appendix C

Under Secretary for Benefits Comments

Department of Veterans Affairs

Memorandum

Date: April 15, 2009

From: Under Secretary for Benefits (20)

Subj: **Audit of Veterans Benefits Administration's Loan Guaranty Program Risk Management**

To: Assistant Inspector General for Auditing (52)

1. Attached are VBA's comments to OIG's Draft Report: Audit of Veterans Benefits Administration's Loan Guaranty Program Risk Management.

2. Questions may be referred to Nancy Holly, Program Analyst, at 202-461-9199.

(original signed by:)

P. W. Dunne

Attachments

Appendix C

Under Secretary for Benefits Comments to Office of Inspector General's Report

The following Under Secretary's comments are submitted in response to the recommendations in the Office of Inspector General's Report:

OIG Recommendations

Recommendation 1. We recommend the Under Secretary for Benefits establish policies and procedures requiring LGY Service to implement a comprehensive risk management program that includes mechanisms for identifying, analyzing, and managing risks.

VBA Response Concur: Loan Guaranty Service (LGY) currently conducts internal control reviews to identify, analyze, and manage risks. However, the scope, frequency, documentation, and concurrence process were not deemed by OIG to be sufficient. Therefore, LGY Service will establish new policies and procedures to implement a comprehensive risk management program.

After a comprehensive risk assessment, LGY will initiate formal A-123 reviews for each of the high-risk LGY functional areas and processes. The A-123 reviews will then be used to conduct annual risk assessments going forward. More frequent risk reviews and analyses will be conducted as necessary to address new risks or changes in risk impact, which may be a result of internal or external events.

Target Completion Date: March 31, 2010

Recommendation 2. We recommend the Under Secretary for Benefits ensure LGY Service establish policies that define the decision authority to make NVP changes based on annual analyses of the potential financial impact and projected changes in financial risk tolerance levels.

Appendix C

VBA Response Concur: Based on this recommendation, LGY will continue to perform annual calculations of property acquisition, management and resale costs as described in the definition of net value in 38 CFR 36.4301. In addition, LGY will analyze the results of these calculations and balance the potential financial impact on the program with the potential negative consequences on future credit availability for veterans when deciding the rate to use each year.

LGY established policy requiring the Service Director to concur in the annual net value percentage (NVP) analysis, justification, and recommendation. Calculation of property acquisition and management costs will be completed annually in November for the prior fiscal year. Analysis and publication of the NVP in the Federal Register (if necessary) will occur annually in December. VBA requests closure of this recommendation.

Target Completion Date: April 14, 2009

Appendix D

OIG Contact and Staff Acknowledgments

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Acknowledgments	E. Marcia Drawdy Harvey Hittner Nathaniel Holman Earl Key Whittie Lockett George Patton Cheri Preston Al Tate Alvin Wiggins

Appendix E

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