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Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds

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U.S. Department of Agriculture
Office of Inspector General
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REPLY TO
ATTN OF: 04703-01-CH

TO: Dallas Tonsager
Under Secretary
Rural Development

Tammye Trevino
Administrator
Rural Housing Service

THROUGH: John Purcell
Director
Financial Management Division

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

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

This report presents the results of our audit of internal controls related to the eligibility of borrowers who obtained single family housing loan guarantees as part of the American Recovery and Reinvestment Act of 2009. The report compiles the results of our work that we reported to you in five Fast Reports during the period May 11, 2009, to June 10, 2009. Excerpts of your responses and the Office of Inspector General's Position are incorporated into the Findings and Recommendations section of the report.

Based on your agency's responses, we have accepted management's decision for all recommendations in the report. Please follow your agency's internal procedures in forwarding documentation for final actions to the Office of the Chief Financial Officer. In accordance with Departmental Regulation 1720-1, all final actions need to be completed within 1 year of each management decision.

We appreciate the courtesies and cooperation extended to us by members of your staff during this audit.

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Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds

Executive Summary

This report presents the results of our first phase of audit work related to the eligibility of borrowers who obtain single family housing loan guarantees from funds authorized by the American Recovery and Reinvestment Act of 2009 (the "Recovery Act").[1] In enacting the Recovery Act, the Congress emphasized the need for accountability over the expenditure of funds. In response, the Office of Management and Budget required Federal agencies to establish rigorous internal controls to ensure that Recovery Act funds were distributed in accordance with that objective.

Our role, as mandated by the Recovery Act, was to monitor agency activities and ensure that funds were expended in a manner that minimized the risk of improper use. Our work during this phase evaluated the agency's policies, procedures, and internal controls in distributing Recovery Act funds, and was designed to be preventative in nature. We did not perform tests to verify lender compliance with agency policies and procedures. As such, we did not conclude on the overall extent of abuse that was, or could be, occurring in the program, or if lenders had made errors or taken advantage of the internal control weaknesses cited in this report.

In performing this role, we identified several internal control findings and reported those findings as we found them to the Under Secretary for Rural Development via five Fast Reports. We issued those reports during the audit to notify agency officials of conditions that needed immediate attention. The findings included (1) no requirement that lenders submit documentation for loans evaluated by the agency's Guaranteed Underwriting System (GUS),[2] (2) noncompliance by field staff and lenders with the agency's maximum debt ratio requirements,[3] (3) insufficient lender oversight of independent brokers originating loans for participation in the program, (4) the lack of a segregation of duties over the review and approval of loan guarantee applications at agency field offices, and (5) weaknesses in the procedures used by independent appraisers to establish the value of property used as collateral for loan guarantees.

The Recovery Act included almost $10.5 billion in funds for the U.S. Department of Agriculture (USDA) to guarantee single family housing loans in rural areas. Rural Development, a mission area within USDA, is responsible for establishing agency policy and procedures for the Single Family Housing Guaranteed Loan Program. As of September 16, 2009, Rural Development had obligated over $7.9 billion to guarantee about 65,000 loans.

In our review of internal controls, we determined that the agency did not require lenders to submit documentation to support borrower eligibility for loans evaluated by the agency's GUS. This control weakness concerned us because lenders could either make mistakes or intentionally enter incorrect borrower information into GUS and it would not be detected by agency field

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[1] Public Law 111-5, dated February 17, 2009.
[2] GUS is an automated underwriting system used by lenders to submit applications for loan guarantees.
[3] Borrowers with high debt to income ratios have a higher risk of default.

officials. In our view, if uncorrected, this weakness increased the likelihood that the agency would guarantee loans for substandard borrowers.

On May 11, 2009, we formally notified the agency about this finding through Fast Report (1) and recommended several actions to correct the weakness. On May 18, 2009, the agency suspended the use of GUS until more stringent controls could be implemented in the system. The agency's response also proposed a pre-loan closing review of 5 percent of all loan guarantee requests made through GUS, a second level review for a random sample of conditional commitment approvals, and increased compliance testing with a focus on GUS loan origination quality. We agreed with the agency's proposed corrective actions.

Our evaluation of another key agency control, the approval of waivers to borrower debt ratio requirements, disclosed that field officials were not following prescribed agency policy.[4] We found that agency field officials had approved lender requests for waivers of borrower debt ratio requirements based only on a description of the compensating factors. This violated agency requirements, which stated that lenders were to provide evidence of compensating factors to support all waiver requests. According to the field staff we interviewed, they did not interpret the requirement to mean that actual physical documents had to be obtained from lenders. The risk of default is higher for borrowers with higher debt ratios. In our audit, we noted that 11 of the 33 borrowers reviewed had total debt ratios that exceeded the agency's guidelines of 41 percent. In fact, 5 of the 11 had debt ratios equal to or greater than 50 percent. None had evidence of compensating factors.

In Fast Report (2), dated May 14, 2009, we formally notified agency national officials about this finding and recommended corrective action. The Under Secretary for Rural Development's response dated May 21, 2009, stated that the immediate supervisor for all loan approval officials would review manually underwritten loans with debt ratios above certain thresholds.[5] Agency national officials also issued a memorandum to its field staff on June 24, 2009, informing them that "Documentation of the compensating factors supporting the ratio waiver must accompany the lender's request." We agreed with the agency's proposed corrective actions.

