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Controls Over Eligibility Determinations for SFH Guaranteed Loan Recovery Act Funds (Phase 2)

Audit Report 04703-02-Ch
September 2011

United States Department of Agriculture
Office of Inspector General
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AUDIT NUMBER: 04703-02-Ch

TO: Dallas Tonsager
Under Secretary
Rural Development

Tammy Trevino
Administrator
Housing and Community Facilities Programs

ATTN: John Purcell
Director
Financial Management Division

FROM: Gil H. Harden /s/
Assistant Inspector General
for Audit

SUBJECT: Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (Phase 2)

This report presents the results of our audit work related to the eligibility of borrowers who obtained Single Family Housing loan guarantees from funds authorized by the American Recovery and Reinvestment Act of 2009. Your written response to the official draft report, dated September 28, 2011, is included in its entirety at the end of the report. Excerpts from your response and the Office of Inspector General's position are incorporated into the relevant sections of the report. Based on your response, we accept management decision on all 29 recommendations in the report. Please follow your agency's internal procedures in forwarding documentation for final action to the Office of 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 our audit fieldwork and subsequent discussions.

Table of Contents

Controls Over Eligibility Determinations for SFH Guaranteed Loan Recovery Act Funds (Phase 2).

Executive Summary

This report presents the results of our second phase of audit work related to the eligibility of borrowers who obtained single family housing loan guarantees[1] from funds authorized by the American Recovery and Reinvestment Act of 2009 ("Recovery Act").[2] 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.[3]

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. In this, the second phase of our Recovery Act efforts, we performed tests to verify compliance with the eligibility requirements of the Single Family Housing (SFH) Guaranteed Loan Program during the loan origination process. As a result of our tests, we determined that Recovery Act assistance was provided to borrowers who were not eligible to participate in the program. Consequently, there is an increased risk that the Government may incur future financial losses because borrowers are unable to repay their loans; and borrowers who were in need of adequate housing were deprived, at least temporarily, of the opportunity to obtain a guaranteed loan to purchase a home.

The Recovery Act included almost $10.5 billion in funds for the United States Department of Agriculture (USDA) to guarantee single family housing loans in rural areas. Rural Development, a mission area within USDA, and its agency, the Rural Housing Service (RHS), were responsible for establishing policies and procedures for the SFH Guaranteed Loan Program. To accomplish this audit, we randomly selected 100 loans[4] from the portfolio of over 81,000 loans, with more than $10 billion of Recovery Act obligations as of December 31, 2009. Rural Development processed a record volume of loans during this time, which understandably stretched its available resources. We conducted audit work with lenders, borrowers, employers, and agency officials throughout the country in order to evaluate borrower eligibility.

Based on our audit sample results, we estimate that 30,310 loans (almost 37 percent of the portfolio) were ineligible with a projected total value of $4.16 billion.[5] Our analysis of the sample identified 33 loans where lenders had not fully complied with Federal regulations or Recovery Act directives in determining borrower eligibility. Specifically, we identified

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[1] A guarantee substantially reduces a lender's risk of loss because the Government will reimburse up to 90 percent of the outstanding principal and interest if the borrower defaults on a loan.
[2] Public Law 111-5, dated February 17, 2009.
[3] Office of Management and Budget M-09-15, Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009, dated April 3, 2009.
[4] We chose a sample size of 100 because we expected a moderate error rate and wanted the ability to report findings for attributes with a +/-10 percent precision (confidence interval) at a 95 percent confidence level.
[5] We are 95 percent confident that between 21,129 (almost 26 percent) and 39,492 (over 48 percent) loans were ineligible for one or more reasons and the total value of those loans is between $2.7 and $5.6 billion.

ineligible borrowers who received loan guarantees even though they: (1) did not demonstrate the ability to repay the loan, (2) possessed incomes that exceeded program limits, (3) possessed sufficient financial resources to obtain loans without a Government guarantee, (4) already owned adequate housing in their local commuting areas, or (5) purchased homes that had swimming pools.

Since Rural Development exhausted its regular and Recovery Act appropriations during the spring of 2010, our results demonstrate there was an adverse impact on the significant number of applicants who were unable to obtain loan guarantees at that time. In September 2010, RHS officials informed us that they received additional funding to guarantee an accumulated backlog of about $1.6 billion of loan applications. Based on our statistical projection of ineligible loans, we concluded that the backlog of accumulated applications could have been reduced, and maybe eliminated, if lenders had properly determined the eligibility of all applicants.

Of the Government's three major guaranteed housing programs,[6] Rural Development characterizes itself as the most restrictive program due to its stringent eligibility requirements. Rural Development's guaranteed housing program has eligibility requirements such as: (1) an annual income limit according to geographic area; (2) a restriction that applicants not be able to obtain credit without a Government loan guarantee; and (3) a restriction that applicants cannot already own adequate homes in their local commuting areas. The other Federal guaranteed housing programs do not have these restrictions.

In the following sections, we summarize several policy (regulatory) issues that contributed to the problems identified during our audit. RHS officials disagreed with our analysis and conclusions on 23 of 33 loans, including the 4 loans related to borrowers who already owned adequate housing in their local commuting areas. (Note: the cumulative number of loans listed in each section is greater than 33 because some loans fell into more than one category.)

Borrowers Had Questionable Repayment Ability

We identified 12 loans in our sample that were guaranteed to borrowers who did not meet the agency's standards to repay the loan.[7] We concluded that the borrowers had total debt ratios or ratios of income to mortgage principle and insurance that exceeded program limits. We attributed this to lenders using unstable or inconsistent earnings, or using only a borrower's most recent earnings, rather than earnings from a longer period of time, such as the 24-month period stated in the regulations.

In our judgment, these borrowers have a higher risk of becoming delinquent and defaulting on their loans. Our review of payment status for the 12 ineligible loans disclosed that 6 of the 12 borrowers were currently, or had been, delinquent on their loans.[8] One of the six borrowers has defaulted on the loan, and a loss claim of $55,000 was paid on an $80,000 loan. Another

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[6] The Government's three major guaranteed housing programs are administered by the Federal Housing Administration (FHA), Veterans Affairs (VA), and RHS.
[7] 7CFR1980.345 (a-b), dated May 22, 1995.
[8] OIG extracted this data from Rural Development's Delinquency Data Model for Single Family Housing as of August 31, 2011.

borrower was more than 450 days delinquent, and a foreclosure is the likely outcome. Based on the results of our audit, we project that 11,661 loans (over 14 percent of the Recovery Act portfolio), with a total value of $1.3 billion, were guaranteed to ineligible borrowers who have a higher risk of future servicing actions and potential default on their loans.[9]

In response to our conclusions, RHS officials indicated that the applicable Federal regulations allowed the lenders flexibility for how to calculate repayment income. As a result, they generally supported the lenders' decisions, and disagreed with our positions on these loans. We used a more conservative approach to determine repayment income that, in our opinion, was more consistent with the agency's regulatory requirements, and that was used by some lenders with loans in our sample. We also considered other factors, such as the borrower's previous use of credit, credit scores, and payment shock.[10] In fulfilling our role, as mandated by the Recovery Act, we were tasked to ensure that funds were expended in a manner that minimized the risk of improper use. This is an area where we concluded RHS officials could have done a better job of managing the Recovery Act funds, and thereby reduced the risk of future losses to the Government.

Borrower Income Exceeded Requirements

We concluded that 12 borrowers in our statistical sample were ineligible to participate in the program because their adjusted annual income exceeded Federal regulations.[11] For these loans, lenders did not properly include borrower earnings, business income, overtime pay, or bonuses when calculating adjusted annual income. In addition, lenders did not always obtain the required borrower earnings information when verifying income with employers, or adequately document how they calculated income. As a result, we project that 13,665 loans (almost 17 percent of the portfolio), with a projected total value of $2.2 billion, was guaranteed with Recovery Act funds for borrowers whose income exceeded program limits.[12]

We discussed each of the 12 loans with RHS officials who agreed with our conclusions for 6 of the 12 cases. For the cases where we disagreed, it was generally because RHS officials thought lenders were correct to exclude overtime or special pay in determining adjusted annual income, or because the lenders relied on incorrect information provided verbally by employers. We disagreed with their position in each of the six cases because information was provided by either the borrower or the employer that should have led the lenders to include the other sources of income.

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[9] We are 95 percent confident that between 4,935 (over 6 percent) and 18,378 loans (over 22 percent) were provided to borrowers that did not demonstrate adequate repayment ability and the total value of those loans is between $441 million and $2.2 billion. Some borrowers were ineligible for more than one reason, and therefore the point estimates for the number of ineligible loans and dollar projections will not add to the values listed on page 1.

[10] Agency instructions define "payment shock" as a percentage that signifies the increase in housing expense experienced by an applicant. Payment shock is calculated using the following formula: New mortgage principal, interest, real estate taxes, and insurance (PITI) ÷ Current housing expense – 1. RD AN 4435, Debt Ratio Waivers and Payment Shock, dated April 30, 2009.

[11] 7CFR1980.345 (a), dated May 22, 1995.

[12] We are 95 percent confident that between 6,405 (almost 8 percent) and 20,932 loans (over 25 percent) were ineligible due to borrowers' income exceeding the income limit and the total value of those loans is between $986 million and $3.4 billion.

Borrowers Did Not Need Guarantees to Obtain Credit

We identified seven loans in our statistical sample that were made to borrowers who possessed sufficient financial resources to obtain loans from lenders without a Government guarantee. Several lenders offered borrowers all of the credit options available to them for financing, including the lenders' own credit. However, the borrowers were allowed to select the guaranteed loan. Based on our sample results, we project that 5,551 loans (almost 7 percent of the portfolio) with a total value of $713 million, were ineligible because the borrowers qualified for conventional loans.[13]

We discussed each of the seven loans with RHS officials. They agreed with our conclusions for two loans because the borrowers possessed the financial characteristics required for conventional credit. However, they disagreed with the remaining cases on the contention that no conventional credit was available during the Recovery Act time period. We understand that credit was not available for everyone, but it was available, as demonstrated by lender statements for these loans. Furthermore, had these guarantees been awarded to different qualifying applicants, the seven borrowers could have still purchased a home using other credit options offered by the lender.

Borrowers Already Owned Adequate Housing

We identified four borrowers in our statistical sample who already had an existing home at the time of application. The four homes were functionally adequate, structurally sound, and located within the local commuting area. Federal regulations state that "an applicant must be a person who does not own a home in the local commuting area or owns a home which is not structurally sound, or functionally adequate."[14] We project that 2,882 loans (almost 4 percent of the portfolio), with a total value of $481 million, were made to borrowers who already owned adequate housing within the local commuting area and, as a result, were ineligible for the Government guarantee.[15]

RHS officials disagreed with our conclusion on all four loans. They maintained that the regulations allowed the guarantee as long as the borrowers sold their existing homes prior to purchasing a new home. We disagree on the interpretation of the regulation. In addition, other regulatory citations state that, "…the program is designed to assist eligible households in obtaining adequate but modest dwellings" and that a borrower must "be without sufficient resources to obtain the necessary housing and be unable to secure the necessary conventional credit."[16] In these cases, the borrowers had adequate homes that were financed with conventional credit and therefore did not need a guarantee. Because these borrowers received

[13] We are 95 percent confident that between 829 (over 1 percent) and 10,273 loans (almost 13 percent) were provided to borrowers who qualified for financing directly from lenders and the total value of those loans is between $50 million and $1.4 billion.
[14] 7CFR1980.346(a), dated May 22, 1995.
[15] We observed 4 instances of this condition, with a total value of $737,810. Because this number is within the 95 percent confidence interval, we are reporting the lower bound as the actual observation. The upper bound, for the 95 percent confidence interval, is 6,299 loans (almost 8 percent), totaling $1.0 billion.
[16] 7CFR1980.301(b) and 7CFR1980.346(b), dated May 22, 1995.

guaranteed loans, other borrowers, who were in need of adequate housing were not able to obtain such funding to assist them to purchase their own home.

Homes Were Purchased with Swimming Pools

We identified three homes in our sample with swimming pools, which was specifically prohibited by the Recovery Act. In response, RHS officials changed these loans from Recovery Act funds to their regular program funding, which allows swimming pools. Based on our sample results, we project that 1,659 loans (over 2 percent of the portfolio), with a total value of $230 million, were ineligible for Recovery Act loans because the borrowers purchased homes with swimming pools.[17]

Lender Compliance Reviews and Other Management Control Concerns

We also determined that a key management control, the Lender Compliance Review (LCR), was not effective to safeguard Recovery Act funds. RHS officials included a provision in their Recovery Act Implementation Plan that LCRs would be used to monitor the funds.[18] This control reviews loans after they are made. Therefore, to be effective at preventing problems it needed to be executed early in the Recovery Act spending period, so corrective actions could be used to prevent problems with the remaining use of funds. However, only a small percentage of Recovery Act loans were monitored by the LCRs during the time period when most loan obligations were made. Staff reviews were inhibited by the record volume of loans being made, and RHS officials were unable to revise the focus of the reviews before Recovery Act funds were fully obligated. As a result, LCRs provided little oversight to monitor and safeguard Recovery Act funds.

The LCR guidelines and results of past reviews were also not designed to cover all borrower eligibility qualifications or to prevent the problems we detected. The published steps reviewers used to check lender compliance with RHS policies did not include tests for four of the findings we include in this report. For example, there was no test to determine whether borrowers made too much money to qualify for the program. We found that prior year LCRs did detect three areas where we reported problems, such as borrower repayment ability. But the results were not used for broader program changes, so the conditions continued to be reported in the annual LCR reports for fiscal years 2007 through 2009, and were identified in the Recovery Act loans that we reviewed.

In addition to these concerns, we also identified other areas that were not functioning as intended or could not because of the record volume of loans. These additional areas include lender documentation, rural area designations, and the accuracy of agency loan information. Lenders are required to clearly document their efforts but were not doing so, especially for borrower income. Rural Development field staff had not updated rural area designations to ensure that

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[17] We observed 3 instances of this condition, with a total value of $563,977. Because this number is within the 95 percent confidence interval, we are reporting the lower bound as the actual observation. The upper bound for this confidence interval is 4,131 (over 5 percent) totaling $522 million.
[18] USDA Rural Development American Recovery and Reinvestment Act Implementation Plan, dated May 1, 2009, and updated May 15, 2010.

loans were only provided for homes in rural areas. We also found a large number of discrepancies within the information system used by the agency to record loan details such as borrower name and address, to name just a few examples. As a result of our work, RHS has already been training lenders on documentation problems, and it will hold a national seminar with field staff later this year.

