UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

DATE: June 26, 2009

REPLY TO
ATTN OF: 04703-1-KC

TO: Dallas Tonsager
Under Secretary
Rural Development

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Single-Family Housing Direct Loans Recovery Act Controls (2)

The American Recovery and Reinvestment Act of 2009 (Recovery Act) included $1 billion for the Rural Housing Service (RHS) to provide single-family housing direct loans to borrowers.[1] Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of 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.[2] As of June 23, 2009, Rural Development had obligated approximately $156 million in direct loans to 1,209 very-low and low income borrowers.

RHS, an agency within the Rural Development mission area, is responsible for distributing Recovery Act funds through the Section 502 Single-Family Housing (SFH) Direct Loan Program.[3] These loans are available for very-low and low income households who cannot qualify for other credit to obtain homeownership. Applicants may obtain 100 percent financing to purchase an existing dwelling, purchase a site and construct a dwelling, or purchase newly constructed dwellings located in rural areas.

Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure agencies expend funds in a manner that minimizes the risk of improper use. During this initial phase, we found that Rural Development does not perform adequate compliance activities to review the quality of loan underwriting for its SFH direct loans to ensure it properly and prudently uses Section 502 Program funds, including Recovery Act funds. This memorandum is one in a series that will report on our oversight activities regarding SFH direct loans. Issues identified in these memoranda will be compiled into a final report at the conclusion of our audit.

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[1] The American Recovery and Reinvestment Act, H.R. 1, was signed into law by President Obama on February 17, 2009.
[2] *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, April 3, 2009.
[3] SFH Direct Loans are authorized by title V of the Housing Act of 1949 under Section 502. 7 CFR Part 3550 provides the policies for the SFH Direct Loan Program.

To accomplish our overall objectives, we assessed the program's policies and procedures, as well as its internal controls.[4] Agency officials follow this guidance to process Section 502 Direct Loans obligated under the Recovery Act. We interviewed Rural Development National Office officials and visited two Rural Development State offices to discuss the controls and procedures for making loans using Recovery Act funds. To meet this specific objective, we also discussed Section 502 Direct Loan Program compliance activities with Rural Development National Office and State office officials in Missouri and Kansas. We compared compliance activities performed on regular and Recovery Act direct loans with the procedures required in Rural Development Handbook HB-1-3550 (the Handbook). We also accompanied a State SFH Program Director as he performed his scheduled State Internal Review (SIR) in two field locations.[5]

During this phase, we found that although the Recovery Act has almost doubled the funding for the SFH Direct Loan Program, the Rural Development National Office has not specified, nor have the State offices adopted, any additional compliance activities to review the quality of loan underwriting for Recovery Act loans.[6] In addition, the States we visited were not effectively performing loan underwriting reviews of delinquent loans. These reviews can identify whether the basis for loan-making decisions is adequately supported and documented. In addition to these reviews, we recommend that Rural Development immediately assess the quality of loan underwriting for Recovery Act loans.

Underwriting Reviews of Delinquent Loans

We determined that neither the Missouri nor Kansas State offices are conducting underwriting reviews of delinquent loans as often as required in Rural Development's Handbook. Officials at both the State offices explained they do not have enough staff to review these loans each quarter, as required. Instead, they review loan files as part of the SIR, which is performed at least once at each field office every 5 years. They also rely on the State average delinquency rate as an indicator of problems. The review of delinquent loans is an important control for assessing the quality of loan-making decisions. For example, loan underwriting reviews have recently found that field office staff did not always document reasons for making exceptions to unacceptable credit indicators, such as low credit scores or high total debt ratios. Allowing borrowers with unacceptable credit to obtain loans can lead to increased delinquency rates in the Section 502 Direct Loan Program.

Rural Development's Handbook states that on a quarterly basis, every State office should conduct a review of all field offices with a first year delinquency rate that has remained above the State average for the preceding 3-month period. For field offices that surpass this threshold, State offices should review delinquent loans (especially those involved in foreclosure or bankruptcy) that occur in those field offices during the fiscal year to date.

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[4] Rural Development Handbook HB-1-3550, Direct Single Family Housing Loans and Grants, Field Office Handbook, dated January 23, 2003, and associated Special Procedural Notices.

[5] According to Section 2006.609 of RD Instruction 2006-M, dated May 19, 2004, SIRs are comprehensive evaluation reviews of the delivery of program and administrative functions in field offices and centralized program functions within a State. The SIR occurs at each field office at least once every 5 years.

[6] Congress allocated about $1 billion in Recovery Act funds for the Section 502 Direct Loan Program over fiscal years 2009 and 2010, which is about double the program's 2009 normal funding.

Missouri State office officials stated that as of March 31, 2009, the first year delinquency rate for Missouri's Direct Loan Program was only 2.73 percent, which is well under the National Office's 4.5 percent standard; therefore, delinquent loan file reviews were not warranted. However, our review of the delinquency data for Missouri as of March 31, 2009, identified 9 of the 27 Missouri field offices had first year delinquency rates that exceeded the State average and the National Office standard. Several of them more than doubled the State average, including Sedalia (7.69 percent), Farmington (7.14 percent), Hillsboro (6.67 percent), and Kirksville (6.25 percent). With the current economy, it is even more important that delinquency rates are closely examined.

