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Office of Inspector General

Single-Family Housing Direct Loans Recovery Act Controls – Compliance Review



Audit Report 04703-0003-KC

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AUDIT NUMBER: 04703-0003-KC

TO: Dallas Tonsager
Under Secretary
Rural Development

Tammye Trevino
Administrator
Rural Housing Service

ATTN: John Purcell
Director
Financial Management Division

FROM: Gil H. Harden
Assistant Inspector General
for Audit

Gil H. Harden

SUBJECT: Single-Family Housing Direct Loans Recovery Act Controls – Compliance Review

Attached is a copy of the final report on the subject audit. Your written response to the official draft report, dated May 8, 2012, is attached, with excerpts from your response and the Office of Inspector General's position incorporated in the relevant Findings and Recommendations sections of the report.

Based on the agency's response to our official draft report, we accept management decisions for all recommendations in the report. You should follow your internal agency procedures for providing final action correspondence for these recommendations. In accordance with Departmental Regulation 1720-1, final action on the management decisions should be completed within 1 year of the date of the management decisions to preclude being listed in the Department's annual Performance and Accountability Report.

We appreciate the courtesies and cooperation extended to us by members of your staff during our audit fieldwork and subsequent discussions.

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Single-Family Housing Direct Loans Recovery Act Controls – Compliance Review

Executive Summary

The American Recovery and Reinvestment Act of 2009 (Recovery Act) was signed into law on February 17, 2009.[1] The purposes of the Recovery Act include preserving and creating jobs, promoting economic recovery, and assisting those most impacted by the recession. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of funds. The Office of Management and Budget (OMB) subsequently issued 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]

The Recovery Act included $1 billion for the Rural Housing Service (RHS) to provide single-family housing (SFH) direct loans to borrowers for fiscal years 2009 and 2010.[3] These loans are directly funded by the Government, and are available for very-low and low income households that cannot qualify for other credit to obtain homeownership.[4] These loans are commonly referred to as Section 502 direct loans.

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. We are using a multi-phase approach in performing our review of the Recovery Act-funded Section 502 SFH Direct Loan Program. The objective of this compliance review segment was to determine if Rural Development field personnel complied with the agency's established internal control procedures at loan origination and closing to ensure homes and program participants who received Recovery Act funds met eligibility guidelines.

To accomplish our objective, we statistically selected 100 loans from a universe of about 8,100 Recovery Act direct loans, totaling over $1 billion, which had closed as of June 30, 2010. We reviewed loan file documents and found that field personnel had not always fully complied with Rural Development's established internal control procedures or Recovery Act provisions to ensure homes and program participants who received Recovery Act funds met eligibility guidelines. Specifically, we questioned borrower eligibility determinations for 17 loans where borrowers (1) had no history of stable and dependable income, (2) had a credit history that did not indicate the ability and willingness to repay a loan, or (3) did not meet repayment ability guidelines. We also questioned property eligibility determinations for six loans where properties had above-ground swimming pools, or which lacked sufficient

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[1] Public Law 111-5.
[2] OMB Memorandum M-09-10, *Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, February 18, 2009, and OMB Memorandum M-09-15, *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, April 3, 2009.
[3] The program level increased to about $1.56 billion due to changes in subsidy rates for fiscal year 2010. The agency obligated almost $1.4 billion during the Recovery Act period, which ended September 30, 2010.
[4] Very-low income is defined as below 50 percent of the area median income, and low income is between 50 and 80 percent of the area median income.

documentation that the homes were decent, safe, and sanitary. From our sample, we project that 1,772 loans worth $208 million (22 percent of the universe) may have similar noncompliance issues where we would have questioned whether the loans were approved for ineligible borrowers and properties.[5]

Rural Development field-level personnel made these questionable determinations because they were not sufficiently trained on how to either conduct or adequately document proper determinations; did not have an effective second party review process in place to catch errors; and did not have sufficient guidance on the characteristics and requirements needed for a property to become eligible. Rural Development conducted a follow-up review of the questionable loans and agreed that they were not fully processed in accordance with regulations or handbook requirements.

We also tested the reliability of the data in Rural Development's automated information technology system. For the 100 loans in our sample, we found that in 5 fields critical for determining a borrower's repayment ability, over 10 percent of the entries did not match with information in Rural Development's loan files. In some cases, the system contained blank fields because it did not have automatic data checks in place. In other cases, field personnel were not updating the system based on current information in the loan file because Rural Development lacked appropriate controls to ensure updated entries. These data issues prevented Rural Development from accurately analyzing its data and effectively using the data for compliance purposes.

Rural Development implemented numerous corrective actions during the course of our audit, including providing direct loan underwriting training at the SFH national policy meeting held in August 2011. In addition, Rural Development clarified or enhanced procedures for evaluating an applicant's income and credit history, and for ensuring that current information is used to determine eligibility. Finally, Rural Development implemented corrective actions to address the identified data integrity issues. To continue these positive developments, we believe Rural Development should ensure that it consistently updates its handbook, effectively publicizes the updates, and maintains ongoing training for field staff.

Recommendation Summary

Rural Development needs to (1) provide continuing and targeted training to field personnel, (2) review the program handbook and determine if it should be revised to provide further clarity

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[5] We are 95 percent confident that borrower or property eligibility is questionable in loans ranging between 1,111 (about 14 percent) and 2,433 (about 30 percent) of our total universe of 8,054 SFH direct loans. Those loans have a projected value between $124 million and $292 million, with a midpoint at 1,772 loans and a projected total value of $208 million. We questioned both the borrower and property eligibility determinations in 1 of the 100 loans in our sample; however, we only counted it once in our total projections. Since the objective of this audit was to test Rural Development's controls over eligibility determinations and not intended to be an improper payments review, our projections are based on the total amount of each loan where we questioned eligibility instead of computing incremental improper payment amounts for each loan. If partial loan amounts were used to project an improper payment amount, this would result in a lower total projection than the above total value of $208 million. See Exhibit B for the statistical sample design.

to field personnel carrying out the policies and procedures, (3) ensure that the document checklist and underwriting compliance tool specifically address the borrower-related issues described in this report, and (4) ensure new regulations, policies, and procedures are effectively communicated and implemented at field office locations.