Phase 1 Recovery Act Audit[19] and Fast Report 04703-02-Ch (1)

The first phase of Recovery Act audit work evaluated the agency's policies, procedures, and internal controls in distributing Recovery Act funds, and was designed to be preventative in nature. We identified several findings and issued a series of five Fast Reports from May to June 2009. Agency officials implemented corrective actions by July 2009. The improvements we recommended in Phase 1 did not represent widespread changes because the existing regulatory framework, if it was executed as presented to us, provided a reasonable basis to ensure funds were properly used. At that time RHS officials agreed with our assessment.

Our tests during this audit (Phase 2) revealed that RHS' policies and procedures were not functioning as intended, or as described to us in our Phase 1 audit. However, it was not until we began to question lender decisions that differences in the meaning and the application of policies between us and RHS officials began to surface. We reported the five eligibility findings in this report on December 6, 2010, in a Fast Report to the Under Secretary for Rural Development. We issued that report during the audit to notify agency officials of conditions that needed immediate attention, since we concluded that ineligible borrowers were being allowed into the program.

In their response to the Fast Report, RHS officials generally agreed improvements were needed, but they disagreed with many of our conclusions and, in some cases, with our application of their policies. In addition, RHS officials stated that the regulations were outdated, vague, and ambiguous. This is a significant departure from our Phase 1 audit when they maintained these policies could be used to safeguard Recovery Act funds. Therefore, in most cases, RHS officials supported the lenders' decisions to make the loans. In the meantime, RHS officials have initiated training and continue to work on adjustments to their future policies.

In our discussions with RHS officials about our Fast Report, questions surfaced about the relatively small size of our sample of 100 loans in relation to the universe of over 80,000 loans. To further ensure our sample was sound, we discussed and provided our methodology to USDA's Chief Economist and staff from the National Agricultural Statistics Service. They both agreed that our sample was acceptable.

In conclusion, this phase of our planned audit work in the SFH Guaranteed Loan Program focused on tests to verify lender compliance with Federal regulations and RHS' policies, to ensure the eligibility of borrowers participating in the program. Because Recovery Act funding was provided for an existing program, the agency made no significant additions to its existing structure or processes. Therefore, the findings in this report are not limited to the use of

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[19] Audit Report 04703-01-Ch, *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds, (Phase 1),* dated September 2009.

Recovery Act funds, but pertain to the SFH Guaranteed Loan Program as a whole. We determined that their existing controls, and those implemented as a result of our first Recovery Act audit, were not always adequate to safeguard Recovery Act funds. RHS officials agree that changes are needed to improve the program, and they are in the process of conducting training and revising all of their existing policies. We have additional Recovery Act audit work in process that is designed to evaluate the internal controls over issuing loss claim payments to lenders.[20]

Recommendation Summary

We made 29 recommendations to Rural Development and RHS officials to address issues identified during our audit. The most significant recommendations included strengthening the use of regulations and policies in relation to: (1) borrower repayment ability and the use of compensating factors to justify loans, (2) adjusted annual income, (3) conventional credit, (4) applicants with an existing home, (5) revisions to current controls that enhance the lender compliance review process, (6) updates to rural area designations, and (7) application controls for the Guaranteed Loan System. The recommendations in this report are not limited to the use of Recovery Act funds, but pertain to the SFH Guaranteed Loan Program as a whole.

Agency Response

Rural Development and RHS officials generally disagreed with our findings, but did agree with the recommendations in the report. They proposed corrective actions that should reduce the risk of errors in determining eligibility for the SFH Guaranteed Loan Program.

OIG Position

The agency's response included proposed corrective actions sufficient enough to reach management decision on all 29 recommendations in the report. However, the initial sections of the agency's response included many statements regarding our work that were either inaccurate or misrepresented the facts. For instance, on page 5 of the response, agency officials cited a borrower who worked only 239 days a year and stated that we projected income as if the borrower had worked the full year. The implication of this statement is that the borrower was included in our results. That implication is inaccurate because we did not take exception to that borrower and the loan was not included in the findings of this report. The list of ineligible loans we provided Rural Development did not include the cited borrower.

The agency also stated, in the "Need for Guarantees" section on page 6, that the basis for our finding was that we asked lenders if they offered loans with adjustable interest rates, balloon payments, the potential for negative amortization, a requirement for private mortgage insurance, or other features riskier to the borrower. This statement is inaccurate. We asked lenders if they would have provided a loan without the guarantee to the borrowers with reasonable rates and

[20] Audit 04703-3-Hy, *Rural Housing Service Loss Claims Related to Single Family Housing Loans Guaranteed with Recovery Act Funds*.

terms as cited in the agency's regulations. We never asked lenders about alternative financing measures. We reported this issue in Finding 3.

On page 8 of the response, the agency misrepresented that a recently divorced single mother with three children had to divest herself of her former marital home to purchase a home for her family. The agency contended that this would not have been possible without the loan guarantee. However, we obtained evidence during our audit that determined the borrower's divorce was finalized in 2004 and the marital home was sold the same year, not in 2009 when Rural Development guaranteed the loan. The agency's response also stated that if the borrower had been denied a guarantee, she and her dependent children may not have had any affordable housing alternatives. The evidence we obtained disclosed that the borrower was employed and her income (salary and child support payments) was more than $76,500, which, based on our analysis, exceeded the agency's income limit for the geographical area. Thus, the borrower was ineligible for the guarantee. We included this loan in Findings 2 and 4 of the report.

The agency also described, on page 9 of the response, a household confronted with the painful reality of job loss resulting in the need to "downsize" their living arrangements. We obtained the Verification of Employment forms on file with the lender, which stated that the borrower and co-borrower were employed and the probability of continued employment for both borrowers was good and very good, respectively. We also dispute the agency's contention that the borrowers downsized their home. The borrowers sold their existing home for $181,000 and purchased a new one for $290,000. The borrowers' monthly mortgage payments increased from $1,360 to $1,650. We included this loan in Findings 4 and 5 of the report.

Background & Objective

Background

In response to the economic downturn, Congress passed the American Recovery and Reinvestment Act of 2009 (the Recovery Act).[21] Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of funds. The Recovery Act appropriated $10.5 billion in funds to Rural Development for the Single Family Housing (SFH) Guaranteed Loan Program to guarantee[22] the repayment of loans made by private lenders to low-and moderate-income borrowers in rural areas. 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. On March 20, 2009, Rural Development began distributing the Recovery Act funds through the Section 502 SFH Guaranteed Loan Program.

The United States Department of Agriculture (USDA), through its Rural Development mission area, guarantees single family homes in rural areas. The Rural Housing Service (RHS), an agency within the Rural Development mission area, is responsible for providing guidance on program activity, and for performing compliance reviews of approved lenders. Rural Development field staff in 47 States are 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 field staff approves lenders, which generally have smaller operations, to participate in individual States. The agency performs reviews of lenders approved by the State and national office. Those reviews are called "Lender Compliance Reviews" and are performed on a 2 or 5-year cycle depending on the volume of loans originated by a lender.

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 through the Guaranteed Underwriting System (GUS). GUS is an automated underwriting system implemented in March 2007 to streamline the process used by lenders to submit applications for loan guarantees. For Recovery Act funds, RHS officials estimated that about 50 percent of the applications for loan guarantees were processed through GUS.

Lenders determine a borrower's eligibility either through manual underwriting analysis or by using the electronic analysis performed by GUS. A lender's underwriting analysis includes a verification of income, determination of a borrower's repayment ability and creditworthiness, and an appraisal report for the property. For loan applications processed manually, lenders provide the application and documentation to Rural Development field staff for review and

[21] Public Law 111-5, dated February 17, 2009.
[22] A guarantee substantially reduces a lender's risk of loss because the Government will reimburse up to 90 percent of the outstanding principal and interest if the borrower defaults on a loan.

approval. For loan applications processed electronically, GUS provides lenders with a preliminary decision of potential acceptance ("Accept") or rejection ("Refer") before an application is submitted to Rural Development. There is substantially less documentation required to be submitted for GUS underwritten loans, but the lender is still required to maintain those documents in the loan file.

Rural Development field staff is responsible for reviewing loan applications for completeness and to determine that proposed loan guarantees are made to eligible borrowers. The staff also inputs information such as lender and borrower names, the amount loaned to the borrower, and other loan specifics into a database recordkeeping system. This database is called the Guaranteed Loan System (GLS).

The Office of Inspector General's (OIG) role, as mandated by the Recovery Act, is to evaluate agency activities and to ensure funds were used in accordance with the underlying legislation and Federal regulations. Accordingly, we initiated this audit in December 2009 to determine if lenders and Rural Development officials met those requirements in providing loans and loan guarantees to borrowers. To accomplish this objective, we randomly selected 100 loans from over 81,000 loans made by lenders across the nation as of December 31, 2009, which were guaranteed by Rural Development with Recovery Act funds.

OIG recently completed two additional audits of direct relevance to the SFH Guaranteed Loan Program.[23] The first phase of our Recovery Act work evaluated the adequacy of internal controls designed to ensure compliance with borrower eligibility requirements.[24] RHS officials used their existing policies and procedures for Recovery Act funds. They did not incorporate any additional controls or approaches to meet the accountability objectives as suggested by OMB for the Recovery Act. In Phase 1, we reported the following internal control issues: (1) lack of any requirements for lenders to submit supporting documentation for loans evaluated by GUS, (2) field staff were not following the agency's policy in waiving borrower debt ratio requirements, (3) insufficient lender oversight of independent brokers, (4) lack of segregation of duties over the review and approval of loan guarantees at field offices, and (5) weaknesses in the procedures used by independent appraisers to establish property value. As a result of our work, we made eight recommendations to improve internal controls. In July 2009, we reported that lender quality control reviews and agency monitoring efforts needed strengthening to prevent loan origination abuse.[25] Seven of our ten recommendations in the lender activity report were to make improvements that are relevant to our Phase 2 Recovery Act work. The remaining three recommendations are related to improvements in RHS' control over interest rates being charged by the lenders.

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[23] Audit Report 04703-01-Ch, *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Recovery Act Funds (Phase 1),* dated September 2009, and Audit Report 04601-17-Ch, *Controls Over Lender Activities in the SFH Guaranteed Loan Program,* dated July 2009.

[24] Audit Report 04703-01-Ch, *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Recovery Act Funds (Phase 1),* dated September 2009.

[25] Audit Report 04601-17-Ch, *Controls Over Lender Activities in the SFH Guaranteed Loan Program,* dated July 2009.

Our current audit assessed the agency's improvements made in response to both prior audits. During Phase 1, we did not perform tests to verify lender compliance with agency policies and procedures. In particular, we did not verify information used by lenders in the underwriting analysis process. In Phase 2, we performed follow up work to verify lender compliance and agency oversight. In December 2010, we issued an interim report (Fast Report) that outlined the findings identified during Phase 2 of our audit.[26] The Fast Report was issued to bring to the attention of the agency the results of our preliminary analysis of the 100 randomly selected loans. We reported that lenders had not fully complied with Federal regulations or Recovery Act directives in determining borrower eligibility for 28 of the 100 loans reviewed. Issues identified included: (1) borrowers whose income exceeded agency eligibility limits; (2) borrowers with questionable repayment ability; (3) borrowers who had the ability to secure financing without Government assistance; (4) borrowers who already owned adequate housing in the local commuting area; and (5) borrowers who purchased homes with swimming pools, which was expressly forbidden by the Recovery Act.[27] In the Fast Report, we made five recommendations to improve the loan-making process.

Because Recovery Act funding was provided for an existing program, RHS officials made no significant additions to its structure or processes. Therefore, the findings and recommendations in this report impact the SFH Guaranteed Loan Program in general and are not specific to activities funded by the Recovery Act. .

Objective

The objective of our audit was to evaluate Rural Development's use of Recovery Act funds to ensure that SFH loan guarantees were only approved for eligible borrowers.

[26] Fast Report 04703-02-Ch (1), *Rural Development Guaranteed Single Family Housing Loans Made by Lenders to Ineligible Borrowers*, dated December 6, 2010.
[27] Public Law 111-5, Division A, Title XVI, Section 1604, dated February 17, 2009.

Section 1: Borrower Eligibility Issues

Finding 1: Borrowers Did Not Demonstrate the Ability to Repay Loans

Rural Development guaranteed 12 loans in our statistical sample to borrowers who did not demonstrate the ability to repay the loans. Regulations state that repayment income must be stable and dependable; and typically should not be used if it is less than 24 months in duration.[28] The lenders based their decisions on information such as current job earnings, which were not always stable, dependable, or supported in the loan files. In most of these cases, we questioned the stability of income due to the borrowers' frequent job changes. Current job earnings, based on as little as 2 months on the job, can improve the borrowers' financial profile by lowering the repayment ratios to within the program limits. RHS officials stated that Federal regulations are not specific and allow the lenders flexibility for calculation purposes. As a result, RHS generally supported the lenders' decisions, and disagreed with our positions on these loans. Based on the results of our audit, we project that 11,661 loans (over 14 percent of the Recovery Act portfolio), with a total value of $1.3 billion, were made to ineligible borrowers who have a higher risk of future servicing actions and potential default on their loans.[29] Including high risk borrowers in the program could increase the loss claims if the borrowers default on their loans.

Our approach, based in part on the practices of a few of the lenders, did not rely on current income, but rather used the borrowers' earnings over the last 24 months. The agency stated that our conclusions are not accurate because the default rate has not risen as we estimated it would in the Fast Report issued in December 2010.[30] To date, 6 of the 12 ineligible borrowers were, or have been, delinquent on their loan payments. Overall, 28 of 100 borrowers in our sample have been delinquent at least one month during the course of their loan, some for multiple months. Of the six loans, a loss claim has been paid on one and another loan is over 450 days delinquent and a foreclosure is the likely outcome. Additionally, the lack of an increase in foreclosures may be due, in part, to the current state of the mortgage industry. Lenders may not be processing foreclosures at this time due to the legal issues impacting the industry.

We also compared the delinquency rate for Recovery Act loans versus loans funded with regular appropriations for the same time period. The delinquency rate for Recovery Act loans was almost 12 percent while the delinquency rate for the regular funded loans was 8 percent.[31] The Recovery Act stipulated that the funding should be used with more stringent controls.

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[28] 7CFR1980.345(a-c), dated May 22, 1995.

[29] We are 95 percent confident that between 4,935 (over 6 percent) and 18,378 loans (over 22 percent) were provided to borrowers that did not demonstrate adequate repayment ability and the total value of those loans is between $441 million and $2.2 billion.

