UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

MAY 2 2 2009

REPLY TO
ATTN OF: 04703-0001-Ch

TO: Dallas Tonsager
Under Secretary
Rural Development

FROM: Robert W. Young
Assistant Inspector General
for Audit

Robert W. Young

SUBJECT: Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (3)

The American Recovery and Reinvestment Act of 2009 (the Recovery Act) included almost $10.5 billion in funds to guarantee single-family housing loans in rural areas. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of the funds. Further, on February 18, 2009, the Office of Management and Budget (OMB) issued initial guidance that required Federal agencies to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability objectives of the Recovery Act.[1] On March 20, 2009, Rural Development was authorized to begin distributing Recovery Act funds.

The Rural Housing Service, an agency within the Rural Development mission area, is responsible for distributing Recovery Act funds through the Section 502 Single-Family Housing Guaranteed Loan Program. As of May 13, 2009, Rural Development had obligated over $4 billion to guarantee over 34,000 loans. Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure funds are expended in a manner that minimizes the risk of improper use. This memorandum is the third one to report on our oversight activities related to rural housing. This report relates to lenders' use of independent mortgage brokers ("brokers") to originate loans that are guaranteed by Rural Development. This issue, along with the others identified in these memoranda, will be compiled into a final report at the conclusion of our audit.

To accomplish our objectives, we assessed the program's policies and procedures, as well as its internal controls, and discussed them with the agency's national, State, and area officials.[2] Agency officials followed this guidance to process loan note guarantees obligated under the

[1] On April 3, 2009, OMB issued "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009."
[2] Rural Development Instruction 1980-D, dated June 21, 1995, and associated Administrative Notices.

authority of the Recovery Act. We visited four Rural Development area offices in two States to examine borrower files and observe the loan note guarantee process. We did not perform testing to verify lender compliance with agency policies and procedures.

A common practice in the mortgage industry is for lenders to use in-house loan officers as well as brokers to originate loans. The loan origination function consists of taking applications from prospective borrowers, determining the eligibility of borrowers, and verifying borrower information such as income and employment. We noted during our review that lenders that participate in multiple States and have the potential for submitting significant loan volume were more likely to use brokers than small lenders such as local community banks.

The agency relies on lenders' underwriting processes to scrutinize loan applications originated by brokers. Rural Development guidance states that a lender may use agents (i.e., brokers) in carrying out its responsibilities. However, lenders are fully responsible for the actions of the agents.[3] We are concerned that some lenders will not adequately evaluate broker originated loans before submitting them to Rural Development officials. Our concern is based on two factors that, in our view, increase the risk that lenders will submit substandard loans to Rural Development. The two factors are (1) the compensation method for brokers and (2) the industry practice by which originating lenders typically sell loans to other lenders after loan closing.

Brokers are compensated for each originated loan.[4] Thus, there is an incentive to submit as many loan applications as possible to originating lenders to increase the brokers' income. With the increased level of funding due to the Recovery Act, there is an increased risk that some brokers may alter information on loan applications, thereby making otherwise ineligible borrowers able to qualify for loans.

As stated above, the agency relies on lenders to review information on applications during the underwriting process to prevent such abuse. However, those reviews may not always be effective because it is a common industry practice for originating lenders to sell the loans they make to other lenders for servicing. Therefore, some originating lenders may be less willing to dedicate resources to scrutinize loans that will be sold to other lenders. In addition, the agency generally does not deny loss claims made by servicing lenders or seek recourse against originating lenders. This could also contribute to an originating lender's decision to reduce oversight. During our field visits to area offices, agency officials also expressed concern about loans originated by brokers.