We found that one of the agency's internal controls relied upon lenders to monitor the actions of independent brokers who were originating loans. We concluded that brokers who altered critical information on loan applications, such as borrower income, would only be detected if lenders reviewed and verified the information. We determined, however, that lenders had little incentive to do so because they typically sell the loans to other lenders shortly after making the loans. Thus, in our view, loans originated by mortgage brokers were more vulnerable to abuse.

In Fast Report (3), dated May 22, 2009, we formally notified agency national officials about this finding and recommended corrective action. The Under Secretary for Rural Development's response dated June 1, 2009, stated that the agency would increase its compliance testing with a focus on loans originated by brokers. We agreed with the agency's proposed corrective actions.

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[4] A borrower's debt ratio is calculated by dividing total debt or house payments, interest, taxes, and insurance by gross income.
[5] These loan guarantee requests were sent directly to Rural Development field offices, as opposed to being underwritten by GUS.

A basic internal control for any organization is the segregation of duties between the review, approval, and recording of a transaction. In fact, the Government Accountability Office emphasized that no one individual should control all key aspects of a transaction or event.[6] We found that the agency did not require the segregation of duties at field offices. We observed that agency loan specialists were able to, and on occasion did, perform all functions in the loan guarantee process with no supervisory review prior to issuance of the guarantee. These functions included the review, approval, and recording of applications for loan guarantees into the agency's system of records where the obligation of funds would occur.

On May 22, 2009, we issued Fast Report (4) to the agency. In our report, we recommended that the agency implement a second party review of applications prior to issuance of the guarantee. We also recommended that the agency segregate duties in offices where it was feasible based on staffing levels.

The Under Secretary for Rural Development's June 1, 2009, response stated that the agency would implement a second party review of guaranteed loan applications. The Under Secretary added that a random sample of applications for loan guarantees that had not been closed would be selected for second party review on a bi-weekly basis. However, agency national officials were reluctant to segregate duties at field offices because of staff limitations and the difficulty with implementation when the staff is busy. They were confident that the second party review procedures, along with procedures currently used by field staff when reviewing and approving applications for loan guarantees, would adequately address our concerns.

In our view, the segregation of duties would be the best action to reduce the risk of errors or abuse. However, we accepted management decision for this recommendation because we had not performed tests of guaranteed loans and could not reference errors or mistakes attributable to the lack of a segregation of duties. We plan to examine this control and loans as we continue our assessment of program activities related to the Recovery Act.

We also concluded that a key internal control, an independent property appraisal to ensure that homes are accurately valued, may not be adequate to protect the Government's security interests. We noted that 29 of the 33 appraisals we examined indicated a stable housing market, which contradicted statistics reported by the National Association of Realtors that showed declining markets in most of the country. In addition, we noted that some appraisers had used older sales data to determine market value. Further, none of the appraisals considered distressed sales when assessing the value of homes. Since Rural Development guarantees up to 100 percent of the purchase price of residential property, plus up to an additional 2 percent for fees, it is critical to ensure that the value is not overstated at the time of purchase.

On June 10, 2009, we issued Fast Report (5) to formally notify agency national officials about this finding and recommended that the agency conduct an analysis using agency appraisers. The Under Secretary for Rural Development's response dated June 17, 2009, stated that the agency would require the use of Fannie Mae Form 1004MC/Freddie Mac Form 71, Market Conditions Addendum to the Appraisal Report, and a technical desk review by agency State licensed or certified appraisers. We agreed with the agency's proposed corrective actions.

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[6] Government Accountability Office, Standards for Internal Control in the Federal Government, dated November 1999.

In conclusion, this phase of our planned audit work in the Single Family Housing Guaranteed Loan Program focused on key internal controls designed to ensure the eligibility of borrowers participating in the program. One key control we did not evaluate during this phase of our audit work was the verification of information used by lenders in the underwriting analysis process. We evaluated that control, and reported our concerns and recommendations in an audit report issued in July 2009.[7] In that report, we notified agency national officials that the findings would directly impact funds disbursed as part of the Recovery Act. We encouraged agency officials to quickly implement the corrective actions agreed upon in the report to protect Recovery Act funds. We plan to perform follow up work to verify lender compliance during the next phase of our planned audit work.

Recommendation Summary

We made 8 recommendations to agency national officials to improve internal controls over program activities. The most significant recommendation included requiring documentation to support the accuracy and existence of information for loans evaluated by GUS. We also recommended increased oversight of lenders, mortgage brokers, and agency field officials; the segregation of duties at agency field offices; the clarification of agency guidelines on debt ratio waivers; and an analysis using agency appraisers to determine the accuracy of property values for loans funded by the Recovery Act.

Agency Response

Agency national officials generally agreed with our findings and recommendations. They proposed corrective actions that should reduce the risk of errors or potential lender abuse that would result in significant loss to the program.

The agency responses are posted on our website with the applicable Fast Report. These reports can be found at http://www.usda.gov/oig/recovery/recovery_reports.htm.