[30] The Fast Report estimated that almost 11 percent of the portfolio was at risk because loans were guaranteed to borrowers who did not demonstrate the ability to repay those loans. Fast Report 04703-02-Ch (1), *Rural Development Guaranteed Single Family Housing Loans Made by Lenders to Ineligible Borrowers*, dated December 6, 2010.

[31] OIG extracted this data from Rural Development's Delinquency Data Model for Single Family Housing as of August 31, 2011.

We also identified 13 other borrowers whose attributes were less severe than the borrowers we determined to be ineligible in our sample, but still had sufficiently questionable work histories or repayment ability that there is an increased likelihood of future servicing actions. In addition, we found that lenders did not always adequately verify employment or document their income calculations, even though it is required by Federal regulations.[32] The lenders' documentation was not always sufficient or complete for us to accurately assess borrower eligibility. At times, we contacted employers and borrowers to obtain additional information to support the income determination.

The critical component of both debt ratio calculations is a borrower's qualifying income. Lenders must determine if there is a historical basis to conclude that the applicant's income is likely to continue. In determining eligibility, lenders must calculate an applicant's total debt ratio[33] and the borrower's monthly mortgage principal, interest, real estate taxes, and insurance (PITI) ratio.[34] The total debt ratio must be less than or equal to 41 percent and the ratio of PITI to income must not exceed 29 percent for an applicant to be eligible for a loan guarantee.[35] If the applicant's repayment ratios exceed the limits, the lender may request concurrence from Rural Development in allowing a higher ratio based on compensating factors.[36]

To determine if the borrowers in our sample had income that was stable and dependable, we included all of the income for their jobs over the 24 months prior to the loan application, rather than just current income. In our view, this method more closely adhered to the regulatory requirements for borrowers to have stable and dependable income. Also, this method compensated for any instability in the borrower's work history. The following sections further describe our concerns.

Ineligible Loans

We gave careful consideration to the individual characteristics of every borrower, and while each was different; our analysis did find some common characteristics that contributed to our conclusions. Generally, lenders used only current wages to calculate qualifying income for the 12 ineligible loans in our sample. Use of the most recent income increased qualifying income and reduced debt ratios, which did not provide an accurate depiction of the borrowers' ability to repay their loans.

The use of borrowers' most recent earnings solely to calculate qualifying income was more widespread than with just the 12 loans we determined to be ineligible. Lenders calculated qualifying income using methods that focused on the borrowers' most recent earnings for more than 70 percent of our sample. This is a significant percentage when compared to the regulations, which state that "typically" income of less than 24 months should not be used by

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32 7CFR1980.347, dated May 22, 1995.
33 The total debt ratio is calculated by dividing the applicant's monthly debt obligations by gross monthly income. Monthly obligations consist of PITI for the proposed loan, homeowner and other assessments, and the applicant's long term debt obligations.
34 The PITI ratio is calculated by dividing the applicant's proposed PITI by gross monthly income.
35 7CFR1980.345, dated May 22, 1995.
36 7CFR1980.345(c)(5), dated May 22, 1995.

lenders to calculate borrower repayment ability. This citation implies that it should be the normal procedure and only on a rare occasion should lenders use short periods of income. A few lenders explained that they used current wages because it best reflected the amount borrowers could afford at the time of making the loan.

Lenders for 15 additional loans used current earnings for one of the two co-borrowers on the loan. However, for the other co-borrower, the lender used a historical average. We identified only 9 loans, out of the 100 in our sample, where lenders used borrower earnings over a longer period of time, such as 24 months, to calculate qualifying income. One of the largest lenders in the program preferred this method because it was more conservative, and provides security if a borrower loses his or her current job and must return to a previous job and pay rate. We believe this is a more practical approach and consistent with the regulations, particularly for borrowers who change jobs frequently.

The following examples illustrate the details of two of our sample loan guarantees that we considered ineligible for the program:

- One borrower was employed for 2 months at a new position prior to the loan application date. Over the past 24 months the borrower worked at least two different occupations with three different companies.[37] The borrower's employment at each position ranged from 2 to 14 months. The lender based qualifying income on the borrower's current compensation of $2,539 per month, which was higher than previous positions. The lender also incorrectly doubled the borrower's overtime pay for the year. The lender calculated the borrower's PITI and total debt ratios at almost 22 and 30 percent, respectively, based on the borrower's most recent earnings.

  We calculated the borrower's qualifying income to be $1,240 per month using all sources of income over the prior 24-month period. This method resulted in PITI and total debt ratios of over 44 and 61 percent, respectively, which are higher than allowed by the regulations. In addition, the borrower had a credit score of 632, a very limited credit history, and payment shock of over 100 percent. When we discussed this loan with RHS officials, they said this is an example of poor underwriting, but they did not consider it ineligible for the program. The borrower defaulted on the $80,000 loan in less than 3 months, and the agency paid a loss claim of nearly $55,000 to the lender.[38]

- The primary borrower worked at a current job for 6 months prior to the loan application date. The lender based qualifying income for the loan on the current position. In the 24 months prior to obtaining the loan, the borrower moved from one State to another and worked for three different employers. The borrower held these jobs for periods ranging from 3 to 13 months, and the current income at the time of application was higher than the income for the previous positions. The borrowers had credit scores of 648, 659, and 681. Based on the most recent job earnings of $3,167 per month for the primary

[37] We were unable to determine the line of work at the second company. The borrower was a cashier, and then became a meat processor at a slaughter plant.
[38] OIG extracted this data from Rural Development's Delinquency Data Model for Single Family Housing as of August 31, 2011.

borrower, plus other household income of $861 for the other borrowers, the lender determined the debt ratios to be almost 38 percent for PITI and 49 percent for the total debt.

We calculated the qualifying income to be $2,253 per month, by calculating an average of the borrowers' income for the prior 24-month period. Using this method, the debt ratios were significantly higher at more than 48 percent for PITI, and nearly 63 percent for the total debt. RHS officials said that one of the borrowers had a good credit score and this loan was a GUS "Accept,"[39] which in their opinion, means it will be a successful loan. The borrower is over 450 days delinquent on the loan and foreclosure is the likely outcome.[40]

We discussed each of the 12 loans we considered to be ineligible with RHS officials. During the discussions, we explained our analysis and our rationale for calculating qualifying income for each borrower. That information, along with other factors such as credit history and payment shock, was used in our overall conclusion regarding the borrowers' ability to repay the loan. RHS officials were concerned with some of the attributes in these loans, but disagreed with our overall conclusion of ineligibility for 11 of the 12 loans. In their view, the lenders applied appropriate judgment in calculating qualifying income because they used the borrowers' most current income, which they informed us was an industry standard. They also placed a significant amount of weight on the borrowers' credit scores.

We disagreed with their position for two reasons. First, the use of only current income was not supported by regulations, which we concluded are adequate to protect the program from excessive loss claims. Further, we were unable to find, and the agency did not provide, commonly accepted industry standards that suggest using only current income. Second, the RHS officials' emphasis on credit scores is not entirely applicable for these cases, as the borrowers' credit scores were below 660 for 6 of 12 loans. Also, agency guidance allows a credit score above 660 to mitigate only one risk factor, and that is only if no other risk factors exist. These loans had more than one risk factor.

Questionable Loans

We identified 13 additional loans made to borrowers with questionable repayment ability. When forming our conclusions for each of the 13 loans, we considered all risk factors including debt ratios, credit history, payment shock, and cash reserves. We concluded that these borrowers had slightly better financial attributes or more stable and dependable income than the borrowers we considered to be ineligible. In general, they still had PITI or total debt ratios that exceeded agency requirements when we recalculated income using an average of the borrowers' 24-month work history.

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[39] GUS renders an underwriting determination of "Accept," "Refer," or "Refer with Caution." If GUS renders an "Accept" determination based on the analysis of credit, capacity, and other loan characteristics, the loan is eligible for Rural Development's loan guarantee, provided the data entered into GUS are true, complete, and accurate. RD AN 4423, Guaranteed Underwriting System, dated March 26, 2009.

[40] OIG extracted this data from Rural Development's Delinquency Data Model for Single Family Housing as of August 31, 2011.

The following examples illustrate some of the borrowers who we concluded had questionable repayment ability:

- One lender used a borrower's most recent earnings of over $70,000 to determine qualifying income for a $282,000 loan. This resulted in PITI and total debt ratios of over 33 and 40 percent, respectively. We used the borrower's historical average to determine qualifying income because the prior years' earnings, while sizeable (at $40,000 and $50,000), were significantly less than current income. Our analysis resulted in PITI and total debt ratios of 40 and 48 percent. In addition to the high debt ratios, the borrower had other risk factors including over 100 percent payment shock. In this case, the borrower had no previous housing costs, and the home purchase raised the borrower's costs from $0 to $1,925 per month. Additionally, this borrower only had $93 in cash reserves, which was not enough for even one month of mortgage payments. The combination of these factors led us to conclude that the borrower may have difficulty repaying the loan. RHS officials disagreed with our position, and noted that the borrower had stable employment and was successful based on the large increases in pay, plus the borrower had a high credit score (707). This borrower has subsequently become delinquent on the loan payments. [41]

- Another borrower had multiple risk layers including 99 percent payment shock, $14,000 in contract liabilities, and $600 per month in child support payments. The lender calculated PITI and total debt ratios of almost 30 and over 52 percent, respectively. For a $226,500 loan, this borrower also did not have enough cash reserves for one month of housing expenses. We calculated the ratios at almost 33 percent for PITI and 57 percent for total debt. Due to the multiple layers of risk, we considered this loan questionable for repayment ability. RHS officials stated that the borrower's credit score of 679 was enough to justify approval of this loan guarantee. They also noted that it was a "GUS Accept," and disagreed with our using an average of income over a 24-month period.

Our concern is that these loans will be more likely to require servicing actions and possibly go into default because borrowers have questionable repayment ability. As of August 2011, 5 of the 13 loans in this category were, or have been, delinquent on their loan payments.[41] RHS officials disagreed with our conclusion on all 13 questionable loans, due to borrowers' credit scores, our use of a 24-month average of income, and other reasons that may have been specific to each loan.

Insufficient or Incomplete Verification of Employment Documentation

We determined that the income verification information in the lenders' files was insufficient to support a decision of borrower eligibility in 16 of our sampled loans. In these cases, the lenders' documentation was not always complete and adequate to determine stability, dependability, and continuity of the borrower's income. We also reviewed the lenders' compliance with agency

[41] OIG extracted this data from Rural Development's Delinquency Data Model for Single Family Housing as of August 31, 2011.

guidance[42] for Verification of Employment (VOE), and found that 30 additional loans did not completely follow the rules. Lenders are responsible for obtaining and documenting this information.

RHS issued guidance which allows three options for acceptable documentation to verify employment and income. The three options include: (1) Form RD 1910-5, *Request for Verification of Employment*, and the most recent paycheck stub; (2) paycheck stubs covering the most recent 30-day period, W-2 tax forms[43] for the previous 2 years, and a telephone verification of the applicant's current employment (verbal VOE); and (3) electronic verification or other computer generated documents, W-2 tax forms for the previous 2 tax years, and a telephone verification of the applicant's current employment.[44] We found problems with each of the agency approved options lenders used to verify income. These methods are susceptible to employer errors and their refusal to provide some or all of the requested information.

We found that sections for determining stable and dependable income were not completed within the forms such as: probability of continued employment, date and projected amount of next pay increase, and prior year gross earnings. This missing information made it difficult to determine if the income was dependable and likely to continue. We analyzed the verbal VOEs and determined that these forms generally only provided the start date of employment and verification that the borrower was currently employed. The verbal method excluded information such as past earned income to determine stability and it did not address the continuity of employment. Lenders have the ability to request more information to improve their documentation, but in these cases there was no evidence that they tried to do that. Occasionally a tax return and bank statement would be located within the loan file, but this was not standard practice.

According to RHS' guidance, income documentation should be used to verify the other documents. For example, the VOE should have current earnings to compare to the current earnings on the paycheck stubs. Therefore, to ensure that all information is obtained, policies should be adjusted to require the lenders to obtain additional information. The most recent 30 days of pay stubs would help verify current income. Two years of complete tax returns, W-2s, and 1099s,[45] will provide evidence for the borrowers' past employment, all sources of personal income, business expenses, child care, and household members. Additionally, bank statements will provide verification of payroll deposits as well as any additional deposits to determine income earned. Obtaining this additional information will help solidify borrower income and lessen the impact of employer errors or lack of cooperation.

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[42] RD AN 4363, Acceptable Alternative Documentation to Verify the Applicant's Employment Income, effective May 2, 2008, through April 30, 2009; and RD AN 4470, SFH GLP Underwriting and Closing Loans-Documentation Matrix, effective August 18, 2009, through July 31, 2010. RD AN 4470 provides three options for the lenders to use to document income.
[43] The Internal Revenue Service form that an employer uses to report an employee's annual wages and taxes withheld.
[44] RD AN 4363, Acceptable Alternative Documentation to Verify the Applicant's Employment Income, dated May 2, 2008.
[45] The Internal Revenue Service form used to report non-employee compensation.

Rural Development Policies Were Insufficient to Detect Income Deficiencies

We found that Rural Development field staff was only performing a cursory review of applications prior to approving the loan guarantee. These reviews were insufficient to detect the ineligible and questionable loans we found because the field staff was not required to recalculate income or repayment ratios and did not enforce the documentation requirement with the lenders. We determined that even if the reviews were completed more thoroughly, the field staff would continue to allow ineligible borrowers into the program because they did not agree with our methodology. Additionally, even though income is a critical component of every application, Rural Development lacks standard methods for calculating income. RHS officials stated that field staff is not supposed to underwrite the loans,[46] rather, the field staff is to ensure the loan application is complete and for an eligible purpose.[47] Underwriting of the loan is the lender's responsibility. Because the agency is guaranteeing the loan, we believe a more thorough review should be completed, including recalculating income and repayment ratios.

Prior to approval, Rural Development field staff reviews applications submitted by lenders for completeness to determine whether the proposed loan is to an eligible applicant for an eligible loan purpose, and for documentation to determine that there is reasonable assurance of repayment ability and sufficient collateral.[48] To assist with this process, field staff utilized a checklist to process and close guaranteed loans.[49] This checklist includes a procedure to verify that lenders submitted the applicant's income documents. Rural Development field staff informed us that it is the lender's responsibility to insure the accuracy and quality of income information. Guidance supports this statement. We agree that the lender is responsible. However, we believe that Rural Development field staff should strengthen its review because this is the only opportunity for the field staff to question or deny a guarantee. After the guarantee is approved, the options to alter the guarantee only exist if fraud or misrepresentation occurs. If a lender approves an ineligible borrower, there is little the Government can do to remedy that particular guarantee. This was confirmed by the lenders' attitudes when we questioned them on their loans as more than one lender remarked that their actions were justified by Rural Development's approval of the guarantee. Therefore, RHS officials should strengthen the field staff review.