Agency Response

In its May 8, 2012, written response to the official draft report, Rural Development expressed agreement with all our findings and recommendations. We have incorporated the Rural Development response in the Findings and Recommendations section of this report, along with our comments in the applicable OIG Position sections. Rural Development's response to the official draft is included in its entirety at the end of this report.

OIG Position

We concur with the agency's proposed corrective actions and reached management decision on all four recommendations in the report.

Background and Objectives

Background

The Rural Housing Service (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. These loans are directly funded by the Government and are available for very-low and low income households that 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. Mortgage payments are based on the household's adjusted income.[6] These loans are commonly referred to as Section 502 direct loans.[7]

Rural Development's mission is to increase economic opportunity and improve the quality of life for all rural Americans. Rural Development has an $86 billion portfolio of loans and administers nearly $16 billion in program loans, loan guarantees, and grants through its programs each year. The Rural Development mission area administers the Section 502 SFH Direct Loan Program through the RHS national office in Washington D.C., and its network of State, area, and local offices. RHS helps rural communities and individuals by providing loans and grants for housing and community facilities such as fire and police stations, hospitals, libraries, and schools. As of November 2011, the Section 502 SFH Direct Loan Program portfolio consisted of almost 331,000 loans with an unpaid balance of about $16 billion.

The RHS national office is responsible for establishing policy, procedures, and internal controls for the program.[8] In the field, RHS operations are carried out through 47 State and 481 area and local Rural Development offices, which are responsible for issuing direct loans to borrowers. The Rural Development Centralized Servicing Center (CSC), located in St. Louis, Missouri, services or provides support to local servicing efforts for all RHS SFH loans.[9]

Section 502 direct loan applicants must have very-low or low incomes. Very-low income is defined as below 50 percent of the area median income (AMI), and low income is between 50 and 80 percent of AMI.[10] Families must be without adequate housing, but be able to afford the mortgage payments, including taxes and insurance, which are typically 24 percent of an

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[6] Adjusted income is used to determine whether a household is income eligible for payment assistance. It is based on annual income and provides for deductions to account for varying household circumstances and expenses such as child care expenses.
[7] Section 502 direct loans are authorized by Title V of the Housing Act of 1949 under Section 502.
[8] 7 Code of Federal Regulations Part 3550 provides the policies for the Section 502 SFH Direct Loan Program. *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 describe loan processing policies and establish procedures for originating Section 502 direct loans.
[9] CSC performs limited servicing for loans originated in Western Pacific territories.
[10] Area median income is established by the United States Department of Housing and Urban Development. For example, if the area median income of a county was $36,600 for a family of two, then the upper limit is $18,300 to be considered very-low income.

applicant's adjusted income. Applicants must be unable to obtain credit elsewhere, yet have reasonable credit histories.

Section 502 direct loans are financed for up to 33 years (38 for those with incomes below 60 percent of AMI and who cannot afford 33-year terms). RHS sets the promissory note interest rate based on the Government's cost of money. However, that interest rate is modified by payment assistance subsidies. Under this program, housing must be modest in size, design, and cost. Modest housing is property that is considered modest for the area, does not have market value in excess of the applicable area loan limit, and does not have certain prohibited features (e.g. income-producing land or structures).

The Recovery Act included $1 billion for RHS to provide SFH direct loans to borrowers for fiscal years 2009 and 2010. The program level increased to about $1.56 billion due to changes in subsidy rates for fiscal year 2010. RHS obligated almost $1.4 billion during the Recovery Act period which ended September 30, 2010. RHS treated the SFH Direct Recovery Act Program as an extension of the regular SFH Direct Program. The regulations we reviewed in this audit governed both the Recovery Act and regular SFH Direct Programs alike, with one notable exception. Above-ground swimming pools are allowed when funded with regular annual appropriations but prohibited for loans approved with Recovery Act funds (See Finding 2). Therefore, our recommendations in this report apply to the SFH Direct Loan Program overall.

The Office of Inspector General (OIG) previously completed two additional SFH Direct Loan Program Recovery Act audits. In the first phase, we reviewed Rural Development's management controls to ensure the Recovery Act-funded SFH Direct Loan Program was timely and effectively implemented. During that phase, we (1) determined that State offices were not fully utilizing funds for administrative costs provided by the Recovery Act to mitigate staff shortages, (2) identified additional performance measures that Rural Development could be tracking and reporting to better define its accomplishments in meeting the goals of the Recovery Act, and (3) found that Rural Development did not perform adequate compliance activities to review the quality of loan underwriting for its SFH direct loans.[11]

In the first segment of our Phase II audit, we tested the effectiveness of the key controls identified in Phase I. We identified specific weaknesses in the controls over (1) detecting, reducing, and preventing improper payments; (2) preventing previously identified weaknesses from recurring; and (3) segregating the key duties of initiating, approving, obligating, and disbursing loans.[12]

In this compliance review segment of Phase II, we issued a Fast Report on Finding 1 of this report on August 19, 2011, and the agency responded on August 31, 2011.

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[11] Audit Report 04703-1-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Phase I*, issued November 5, 2009.
[12] Audit Report 04703-2-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Phase II*, issued September 24, 2010.

Objectives

The objective of this compliance review segment of Phase II was to determine if Rural Development field personnel complied with the agency's established internal control procedures at loan origination and closing to ensure homes and program participants who received Recovery Act funds met eligibility guidelines.