OIG Position

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

[7] Audit Report No. 04601-17-Ch, Controls Over Lender Activities in the Single Family Housing Guaranteed Loan Program, dated July 2009.

Background and Objectives

Background

In response to the current economic downturn, Congress passed the American Recovery and Reinvestment Act of 2009 (the "Recovery Act"), (Public Law 111-5, dated February 17, 2009). The Recovery Act appropriated $10.472 billion in funds to guarantee the repayment of single-family housing loans made by private lenders to low- and moderate-income borrowers in rural areas. A guarantee substantially reduces a lender's risk of loss because the Government will reimburse the outstanding principal and interest if a borrower defaults on a loan.

Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of the funds. On February 18, 2009, the Office of Management and Budget (OMB) 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. OMB issued additional guidance on April 3, 2009, to reinforce ongoing work by clarifying existing requirements and establishing additional steps that must be taken to facilitate the accountability and transparency objectives of the Recovery Act. On June 22, 2009, OMB issued guidance for carrying out the reporting requirements included in Section 1512 of the Recovery Act.

The U.S. Department of Agriculture (USDA), through its Rural Development mission area, guarantees single-family housing loans in rural areas. On March 17, 2009, Rural Development was authorized to begin distributing Recovery Act funds through the Section 502 Single-Family Housing Guaranteed Loan Program. The Rural Housing Service (RHS), an agency within the Rural Development mission area, is responsible for overseeing the distribution of those funds. As of September 16, 2009, Rural Development had obligated over $7.9 billion to guarantee about 65,000 loans.

RHS officials are responsible for providing guidance on program activity,[8] and for performing compliance reviews of all lenders approved by the national office. Rural Development field staff in 47 States is responsible for issuing guarantees on loans made by private lenders such as rural community banks, national banks with operations in multiple States, and nationwide mortgage lenders. The RHS national office is responsible for approving lenders to participate in the program on a nationwide basis. Rural Development's field staff approves lenders, which generally have smaller operations, to participate in individual States. The agency performs both State and national office Lender Compliance Reviews on 2 or 5-year cycles depending on the volume of loans originated by a lender.[9]

Lenders submit requests for loan guarantees on Form RD 1980-21 "Request for Single Family Housing Loan Guarantee." Rural Development requires lenders to submit Form RD 1980-21 when applications for guarantees are sent either by mail or electronically via the Guaranteed Underwriting System (GUS). The GUS is an automated underwriting system implemented in March 2007 to streamline the process used by lenders to submit applications. For

[8] Rural Development Instruction 1980-D, dated June 21, 1995 (as revised).
[9] Rural Development Instruction 1980.309(g)(2)(iii), dated June 21, 1995.

Recovery Act funds, agency national officials estimated that about 40 percent of the applications for loan guarantees will be processed through GUS.

For loan guarantee requests sent directly to Rural Development field officials, and processed manually, lenders must perform an underwriting analysis that includes a credit report, appraisal report and verification of the borrower's income. After submission, field officials review applications for completeness and to verify borrower eligibility to participate in the program. However, agency field officials do not verify the accuracy of borrower information with an independent source, such as borrower income with employers. (Note: We reported this control weakness and our recommendations for corrective action in an audit report issued in July 2009.[10]) In that report, we notified agency national officials that the findings would directly impact funds disbursed as part of the Recovery Act. We encouraged agency officials to quickly implement the corrective actions agreed upon in the report to protect Recovery Act funds.

For requests submitted electronically by lenders, GUS performs the underwriting analysis. GUS will provide lenders with a preliminary decision of potential acceptance ("accept") or rejection ("refer") before an application is submitted to the agency. Prior to this audit, RHS did not require lenders to submit documentation to support borrower information input into GUS. Regardless of the method of submission, the agency will guarantee up to 102 percent of the purchase price of residential property.[11]

RHS requires that borrowers have a credit score of 620 or higher.[12] The agency also requires that a borrower's total of principal, interest, taxes, and insurance payments not exceed 29 percent of gross income. Further, a borrower's total debt to gross income cannot exceed 41 percent.[13] These measures are designed to ensure that borrowers are credit worthy and can afford the mortgage payments. The instructions must be adhered to unless waived by agency officials.[14]

In the mortgage lending industry, it is common for one lender to originate a loan and then to sell that loan to another lender who services it. In these situations, it is the servicing lender and not the originating lender that will request RHS officials to honor the Government's guarantee on a defaulted loan. RHS officials determine if the lender has serviced the loan in accordance with agency instructions prior to paying a loss claim.[15]

Objectives

Our audit oversight of Recovery Act funds involves several objectives. These include ensuring that agency officials (1) timely and effectively distribute funds, (2) establish effective internal control procedures, and (3) establish compliance and monitoring operations. We will also monitor participatory compliance with eligibility requirements. During this phase of our audit efforts, we focused on the internal controls in place to provide reasonable assurance that single family housing loans guaranteed with Recovery Act funds were made to eligible borrowers in accordance with program requirements.