We discussed the loan process with Rural Development field staff and some indicated they would try to calculate income, and we did find evidence of staff calculations in some case files, even though it was not required. However, workload volume and pressure to get the guarantees processed within the 48 hour goal[50] made this increasingly difficult to accomplish. Other field staff informed us that they are not required to calculate income, and did not do so as part of their loan application review. Further, with a GUS "Accept" loan application, staff indicated that they do not receive income information and, therefore, are unable to verify income.[51] We concluded that Rural Development field staff is inconsistently reviewing the applications because some are

[46] RD AN 4435, Debt Ratio Waivers and Payment Shock, dated April 30, 2009.
[47] 7CFR1980.354, dated May 22, 1995.
[48] RD Instruction 1980-D, 1980.354, dated June 21, 1995.
[49] RD AN 4465, Checklist for Guaranteed Loans, dated July 16, 2009.
[50] RD Instruction 1980-D, 1080.354, dated June 21, 1995.
[51] RD AN 4330, Guaranteed Underwriting System, dated January 30, 2008.

recalculating income, others are not, and applications submitted through GUS generally do not provide income documentation to verify. Therefore, we recommend that Rural Development field staff verify the lender's income determination by recalculating the income and repayment ratios.

One problem that made both qualifying and adjusted annual income calculations more difficult was the lack of standardized methods or processes for lenders to follow. Lenders were allowed to determine the method for calculating income. We observed the use of multiple methods and weak corresponding documentation. This made it difficult for us, the field staff, and even the lenders to later determine what information and method was used when they originally processed the application. However, it was clear for both types of income, that lenders were using the most favorable method to help qualify applicants. For example, the lender and Rural Development field staff could not explain how the income was calculated for one of our sample borrowers who worked for the bank providing the loan. We also could not recreate their calculations and concluded that the borrower was ineligible for the loan due to income that exceeded the program's limit. (See Finding 2 for more information on this topic.) We concluded that the income calculation process needed to be standardized to decrease the disparity among income calculations and prevent ineligible loans from getting into the program.

We recommend that RHS officials standardize the income calculation process. This change will also help with similar problems in adjusted annual income as discussed in Finding 2. Modifications to GUS can also help. If additional income information is incorporated into GUS, such as fields for base pay rates, year-to-date pay, and the prior 2 years of income, this could greatly enhance the field staff's ability to determine whether to approve the loan guarantee. The system could also be used to calculate income and the debt ratios. In addition, the lenders should be required to input the start date of the borrower's current job. If the start date is within the past 12 months, we recommend that a new rule be included in the GUS Underwriting Findings Report, which will require that the lender submit income documentation for the Rural Development field staff to make a determination on the stability of the borrower's income.

Additional Controls Implemented as a Result of Our Phase 1 Recovery Act Audit

As a part of our work at Rural Development State and field offices, we analyzed the controls the agency implemented as a result of a prior audit (Phase 1).[52] In our Phase 1 audit, we reviewed the agency's internal controls, but we did not test the effectiveness of the controls. We recommended some improvements as a result of our work, but we did not make recommendations pertaining to a significant portion of the loan origination process. We determined that the existing regulatory framework, if executed properly, provided a reasonable basis for Rural Development to arrive at a correct eligibility decision.

The agency quickly responded to our Phase 1 concerns and implemented a corrective action plan by July 2009, with only one exception; they did not segregate duties in field locations. The agency did make adjustments to GUS, and implemented actions to address other concerns

[52] Audit Report 04703-01-Ch, *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds, (Phase I),* dated September 2009.

including: detection of inaccurate information in GUS, use of brokers, monitoring of debt ratio waiver requirements, changes to the appraisal valuation process, and the need to segregate duties over the loan review and approval process. Because we had not tested the universe at that time, we were not aware if there were problems that warranted the immediate segregation of duties, or other more substantive measures. Instead of segregating duties, the agency suggested a secondary review that we accepted as a substitute corrective action.

As a result of this audit, we found that the corrective action that RHS officials used for two areas was not sufficient: the lenders' ability to submit inaccurate information in GUS that would not be detected by the agency and segregation of duties. The agency programmed GUS to select a 5 percent random sample of loans for a full documentation review by the field staff. While one of our sampled loans was randomly selected for review, there was no evidence to support that the file was actually reviewed by the field staff. However, the box in GUS was checked to indicate that a review was performed. The field official could not explain what was done to address this requirement or the lack of loan documents, but was convinced it was completed because the box was checked. RHS officials said that the field official should have retained applicable documentation to support the full review, as is required for manually submitted loans. In response to our Fast Report, agency officials stated that 5,768 GUS loan submissions were selected in the 5 percent random sample for full documentation review. However, they never accumulated or summarized the results of these reviews.

To further test our concern regarding inaccurate data in GUS, we compared the source documents to the data in GUS. We found 12 cases in which the lenders excluded or submitted inaccurate information in GUS, for items such as cash on hand, overtime, and bonus income. For example, one lender submitted an inaccurate amount for qualifying income. Since this application came through GUS, the Rural Development field staff was unaware of the circumstances. This miscalculation resulted in a PITI ratio of almost 39 percent and total debt ratio of over 56 percent. We concluded that if the correct income was included in GUS, the loan would not have been accepted for a guarantee. We considered this borrower to be ineligible due to lack of repayment ability.

We also reported the lack of segregation of duties within the field offices as a concern in our Phase 1 audit report. This weakness creates a situation where Rural Development field staff could fail to detect lender errors or collude with lending officials to guarantee substandard loans. Government Accountability Office standards for internal controls state key duties and responsibilities need to be divided or segregated to reduce the risk of error or fraud. No one individual should control all aspects of a transaction or event.[53]

In response to our recommendations, RHS officials indicated that segregating duties was impractical because of staffing limitations and, in part, because the field staff was extremely busy processing a record volume of loans. Instead, loans were randomly selected for a second party review. We analyzed the reviews conducted by the State offices that we visited and found that the review was a basic checklist of administrative items, ensuring that all documentation was

[53] United States Government Accountability Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1, dated November 1999.

provided, dated, and signed. We noted that the review was not substantive and did not require any re-calculations. We found that two loan specialists reviewed their own work. The field staff detected a variety of issues as part of their work, but these results were not tabulated or used in any way by RHS officials. The reviews were terminated after 3 months, because RHS officials concluded the second party reviews were ineffective and cumbersome.

In our current audit (Phase 2), we tested the eligibility of borrowers and found that key eligibility controls and documentation standards were not functioning as described in regulations or agency instructions. We found that lenders were not always performing to standards, and Rural Development field staff did not always identify or seek corrections prior to approving the loan guarantees. To ensure the accuracy of all applications, we recommend that RHS officials segregate duties in offices where it is feasible based on staffing levels, and implement a second party review that re-calculates income and ratios. In addition, a pre-loan closing review should be implemented at smaller offices that are unable to suitably segregate duties among existing staff.

Fast Report 04703-02-Ch (1)[54]

In an interim report (Fast Report), we formally notified RHS and Rural Development officials about eight loans we considered to be ineligible because the borrowers did not meet the agency's regulatory requirements for repayment ability. We also reported that another ten loans were made to borrowers with questionable repayment ability. Since the issuance of the Fast Report, we have added additional loans to the ineligible and questionable loan categories. In the Fast Report, we made three recommendations to correct the problems. Those recommendations are included in this report, along with the agency's response and our position, as Recommendations 1, 2, and 3.

In their response to recommendations in the Fast Report, Rural Development and RHS officials generally disagreed with our conclusions for the ineligible and questionable loans. However, they acknowledged that there are many ambiguities associated with qualifying income, making it difficult to determine an exact figure for every loan file. They also stated that lenders perform an investigation of the documents supporting income as well as any comments made by employers on the VOE form to arrive at a precise reason to support the underwriting decision. As we have identified in this report, the lender does not always take into consideration all pertinent income information as required by the regulations and the lender's documentation is not always sufficient to support the underwriting decision. Actions to standardize the income calculation process could help eliminate the weaknesses we found, and make it easier for all parties to reach the same conclusions.

Agency officials also stated that the regulations were written in 1995, and did not include credit scoring as an extremely important factor in evaluating an applicant's repayment ability. They stated an atypically strong credit score is indicative of the applicant's stability in meeting credit obligations even if a borrower has less than 24 months in his or her current job. According to the

[54] Fast Report 04703-02-Ch (1), *Rural Development Guaranteed Single Family Housing Loans Made by Lenders to Ineligible Borrowers*, dated December 6, 2010.

officials, the RHS approach remains consistent with the Federal Housing Administration (FHA) and the mortgage industry and has permitted applicants with less than 24 months with their current employer to obtain loan guarantees provided they have very strong credit scores. The officials did not provide an exact credit score. We reviewed FHA's guidance and found that while it indicates that sufficient documentation and reasoning must exist for using income less than 24 months, the guidelines do not indicate that a credit score is a compensating factor. We requested industry standard information from RHS officials but they were unable to provide us with any documentation that shows current industry standards.

In addition, the agency's reply stated that high credit scores are used industry wide as a legitimate predictor of loan repayment. They explained that GUS may render an "Accept" underwriting recommendation for applicants with atypically high credit scores even if they are only on their current job for a few months or have other shortcomings. The agency's reply also explained the "scorecard" within GUS is based on empirical data comprising many thousands of loans and a GUS "Accept" shares credit characteristics closely associated with historically successful homeowners.

Recommendation 1

Take appropriate actions and measures concerning the ineligible loans.

Agency Response

The agency's response to our Fast Report stated that according to Federal regulations, the loan note guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation. Unless the agency or OIG determines the presence of fraud or misrepresentation, the loan note guarantee remains valid. To hold originating lenders accountable in the future, the agency implemented requirements, which became a final rule on May 31, 2011, that allow the agency to seek indemnification from the lender if a loss is paid under certain circumstances.

OIG Position

We accept management decision for this recommendation.

Recommendation 2

Notify field staff and lenders about the regulatory issues included in the Fast Report and emphasize the need for compliance with those regulations.

Agency Response

The agency's response to our Fast Report stated that the importance and proper use of Recovery Act funds was relayed to lenders and field staff on many occasions during fiscal years 2009 and 2010. To resolve this recommendation, the agency proposed sharing the Fast Report with field staff and lenders and re-emphasizing the need for compliance with applicable regulations.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Review and revise, as necessary, the agency's policies regarding income eligibility and qualifying income. In addition, strengthen the oversight procedures used by field staff to verify compliance with those regulatory requirements.

Agency Response

The agency's response to our report stated that they clarified the income requirements through six regional lender training sessions; a SFH national policy meeting for field staff; and by issuance of Administrative Notice (AN) 4575 on May 23, 2011. This AN provides detailed guidance for calculating both eligibility and qualifying income. Since ANs are temporary in nature, the agency proposed to make the guidance permanent by incorporating the content of the AN into a new regulation and corresponding handbook. The AN will be renewed until publication of the 7CFR3555 occurs. The new regulation and related handbook will replace the current 7CFR1980-D and related ANs, and will be published by September 30, 2012.

In a supplemental email response dated September 29, 2011, the agency addressed our concern with oversight procedures. They stated that field staff will verify lender income calculations for manually submitted loan applications and the lender compliance reviews will verify income calculations for loans submitted electronically through GUS. In addition, centralizing the program functions in each State will afford the field staff opportunity for second level reviews of loan files.

OIG Position

We accept management decision for this recommendation.

Recommendation 4

Require Rural Development field staff to verify lender income calculations by recalculating income and repayment ratios.

Agency Response

The agency's response stated that field staff is responsible for reviewing all information submitted by the lender. However, it is the lender's responsibility to properly verify and analyze the applicant's income and employment history to ensure it is in accordance with agency guidelines. As recommended, the field staff will be required to verify lender income calculations by recalculating income and repayment ratios for manually underwritten loans when the repayment ratios calculated by the lender are within 10 percent of the debt ratio limit(s). The revisions will be accomplished with the publication of a new regulation and handbook. The 7CFR3555 will be published by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 5

Develop and implement standardized procedures for computing repayment income using a historical average, to ensure uniformity and consistency of determinations among lenders.

Agency Response

The agency's response stated that a standardized worksheet was developed for lenders to use to document repayment income. AN 4575 provides four options for calculating income (straight, average, year to date, and historical). The worksheet is in line with current underwriting guidelines used by the Federal Housing Administration (FHA), Fannie Mae, and Freddie Mac. Using a historical average may not be appropriate for all applications. Since ANs are temporary in nature, the AN will be incorporated into the new regulation and corresponding handbook. The AN will be renewed until publication of the 7CFR3555 by September 30, 2012.

In a supplemental email response dated September 29, 2011, RHS officials addressed our concern that the guidance discussed in AN 4575 was not mandatory. They stated that use of the worksheet published in AN 4575 will become mandatory with the publication of the 7CFR3555 and handbook.

OIG Position

We accept management decision for this recommendation.

Recommendation 6

Develop a standardized form for manually submitted applications and require the lender to document and explain both qualifying and eligible income calculations

Agency Response

The agency's response stated that AN 4575 provides a standardized worksheet that lenders may use to document annual and repayment income. The worksheet contains a section for lenders to provide a written analysis detailing the annual and repayment income calculations utilized. Since ANs are temporary in nature, the AN will be incorporated into the new regulation and corresponding handbook. The AN will be renewed until publication of the 7CFR3555 by September 30, 2012.

In a supplemental email response dated September 29, 2011, RHS officials addressed our concern that the guidance discussed in AN 4575 was not mandatory. They stated that use of the worksheet published in AN 4575 will become mandatory with the publication of the 7CFR3555 and handbook.

OIG Position

We accept management decision for this recommendation.

Recommendation 7

Develop a standardized method that requires the lenders to provide the base income, year-to-date pay from the most recent paystub(s), and the prior 2 years of income as reported on the borrower's W-2. In addition, require the lenders to input the start date of the borrower's current job. If the start date is within the past 12 months, a new rule should be included in the GUS Underwriting Findings Report for a review of income documentation by Rural Development field staff.