Section 1: Review of Eligibility Determinations

Finding 1: Rural Development Made Questionable Borrower Eligibility Determinations

We identified 17 out of the 100 loans we reviewed where we questioned borrower eligibility determinations because field personnel had not always fully complied with one or more of Rural Development's established internal control procedures.[13] We found these approved borrowers (1) had no history of stable and dependable income, (2) had a credit history that did not indicate the ability and willingness to repay a loan, or (3) did not meet repayment ability guidelines. Rural Development field-level personnel determined these borrowers to be eligible at closing because they were not sufficiently trained on how to either conduct or adequately document proper determinations, and did not have an effective second party review process in place to catch errors. Based on our overall sample results, we estimate that 1,369 loans (17 percent of the universe), with a projected total value of about $162 million, may have similar noncompliance issues where we would have questioned whether the loans were approved for ineligible borrowers, or those with higher risk of default.[14] As of December 2011, 3 of the 17 questioned loans were under a servicing action (foreclosure, moratorium, or delinquency workout agreement) and a fourth borrower had declared bankruptcy.[15]

Rural Development's program handbook details the borrower eligibility requirements. It states that loan approval officials should review all case file documents to ensure that they are completed properly, and must confirm that the decision to underwrite the loan is sound.[16] Rural Development conducted a follow-up review of these 17 questionable loans and agreed that they were not fully processed in accordance with regulations or handbook requirements.

Borrowers Did Not Have a History of Stable and Dependable Income

We identified 8 of 100 loans in our sample, totaling about $922,000, where we questioned the borrowers' eligibility because they did not have a history of earning stable income.[17] Of the eight, five did not have stable wage-based employment income and three did not have stable self-employment income. In all of these cases, borrowers were incorrectly approved for loans

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[13] We issued a Fast Report, dated August 19, 2011, to the Under Secretary for Rural Development describing this issue.

[14] We are 95 percent confident that borrower eligibility is questionable in loans ranging between 770 (about 10 percent) and 1,969 (about 24 percent) of our total universe of 8,054 SFH direct loans. Those loans have a projected value between $86 million and $238 million. See Exhibit A for the summary of monetary results and Exhibit B for the statistical sample design.

[15] Foreclosure is the process of taking possession of a mortgaged property as a result of the mortgagor's failure to keep up mortgage payments. A moratorium is a period of up to 2 years during which scheduled payments for principle, interest, and deposits to the escrow account are not required, but are subject to repayment at a later date. A delinquency workout agreement is an agreement establishing a new repayment plan for a borrower who has delinquent agency debt.

[16] HB-1-3550, Paragraph 8.2.

[17] In one of these loans, we questioned the eligibility determination in both the stable income and the ratio categories. Therefore, it is addressed twice in this finding (totaling 18, versus 17 questionable loans). However, we only counted it once in our total projections.

because field-level personnel had inconsistently interpreted how proper eligibility determinations should be conducted for the SFH Direct Loan program, and, consequently, developed their own methods for conducting determinations.

Rural Development's previous experience has shown that applicants with stable jobs are more likely to repay the loan.[18] According to the program handbook, an applicant must show a history of receiving stable income and a reasonable expectation that the income will continue. This is demonstrated by a 2-year history of stable income. If an applicant's income source (such as wages, salary, overtime, tips, etc.) is unstable and undependable, the income must be excluded from the repayment income.[19] Additionally, self-employed borrowers must submit signed copies of their last two complete Federal Income Tax Returns, along with the appropriate schedules, as well as an additional form that verifies their current income and expenses.[20]

Regarding wage histories, in one case, we identified that the loan file included documentation that showed the borrower had worked at her current job for only 5 months, as of March 2009, and the employer indicated on a form that the borrower's probability of continued employment was "good."[21] The tax return in the file showed the borrower made about $4,300 in 2008, and there was no information on how much the borrower made in 2007. At the same time, the borrower's Form W-2, *Wage and Tax Statement*, for 2005 and 2006 showed that the borrower made less than $1,000 for both of those years. Based on this information, Rural Development improperly determined this borrower to have stable and dependable income and approved the loan in April 2009. A Rural Development State Internal Review later found that the borrower subsequently lost her job and has been unable to make her mortgage payments. The borrower subsequently has declared bankruptcy.

We discussed this case with the field personnel who made the loan. A loan officer said that the eligibility determination relied primarily on the employer's indication that the borrower had a "good" probability of continued employment as sufficient evidence of stable income. Rural Development's national office officials agreed that it appears this borrower did not have stable and dependable income, as the applicant had only held her current job for 5 months and had a sporadic work history prior to that.

We identified three other cases where borrowers had similar short-term employment histories (four to nine months). When we questioned field office personnel on how to prevent occurrences similar to the above four cases in the future, loan officers commented that the national office needs to provide training on scenarios such as these to help them determine whether a borrower's income is stable and dependable. In the fifth wage income case, we found an approved loan for a borrower who was receiving unemployment compensation. The responsible loan officer believed that, in most cases, unemployment compensation is more stable and dependable than job wages. However, national office officials agreed that the determination should have been questioned because unemployment benefits expire after a certain period of time.

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[18] HB-1-3550, Attachment 3-D.
[19] HB-1-3550, Paragraph 4.2, A, 5.
[20] HB-1-3550, Attachment 4-C.
[21] Form RD 1910-5, Request for Verification of Employment.

Regarding self employment income, we found one loan file that showed the borrower's income declined 30 percent from 2007 to 2008. The file also contains a note stating that the borrower had to sell his previous house in 2008, due to declining business income. Further, although the borrower should have been required to submit updated income information before the loan closed in March 2010, we found no information on the borrower's 2009 business income and expenses in the loan file. As of December 2011, this loan is currently being serviced under a moratorium.

Field personnel who made the loan said they did not require updated documentation because they rely on the last 2 years of tax returns to determine eligibility. However, national office officials stated that the field office should have asked for more documentation to determine if the declining income was a general trend, and agreed that the determination was questionable.

In the other two self-employment cases, we found only 1 year of tax returns supporting the borrowers' self-employment income levels. In both cases, field office personnel gave the borrowers an unauthorized exception to the handbook's 2-year tax return requirement. When we discussed these cases with Rural Development field personnel in the offices that made these loans, one loan officer said they only require 1 year of tax returns if the borrower has good overall credit. The other loan officer said that they rely on 1 year of tax returns if the borrower has been self-employed for only 1 year. Rural Development national office officials agreed that Rural Development's procedures require 2 years of tax returns for self-employed individuals and agreed that these borrowers did not appear to have stable and dependable income. Field office personnel again attributed these errors to lack of specific training on these types of scenarios.