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[10] Audit Report No. 04601-17-Ch, Controls Over Lender Activities in the Single Family Housing Guaranteed Loan Program, dated July 2009.
[11] 100 percent of the purchase price of the property plus up to 2 percent of approved fees.
[12] Rural Development Administrative Notice 4441, dated May 7, 2009.
[13] Rural Development Instruction 1980.345(c)(1) and (3), dated June 21, 1995.
[14] Rural Development Instruction 1980.345(c)(5), dated June 21, 1995.
[15] Rural Development Instruction 1980.376(a)(3) and (b)(6), dated June 21, 1995.

Section 1: Control Weaknesses Provide Opportunities for Guarantees on Substandard Loans

Finding 1: Lenders Could Submit Inaccurate Borrower Information Undetected through the Agency's Automated Underwriting System

RHS did not require lenders to submit documentation that supported borrower eligibility for loan guarantee applications accepted by the agency's Guaranteed Underwriting System (GUS). Thus, lenders had the ability to enter inaccurate borrower information into GUS without detection by agency officials prior to approving a loan guarantee. This control weakness increased the likelihood that the agency would incur losses because it had guaranteed loans for substandard borrowers.

We are concerned about the lack of supporting documentation because lenders could either make mistakes or intentionally enter incorrect borrower information into GUS and it would not be detected by agency field officials. By contrast, for applications that are processed manually by agency field officials, the agency requires lenders to submit supporting documentation, such as employer earning statements that support borrower income.[16] In this way, agency field officials can verify that lenders had not entered inaccurate information on applications.

Agency national officials stated they had not required supporting documentation for two reasons. First, it would slow the process of approving loan guarantee applications. This would contradict an important reason for implementing GUS, which was to streamline the underwriting and approval process. Second, agency statistics indicate that loan guarantee applications accepted by GUS have a lower default rate than applications submitted physically by lenders.

To support their contention, agency national officials stated that "Based on current data, loans initiated through GUS that receive "Accept" recommendations continue to perform better than manually underwritten loans. GUS represents a considerable investment, which we are monitoring very closely. Approved lenders who choose to utilize GUS must meet certain lender eligibility requirements and undergo Agency approved training prior to using GUS."[17]

Our review of the agency's statistics confirmed that loans guaranteed through GUS had a lower default rate. However, we noted that the agency's statistics were from a period when fewer lenders participated in the program, and those lenders were selected because the loans they made generally had lower default rates. Thus, they were lenders who had historically submitted high quality loans.

Since enactment of the Recovery Act, the agency has seen a significant increase in the number of lenders submitting applications through GUS. In fact, the agency authorized all lenders who have completed training to submit applications via this method. According to agency national officials, at the time of our field work approximately 40 percent of all applications for loan

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[16] Rural Development Instruction1980.353(c)(15) and (e)(ii), dated June 21, 1995.
[17] Rural Development response to the Office of Inspector General Fast Report (1), Audit No. 04703-01-Ch, dated May 14, 2009.

guarantees involving Recovery Act funds had been processed through GUS compared to an average 25 percent prior to that time. Thus, in opening the system to all lenders, rather than those who have historically submitted high quality loans, default rates may rise.

During our field visits, we asked agency field officials if lenders were making multiple preliminary inquiries of the system before submitting applications. Several officials informed us that some lenders had modified borrower information multiple times before submitting loan applications for approval through GUS. We considered this activity to be suspicious, as did agency officials. It was possible that at least in some instances, this was done by lenders in an effort to overcome GUS' eligibility controls that were designed to prevent the submission of substandard loan applications.

We discussed our conclusions regarding this control weakness in detail with agency national officials on April 28, 2009. They generally agreed with our conclusions and agreed to implement our corrective actions. In Fast Report (1) to the agency, dated May 11, 2009, we formally notified agency national officials about this finding. At that time, we did not conclude on the overall extent of abuse that was, or could be, occurring in the program because we had not yet performed tests to determine if lenders had made errors or purposely taken advantage of the weakness. However, we were concerned that some lenders would exploit the weakness and submit substandard loans to Rural Development. Therefore, we recommended that agency national officials take action to mitigate the potential for abuse.

Recommendation 1

Perform additional compliance reviews of lender files to verify the existence and accuracy of information submitted via GUS.

Agency Response

On May 14, 2009, the Acting Under Secretary for Rural Development stated in a response to our Fast Report (1) that effective May 18, 2009, RHS would suspend the use of GUS to process loan guarantee requests with Recovery Act funds. The response added that "We are erring on the side of caution with this action, as we have no indication that the ARRA loan funds or that GUS are being used improperly. Our goal is to adopt recommendations from OIG and do our utmost to ensure the ARRA funds are being expended in a manner that minimizes the risk of improper use."

The May 14, 2009, memorandum stated that agency national officials would develop additional quality control standards for GUS, which would be completed within 4 to 12 weeks. Specifically, it stated that "We are incorporating a pre-loan closing review of 5 percent of GUS submissions for each GUS approved lender." It added that "GUS will be modified to flag 5 percent of all loans for review. The agency will issue additional quality control procedures for all manually underwritten conditional commitment approvals, including loans processed through GUS. The memorandum also stated that "A second level review of a random sample of conditional commitment approvals will be performed by a designated Agency employee. The review will have increased emphasis on a number of risk factors including the approval of ratio waivers exceeding certain thresholds."