Kansas State office officials began conducting delinquent loan underwriting reviews in February 2009. They had not conducted these reviews until the first-year delinquency rate increased to about 5 percent, which exceeded the National Office's 4.5 percent standard. Since performing these reviews, first-year delinquency rates in Kansas have significantly dropped. In interviews, they acknowledged that waiting to perform reviews until the first-year delinquency rate exceeded the national standard was reactive rather than proactive. Even so, the Kansas State office officials told us they will not conduct the next loan underwriting review until about 6 months after the last one, because they do not currently have the staff to conduct these reviews on a quarterly basis.

When we discussed these issues with Rural Development on June 4, 2009, National Office officials acknowledged that some States are not performing quarterly loan underwriting reviews as specified in the Handbook. They also stated that the National Office does not have a formal process in place to monitor and ensure each State completes the underwriting reviews of delinquent loans as required. Because Rural Development has limited time to distribute Recovery Act funds, we believe the timeliness of compliance activities is essential. Therefore, underwriting reviews of delinquent loans should be conducted on a quarterly basis (as required) as compared to SIRs that occur in each office once every 5 years. The quarterly reviews also focus on the locations with the highest first-year delinquency rates, targeting loans with a high potential risk of failure. We recommend that Rural Development reinforce the importance of loan underwriting reviews and develop a formal process for monitoring and ensuring that each State performs loan underwriting reviews of delinquent Section 502 direct loans at least quarterly.

Nationwide Sample of Recovery Act Direct Loan Files

To overcome the above control deficiency in its State offices, Rural Development needs to establish a compensating control to immediately assess the quality of underwriting for Recovery Act loans. Due to the reported staff shortages in State and field offices, one option would be for Rural Development National Office officials to review a sample of Recovery Act loan files. Completing these reviews and notifying States early on of problems noted will help ensure corrective actions are taken before the Recovery Act funds are exhausted. Quality loan underwriting not only ensures that Rural Development properly and prudently uses Recovery Act funds, it helps ensure continued success of the Section 502 Direct Loan Program.

In our discussion on June 4, 2009, Rural Development National Office officials agreed that pulling samples of Recovery Act direct loan files was needed, and the review should be performed on a nationwide basis. National Office officials also told us they planned to perform a nationwide Improper Payments Information Act (IPIA) review scheduled for August 2009. The tentative plan was to randomly select and review 75 Recovery Act loan files as part of the IPIA review. We agree that combining the Recovery Act direct loan file sample with the IPIA review is an efficient strategy to verify the quality of loan underwriting for the Recovery Act loans. We also suggest that this review begin immediately because all 50 States have made loans using Recovery Act funds and Rural Development officials anticipate a surge once regular funding for fiscal year 2009 is exhausted. We also discussed these issues with Rural Development National Office officials on June 26, 2009, and they generally agreed with our findings.

We therefore recommend that the Rural Development National Office:

> Develop a formal process for monitoring and ensuring that each State performs underwriting reviews of delinquent Section 502 direct loans at least quarterly.
>
> Establish a compensating control to immediately assess the quality of loan underwriting for Recovery Act loans to ensure the proper and prudent use of these funds. Notify States of the review results and follow-up on corrective actions.

Please provide a written response within 5 days outlining your proposed corrective action for this issue. 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.

United States Department of Agriculture
Rural Development
Office of the Under Secretary

July 2, 2009

TO: Robert W. Young
Assistant Inspector General for Audit

ATTENTION: 04703-1-KC

FROM: Dallas Tonsager /s/ Dallas Tonsager
Under Secretary
Rural Development

THROUGH: Tammye H. Trevino /s/ Tammye H. Trevino
Administrator
Housing and Community Facilities Programs

SUBJECT: Single Family Housing Direct Loans Recovery Act Controls (2)

We are in receipt of your memorandum on the above subject. The Office of General Inspector General has been briefed on the existing controls and oversight for Single Family Housing Direct Loans.

In response to your initial findings that the visited State Offices are not conducting quarterly underwriting reviews of delinquent new loans as outlined in Handbook-1-3550, Attachment 6-C (Loan Underwriting Review) and that the National Office is not sufficiently monitoring completion of these reviews, we will modify Attachment 6-C to account for staff shortages and increased workloads and to heighten the effectiveness of the selection criteria while maintaining the integrity of the process. As outlined in attachment, the National Office routinely holds teleconferences with selected States to discuss their first year delinquency and monitoring efforts. To strengthen this National Office monitoring, the attachment will be revised to require the State Offices to submit periodic reports on the results of their reviews.

As it relates to the compensating control to immediately assess the quality of loan underwriting for Recovery Act loans, as mentioned we will be reviewing 75 randomly selected Recovery Act loans as part of the Improper Payments Information Act review. Individual review results will be shared with the appropriate State Offices and corrective actions will be monitored. General findings will be shared with all State Offices.

We look forward to continuing to work with OIG towards meeting the goals and objectives of the Recovery Act.

If you have any questions regarding this memorandum, please contact the Single Family Housing Direct Loan Division at (202) 720-1474.