Borrowers Did Not Demonstrate a Reliable Credit History

We identified 4 of 100 loans in our sample, totaling about $535,000, where we questioned the borrowers' eligibility because they did not demonstrate a history of reliable credit. Two borrowers had an overall history of adverse credit and two borrowers were listed as having delinquent Federal debts in the Credit Alert Interactive Voice Response System (CAIVRS).[22] This occurred because the loan approving officials did not ensure loan originating officials adequately supported their decision to accept the borrowers' credit histories. Loan approval officials should review all of the documents in a loan file to ensure that they are complete and that the loan originator's decision is sound.[23] These are known as second party reviews. However, the handbook currently provides no further guidance on how to document the scope and timing of their second party reviews in the loan files.

Applicants must demonstrate a credit history that "indicates ability and willingness to repay a loan."[24] Rural Development requires that any applicant with a credit score below 640 be subject

[22] CAIVRS is a Federal government database of delinquent Federal debtors that allows agencies to reduce risk to Federal loan and loan guarantee programs. CAIVRS alerts participating Federal lending agencies when a credit applicant has a Federal lien, judgment, or a Federal loan that is currently in default or foreclosure, or has had a claim paid by a reporting agency. Our audit scope did not include testing the data integrity of CAIVRS; therefore, we make no representations regarding its data validity.
[23] HB-1-3550, Paragraph 8.2.
[24] HB-1-3550, Paragraph 4.1.

to further credit analysis, unlike applicants with a credit score of 640 or higher.[25] The credit analysis brings other information, such as past late payments or collection notices, into the eligibility determination. Loan officers should also check to see whether an applicant is listed in CAIVRS as having delinquent Federal debt. Except in very unusual circumstances, an applicant who is delinquent on a Federal debt is not eligible for a SFH Direct Loan. If the applicant does not notify the agency within 30 days that the CAIVRS problem has been resolved, the application must be rejected.[26]

For two loans in our review, the borrowers' overall credit history did not demonstrate the ability and willingness to repay the loan, and field office personnel did not provide adequate documentation to support their decision to waive the adverse credit history. For example, in one case, the borrower had a credit score of 567, was 30 days late on four rent payments in the prior 24 months, and had a history of other problems, such as collections and past due accounts. We also identified two loans where the borrowers were listed in CAIVRS. The loan files had no documentation to show that the delinquent debt problems in CAIVRS were resolved. In both cases, the loan approving officials did not adequately question the CAIVRS reports in the loan files.

Field office personnel essentially told us loan approving officials did not require additional documentation to support their decisions to approve these borrowers. Loan approving officials did not adequately review and were not required to document the scope and timing of their secondary review of each borrower's credit history. Rural Development national office officials agreed that the credit history of these borrowers was questionable and affirmed that applicants with unresolved CAIVRS issues are ineligible for a loan.

Borrowers' Repayment Ability Ratios Did Not Meet Guidelines

We questioned the borrowers' eligibility in 6 of 100 loans in our sample, totaling about $636,000, because their repayment ratios exceeded Rural Development's established limits.[27] As of December 2011, two of the six loans were under a servicing action. These six borrowers exceeded the repayment ratio limits because Rural Development personnel either miscalculated the borrowers' repayment income or monthly total debt, or did not update the borrowers' information and re-verify their eligibility as part of loan closing preparations. This occurred because of inadequate second party reviews and lack of training in calculating repayment ratios.

The primary consideration in determining whether an applicant can afford to purchase a home is the applicant's repayment income. Repayment ratios are based on an analysis of how much of the applicant's income would go towards housing costs and an analysis of the applicant's total debt if the loan is approved. The principal, interest, taxes, and insurance (PITI) ratio compares housing costs to the applicant's repayment income. The total debt (TD) ratio compares the applicant's total monthly liabilities (non-housing and housing) to repayment income. Borrowers

[25] HB-1-3550, Paragraph 4.12, A.
[26] HB-1-3550, Paragraph 4.11, A.
[27] In one of these loans, we questioned the eligibility in both calculations and re-verifications. Therefore, it is addressed twice in this finding of this report (totaling 7, versus 6, cases). However, we only counted it once in the overall results of this section and in our projections.

must meet the agency's standards for both ratios—no more than a 41 percent TD ratio for all applicants, and a PITI ratio of no more than 33 percent for low income and 29 percent for very low income applicants.[28]

We identified four loans where miscalculations of the borrowers' monthly total debt would have resulted in TD ratios exceeding the 41 percent limit. For example, Rural Development field personnel did not include homeowner's association (HOA) fees as part of the borrowers' total debt. The handbook states that total debt includes regular assessments, such as HOA fees.[29] These miscalculations occurred because of oversights on the part of the loan originating officials and second-party reviewers. Both Rural Development field and national office officials agreed that HOA dues should be included in TD ratios.

In another two instances, the field personnel miscalculated repayment income, which would have resulted in the repayment ratios exceeding prescribed limits. For example, Rural Development field personnel did not properly subtract business-related debts when computing repayment income for a self-employed borrower.[30] This occurred because field personnel improperly assumed that business debts were already subtracted from the net income figure obtained from the borrower's tax returns. We attributed this to a lack of training in calculating income. We asked field office personnel about the last time they received training on calculating income, and they said it had been up to 6 years since they last received formal training on that topic. Rural Development national office officials agreed that business debts need to be subtracted when calculating repayment income for a self-employed borrower and that training in this area could be beneficial.

Since an applicant's circumstances may change between the time the loan is approved and the time of closing, any new information must be reviewed as part of the closing preparation. After all re-verifications have been completed, the loan officers must create a new eligibility summary for the applicant, reflecting any changes in circumstances.[31] We identified one instance where Rural Development personnel did not update and re-verify the borrower's eligibility at loan closing, which affected eligibility determinations. The loan officer conducting the re-verification continued to use estimated property taxes in the calculations, which did not reflect the actual property taxes that were obtained during closing preparations. If the officer had used the actual property taxes, as was required, the borrower's ratios would have exceeded the prescribed ratio limits at closing. Field personnel attributed this to oversight on the part of the loan originating official and the second party reviewer, who did not catch the errors.