The agency will also increase compliance testing conducted after loan closing with a focus on GUS loan origination quality. Specifically, the memorandum stated that “Reviews will concentrate on the participating lenders that originate a high volume of GUS loans or that may have certain GUS loan performance metrics. This work will be delivered, via an ARRA procurement/contract, and will compliment a host of ongoing compliance work conducted by the National Office and field office staff.” On July 7, 2009, an agency national official informed us that GUS had been modified to randomly select loans and the review processes had been implemented by field offices.

OIG Position

We accept management decision for this recommendation.

Recommendation 2

Require lenders to provide supporting documentation for a random sample of loans submitted via GUS, prior to loan guarantee approval.

Agency Response

On May 14, 2009, the Acting Under Secretary for Rural Development stated that the agency will require lenders to submit supporting documentation for all loan guarantee applications accepted by GUS with a total debt ratio greater than 50 percent, and for all applications where lenders make 10 or more same-loan requests when using GUS. In addition, the agency will require lenders to submit supporting documentation for the 5 percent of applications selected by GUS for the pre-loan closing review. An agency national official informed us on July 7, 2009, that GUS had been modified to notify both lenders and field staff that supporting documentation was to be submitted to Rural Development for all future loans.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Limit the number of preliminary inquiries on each individual borrower application submitted through GUS.

Agency Response

On May 14, 2009, the Acting Under Secretary for Rural Development stated that the agency will require lenders who make 10 or more same-loan requests through GUS to submit supporting documentation for that loan guarantee application. An agency national official informed us on July 7, 2009, that all modifications to GUS had been made, and lenders and field staff were notified on June 29, 2009.

OIG Position

We accept management decision for this recommendation.

Finding 2: Debt Ratio Waiver Requirements Not Followed

Rural Development field officials approved lender requests for waivers of debt ratio requirements based only on a description of the compensating factors.[18] The agency requires lenders to submit requests for waivers in writing and provide documentation of the compensating factors used as the basis for not adhering to debt ratio requirements.[19] Agency national officials expected field staff to obtain evidence such as borrower bank statements where the compensating factor was a large balance in a savings account. However, agency field officials generally did not interpret this requirement to mean that actual physical documents supporting the compensating factors had to be obtained from lenders, and we found no evidence of this documentation in loan files. Thus, the agency may have approved guarantees for substandard loans.

Agency field officials in both States we visited informed us that agency policy did not require lenders to submit documentation. Their interpretation was that lenders merely had to describe the compensating factor. In fact, one State's lender handbook stated that lenders had to request ratio waivers from Rural Development in writing, and had to identify compensating factors on the transmittal summary. The handbook did not mention the submission of documents to support the compensating factors.

We identified where lenders requested waivers of debt ratios for borrowers whose ratios exceeded agency guidelines. Agency field officials approved those waivers based solely on the lenders written requests for the waivers. The agency's guidelines state that the borrower ratio of principal, interest, taxes, and insurance (PITI) to gross income should not exceed 29 percent. It further states that the ratio of total debt to gross income should not exceed 41 percent.

Our concern is that lenders may create or exaggerate compensating factors to justify approving a loan for a substandard borrower. During our review, we identified 9 instances, out of 33 files reviewed, where borrower PITI ratios exceeded agency guidelines. The highest ratio was over 42 percent. We also identified 11 instances, from the 33 files, where borrower total debt ratios exceeded agency guidelines. Five borrowers' total debt ratios were at least 50 percent, with the highest over 60 percent. In our view, the risk that lenders may take advantage of this weakness is significant enough that agency officials needed to take action to mitigate the potential for abuse.

We discussed this finding in detail with agency national officials on April 29, 2009. At that meeting, we explained our concern and recommended that the agency clarify its requirements that lenders submit supporting documentation for all waivers on loans. They generally agreed with our concern and agreed to implement corrective action. In Fast Report (2) to the agency, dated May 14, 2009, we formally notified agency national officials about this finding.

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[18] Rural Development Administrative Notice No. 4336, dated May 7, 2008, states that compensating factors include, but are not limited to, a Fair Isaac Corporation (FICO) score of 660 or higher, a minimal increase in housing costs, a long-term history with one employer, a large cash reserve, and potential for future earnings growth.
[19] Rural Development Administrative Notice No. 4366, dated May 7, 2008.

Recommendation 4

Clarify agency requirements that lenders submit supporting documentation for all waivers on loan guarantees.

Agency Response

On May 21, 2009, the Under Secretary for Rural Development responded to Fast Report (2). In the response, the Under Secretary stated that the immediate supervisor for all loan approval officials will review all manually underwritten loans with debt ratios above certain thresholds. Further, written supervisory concurrence will be required to be retained in the loan file. RHS will also require that supporting documentation of the compensating factors be retained as part of the permanent record. For loan guarantees accepted by GUS, as stated in its May 14, 2009, response to Fast Report (1), the agency will also place increased emphasis on ratio waivers during second level reviews of a random sample of approved conditional commitments.