Agency Response

The agency's response stated that current regulations allow for the use of a standardized form for loan applications known as the Uniform Residential Loan Application (URLA) (Fannie Mae Form 1003, Freddie Mac Form 65). The form has a blank space for "years on the job" but does not include a start date. The URLA does not provide spaces for year to date pay or the previous two years of income as noted on the W-2s. However, AN 4575 provides a standardized worksheet that lenders may use to document annual and repayment income. The worksheet contains a section for lenders to provide a written analysis detailing the income calculations utilized. Additionally, the information suggested as an addition to the GUS application pages would be cost prohibitive to develop and would not add the needed value to the GUS underwriting recommendation. Therefore, the agency proposes to create a new GUS message that requires a full documentation loan file submission when applicants have 12 months or less in their current employment. These changes will be made by September 30, 2012.

In a supplemental email response dated September 29, 2011, RHS officials addressed our concern that the guidance discussed in AN 4575 was not mandatory. They stated that use of the worksheet published in AN 4575 will become mandatory with the publication of the 7CFR3555 and handbook.

OIG Position

We accept management decision for this recommendation.

Recommendation 8

Segregate duties and implement second party reviews in offices where it is feasible based on staffing levels to ensure the accuracy of all applications. Continue the pre-loan closing reviews at smaller offices that are unable to suitably segregate duties among existing staff.

Agency Response

The agency's response stated that a directive will be issued to Rural Development State Directors instructing them to centralize all functions related to the SFH Guaranteed Loan Program. Segregation of duties will be accomplished by ensuring the loan approval official does not request the obligation of funds in the Guaranteed Loan System (GLS). The same control will apply for entering loan closings into GLS. The agency will develop specific guidance to address internal oversight by next level supervisors and/or second party reviewers. With centralization, small offices will be eliminated. The directive will be issued by December 31, 2011, and all States will complete the centralization of the SFH Guaranteed Loan functions by October 1, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 9

Revise current instructions for income documentation to require: the IRS Tax Return for the prior 2 years, the most recent 30 days of paystubs, a completed VOE, and 3 months of bank statements that correspond to income deposits. If the VOE provided is not complete, the lender should follow up with the employer to obtain all answers. Income documentation should be obtained for all household members. In addition, disallow the use of the verbal VOE.

Agency Response

The agency's response stated that revisions will be made to require that all adult household members sign IRS Form 4506-T, "Request for Transcript of Tax Return" for the previous two tax years at loan application. The tax transcript will validate/confirm previous years' reported income for eligibility and repayment purposes. The transcript is proposed in lieu of the tax return. The agency will continue current income verification requirements including the verbal VOE, only if it is used in conjunction with additional forms of income verification. To promote consistency when verbal verifications are used, a standardized form was developed to record verbal verification of employment which will be released with the publication of 7CFR3555 by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Finding 2: Borrowers' Income Exceeded Regulatory Limits

We identified 12 borrowers in our statistical sample that were ineligible to participate in the program because their adjusted annual income exceeded Federal regulations.[55] For these loans, lenders did not properly include borrower earnings, business income, overtime pay, or bonuses when calculating adjusted annual income. In addition, lenders did not always obtain the required borrower earnings information when verifying income with employers, or adequately document how they calculated income. Rural Development field staff did not always re-calculate income or verify the accuracy of calculations submitted by lenders. Further, Rural Development field staff generally did not obtain or verify income documentation for loans accepted by GUS. As a result, we project that 13,665 loans (almost 17 percent of the portfolio), with a projected total value of $2.2 billion, were guaranteed with Recovery Act funds for borrowers whose income exceeded program limits.[56] The improper guarantees prevented other eligible applicants who were denied due to the lack of funds from being considered for loans.

Federal regulations state that to be eligible to participate in the SFH Guaranteed Loan Program an applicant's adjusted annual income must not exceed applicable income limits set by the agency.[57] Lenders are required to determine the total annual income for all adult members of the household.[58] Lenders should include all sources of income such as wages, salaries, overtime pay, commissions, tips, bonuses, and unemployment compensation. Income such as overtime pay should be dependable based on verification with the employer and the applicant's history over the previous 24 month period. Adjusted annual income determinations must be thoroughly documented in the lender's case file.[59] The agency is to review loan applications for completeness and to determine whether the proposed loan is to an eligible applicant.[60] Of the three major Government housing programs – FHA, RHS, and the Veterans Affairs (VA) – Rural Development is the only program with an income eligibility requirement.

We visited and worked with each of the lenders that were responsible for originating the loans in our sample, and used their records to recalculate and verify the accuracy of adjusted annual income for each borrower. In addition to using the lender's information, we separately verified income information with other sources such as employers and the borrowers themselves. We found that the lenders did not always include all of the borrowers' income as part of their calculations. This is in contrast to what we noted in Finding 1 for repayment income. When determining qualifying income for repayment purposes, the lenders included all types of income.

Through our analysis, we determined that the lenders neglected to include wages, salaries, overtime pay, bonuses, or other income in their calculations of adjusted annual income. The income that was excluded was sufficient to place the 12 borrowers over the regulatory limits.

[55] 7CFR1980.345 (a), dated May 22, 1995.
[56] We are 95 percent confident that between 6,405 (almost 8 percent) and 20,932 loans (over 25 percent) were ineligible due to borrowers' income exceeding the income limit and the total value of those loans is between $986 million and $3.4 billion.
[57] 7CFR1980.345(a), dated May 22, 1995.
[58] 7CFR1980.347(a), dated May 22, 1995.
[59] 7CFR1980.347, dated May 22, 1995.
[60] RD Instruction 1980-D, 1980.354, dated June 21, 1995.

Specifically, we identified four instances where lenders omitted overtime or extra pay; two instances where lenders did not use current wage or salary information; two instances where lenders failed to include borrower salary increases; one instance where the lender used the wrong household size in its calculations; one instance where a lender excluded income from an outside business; and two instances where lenders excluded income from a borrower or another household member. The following examples illustrate the omission of income:

- In one case, we interviewed the borrowers to verify their income and learned that the co-borrower had not quit the first job as the lender stated in the application. The co-borrower had held this job since 2004. We also learned that the co-borrower earned commissions and tips on a second job that were not included in the lender's calculations of adjusted annual income. When earnings for both borrowers were added together, their total income exceeded the agency's limit; potentially by as much as $10,000. The lender explained to us that it was not aware that the borrower was still working the first job, and it could not recall the details surrounding the borrower's second job. RHS officials agreed with us that the loan exceeded the income limit.

- In another case, we found evidence in the lender's loan file that, in addition to a full time job, the borrower participated in two income producing businesses. The lender omitted income from the business interests, but there was no information in the file stating a reason. We talked to the borrower and verified the borrower's salary and involvement with the two businesses. When the business income was added to the borrower's salary, the total income exceeded the agency's limit by about $570. We asked the lender why the income was omitted, and it told us the income was not necessary to qualify the borrower for the program, and did not affect eligibility when added to the borrower's income. For this case, RHS officials indicated that the borrower was negligent for not including the business income in his loan application. In their opinion, the lender was provided bad information, and as a result, RHS officials supported the lender's calculation.

We found that lenders generally used multiple methods to calculate income, such as using the borrower's year-to-date pay,[61] base pay,[62] or historical average pay.[63] For some cases, they used calculations that were not clearly discernable. We also observed some lender calculations in the loan files that resulted in a borrower exceeding the income limit, but a different calculation with a lower total amount was used when applying to Rural Development for a loan guarantee. Further, some lenders used various methods to calculate income for different borrowers. For instance, one lender used base pay to calculate annual income for one borrower, and then used a multi-year average to calculate the total income for the co-borrower. The lender's use of base pay excluded the borrower's latest raise, overtime, and bonus; even though the VOE clearly

[61] Year-to-Date Pay – annual income calculated using borrower's year-to-date gross earnings as stated on his or her most recent pay stub.
[62] Base Pay – annual income calculated using base pay as identified on pay stub or verification of employment documentation obtained from applicant's employer. For example, base pay of $30,000 annually or $12.00 per hour.
[63] Historical Average Pay – annual income calculated using current and prior year income data. For instance, using 2008 income reported on W-2 and 2009 year-to-date income reported on pay stub to determine borrower's average annual income.

indicated the earnings would continue in the future. Had the lender used the co-borrower's year-to-date earnings, the adjusted annual income would have exceeded the limit by over $6,100. We asked a lender official about the choice of methods, and she replied, "Calculations for borrowers like this one is subjective at best. Rural Development reviewed the income documentation and provided a guarantee on this loan." RHS officials stated that the lender was conservative in treating income in this case, and they agreed with the lender's method to calculate income.

Overall, we found a lack of consistency and standardization in how lenders were calculating adjusted annual income, which at times resulted in incorrect conclusions about a borrower's eligibility. RHS' policies do not require that lenders use a standard template or uniform methodology. Instead, the agency relies on the lender to decide which methodology is best. We questioned lenders about how income was calculated in our sample cases, but there was no uniform response. We also found that the level of documentation in the loan files was weak, even though lenders are required to thoroughly document their work.[64] Some lenders had their calculation worksheets, others included calculations on the income documents, but others did not document any calculations. To further compound the problem, as discussed in Finding 1, VOEs and other income information did not always meet specifications. In some cases, the lenders could not use their own files to re-create or explain how they calculated income.

The agency internal control in place to check the income in a loan application, before the guarantee is approved, is the review performed by the Rural Development field staff. The field staff is required to review each application for completeness and to determine whether the proposed loan is to an eligible applicant.[65] Income is a critical component of every application; however, in many cases the field staff does not always check annual income. The field staff receives loan files from lenders for manually submitted loans and for loans that receive a "Refer" and "Refer with Caution"[66] determination from GUS. The lenders are required to provide three documents[67] and the GUS Underwriting Findings Report[68] to Rural Development field staff for applications submitted electronically through GUS. Those documents include: (1) FNMA Form 1004, *Uniform Residential Appraisal Report*; (2) FEMA Form 81-93, *Standard Flood Hazard Determination Form*; and (3) RD Form 1980-21, *Request for Single Family Housing Loan Guarantee*. However, field staff is not required to recalculate annual income using the documentation submitted by lenders. As a result, Rural Development field staff is unaware if applicants do not meet agency income guidelines. We determined that eight manual loans and four GUS-approved loans in our sample were made to borrowers who had income that exceeded agency limits. We recommend that the field staff recalculate income during the review process and ensure that all household members are accounted for within the total household income.

[64] 7CFR1980.347, dated May 22, 1995.
[65] RD Instruction 1980-D, 1980.354, dated June 21, 1995.
[66] A "Refer" or "Refer with Caution" determination made by GUS means that RHS will not approve the loan until the lender provides additional information. The lender is required to perform a manual underwriting analysis and provide the loan application package to Rural Development using the same requirements as a manually submitted loan.
[67] RD AN 4423, Guaranteed Underwriting System, dated March 26, 2009.
[68] The GUS Underwriting Findings Report is delivered to the submitting lender and Rural Development with the underwriting evaluation determination of "Accept," "Refer," or "Refer with Caution." RD AN 4423, Guaranteed Underwriting System, dated March 26, 2009.

We discussed the loan process with Rural Development field staff and worked with them to evaluate the determinations made on our sampled loans. They provided a variety of responses in terms of what processes were applied to the manual loan applications. Some staff indicated they tried to recalculate income, and we did find evidence of staff calculations in some case files. A few staff noted that at times they tried to apply the Single Family Housing Direct Loan Program's four method approach,[69] to the extent possible, as a quick check. This included calculating the borrowers' verified income using the four different methods to determine which figure was most representative of income likely to be received during the next 12 months. The guidance for the four method approach also states that conservatively selecting the lowest figure without analysis is not acceptable. Other staff informed us that they are not required to recalculate income, and did not do so as part of their loan application review. Further, with a GUS "Accept" loan application, staff stated that they did not receive income information and, therefore, were unable to verify income.[70]

Rural Development does require lenders to submit income information for a random selection of 5 percent of loans submitted through GUS with an "Accept" determination. GUS randomly selects the loan applications and alerts the lender to provide the documentation that supports the loan to Rural Development for review. For these selected loans, the Rural Development field staff must perform a full documentation review prior to issuance of the Conditional Commitment for the loan guarantee. Only 1 of our 100 sample loans was included in the 5 percent random sample and the Rural Development field staff was unable to provide us with the documentary evidence to support that they conducted a full file review. We determined this occurred because there was no procedure or instruction for the field staff to process the full documentation review. Without documentary evidence of the required full file review, Rural Development cannot demonstrate that income was correctly computed for a majority of the loans processed through that system. GUS was responsible for originating more than 40,000 Recovery Act loan guarantees from March 2009 through September 2010.

Overall, we concluded that Rural Development field staff reviews of manual or GUS applications could not be counted on to ensure the accuracy of adjusted annual income. Some field staff did try to verify income eligibility, but others did not. Most importantly, RHS officials indicated that they did not count on the field staff to verify adjusted annual income, because this was the lender's responsibility. Additionally, we found that the lender compliance reviews did not include an assessment of adjusted annual income within the review process. (See Finding 6 for more detailed information on this topic.) We concluded that this placed an overreliance on the lender's decisions, which resulted in ineligible borrowers participating in the program.

We discussed each of the 12 cases that we concluded were ineligible with RHS officials, who agreed with our conclusions for 6 of the 12 cases. For the cases where we disagreed, it was generally because they thought lenders were correct in taking a conservative approach in the handling of overtime or special pay when calculating adjusted annual income or because the lenders relied on information provided directly from employers. We disagreed with their

[69] Rural Development, Direct Single Family Housing Loans and Grants Field Office Handbook; HB-1-3550; Chapter 4: Borrower Eligibility, Section 3: Sources of Income, dated January 1, 2003, provides four calculation methods: Straight Base, Average, Year To Date, and Historical.
[70] RD AN 4330, Guaranteed Underwriting System, dated January 30, 2008.

position because in each of the six cases information was provided by either the borrower or the borrower's employer that should have led the lenders to include the other sources of income based on current program requirements.

In our Fast Report, we formally notified Rural Development and RHS officials about the 12 borrowers who had adjusted annual income that exceeded the program's limits.[71] In response to our report, the agency stated that "Federal regulations provide guidance on the various types of income that may be included and allow lenders to utilize the most representative calculation of annual income. Due to the many methods of calculation available and the interpretation thereof, it is difficult for all parties – OIG, the agency and the lender – to conclude an exact same income figure." To address the finding dealing with eligibility income determinations, the agency has conducted training sessions at various locations around the country for lenders that include income and the importance of adequate documentation as topics. In August 2011, Rural Development held a National Policy Conference for field staff to discuss various program topics.