In our preceding audit, dealing with National and State level internal controls, we reported issues similar to those described above. While examining results of State-level reviews, we identified recurring control deficiencies, such as borrowers' incomes not being verified, calculated, or documented properly and adverse credit waivers not being properly justified or documented. We

[28] HB-1-3550, Paragraph 4.22, A and Paragraph 4.22, B, 1.
[29] HB-1-3550, Paragraph 4.22, B, 2.
[30] HB-1-3550, Attachment 4-C.
[31] HB-1-3550, Paragraph 8.6, D.

also reported that information was not updated and eligibility was not re-verified at closing, and the scope and timing of second party reviews were not adequately documented.[32]

In response to our prior audit report, Rural Development stated that it is working to implement effective controls to eliminate recurring deficiencies in the SFH Direct Loan Program, and to provide necessary training. In immediate response, the Financial Management Division performed a multiple-year analysis of identified deficiencies from State-level reviews and issued the analysis to Rural Development national office officials. It also provided each Rural Development Administrator with an e-mail detailing the deficiencies for his/her program, so that the Administrator could work to implement effective controls to eliminate recurring deficiencies. We believe these actions will ensure that Rural Development national office officials are aware of recurring problems and help reduce the chances that similar problems occur in future years. Rural Development also represented that it would develop an underwriting compliance tool for second party reviews. This tool would guide loan approving officials through a series of questions to assist them in evaluating credit risk factors, assessing the applicant's eligibility, and documenting their actions. Finally, Rural Development planned to revise its loan file document checklist, in order to improve the re-verification process and ensure that updated information is assessed before loan closing is completed.

We obtained updates on the implementation of these initiatives as of January 2012. Rural Development implemented the new document checklist in September 2011 and the underwriting compliance tool is scheduled to be implemented by March 31, 2012.[33] In addition Rural Development issued Procedure Notice 451 on September 1, 2011, detailing changes made to HB-1-3550. The changes clarified or enhanced procedures such as evaluating whether an applicant's income is stable and dependable, ensuring that current information is used to determine eligibility, and evaluating credit history. Rural Development provided direct loan underwriting training at the SFH national policy meeting, which was held in August 2011. Rural Development also plans to provide internet-based training every 1-2 months during fiscal year 2012 that focuses on the areas of concern.

In conclusion, we are pleased to see that Rural Development is developing new tools and training for the program. We believe this will aid field personnel in carrying out accurate and thorough eligibility determinations, which would help protect the program from ineligible borrowers, with potentially higher risk of default, from receiving direct housing loans.

Recommendation 1

Provide continuing and targeted training to field personnel in the areas of: calculating income, determining stable and dependable income, calculating repayment ratios (including steps to take when updating information as part of closing preparations), and determining if the borrower's credit history indicates the ability and willingness to repay a loan so ineligible applicants do not

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[32] Fast Reports 04703-2-KC (1) and 04703-2-KC (2), May 28, 2010, and Audit Report 04703-2-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Phase II*, September 24, 2010.
[33] The underwriting compliance tool was implemented on March 15, 2012.

receive SFH direct loans. The training should also address how to properly document each of these steps, and should present specific scenarios relevant to the daily work of a loan officer.

Agency Response

The agency responded to our Fast Report, stating that in response to OIG's initial findings that field office personnel need additional training on how to conduct and document accurate eligibility determinations, the agency agrees that enhancing performance tools and providing targeted training will be beneficial for the program. To accomplish this, Rural Development provided direct loan underwriting training at the SFH national policy meeting, which was held in August 2011. Starting in March 2012, Rural Development began providing internet-based training every 1-2 months of fiscal year 2012 that focuses on the areas of concern.

OIG Position

We accept management decision for this recommendation.

Recommendation 2

Review the program handbook sections that address the issues described in this report, and determine if those sections should be revised to provide further clarity to field personnel carrying out the policies and procedures.

Agency Response

The agency's response to our Fast Report stated that the National Office has already made extensive revisions to the HB-1-3550, Direct Single Family Housing Field Office Handbook, to address most of the issues noted in OIG's report. These revisions strengthen guidance on borrower-related underwriting factors, particularly in areas dealing with income, capacity, and credit determinations. Rural Development introduced these Handbook changes during the SFH National Policy Meeting in August 2011. Rural Development issued Procedure Notice 451 on September 1, 2011, detailing the Handbook changes.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Ensure that the cited new document checklist and underwriting compliance tool specifically address the issues described in this report (e.g., information is updated and eligibility is re-verified at closing and the scope and timing of second party reviews are adequately documented).

Agency Response

The agency's response to our Fast Report stated that Attachment 3-G, 502 SFH Checklist, has been revised to instruct field personnel to re-verify an applicant's eligibility using updated documentation. The revised 502 SFH Checklist requires the Loan Approval Official to record the date of closing and the date of the credit documents in the loan file to ensure that these documents are not more than 120 days old by the closing date. The revised 502 SFH Checklist was implemented on September 1, 2011.

As it relates to ensuring an effective second party review process to validate eligibility determinations, obtain re-verifications before loan closing, and document the scope of the Loan Approval Official review, the agency is developing an underwriting and compliance tool that will assist field office personnel in documenting lending decisions. This performance tool will guide the loan reviewer through a series of questions that should be considered during the underwriting analysis and compliance review. This tool was implemented on March 15, 2012.

OIG Position

We accept management decision for this recommendation.

Finding 2: Rural Development Made Questionable Property Eligibility Determinations

Of the 100 loans we reviewed, we questioned eligibility determinations for a total of 6 properties for above-ground swimming pools or for dwellings without sufficient documentation that they were decent, safe, and sanitary. Rural Development field personnel had not always fully complied with the agency's established internal control procedures or Recovery Act provisions. This occurred because Rural Development did not provide field staff with sufficient guidance on the characteristics and requirements needed for a property to be determined eligible. Based on our sample results, we estimate that 483 loans (6 percent of the universe), with a projected total value of $59 million, may have similar issues that would have resulted in loans for ineligible properties.[34] It is important that very-low and low income borrowers are not subjected to costly repairs after closing.