On June 24, 2009, the agency issued a memorandum to its field staff informing them of additional quality control measures being implemented for loan guarantees obligated using Recovery Act funds. The memorandum stated that effective July 1, 2009, supporting documentation would be required from lenders for all loan guarantees accepted by GUS when the total debt ratio is 50 percent or higher. The agency notified lenders of this requirement on June 12, 2009. The memorandum also stated "Documentation of the compensating factors supporting the ratio waiver must accompany the lender's request." The memorandum also stated that a second level approval would be required if the PITI ratio exceeds 35 percent or the total debt ratio exceeds 45 percent.

OIG Position

We accept management decision for this recommendation.

Finding 3: Loans Originated by Mortgage Brokers Vulnerable to Abuse

Mortgage brokers who alter critical information on loan applications, such as borrower income, will only be detected if originating lenders review and verify the information. We determined, however, that originating lenders have little incentive to do so because they typically sell the loans to other lenders shortly after making the loans. In this way, they can avoid liability for substandard loans. Thus, Rural Development may unknowingly guarantee such loans.

It is a common practice in the mortgage industry for lenders to use in-house loan officers as well as independent mortgage brokers to originate loans. The loan origination function consists of taking applications from prospective borrowers, determining their eligibility, and verifying information such as borrower income and employment. Agency field officials informed us that larger lenders were more likely to use brokers to originate loans than small lenders such as local community banks. In addition, they informed us that some lenders originated significant loan volume using brokers.

The agency relies on lenders' underwriting processes to scrutinize loan applications originated by brokers. Its 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.[20] We are concerned that some lenders will not adequately evaluate broker originated loans before submitting them to agency field 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.[21] 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 contribute to an originating lender's decision to reduce oversight. During our visits to agency field offices, officials also expressed concern about loans originated by brokers.

In Fast Report (3) to the agency, dated May 22, 2009, we formally notified agency national officials about this finding. At that time, we did not conclude on the overall extent of abuse that was, or could be, occurring in the program because we had not yet performed tests to determine if brokers had taken advantage of the weakness. However, we were concerned that some brokers would exploit the weakness and submit substandard loans to lenders that would then be guaranteed by Rural Development. Therefore, we recommended that agency national officials take action to mitigate the potential for abuse.

Recommendation 5

Increase oversight of any lender identified as not properly reviewing loans originated by brokers.

Agency Response

On June 1, 2009, the Under Secretary for Rural Development, in response to Fast Report (3), stated that the agency would increase its compliance testing with a focus on the quality of loans originated by brokers. The compliance reviews would concentrate on participating lenders that submit a high volume of loans originated by brokers. The response added that agency national officials would "draft and issue guidance to approved lenders, and to Rural

[20] Rural Development Instruction 1980.309, dated June 21, 1995.

[21] 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.

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."

On July 7, 2009, an agency national official informed us that the agency had issued a Request for Proposal to contract for compliance testing and that agency national officials would begin reviewing bids on August 1, 2009. The official also stated that the agency had issued a memorandum dated June 24, 2009, that informed field officials about the use of unacceptable procedures when processing applications originated by a third party. The memorandum reiterated to agency field officials the correct processing procedures and provided additional guidance regarding the responsibilities of lenders and agency staff in requesting and processing loan guarantee applications.

OIG Position

We accept management decision for this recommendation.

Finding 4: Segregation of Duties Needed over the Loan Review and Approval Process

During our visits to agency field offices, we observed that agency loan specialists were able to, and on occasion did, perform all functions in the loan guarantee process with no supervisory review prior to issuance of the guarantee. These functions included the review, approval, and recording of applications for loan guarantees into the agency's system of records (the Guaranteed Loan System) where the obligation of funds would occur.[22] The agency does not require a segregation of duties or supervisory (or second party) review prior to issuance of the loan guarantee.[23] This creates a situation where agency loan specialists and other field staff could fail to detect lender errors or collude with lending officials to guarantee substandard loans.

We consider the risk of collusion between agency loan specialists and lending officials to be low. Of greater concern to us, and a more likely scenario, is that agency field staff would not detect lender errors and mistakes because of the significant volume associated with the distribution of Recovery Act funds. As a result, agency field staff could inadvertently guarantee substandard loans. The agency typically guarantees around 30,000 loans, totaling almost $3 billion, for each of the past 5 years. The agency had already exceeded those figures in the first two months of distributing Recovery Act funds.

Based on our observations and discussions with agency field officials, they were processing up to three times as many applications as usual. The loan specialists at one field office stated that it typically takes about two hours to fully process a manually submitted application and about a half-hour to fully process an application submitted via the GUS. We calculated that in a normal day, with a combination of manual and GUS processed applications, a loan specialist would

[22] Rural Development Instruction 1980.354, dated June 21, 1995.
[23] Rural Development Instruction 2006-M, dated May 19, 2004, includes provisions for the agency to conduct periodic second party reviews after issuance of a loan guarantee. Area Directors review a sample of loan guarantees on a quarterly basis. The agency's Management Control Review and State Internal Review processes review guaranteed loans on a five year rotational basis.

process up to 10 loan applications. In one office we visited, the loan specialist stated he was involved in processing partially or fully 10 applications in approximately 4 hours.