In our view, the risk that lenders will not adequately scrutinize loans originated by brokers is significant enough that agency officials should take action to prevent potential abuse. However, as stated above, we have not yet performed tests to determine if lenders have actually submitted substandard loans originated by brokers. As a result, we have no conclusions on the overall

[3] Rural Development Instruction 1980.309, dated June 21, 1995.
[4] Brokers' specific compensation depends on their contract with the originating lenders and State regulations. For example, brokers are generally paid by the number of loans accepted by a lender. Some brokers also charge the applicants a fee.

extent of abuse that is, or may be, occurring in the program. Our concern is that lenders could submit substandard loans to Rural Development originated by brokers.

We discussed this issue in detail with agency national office officials on April 29, 2009. They generally agreed with our conclusion and agreed to implement corrective action. One recommendation we made was that agency officials needed to perform additional compliance reviews of lender files to determine if lenders adequately reviewed loan applications. (We made this recommendation in the OIG Memorandum dated May 11, 2009.) In the agency's May 14, 2009, response to that memorandum, the agency agreed to increase lender compliance testing conducted after loan closing. To expand on our prior recommendation, the agency should increase its oversight of any lender found not to be properly reviewing loans originated by brokers and to take appropriate administrative action against those lenders in accordance with Rural Development guidance.[5]

Please provide a written response within 5 days that outlines your corrective action on this matter. If you have any questions, please contact me at (202) 720-6945, or have a member of your staff contact Steve Rickrode, Audit Director, Rural Development and Natural Resources Division, at (202) 690-4483.

cc: Director, Financial Management Division

[5] Rural Development Instruction 1980.398, dated June 21, 1995.

USDA Rural Development

United States Department of Agriculture
Rural Development

TO: Robert W. Young
Assistant Inspector General for Audit

ATTENTION: 04703-001-Ch

JUN - 1 2009

FROM: Dallas Tonsager Cheryl L. Cook
Under Secretary for
Rural Development

THROUGH: James C. Alsop James C. Alsop
Acting Administrator
Housing and Community Facilities Programs

SUBJECT: Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds – Memorandums (3) and (4)

We are in receipt of your letters on the subject. The Office of General Inspector General (OIG) has been briefed on the existing controls and oversight for Single Family Housing Guaranteed Loans.

Memorandum 3

In response to the OIG concerns regarding broker initiated loans, the origination of quality loans is critical to the success of the Single Family Housing Loan Program. We will increase the compliance testing with a focus on loan origination quality for loans originated by brokers. Reviews will concentrate on participating lenders that originate a high volume of loans initiated by brokers. Special work programs will be developed regarding this focus. This work will be conducted through a procurement/contract and will compliment ongoing compliance work in process.

We will draft and issue guidance to approved lenders, and to Rural Development field offices, regarding the necessity to receive and act upon loan origination files submitted only from approved lenders that have been fully underwritten by them. The existing policy of not allowing loan guarantee requests, or supporting documentation to be submitted to Rural Development from mortgage brokers, will be reinforced.

In response to concerns raised in the OIG letter regarding the financial interest of brokers and the method of compensation for loans originated, we are exploring the feasibility of requiring approved participating lenders to be responsible for selecting, retaining and providing for payment of all compensation to the licensed or certified appraiser who will appraise the security collateral for a loan.

Memorandum 4

OIG raised concerns regarding segregation of duties or supervisory (or second party) review, prior to issuance of the loan guarantee. It was acknowledged by OIG that many offices have too few employees to separate duties. Rural Development has some preventive control measures already in place through security access to the Guaranteed Loan System, the agency's system for recording loan information and obligating guarantees. Security is issued in accordance with standards set forth in 7 C.F.R. §1901-A, Loan and Grant Approval Authorities. We propose additional quality control procedures to ensure a second party review is taking place on a selection of loans approved by Rural Development officials. A second level review of a random sample of conditional commitment approvals will be performed by designated Agency employees. The second level review will better ensure loans originated were adequately reviewed for eligibility by Rural Development staff.

We look forward to continue working with the OIG towards meeting the accountability objectives of American Recovery Reinvestment Act.

If you have any questions regarding this memorandum, please contact the Guaranteed Loan Division at 202.720.1452.