The Recovery Act stipulated that no funds from the Act could be used for swimming pools. On March 20, 2009, the President issued the *Memorandum for the Heads of Executive Departments and Agencies*, which also contained the Recovery Act language stating that none of the Recovery Act funds may be used for any swimming pool. Rural Development's program handbook states that existing dwellings must be decent, safe, and sanitary and meet all applicable State and local

[34] We are 95 percent confident that property eligibility is questionable in loans ranging between 104 (about 1 percent) and 862 (about 11 percent) of our total universe of 8,054 SFH direct loans. Those loans have a projected value between $9 million and $109 million. See Exhibit A for the summary of monetary results and Exhibit B for the statistical sample design.

codes.[35] Rural Development conducted a follow-up review of these 6 questionable loans and agreed that they were not fully processed in accordance with regulations or handbook requirements.

Properties with Swimming Pools

We identified 4 of 100 loans in our sample, totaling about $538,000, where we questioned Rural Development's property eligibility determinations because the properties had swimming pools. This occurred because Rural Development did not issue guidance to the field emphasizing that all swimming pools were prohibited for loans approved with Recovery Act funds. Above-ground pools are allowed in the SFH Direct Loan Program when funded with regular annual appropriations. Field personnel stated that they did not receive guidance that all swimming pools were prohibited for Recovery Act-funded SFH Direct loans.

On March 26, 2009, national office officials forwarded the President's March 20, 2009, memorandum to field personnel in an all-employee e-mail. However, the e-mail did not emphasize the swimming pool prohibition. National office officials agreed that Recovery Act-funded loans should not be approved for properties with above-ground swimming pools. They also stated that Rural Development could have done a better job emphasizing the swimming pool provision to the field staff.

Dwellings Were Not Documented as Decent, Safe, and Sanitary

We identified 2 of 100 loans in our sample, totaling about $199,000, where we questioned the properties' eligibility because the dwellings were not documented to be decent, safe, and sanitary. This occurred because Rural Development procedures do not specify how field personnel are to ensure and document that existing dwellings with decent, safe, and sanitary issues identified during the home inspection are adequately addressed by the seller prior to loan closing. Field personnel in the offices that made these two loans said they relied on the real estate agent and the borrower to determine if the seller made the needed repairs and did not obtain sufficient documentation verifying that the repairs were made.

For example, the inspection report at one property noted that (1) the foundation exhibits evidence of substantial bowing and cracking, (2) there is evidence of wood rot under the rear porch, (3) a handrail should be provided for the stairway to the basement for improved safety, (4) the radiator in the dining room is not in service, (5) the control valves on other radiators are frozen and some of the handles are missing, (6) there were electrical safety issues within the garage, and (7) the chimney is deteriorated under the roof and should be monitored. We found insufficient evidence in the loan file to support that these issues were addressed prior to loan closing.

National office officials confirmed that there is no firm guidance on how field staff should handle/oversee repairs done by the seller prior to closing. We believe that Rural Development should ensure that its guidance adequately addresses this issue, as subjecting very-low and low

[35] HB-1-3550, Paragraph 1.11, B.

income borrowers to costly repairs after closing is not the intended purpose of the SFH Direct Loan Program.

Recommendation 4

Rural Development should ensure property eligibility by (1) effectively communicating new regulations, policies, and procedures to field office locations, and (2) revising HB-1-3550 to specify the actions and loan file documentation required to ensure that problems with indecent, unsafe, and unsanitary conditions are addressed before loan closing.

Agency Response

The agency's May 8, 2012, response to our report states that as it relates to the first item, RHS has long had the practice of discussing new regulations, policies, and procedures during the monthly teleconference with the housing staff in the State Offices. While the State Offices are expected to disseminate the information to their Field Offices, a transcript of the teleconferences is posted to Rural Development's SharePoint site which is accessible to field staff.

Field staff should also be signed up to receive Regulation Update emails from the Regulations and Paperwork Management Branch. RHS will remind the members of the National Association of Credit Specialists and National Association of Support Personnel of these resources at their National Conference in June 2012, (provided travel funds are available or arrangements can be made to participate telephonically), or ask the associations to post a reminder in their newsletters. The estimated completion date for this action is September 30, 2012.

As it relates to the second item, an offer to purchase a property typically contains a repair contingency. If the seller agrees to do the repairs, the buyer and their agent should conduct a walk-thru inspection of the repairs prior to closing. However, relying solely on an anxious first time homebuyer and their commissioned-based agent to conclude that the needed repairs have been satisfactorily completed is not sufficient. RHS will revise Handbook-1-3550 to address how to determine and document the acceptability of seller completed repairs prior to loan closing. The estimated completion date for this action is September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Section 2: Data Integrity

Finding 3: Rural Development Made Improvements to Data Integrity

In our prior audit, we found data input errors and missing data in critical fields in Rural Development's automated information technology system, the Dedicated Loan Origination and Servicing System (DLOS).[36] In this audit, we re-tested the reliability of the data in Rural Development's automated system and confirmed our prior analysis. For this test, we compared source documents in the 100 loan files we reviewed with data from 5 fields that we determined were critical in evaluating the borrower's repayment ability (adjusted income, repayment income, monthly liabilities, PITI ratio, and TD ratio). For the 100 loans in our sample, we found that over 10 percent of the entries in the data system for those 5 fields did not match the information in the loan files that Rural Development field personnel used to make underwriting decisions. In some cases, the system contained blank fields because it did not have automatic data checks in place. In other cases, field personnel were not updating the system based on current information in the loan file because Rural Development lacked appropriate controls to ensure updated entries. These data issues prevented Rural Development from accurately analyzing its data and effectively using the data for compliance purposes.