At another field office, a loan specialist stated that because of the significant guaranteed loan workload and responsibilities for other agency programs, it was common for more than one loan specialist to process a single application. The loan specialists generally worked on different sections of the guarantee process without overlapping, or reviewing, the work done by each other. As a result, the loan specialist stated that some applications may not have been scrutinized as closely as under normal circumstances. These findings concern us because it may be easy for errors and mistakes to go undetected by agency field officials.

We are aware that some field offices have too few employees to adequately segregate duties. For instance, one of the four field offices we visited had three employees, only one of which was a loan specialist. It would be difficult to adequately segregate duties in that field office. However, the other three field offices had five employees, four of which were loan specialists. Therefore, it would be more feasible to segregate duties in those circumstances.

We discussed this finding in detail with agency national officials on April 29, 2009. At that meeting, we explained our concern and recommended that the agency initiate a second party review of loan guarantee applications, and segregate duties wherever feasible. They generally agreed with our concern and agreed to implement corrective action regarding second party reviews. However, in regards to segregating duties, agency national officials stated they were confident that the second party review procedures, along with procedures currently used by field staff when reviewing and approving applications for loan guarantees, would adequately address our concerns. Moreover, they stated that segregating duties was impractical because of staff limitations, and it would be difficult to implement when the field staff was so busy.

In our view, the segregation of duties, a preventive control activity common to all agencies as described by the Government Accountability Office (GAO), would be the best action to reduce the risk of errors and abuse. The GAO emphasized that no one individual should control all key aspects of a transaction or event.[24] However, since we have not performed testing of guaranteed loans made under the Recovery Act, we cannot reference errors or mistakes attributable to lack of a segregation of duties. Nonetheless, the risk remains and is more of a concern in the acknowledged, busy processing environment at agency field offices.

On May 22, 2009, we issued Fast Report (4) to the agency. In our report, we recommended that the agency implement a second party review of applications prior to issuance of the guarantee. We also recommended that the agency segregate duties in offices where it was feasible based on staffing levels. This would ensure the accuracy of all applications versus just a sample.

Recommendation 6

Develop and implement procedures to perform second party reviews of applications prior the issuance of loan guarantees.

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[24] Government Accountability Office, Standards for Internal Control in the Federal Government, dated November 1999.

Agency Response

The Under Secretary for Rural Development's June 1, 2009, response to Fast Report (4) stated that the agency would implement a second party review of guaranteed loan applications. The Under Secretary's response added that a random sample of applications for loan guarantees that had not been closed would be selected for second party review on a bi-weekly basis. On July 7, 2009, an agency national official informed us that the agency had issued a notice to field staff about the second party review process. He stated that the national office had also developed and issued a checklist for the staff to use in conducting the review.

OIG Position

We accept management decision for this recommendation.

Recommendation 7

Require the segregation of duties in field offices where there is sufficient staff.

Agency Response

Agency national officials stated they were confident that the second party review procedures, along with procedures currently used by field staff when reviewing and approving applications for loan guarantees, would adequately address our concerns. Furthermore, they stated that segregating duties was impractical because of staff limitations, and it would be difficult to implement when the field staff was so busy.

OIG Position

We accept management decision for this recommendation. Our decision is based on the fact that we did not perform testing of guaranteed loans and cannot reference errors or mistakes attributable to the lack of a segregation of duties. We plan to examine this control and loans as we continue our assessment of program activities related to the Recovery Act.

Finding 5: Additional Measures Needed to Reduce the Risk of Overstated Property Values

Rural Development could guarantee loans with Recovery Act funds that have overstated property values. The agency's primary control to ensure that homes are accurately valued is through an independent appraisal of the property. However, based on our review, we concluded that this control as implemented may not adequately protect the Government's security interests. Thus, the agency is susceptible to losses if borrowers default on their loans and properties are sold for less than the amount owed to the Government.

Rural Development guarantees up to 102 percent of the purchase price of residential property. Since loans are financed at this level, the agency is likely providing guarantees on loans where borrowers owe more than their homes are worth. This situation could become a problem for Rural Development if the value of property is overstated when it is purchased by borrowers.

To ensure that the purchase price of a property approximates its fair market value at the time of loan closing, the agency requires lenders to obtain an independent appraisal from a licensed or certified appraiser. The appraisals are to be performed in accordance with criteria established by the Appraiser Qualification Board of the Appraisal Foundation.[25] It is imperative that appraisals accurately reflect the value of the underlying property. This is especially true in a declining market since it would reduce potential losses to the agency if borrowers defaulted on their loans.

During our review at agency field offices, we noted that 29 of the 33 appraisals we examined indicated a stable housing market. This contradicts statistics reported by the National Association of Realtors, which show a declining housing market, of varying degrees, across the nation.[26] In our view, most of the appraisals should have factored declining market conditions into the assessment of property value. The reason for our conclusion is that even a 10 percent decline in home values could expose the agency to potential losses on loans that were financed at 100 percent or more of property value.