Rural Development's response also acknowledged our statement in the Fast Report that field staff did not verify annual income calculations accepted by GUS. They noted that GUS applications classified as "Refer" and "Refer with caution" require lenders to submit the entire loan file for agency review. They also indicated that they made additional quality control adjustments in response to recommendations OIG made in 2009.[72]

Although we agree that additional training is necessary, we feel that additional controls and procedures are needed to ensure eligibility income calculations are correctly computed and include all applicable income. Additional controls and clearer procedures will help to ensure that only eligible borrowers obtain funding through the SFH Guaranteed Loan Program. To this end, Rural Development officials explained that they are drafting adjustments to existing regulations and a new handbook that will cover the entire guaranteed loan process in detail. Because improvements to income policies and procedures apply to both qualifying and adjusted annual income determinations, the substance of our suggested corrective actions can be found in Finding 1 of this report.

[71] Fast Report 04703-02-Ch (1), *Rural Development Guaranteed Single Family Housing Loans Made by Lenders to Ineligible Borrowers*, dated December 6, 2010.
[72] Audit Report 04703-01-Ch, *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (Phase 1)*, dated September 2009.

Recommendation 10

Develop and implement standardized procedures, such as using current earnings, to calculate eligibility income to ensure uniformity of determinations by lenders for both manual and electronically submitted loan applications.

Agency Response

The agency's response stated that regulations require current verified income to be used for calculating eligibility for the household. The agency has expanded on this guidance through issuance of AN 4575 and by conducting training for both lenders and field staff. Since ANs are temporary in nature, the guidance will be incorporated into the new regulation and corresponding handbook. The handbook devotes a chapter to income calculations. The AN will be renewed until publication of the 7CFR3555 by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 11

Require Rural Development field staff to verify the lender's adjusted annual income calculations by recalculating income and determining the number of household members earning income.

Agency Response

The agency's response stated that lenders will be required to obtain the IRS tax transcript for the previous two years for all adult household members. Further, for manually underwritten loans, the field staff will be required to recalculate income if it is within 10 percent of the applicable income limit. Both proposals will be implemented upon publication of the 7CFR3555 by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Finding 3: Loans Were Guaranteed to Borrowers Who Had the Ability to Secure Financing with Reasonable Terms and Conditions Directly from Lenders without Government Assistance

We identified seven loans in our statistical sample that were made to borrowers who possessed sufficient financial resources to obtain loans from lenders without a Government guarantee. Several lenders offered borrowers all of the credit options available to them for financing, including the lenders' own credit. Some lenders stated that they were not aware that a borrower's inability to obtain conventional credit was a requirement for the program. In addition, RHS officials had no policy or procedure to verify that a borrower did not qualify for a conventional loan or to review the borrower's assets, which were considerable in some instances. Based on our sample results, we project that 5,551 loans (almost 7 percent of the portfolio) with a total value of $713 million were made to borrowers who were ineligible because they qualified for conventional loans.[73] The guarantees associated with these loans should have been provided to borrowers who were unable to obtain conventional credit.

The basic objective of the SFH Guaranteed Loan Program is to assist eligible households in obtaining homes in rural areas by guaranteeing loans which otherwise would not be made without a Government guarantee.[74] Federal regulations state that a borrower must be without sufficient resources to obtain the necessary housing and be unable to secure the necessary conventional credit, without an agency guarantee, upon terms and conditions which the applicant could reasonably be expected to fulfill.[75] As part of the application process, the borrower certifies that "I am unable to provide the housing I need on my own account and I am unable to secure the credit necessary for this purpose from other sources upon terms and conditions which I can reasonably fulfill." The lender certifies that "the applicant is unable to secure the necessary conventional credit without a Rural Development guarantee upon terms and conditions which the applicant could reasonably be expected to fulfill."[76] Based on our work, we concluded that not all of RHS' lenders, borrowers, or Rural Development's field staff clearly understood the meaning of the regulations, or the corresponding certifications.

We discussed lending practices with 25 lenders[77] that provided loans to borrowers in our sample. Ten lenders said that they routinely offered a borrower all loan options, including both private and Government financing choices. We found that some lenders and borrowers were not aware of, or misunderstood, the policy for Rural Development guaranteed loans. For example:

- One borrower in our sample had $44,000 in cash and a credit score of 743. The responsible lender said it normally required a 10 percent down payment for a conventional loan, and it lets the applicant choose the type of loan. This borrower could afford to put 20 percent down, but did not want to make a down payment if it could be avoided. In this case, both the lender and the borrower did not understand the policy.

- We asked another lender why co-borrowers with over $58,000 in cash and credit scores of 714 and 683, did not qualify for a conventional loan. The borrowers had enough for a 20 percent down payment. The lender stated that USDA no longer required the borrower to be unable to obtain other financing.

These examples demonstrate that borrowers had the means to meet traditional loan options from lenders, but they still certified that they could not obtain financing with reasonable terms and

[73] We are 95 percent confident that between 829 (over 1 percent) and 10,273 loans (almost 13 percent) were provided to borrowers who qualified for financing directly from lenders and the total value of those loans is between $50 million and $1.4 billion.
[74] 7CFR1980.301(b), dated May 22, 1995.
[75] 7CFR1980.346(b), dated May 22, 1995.
[76] Form RD 1980-21, *Request for Single Family Housing Loan Guarantee*, (Rev 6-06).
[77] Our sample included 65 different lenders.

conditions on their own. Borrowers selected the SFH Guaranteed Loan Program over other available financing options mainly because it required no down payment. In addition to no down payment, borrowers told us they selected the SFH Guaranteed Loan Program because: (1) the application process was easier, (2) it allowed for low monthly payments, (3) there was no requirement to pay private mortgage insurance, and (4) it had no requirement to attend first time home buyer classes.

Some of the Rural Development field staff also did not understand the regulations. One State official informed us that there was no regulatory requirement for a guaranteed applicant to be unable to secure a conventional loan. However, the regulations do not support this statement. Another State official said the language in the Form RD 1980-21 does not say that if borrowers can qualify for a conventional loan, they must choose that option. As noted on the Form RD 1980-21, the borrower is certifying that they do not have any other "reasonable" options available to them.

We determined RHS officials had no policy or procedures that required its staff to verify that a borrower could not obtain financing from a private lender without a Government guarantee. Further, lenders were not required to explain why a borrower did not qualify for a conventional loan. Rural Development relied solely on the lender and applicant certifications on Form RD 1980-21. However, we found that these forms were not always accurate. For instance, two lenders offered conventional loan options to borrowers, thus contradicting their certifications. Additionally, we found that the lender compliance reviews did not include an assessment of the borrower's ability to obtain conventional credit within the review process. (See Finding 6 for more detailed information on this topic.)

We discussed with RHS officials each of the seven loans where our analysis indicated that borrowers could have obtained conventional credit. They agreed with our conclusions for 2 loans because the borrowers could afford to make a 20 percent down payment, had PITI and total debt ratios of 28 percent and 36 percent respectively, and had good credit scores.

RHS officials maintained that there was little to no conventional credit approved during the time when Recovery Act funds were used to guarantee loans. Thus, they disagreed with our conclusion that the borrowers for five of the seven loans could have obtained conventional credit. Further, they stated that the borrowers did not have cash reserves for a 20 percent down payment, sufficient credit, or acceptable repayment ratios. They acknowledged that the regulations did not clearly define conventional credit, but maintained that conventional credit meant having the financial resources to make a 20 percent down payment. However, when we asked the lenders about conventional credit in relation to the seven loans, five lenders indicated that they may have financed a loan for the borrowers without the Rural Development guarantee. Another lender was not aware of the requirement. Generally, lenders said they required anywhere from a 5 to 20 percent down payment during the time that Recovery Act funds were being obligated by the agency.

RHS officials had no policy or procedures to verify that a borrower was not qualified to obtain financing from a private lender. Thus, we recommend that the agency establish a policy. Such a policy would help ensure that Rural Development is approving loan guarantees only for eligible borrowers and help achieve the program's objective by assisting eligible households to obtain adequate housing. In addition, GUS should be modified to watch for borrowers who could be eligible for conventional credit and notify the Rural Development field staff to ensure that the borrowers were not provided reasonable conventional credit alternatives.

In response to our Fast Report,[78] the agency cited the Real Estate Settlement Procedure Act (RESPA)[79] to address the fact that lenders were providing borrowers with several loan options including conventional credit as an alternative to the guaranteed loan. Agency officials noted that changes to RESPA required lenders to disclose information to loan applicants that would allow them to contact other financial institutions for a better mortgage product. RESPA was amended in 2010 to better protect consumer rights against high settlement costs. We were unable to find a citation within the law that covers Government insured loan products or borrowers having the ability to secure conventional financing under reasonable terms and conditions. RHS officials did not provide us with the specific citation.

Agency officials also proposed in their response to our Fast Report to change the terminology in the regulations from conventional credit to "need for guarantee." They also proposed instituting a series of four questions lenders would be required to ask each applicant. The new questions would determine the applicant's ability to obtain traditional credit, and include whether the applicant had: (1) personal non-retirement funds of at least 20 percent of the purchase price that could be used as a down payment; (2) the ability to pay all closing costs; (3) PITI and total debt ratios of no more than 28 percent and 36 percent, respectively; and (4) an acceptable credit history. Generally, we agree that defining these parameters would be helpful. However, such measures would need to specify what the resulting outcomes mean, and corresponding controls to ensure proper operation. Because each lender's credit policy can differ, and some lenders will have the ability to provide financing below these levels, there is potential for the problem to continue.

In addition to the seven borrowers with enough assets to qualify for conventional credit, we identified five more borrowers in our sample that had significant assets,[80] such as cash or real estate,[81] but lacked the ability to qualify for conventional credit. Applicants do not need assets to qualify for a loan guarantee[82] and assets valued at over $5,000 may contribute to an applicant's adjusted annual income at an interest rate equivalent to that of a passbook savings account.[83] If assets are used to help qualify the applicant, then the assets should be documented and verified by the lenders.[84] Otherwise, the lender is not obligated to document or submit assets as part of

[78] Fast Report 04703-02-Ch (1), *Rural Development Guaranteed Single Family Housing Loans Made by Lenders to Ineligible Borrowers*, dated December 6, 2010.
[79] Public Law 93-533, (RESPA) was enacted on December 22, 1974, current through PL 111-319, approved December 18, 2010.
[80] Assets are items such as cash, stocks, bonds, or real and personal property. We considered a liquid asset to be significant if the asset equaled 15 percent or more of the loan amount. We also had three borrowers with real estate valued at: $42,000, $100,000 and over $340,000.
[81] Five of the ten borrowers we considered to have significant assets were also able to obtain credit elsewhere.
[82] RD AN 4423, Guaranteed Underwriting System, effective March 26, 2009; and RD AN 4451, Liquid Asset Types and Documentation, effective June 22, 2009.
[83] 7CFR1980.347(d)(3)(iii), dated May 22, 1995.
[84] RD AN 4423, Guaranteed Underwriting System, effective March 26, 2009; and RD AN 4451, Liquid Asset Types and Documentation, effective June 22, 2009.

the application. As a result of these policies, lenders did not always provide the agency with information about all the borrower's assets. For example, a lender omitted $11,000 in cash from the GUS loan application. The lender said that GUS accepted the application without the cash reserves, so they excluded the asset in the application.

Borrowers with significant assets may not need a guaranteed loan because the assets can be used to reduce or offset the underlying loan risk to the lender as well as the overall loan amount. As a comparison, in Rural Development's SFH Direct Loan Program, applicants are required to use excess assets towards a down payment to reduce the amount of the loan.[85] The following examples illustrate loans made to borrowers with assets that could have altered or reduced the Government's commitment:

- A borrower had over $340,000 in real estate assets and obtained a guaranteed loan for almost $191,000.

- Another borrower obtained a guaranteed loan for almost $36,000, but held $100,000 in real estate investments.

We discussed real estate assets with RHS officials who contend that real estate assets are not liquid and regulations allow for a borrower to have real estate outside the local commuting area, or which is functionally inadequate. However, we concluded that Rural Development field staff should further investigate any loan application that contains substantial assets to determine if the borrowers were eligible for conventional financing. Therefore, we recommend that RHS officials require documentation and verification of all assets held by borrowers to help ensure that the Rural Development field staff will be aware of borrowers who potentially are able to secure other reasonable financing. We also recommend that RHS officials establish a limit for the amount of assets a borrower can hold, similar to the Direct Loan Program. Any excess assets above the limit should be used as a down payment to reduce the loan amount.

In our Fast Report,[86] we formally notified Rural Development and RHS officials about six borrowers who were, in our view, eligible for conventional credit. We identified one more case after we issued the Fast Report. In response to the Fast Report, agency officials generally disagreed with our position regarding conventional credit because they insisted that lenders were not providing conventional loans during the Recovery Act timeframe. However, they agreed to take corrective actions regarding the recommendations we made in that report.

[85] Rural Development Handbook HB-1-3550, Direct Single Family Housing Loans and Grants, Field Office Handbook Chapter 4, Section 2, Paragraph 4.5, revised November 7, 2008.
[86] Fast Report 04703-02-Ch (1), *Rural Development Guaranteed Single Family Housing Loans Made by Lenders to Ineligible Borrowers*, dated December 6, 2010.

Recommendation 12

Review and revise, as necessary, the agency's policies regarding borrower ability to obtain conventional credit without loan guarantees. In addition, strengthen the oversight procedures used by field staff to verify compliance with those regulatory requirements.

Agency Response

The agency's response stated that AN 4594 "Definition of Conventional Credit" was published on July 26, 2011, to establish clear parameters regarding the ability for borrowers to obtain conventional credit. The AN also strengthens the oversight procedures used by field staff to verify compliance with regulatory requirements. This guidance will be included in the new regulation and handbook. The AN will be renewed until publication of the 7CFR3555 by September 30, 2012.

In a supplemental email response dated September 29, 2011, the agency addressed our concern with oversight procedures. They stated that field staff will verify eligibility for conventional credit and the lender compliance reviews will include an additional verification. Centralizing the program functions in each State will afford the field staff opportunity for second level reviews of loan files.

OIG Position

We accept management decision for this recommendation.

Recommendation 13

Modify GUS to notify Rural Development field staff when loan applicants possess the eligibility characteristics for conventional credit. Field staff should then follow up with the lender to ensure that the applicant was not eligible for conventional credit.