Rural Development implemented the following corrective actions during the course of the audit:

- Made system changes to correct data integrity issues, such as ensuring that the PITI ratio was recalculated and not lost after updates. Added a warning message on several screens to inform users when the TD ratio exceeded the 41 percent threshold for eligibility.
- Developed a data check report, giving program directors the ability to quickly identify where data errors are occurring and how to correct them. The initial report was posted in July 2011, with an error rate goal of 10 percent. States with error rates exceeding 10 percent would no longer be eligible for SFH Direct reserve funds starting in February 2012.[37]
- Enhanced the data check query tool in July 2011 to ensure system data are accurate and complete. This tool provides an automated method to ensure critical application data have been entered in DLOS and are within acceptable values. This includes checks to alert loan approving officials when fields are blank. Loan approving officials must now use this tool to review data prior to loan approval.
- Implemented a new document checklist in September 2011 that requires field personnel to update the data system with correct information as part of loan closing, addressing the issue of outdated information in the data system.

Based on the actions taken by Rural Development to address the identified data integrity issues, we are making no additional recommendations at this time.

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[36] Audit Report 04703-2-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Phase II*, issued September 24, 2010.
[37] We learned after the completion of fieldwork that Rural Development implemented this policy regarding reserve funds as intended; therefore, we did not review the policy as part of our audit.

Scope and Methodology

We conducted our audit of the Section 502 SFH Direct Loan Program at the Rural Development national office located in Washington, D.C., and the Rural Development Centralized Servicing Center (CSC), located in St. Louis, Missouri.

The Recovery Act included $1 billion in funds to provide SFH direct loans to borrowers for fiscal years 2009 and 2010. The program level increased to about $1.56 billion due to changes in subsidy rates for fiscal year 2010. On March 20, 2009, Rural Development was authorized to begin distributing Recovery Act Funds. The agency obligated almost $1.4 billion during the Recovery Act period, which ended September 30, 2010.

Our audit covered loans closed during the period from March 2009 through June 2010. We statistically selected 100 loans from a universe of about 8,100 Recovery Act loans, totaling over $1 billion, which had closed as of June 30, 2010. The sampling method we used was a simple random sample (See Exhibit B). Rural Development mailed the 100 selected loan files from 38 States and Puerto Rico to a central location, CSC, for our review. We performed our audit fieldwork from October 2010 through December 2011.

To accomplish our audit objectives, we performed the following procedures:

- Obtained and reviewed documents, such as OMB guidance, to gain an understanding of the Recovery Act provisions and requirements related to Rural Development's Section 502 SFH Direct Loan Program.
- Identified and reviewed Rural Development published guidance, instructions, handbooks, and regulations that detail the controls over, and procedures of, the program.
- Developed an electronic template for reviewing loan files to determine if borrowers and properties met eligibility guidelines.
- Reviewed the 100 statistically selected loan files using the electronic template to determine if Rural Development field personnel followed policies and procedures and made proper eligibility determinations regarding borrowers and the homes they purchased.
- Contacted Rural Development field personnel in the offices that approved the selected loans to ask follow-up questions based on our review of the loan files.
- Prepared summaries of loan files where we questioned borrower and/or property eligibility and sent them to Rural Development's national office for review and comment.
- Met with Rural Development national office officials to discuss the issues we found during our review and to obtain their positions and responses.

We obtained Rural Development SFH Direct Recovery Act loan data. The data came from information uploaded from DLOS to the Data Warehouse. We tested the reliability of the data by comparing them to source documents in the loan files we reviewed and reported those results in Finding 3 of this report.

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, 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.

Abbreviations

AMI	Area Median Income
CAIVRS	Credit Alert Interactive Voice Response System
CSC	Centralized Servicing Center
DLOS	Dedicated Loan Origination and Servicing System
HOA	Homeowner’s Association
OIG	Office of Inspector General
OMB	Office of Management and Budget
PITI	Principal, Interest, Taxes, and Insurance
RHS	Rural Housing Service
SFH	Single-Family Housing
TD	Total Debt

Exhibit A: Summary of Monetary Results

Finding	Recommendation	Description	Amount (In Millions)	Category
1	1	Borrowers Did Not Meet Eligibility Guidelines	$162	Questioned Costs and Loans, No Recovery
2	4	Properties Did Not Meet Eligibility Guidelines	$59	Questioned Costs and Loans, No Recovery

Please Note: The cumulative amount of monetary results is greater than the overall projection of $208 million because there was a loan which had both borrower and property issues.

Exhibit B: Statistical Sample Design

Objective:

This sample was designed to support the objectives and methodology of the related audit.

Audit Universe:

The universe consisted of 8,054 loans, with a total universe value of over $1,020.2 million that were closed by Rural Development under the Recovery Act as of June 30, 2010. The universe list was provided to OIG statisticians in coordination with the OIG Data Analysis and Special Projects Division.

Sample Design and Modifications:

We decided to use a simple random sample design. We chose a sample size of 100 because we wanted the ability to report findings for attributes with a +/- 8 percent precision (confidence interval) for a 20 percent error rate at a 95 percent confidence level.

Results:

Results are projected to the audit universe of 8,054 loans. Achieved precision, which is indicated by the confidence interval, is reported here for a 95 percent confidence level.

The summaries and tables below show the projected number of loans and dollar value for questionable borrower and property eligibility. For each estimate where we question eligibility, the upper and lower bounds of a 95 percent confidence interval are included in the table.

Questionable Borrower Eligibility

Based on the sample results, we project that between 770 and 1,969 loans, totaling between about $86.1 million and $237.6 million, were made to borrowers with questionable eligibility. The point estimate is that 1,369 such loans, totaling about $161.8 million, were made. Achieved precision was +/- 7.4 percent of the universe of loans and +/- 7.4 percent for the dollar value of the loans.

Measure of Criterion	Point Estimate	95 Percent Confidence Level		Precision (+/-)	Raw Data (Actual observed in sample)
		Lower Bound	Upper Bound		
Number of Recovery Act loans where we questioned borrower eligibility determinations	1,369	770	1,969	600 loans[38]	17
Dollar amount of Recovery Act loans where we questioned borrower eligibility determinations	$161,816,604	$86,069,810	$237,563,399	$75,746,795[39]	$2,009,146

[38] Precision of 600 represents +/- 44 percent of the point estimate for loans [600/1,369 = 44 percent], or about +/- 7 percent of the universe [600/8,054 = 7.4 percent].
[39] Precision of $75.7 million represents +/- 47 percent of the point estimate for loans [75.7/161.8 = 47 percent], or about +/- 7 percent of the universe [75.7 million/1,020.2 million = 7.4 percent].