We also noted that some appraisers had used older sales data to determine market value. One comparable sale was more than a year old; many were more than 6 months old. The use of older sales data may have been due to slow home sales in more recent months. However, the use of older comparable sales data, without recognizing recent declines in home prices, increases the risk that appraisals will not accurately reflect the current market value of property secured by Governmental loan guarantees.

The appraisers also did not consider foreclosure or other distressed sales when assessing the value of homes. According to agency national officials, the appraisal industry generally does not consider these types of sales because they distort the prices of homes sold between willing buyers and sellers. Recently, it has been reported that distressed sales have been a significant percentage of overall sales. Thus, it would be prudent to factor this condition into the appraisal process for guarantee purposes. Such a consideration could limit the agency's exposure to losses due to overstated property values.

Another risk we identified was that appraisals may be conducted to support the purchase price of the property. This could occur because appraisers are provided the negotiated purchase price of homes before they determine the value of those properties. Agency field officials in two offices expressed this same concern. Although widely recognized as being standard practice for appraisers to know the property's purchase price in advance, this increases the risk that appraisals will not accurately reflect the fair market value of property.

We discussed this finding in detail with agency national officials on April 29, 2009. At that meeting, we explained our concern that the agency was at risk for losses from overstated property values. We recommended that they use agency employed appraisers to conduct an analysis of property values for loans guaranteed with funds provided by the Recovery Act. This analysis would determine the extent, if any, of potential losses the agency was exposed to because of overstated property values. They generally agreed with our conclusion and agreed to determine the most appropriate form of corrective action considering the circumstances. On

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[25] Rural Development Instruction 1980.334(a), dated June 21, 1995.
[26] Source: Existing Home Sales Overview Chart, April 2009, National Association of Realtors website www.realtor.org.

June 10, 2009, we issued Fast Report (5) to formally notify agency national officials about this finding.

Recommendation 8

For loans guaranteed with Recovery Act funds, conduct an analysis using internal appraisers to determine the extent, if any, of potential losses the agency may be exposed to because of overstated property values.

Agency Response

In a June 17, 2009, response to Fast Report (5), the Under Secretary for Rural Development stated that to address our concerns, the agency proposed the following new additional actions:

1. Require the use of Fannie Mae Form 1004MC/Freddie Mac Form 71, Market Conditions Addendum to the Appraisal Report. In the response, the Under Secretary stated that "The Market Addendum (Form 1004MC) is designed to enhance the transparency of market trends and conditions reported made by the appraiser. The form provides the appraiser with a structured format for reporting market conditions that is easily identified. In addition, the form also requires the appraisers to analyze the effect that foreclosure sales (real estate owned sales) have on current market trends." The form was recently adopted by the Federal Housing Administration and Veterans Affairs.

2. Require a technical desk review by agency State licensed/certified appraisers. In the response, the Under Secretary stated that "We have identified additional quality control measures that will be effective July 1, 2009. On a bi-weekly, basis we will conduct post conditional commitment reviews for a random sample of SFHG obligations. As part of the review, Rural Development plans to require a technical desk review of the appraisal. The technical desk review will be conducted by an Agency licensed/certified appraiser and must be completed in accordance USPAP."

On July 7, 2009, an agency national official informed us that lenders had been notified that effective July 31, 2009, they were required to submit the forms listed in the Under Secretary's response when processing applications using Recovery Act funds.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

We conducted our audit of the Single Family Housing Guaranteed Loan Program at the Rural Housing Service's national office in Washington, D.C., and two Rural Development area offices in both Illinois and Wisconsin. At the Rural Development area offices, we examined borrower files and observed field staff during the loan note guarantee review and approval process.

The period of our review began on March 20, 2009, the date Congress authorized Rural Development to commence distribution of funds as a result of the American Recovery and Reinvestment Act of 2009 (the "Recovery Act").[27] The Recovery Act appropriated $10.472 billion in funds to Rural Development to guarantee the repayment of single-family housing loans made by private lenders to low- and moderate-income borrowers in rural areas. Since March 20, 2009, Rural Development has obligated over $7.9 billion to guarantee about 65,000 loans.

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.[28] Agency field officials followed this guidance to process loan note guarantees obligated under the authority of the Recovery Act. We judgmentally selected 33 borrower files at 4 Rural Development field offices. The files were selected because they were being processed at the time of our visits.

We performed our audit fieldwork from April through August 2009. 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. During this initial phase of our audit, we did not perform testing to verify lender compliance with agency policies and procedures. We also did not review, analyze, or verify information in the agency's Guaranteed Loan System and Guaranteed Underwriting System, and make no representation of the adequacy of the systems or the information generated from them. We plan to perform such testing of the Guaranteed Loan System during the second phase of our audit.

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[27] Public Law 111-5, dated February 17, 2009.
[28] Rural Development Instruction 1980-D, dated June 21, 1995, and associated Administrative Notices.

Abbreviations

GAO............................Government Accountability Office
GUS............................Guaranteed Underwriting System
OIG ....Office of Inspector General
OMB ....Office of Management and Budget
PITI ....Principal, Interest, Taxes and Insurance
RHS............................Rural Housing Service
USDA..........................U.S. Department of Agriculture

Informational copies of this report have been distributed to:

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