Agency Response

The agency's response stated that GUS does not have the capability to read the credit report and determine the number of trade lines and their length of history, all of which must be considered to determine if a borrower qualifies for conventional credit. However, a new rule will be written to alert lenders and the field staff when an applicant has enough assets to make a 20 percent down payment and the debt ratios are below conventional credit thresholds. The new rule combined with the guidance in AN 4594 will assist in the analysis of conventional credit. The AN will be renewed until publication of the 7CFR3555 by September 30, 2012. The revisions to GUS will also be made by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 14

Revise existing policies to require lenders to document and verify the borrower's assets, and for Rural Development field staff to ensure that borrowers were unable to secure other reasonable financing.

Agency Response

The agency's response stated that extensive training was provided to lenders and field staff on the verification, calculation, and required inclusion of household and borrower assets in program eligibility and income calculations. Additionally, AN 4543 "Underwriting and Loan Closing Documentation Matrix" includes clarification and guidance for the verification and documentation of assets. The new revision currently in process will strengthen the requirement for disclosure of all assets held by any adult member of the household. The addition of IRS Form 4506-T will provide new due diligence for any undisclosed assets. Field staff has already been provided with guidance to identify "red flags." AN 4594 and stronger emphasis in the revised and updated renewal of AN 4543 will address the necessity to consider assets in the program eligibility and income calculations. This guidance will be included in the new regulation and handbook, which will be published by September 30, 2012. The ANs will be renewed until publication of the new regulation.

OIG Position

We accept management decision for this recommendation.

Recommendation 15

Establish an asset limit for the program and require borrowers to contribute a down payment when their liquid or non-liquid assets exceed the limit.

Agency Response

The agency's response stated that current regulations and the Housing Act of 1949, as amended, do not support an established asset limit or down payment requirement. When applicants are able to obtain conventional credit based upon the criteria established in AN 4594, they will be ineligible for a guaranteed loan. This guidance will be included in the new regulation and handbook. The AN will be renewed until publication of the 7CFR3555 by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Finding 4: Applicants with Adequate Existing Homes in the Local Commuting Area Received Loan Guarantees

We identified four borrowers in our statistical sample that already had an existing home at the time of application. The four homes were functionally adequate, structurally sound, and located within the local commuting area. Federal regulations state that "an applicant must be a person who does not own a home in the local commuting area or owns a home which is not structurally sound, or functionally adequate."[87] RHS officials maintained that the regulation allowed them to guarantee loans as long as the borrowers had sold their existing homes prior to purchasing a new home, which is not consistent with the wording of the regulation. We project that 2,882 loans (almost 4 percent of the portfolio), with a total value of $481 million, were made to borrowers who already owned adequate housing within the local commuting area and, as a result, were ineligible for the Government guarantee.[88] These loan guarantees should have been provided to borrowers who needed, but did not have adequate housing.

We formally notified the agency through a Fast Report about our concerns in this area.[89] In response to the Fast Report, agency officials stated that "the borrowers had disposed of their existing property (via sale) prior to the agency's issuance of a loan guarantee." They added that because the applicants no longer owned homes, they were eligible for loan guarantees. This statement accurately depicts the situation for all four borrowers in our sample as they bought and sold their homes either the same day or up to 30 days later. However, we disagree with RHS' views on eligibility because all four borrowers had adequate homes when they applied for the loan guarantee. In addition, there was no evidence that any of the four borrowers' first homes were structurally unsound or functionally inadequate. We also identified three statements on Rural Development's website that support our understanding of the regulation. In two locations, the website states that to be eligible, applicants must be without adequate housing. A third location at their website similarly states "applicants do not own a dwelling."[90]

The agency's response to the Fast Report also did not address the fact that the borrowers had moved relatively short distances to their new homes and had financed their prior homes with conventional credit. Our analysis disclosed that the borrowers had moved distances of between 1 and 16 miles from their previous homes, and remained within the commuting area of their place of employment. One borrower moved less than three miles to a home on a lake. At the time of application, the four borrowers in our sample already had adequate housing that was obtained with conventional credit.

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87 7CFR1980.346(a), dated May 22, 1995.

88 We observed 4 instances of this condition, with a total value of $737,810. Because this number is within the 95 percent confidence interval, we are reporting the lower bound as the actual observation. The upper bound, for the 95 percent confidence interval, is 6,299 loans (almost 8 percent), totaling $1.0 billion.

89 Fast Report 04703-02-Ch (1), *Rural Development Guaranteed Single Family Housing Loans Made by Lender to Ineligible Borrowers*, dated December 6, 2010.

90 Sources are http://www.rurdev.usda.gov/HAD-Guaranteed_Housing_Loans.html, http://www.rurdev.usda.gov/rhs/sfh/GSFH_Information/Individuals.htm, and http://www.rurdev.usda.gov//rhs/sfh/GSFH_Information/Common/quick_guide.htm, as of June 17, 2011.

RHS officials maintained that at the time of purchase of the new home, all four borrowers had sold their previous residence. They stated that field staff should have requested documentation on the Rural Development Form 1980-18, "Conditional Commitment for SFH Loan Guarantee," (Conditional Commitment) and obtained the HUD-1 Settlement Statement to support the sale of the prior home. However, the Conditional Commitments for two of the four loans did not include a provision for the existing home to be sold as a condition of the guarantee. Also, one of the loan files did not contain proof of the existing home's sale prior to issuing the guarantee. The Rural Development field official who issued the loan guarantee obtained proof of sale after we brought it to their attention.

In response to our Fast Report, agency officials stated that our interpretation would limit the program to first-time home buyers. We disagree with this statement because the regulation has three exceptions that allow applicants with existing homes to participate in the program. Those exceptions allow for access to the program when homes are not structurally sound, functionally adequate, or within the commuting area.

The agency's reply to our Fast Report also stated that our regulatory interpretation would prohibit borrowers with guaranteed loans from refinancing to a new guaranteed loan with a lower interest rate. They added that borrowers with loans obtained directly from Rural Development would be unable to "graduate" to a loan that was guaranteed by Rural Development. We disagree with the agency's position because according to its guidance, these events are considered to be servicing actions, and are not purchase transactions. Thus, borrowers would be able to refinance and graduate to guaranteed loans.[91]

After we issued our Fast Report, RHS officials requested an opinion from the Office of the General Counsel (OGC) on their interpretation of the regulation. On January 20, 2011, OGC opined that the agency's interpretation of the regulation is legally acceptable, but it was not the only reasonable reading of the regulation. OGC stated that once the existing dwelling is sold, regardless of its condition or the applicant's reason for moving, the applicant will be a "person who does not own a dwelling in the local commuting area," in compliance with 7CFR1980.346(a). OGC closed their remarks by stating, "The agency may choose to clarify 7CFR1980.346(a) in the regulation text or by an administrative notice to ensure consistent interpretation by its field staff."

We met with the OGC official who issued the opinion. The official stated that the opinion was limited to the existing home provision in the regulation, and no other areas. As such, the opinion did not take into consideration other aspects of the program, such as the program objective, the credit elsewhere provision, or the agency's funding considerations. We considered these factors in forming our conclusion. RHS officials should request an OGC opinion on the regulations considering these and any other relevant factors. By serving a segment of the public that already has adequate housing and conventional mortgages, Rural Development precluded other eligible applicants from receiving the assistance needed to obtain modest but adequate housing. Further

[91] RD AN 4335, Refinancing of Section 502 Direct Loans with Section 502 Guaranteed Loans; and AN 4336, Refinancing of SFH Guaranteed Loans, both dated February 28, 2008.

clarification of the regulation and agency policies is needed to ensure that only eligible borrowers obtain guaranteed loans

Recommendation 16

Obtain an OGC opinion on the regulatory citation, 7CFR1980.346(a), as it relates to the overall program in determining borrower eligibility, specifically in relation to the program objective, credit elsewhere provision, and funding limitations.

Agency Response

The agency's response stated OGC offered to review and opine on a policy statement from the agency as it relates to the overall program in determining borrower eligibility, specifically in relation to the program objective, credit elsewhere provision, and funding limitations. OGC indicated that they already provided an opinion on 7CFR1980.346(a), stating that the loans in question were made within the scope of the regulations. The agency acknowledges that the regulations could be interpreted in the way OIG interpreted them. In order to prevent further misinterpretation, the agency will provide a policy statement to OGC. The policy will be clarified based on the OGC opinion and will be incorporated into the 7CFR3555 by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 17

Require lenders to maintain documentation that borrowers' existing homes were either inadequate or structurally unsound.

Agency Response

The agency's response stated that OGC indicated it is not necessary to document that a borrower's existing home was either inadequate or structurally unsound because the existing home was sold prior to purchasing one with a guarantee. As indicated in response to Recommendation 16, the agency will provide a policy statement to OGC. The policy will be clarified based on the OGC opinion and will be incorporated into the 7CFR3555 by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 18

Develop policy and procedures to ensure that field staff verifies the existence and adequacy of documentation related to instances where borrowers had existing homes prior to obtaining a loan guarantee from Rural Development.

Agency Response

The agency's response stated that once OGC issues a legal opinion on the policy statement in reference to Recommendation 16, the agency will clarify the policy and incorporate it into the 7CFR3555 by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Finding 5: Loan Guarantees Provided for Homes with Swimming Pools

We identified three homes in our statistical sample with swimming pools. The Recovery Act specifically prohibited the making of guaranteed loans for homes with pools. This occurred because RHS officials did not inform lenders and Rural Development field staff that the Recovery Act prohibited loan guarantees for homes with swimming pools until after a significant number of loans had already been guaranteed by the agency. Based on our sample results, we project that 1,659 loans (over 2 percent of the portfolio), with a total value of $230 million, were ineligible because the borrowers purchased homes with swimming pools.[92] By providing loan guarantees for these homes, the agency deprived other eligible borrowers from receiving a guaranteed loan. After Recovery Act funds ran out in the spring of 2010, the agency accumulated approximately $1.6 billion in loan requests that were awaiting a loan guarantee.

The Recovery Act stipulated that "None of the funds appropriated or otherwise made available in this Act may be used by any State or local Government, or any private entity, for any casino or other gambling establishment, aquarium, zoo, golf course, or swimming pool."[93] On March 23, 2009, the Secretary of Agriculture issued a memorandum stating, "Funds under the Recovery Act shall not be committed, obligated or expended to support projects of the type described in section 1604… of the Recovery Act…or any other imprudent project." Additionally, the RHS Acting Administrator issued guidance on May 28, 2009, that stated, "…without exception, no swimming pools are permitted for loans obligated using Recovery Act funds."[94]

[92] We observed 3 instances of this condition, with a total value of $563,977. Because this number is within the 95 percent confidence interval, we are reporting the lower bound as the actual observation. The upper bound for this confidence interval is 4,131 (over 5 percent) totaling $522 million.
[93] Public Law 111-5, Division A, Title XVI, Section 1604, dated February 17, 2009.
[94] RD AN 4442, In Ground Swimming Pools, dated May 28, 2009.

We questioned officials from each of the three lenders who made the loans. Those officials all stated they were unaware that homes with above-ground swimming pools were prohibited from receiving Recovery Act funds but were aware that in-ground pools were prohibited by agency regulations. This was also the case for Rural Development field staff. We were repeatedly told by field staff that above-ground pools were allowed, which was accurate for funds obligated with regular annual appropriations. The field staff referred us to a question and answer section on the agency's website, which stated that the prohibition did not apply to above-ground pools for Recovery Act funds. We checked the website and confirmed their statements. We concluded that the question and answer section contradicted the AN issued by the Acting Administrator on May 28, 2009. Additionally, it should be noted that by the time the AN was published, the agency had guaranteed more than 35,000 loans using Recovery Act funds.

RHS officials acknowledged not providing guidance or written notification directly to lenders. However, they stated that since lenders were unaware of the specific funding source (Recovery Act versus regular appropriation) used by the agency, it was the responsibility of Rural Development field staff to detect swimming pools by examining the appraisals provided in the underwriting package. RHS officials also stated that they had sufficiently informed field staff about the prohibition on using Recovery Act funds for swimming pools and that field staff erred in guaranteeing the loans with Recovery Act funds.

In our Fast Report,[95] we formally notified Rural Development and RHS officials about the three homes with swimming pools

Recommendation 19

Take appropriate actions and measures concerning the ineligible loans with regard to swimming pools.

Agency Response

The agency's response to our Fast Report stated that guidance was issued to field staff that properties with swimming pools were not permitted to receive loan guarantees utilizing Recovery Act funds. Guidance was published which officially superseded any informal bulletin board postings. The AN served as official notice to both the field and to lenders which clearly indicated that no Recovery Act funds should be used for properties with swimming pools. As a result of this finding, the agency has de-obligated and re-obligated the identified loans with non-Recovery Act funds, through which above-ground swimming pools are permitted.

OIG Position

We accept management decision for this recommendation.

[95] Fast Report 04703-02-Ch (1), *Rural Development Guaranteed Single Family Housing Loans Made by Lenders to Ineligible Borrowers*, dated December 6, 2010.