Questionable Property Eligibility

Based on the sample results, we project that between 104 and 862 loans, totaling between about $9.2 million and $109.4 million, were for properties with questionable eligibility. The point estimate is that 483 such loans, totaling about $59.3 million, were made. Achieved precision was +/- 4.7 percent of the universe of loans and +/- 5.0 percent for the dollar value of the loans.

Measure of Criterion	Point Estimate	95 Percent Confidence Level		Precision (+/-)	Raw Data (Actual observed in sample)
		Lower Bound	Upper Bound		
Number of Recovery Act loans where we questioned the property eligibility determination	483	104	862	379 loans[40]	6
Dollar amount of Recovery Act loans where we questioned the property eligibility determination	$59,319,321	$9,248,693	$109,389,949	$50,070,628[41]	$736,520

[40] Precision of 379 represents +/- 78 percent of the point estimate for loans [379/483 = 78 percent], or about +/- 5 percent of the universe [379/8,054 = 4.7 percent].

[41] Precision of $50.1 million represents +/- 84 percent of the point estimate for loans [50.1/59.3 = 84 percent], or about +/- 5 percent of the universe [50.1 million/1,020.2 million = 5.0 percent].

Combined Questionable Borrower and Property Eligibility

Based on the sample results, we project that between 1,111 and 2,433 loans, totaling between about $124.3 million and $292.3 million, were made to borrowers or for properties with questionable eligibility. The point estimate is that 1,772 such loans, totaling about $208.3 million, were made. Achieved precision was +/- 8.2 percent of the universe of loans and +/- 8.2 percent for the dollar value of the loans.

Measure of Criterion	Point Estimate	95 Percent Confidence Level		Precision (+/-)	Raw Data (Actual observed in sample)
		Lower Bound	Upper Bound		
Total number of Recovery Act loans where we questioned the overall eligibility determination	1,772	1,111	2,433	661 loans[42]	22
Total dollar amount of Recovery Act loans where we questioned the overall eligibility determination	$208,257,579	$124,254,867	$292,260,291	$84,002,712[43]	$2,585,766

[42] Precision of 661 represents +/- 37 percent of the point estimate for loans [661/1772 = 37 percent], or about +/- 8 percent of the universe [661/8,054 = 8.2 percent].
[43] Precision of $84 million represents +/- 40 percent of the point estimate for loans [84.0/208.3 = 40 percent], or about +/- 8 percent of the universe [84 million/1,020.2 million = 8.2 percent].

USDA’S
RURAL DEVELOPMENT’S
RESPONSE TO AUDIT REPORT

United States Department of Agriculture
Rural Development

May 8, 2012

TO: John M. Purcell
Director
Financial Management Division

FROM: Tammye Trevino /s/ Tammye Trevino
Administrator
Housing and Community Facilities Programs

SUBJECT: Office of Inspector General Official Draft
Single Family Housing Direct Loans Recovery Act Controls
Compliance Review of Borrowers' Eligibility Determinations
(Audit No. 04703-0003-KC)

The Rural Housing Service (RHS) is appreciative for the breadth and depth of the Office of Inspector General's (OIG) subject audit. RHS concurs with the facts presented in the Official Draft Report and welcomed OIG's recommendations that will strengthen the Agency's internal controls and reduce the risk of improper payments. Most of the recommendations have been fully addressed and accepted by OIG. Below is the Agency's response to Recommendation 4 (which is the only open recommendation without a pending request for close out) and to the Recommendation Summary.

According to Recommendation 4:

Rural Development should ensure property eligibility by (1) effectively communicating new regulations, policies, and procedures to field office locations, and (2) revising HB-1-3550 to specify the actions and loan file documentation required to ensure that problems with indecent, unsafe, and unsanitary conditions are addressed before loan closing.

As it relates to the first item, RHS has long had the practice of discussing new regulations, policies, and procedures during the monthly teleconference with the housing staff in the State Offices. While the States Offices are expected to disseminate the information to their Field Offices, a transcript of the teleconferences is posted to Rural Development's (RD) SharePoint site which is accessible to field staff.

Field staff should also be signed up to receive Regulation Update emails from the Regulations and Paperwork Management Branch's regs@newsbox.usda.gov. RHS will remind the members of the National Association of Credit Specialists and National Association of Support Personnel of these resources at their National Conference in June 2012, (provided travel funds are available or arrangements can be made to participate telephonically), or ask the associations to post a reminder in their newsletters. The estimated completion date for this action is September 30, 2012.

As it relates to the second item, an offer to purchase a property typically contains a repair contingency. If the seller agrees to do the repairs, the buyer and their agent should conduct a walk-thru inspection of the repairs prior to closing. However, relying solely on an anxious first time homebuyer and their commissioned-based agent to conclude that the needed repairs have been satisfactorily completed is not sufficient. RHS will revise Handbook-1-3550 to address how to determine and document the acceptability of seller completed repairs prior to loan closing. The estimated completion date for this action is September 30, 2012.

According to the Recommendation Summary:

Rural Development needs to (1) provide continuing and targeted training to field personnel, (2) review the program handbook and determine if it should be revised to provide further clarity to field personnel carrying out the policies and procedures, (3) ensure that the document checklist and underwriting compliance tool specifically address the borrower-related issues described in this report, and (4) ensure new regulations, policies, and procedures are effectively communicated and implemented at field office locations.

Facing a trend of tighter budgets and reductions to salary and expenses, RHS is delicately balancing employee development and program administration. Despite the challenges, RHS has implemented the first three recommendations and will implement the fourth recommendation in Fiscal Year 2012.

I am thankful for the Financial Management Division's coordination efforts during this subject audit and I look forward to this report being finalized.

Should you have any questions regarding the contents of this memorandum, please call Brooke Baumann of the Single Family Housing Direct Loan Division, at (202) 690-4250.

Informational copies of this report have been distributed to:

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Agency Liaison Officer, RHS

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