Section 2: Enhanced Monitoring Over Lender Activity to Safeguard Recovery Act Funds Was Not Achieved

Finding 6: Agency Oversight of Lender Loan-Making Activities Did Not Safeguard Recovery Act Funds

Recovery Act funds were used with little oversight and were approved for ineligible purposes. We attributed this to untimely and ineffective lender compliance reviews (LCR). RHS officials were unable to put sufficient national lender coverage in place while Recovery loans were being obligated, so only a small percentage of Recovery Act loans were reviewed. Rural Development State officials were unable to perform all of their reviews, or add more coverage, because of the record volume of loans processed during that time period. Further, the agency's LCR guides were ineffective because they did not include all the loan eligibility qualification factors, and repetitive findings were not used to improve policies to prevent problems from reoccurring in the future. The lack of appropriate action on LCR's contributed to our current findings on borrower repayment ability, adjusted annual income, conventional credit, existing homes, swimming pools, and compensating factors.[96]

OMB issued guidance that required agencies to take steps beyond standard practice, to mitigate the risks associated with the implementation of the Recovery Act.[97] To comply with OMB's guidance and the transparency requirements of the Recovery Act, the USDA's Single Family Housing Guaranteed Loan Program Recovery Plan, on the Recovery.gov website, stated that the program will conduct compliance reviews to evaluate lender activity, consisting of reviewing the lenders' underwriting standards and quality control reviews.[98] Rural Development Instruction 1980-D requires a review of lenders on a 2 or 5-year schedule depending on the size of the lender's loan portfolio.[99] The agency uses a contractor to conduct LCRs of nationally-approved lenders[100] and occasionally State-approved lenders.[101] Each Rural Development State office is responsible for reviewing State-approved lenders and for reporting the results of these reviews to the RHS officials.[102]

RHS officials rely on LCRs to ensure lenders comply with program policies and procedures. The importance of LCRs has grown in recent years because program funding has increased significantly from $4 billion in fiscal year (FY) 2008 to $24 billion in FY 2011. As a result, the Rural Development field staff had less time to review guarantees before approval. Program expansion also has not been limited to the number of loan guarantees, as the number of national

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[96] A compensating factor is a positive financial attribute, such as a demonstrated savings pattern, that offsets a negative financial weakness, such as high repayment ratios.
[97] OMB M-09-15, Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009, dated April 3, 2009.
[98] USDA Rural Development American Recovery and Reinvestment Act Implementation Plan, dated May 1, 2009, and updated May 15, 2010.
[99] RD Instruction 1980-D 1980.309 (g) (2) (ii)-(iii), dated June 13, 2007.
[100] Nationally-approved lenders are those lenders who received approval from the RHS national office to participate in programs on a multi-state or nationwide basis.
[101] State-approved lenders, in contrast, typically participate in programs only within one State.
[102] RD Instruction 1980-D 1980.309 (g)(4), dated June 13, 2007.

lenders almost doubled in the last 2 years, from 430 to 791. New lenders may not be as familiar with the program's policies and procedures, and could make errors in originating loans. These factors made the agency more reliant upon the lenders to make quality loan decisions, which in turn, increase the importance of LCRs to ensure the lenders are complying with regulations and agency policy.

We analyzed LCRs in terms of their effectiveness for the Recovery Act, and as an internal control for the program. We visited RHS officials, Rural Development State officials, the contractor who performs national compliance reviews, and the lenders to evaluate the execution of LCRs. We determined that LCRs were not performed timely. As a result, they were ineffective in ensuring that Recovery Act funds were spent according to the provisions of the law. The following sections describe our concerns with the LCR process.

Monitoring of Lender Activities Related to the Recovery Act

The national and State LCR processes were not initiated in time, or with enough intensity to adequately ensure Recovery Act funds were used for eligible purposes. We also found that the LCRs were not checking for all loan eligibility factors, or using past results to improve policies to reduce future problems. More than 86 percent of Recovery Act funds were obligated during the period of March to September 2009.[103] Therefore, agency officials and the private firm used by the agency needed to conduct LCRs earlier in the year, such as in April 2009. If RHS officials had taken action by April 2009, the reviews still would not have fixed the individual problems.

According to RHS officials, the SFH Guaranteed Loan Program was initially allocated $2.0 million in Recovery Act funds for administrative purposes. RHS officials obligated $1.15 million of these funds in their combined FY 2010 and FY 2011 contract with a private firm to perform LCRs. By the time the contract was in effect, over 86 percent of the loan guarantee funds had been obligated. RHS officials stated that they were unable to amend the contract for FY 2009, but they did verbally instruct the contractor to review Recovery Act loans prior to the new contract. However, neither RHS officials nor the contractor could provide evidence of when reviews of Recovery Act loans actually began, because the loans were not specifically tracked until FY 2010. In response to our questions, RHS officials and the contractor were able to determine that nearly 15 percent of all the loans reviewed by the contractor in FY 2009 were Recovery Act loans. As the loans had not been originally tracked, the results were not accumulated or used to improve the use of Recovery Act funds, expended at a later date.

We analyzed the State and National Compliance Review Guides (LCR guides) and found that they did not include all 11 areas of borrower eligibility as specified in Federal regulations. The review guides did not include three key areas of eligibility to evaluate whether: the borrower's income exceeded agency limits, the borrower had the ability to secure credit without the need for a Government loan guarantee, and the borrower owned an adequate home within the local

[103] As of September 30, 2009, Rural Development obligated $9.039 billion of the $10.472 billion authorized for Recovery Act funding.

commuting area. The guides were also not updated to reflect Recovery Act provisions to ensure borrowers did not purchase a home with a swimming pool.

We found that different reasons existed for why the four eligibility factors were being omitted from the LCRs. According to the contractor, it discontinued using the procedures related to the review of a borrower's adjusted annual income in December 2005. However, the contractor was confident its personnel would apply the policy if a loan had higher income. We were unable to find any evidence to indicate that the LCRs included an assessment of adjusted annual income. Based on our discussion in February 2011, the contractor and RHS officials agreed to update their database and add a field to calculate and assess adjusted annual income.

RHS officials did not explain their decision to exclude steps in the review guides to check whether the borrower had the ability to secure conventional credit. Since RHS officials' interpretation of owning an adequate home within a local commuting area differed from OIG's interpretation, they did not include this area within the LCR process. Based on our audit results, we recommend that tests be added to check these areas. The last area not included in the LCR guides related to ensuring that homes did not include a swimming pool. This is a Recovery Act specific item that was not added to the review guides, but should have been. Instructions were issued to the field staff and the contractor was verbally notified that homes with a pool were not allowed to be funded by the Recovery Act. The contractor told us they were aware of pools not being allowed, and were checking for them. However, we did not find any evidence that pools were being looked for, or had been identified by the contractor's work. RHS officials should have added procedures to the review guide to ensure that the contractor documented its work.

Our review of past national LCR results disclosed that the contractor had reported findings similar to those mentioned in this report. Over the last 3 years, we found that most of the contractor's origination findings were about borrower repayment ability and income weaknesses. For the same period, the contractor also reported that between 13 and 20 percent of the loans requiring a waiver for repayment weaknesses included a waiver that was unsupported, or the waiver was missing from the lender's file.

Rural Development State operations were responsible for completing LCRs for State-approved lenders. We visited 35 State offices[104] and asked if any special adjustments were made to oversee Recovery Act funding, but none had used LCRs to oversee Recovery Act loans. We determined that as many as 17 of the 35 States and Puerto Rico did no LCRs from March through September 2009, when most of the Recovery Act funds were obligated. RHS officials explained that the Rural Development field staff was busy processing a record volume of guaranteed loans during the key Recovery Act obligation period, in addition to their other program responsibilities. Therefore, time was not available for many States to perform LCRs.

[104] Our sample spanned 36 different States. However, two States share State Office responsibilities.

National and State LCR Coverage

We analyzed the scheduling of reviews for national and State lenders and found RHS and State officials were unable to accomplish all the reviews required by established guidance.[105] In addition, we were unable to evaluate the State process. RHS officials could not provide us with information on the status of the State LCR process because not all States send them the information needed to make this kind of determination.

Nationally-approved lenders were not being reviewed as often as required, and RHS officials stated they could not review all lenders within a 5-year period due to a lack of resources. This problem has been compounded because the number of national lenders participating in the program almost doubled from FY 2009 to FY 2010, from 430 to 791 lenders. Therefore, RHS officials schedule national lenders for review on a risk-based analysis performed by the contractor. The contractor generally selects lenders based on loan origination volume, delinquency rates, and the time elapsed since their last review. However, we found limitations to the selection process. Of the 65 lenders associated with our sample, 8 lenders had not been reviewed in the past 6 to 13 years due to low loan volume and low delinquency rates. RHS officials stated these were considered "low risk" lenders. During our audit, we determined that three of those lenders submitted loans for borrowers who we considered to be ineligible and who had questionable repayment ability. In addition, 11 new lenders to the program originated 11 of our sample loans. We determined that 7 of the 11 loans were ineligible and the remaining 4 had questionable repayment ability. These new lenders had not been subject to an LCR due to their recent approval to participate in the program. Based on our results, we recommend that RHS officials consider a sampling technique that will better capture lenders who have not been reviewed for a long period of time, and new lenders in the LCR selection process.

We also found that State offices did not always provide RHS officials with scheduled reviews or results. We determined that 36 out of 47 State offices submitted their 2009 LCR schedule at the beginning of the year, but only 16 shared their results at the end of the year. Our analysis of LCR information obtained during field visits disclosed that just a few State offices conducted the majority of the LCRs. For the 35 State offices that we visited, LCRs were completed for 202 of the 291 (69 percent) lenders that were scheduled for review. However, the contractor and three State offices were responsible for completing 133 of the 202 LCRs (66 percent). Our analysis also showed that 11 States did not review any of their lenders in FY 2009. Rural Development State officials informed us that they did not have the necessary personnel to process and approve the record volume of loans in addition to conducting LCRs.

We were unable to determine whether State LCRs could meet Instruction 1980-D which requires lenders be reviewed every 2 to 5 years.[106] Some States did not perform the required number of reviews over the 5-year period, but we were unable to accumulate total figures for how often this occurs. For example, officials in one State informed us that they have in excess of 90 lenders, but they only execute 5 LCRs a year, due to staffing limitations. It is clear that these State officials will not meet the 5-year requirement.

[105] RD Instruction 1980-D 1980.309 (g) (2) (ii)-(iii), dated June 13, 2007.
[106] RD Instruction 1980-D 1980.309 (g) (2) (ii)-(iii), dated June 13, 2007.

We discussed the different reviews with RHS officials, and the disparity in information available between the national and State results. RHS officials understand that the States were under duress with the loan volumes the last few years. However, the performance and reporting of the required number of State LCRs has been a problem for some time. RHS officials stated that they could centralize the LCR process and conduct all reviews at the national level, but would need more resources to perform this function. Centralization may be a future possibility, but the existing State process needs to be improved as well. RHS officials need to work with Rural Development officials to get LCRs completed and submitted in a timely manner in accordance with agency policy. Once LCRs are received, RHS officials should compile and analyze the results, and use these results to implement corrective actions as needed.

Common Findings and Use of LCR Results

We discussed and reviewed the national LCR process and annual reports with RHS officials and the contractor. We found that the contractor has reported important issues similar to what we found in FYs 2007 to 2009 that included problems with repayment ability, income documentation, and compensating factors. However, the RHS officials did not address those issues by implementing new policies or procedures.

The national LCR process was flexible in selecting samples but often focused on delinquent loans and those that have been active for at least 6 months. RHS officials and the contractor noted that when loans fail in the first few months, it is more likely to be caused by poor underwriting than other possible conditions. We agree that these methods will help identify and focus corrective actions on issues that can result in a direct loss to the Government.

The contractor's annual reports compile all of the issues found during the LCRs for the entire year.[107] The issues are presented on a per finding basis. Individually, these items do not appear significant. In order to determine the magnitude of the problems found during the LCRs, we compiled these issues into more general topic areas. For example, in FY 2009, the contractor found a total of 202 occurrences where the lender did not adequately underwrite the loan. Of those 202 occurrences, 6 involved a lender who miscalculated income or did not provide sufficient income documentation. We added up all the occurrences of repayment related issues in the FY 2009 Annual Report, and found that 116 of the 202 occurrences, or 57 percent, involved miscalculations of repayment income and income documentation weaknesses. Similar results were reported in FYs 2007 and 2008. For the same 3-year period, the contractor also reported between 13 to 20 percent of loans requiring waivers for repayment weaknesses, including waivers that were unsupported, or waivers that were missing from the lender's file (see Finding 8).

We discussed the results of the Annual Reports and our analysis with RHS officials to specifically determine if policies and procedures were implemented to correct these recurring weaknesses. They acknowledged that miscalculation of qualifying income has been a problem area, but could not provide evidence to show that they used the results of LCRs to improve

[107] The FYs 2007 to 2009 annual reports do not break the findings down for Recovery Act loans because these were not tracked until FY 2010.

policies, alert staff, or broaden lenders' understanding of this area or others. The annual reports were made available to the Rural Development personnel, but RHS officials informed us that most of the change derived from the results of the annual reports stemmed from verbal discussions. They informed us that guidance discussing proper treatment of deferred student loans and their most recent documentation matrix were implemented as a result of the contractor's work. We believe that periodically summarizing the issues found in LCRs and providing results to lenders and field staff as a program notification would be an effective procedure to help inform and possibly avoid future problems.

As noted earlier, LCR information was not always obtained from State offices, and it was not being compiled or distributed for broader program improvements. LCRs are intended to identify common areas of weaknesses and strengths among lenders, and to help reduce the risks associated with guaranteed loans. Since RHS officials did not have review results from the States, they were left without information on a substantial number of lenders each year. We recommend that RHS officials annually obtain and summarize the results disclosed in both the national and State LCRs, and provide the results to lenders and to the Rural Development field staff.

Recommendation 20

Revise national and State LCR guides to include coverage of all eligibility areas, including adjusted annual (eligible) income, conventional credit, and applicants who own existing homes.

Agency Response

The agency's response stated that revisions will be made to the State and National Lender Compliance Review (LCR) guides to include coverage of all eligibility areas, including adjusted annual (eligible) income and conventional credit. The agency will address existing homes as described for Recommendations 16 through 18. Work papers and sampling will be updated once OGC's opinion is known. The LCR guides will be updated by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 21

Establish monitoring controls to ensure that State-approved lender compliance reviews are conducted and submitted as required.

Agency Response

The agency's response stated that meeting monitoring goals will now be included within the requirements for each State Director's performance elements and standards. By including this requirement in the annual performance elements for each State Director, the agency will establish monitoring controls to ensure that LCRs are conducted and submitted as required. This requirement will be included in State Director performance elements and standards beginning in Fiscal Year 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 22

Modify the lender selection process to better identify lenders who have not been reviewed for long periods of time, and lenders who have recently been approved to participate in the program.

Agency Response

The agency's response stated that modifications will be made to the lender selection process to better target lenders who have been recently approved or have not been reviewed for long periods of time. The LCR guides will be updated by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 23

Establish procedures to summarize the results of concerns disclosed in national and State LCRs at least annually, and provide the results to lenders and field offices as a program notification of problems to look for and address with lenders.

Agency Response

The agency's response stated they will publish an annual report summarizing the results of concerns found in national and State LCRs. A notification will be made to field offices, and lenders will be provided with results specific to each lender as they are reviewed. The first notification will be made by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Section 3: Additional Eligibility Controls Need Strengthening

Finding 7: Recovery Act Funded Loans May Have Been Guaranteed in Non-Rural Areas

We identified four homes in our sample that we determined were located in areas which could be considered non-rural according to the Federal regulatory definition. We attributed this to Rural Development field staff not performing required updates of rural designation for their respective areas. Generally, field staff stated that they were waiting for the release of the 2010 Census data. The fact that they did not perform the updates made it impossible for us to definitively conclude that the homes were located in non-rural areas. As a result, there is the potential that 17,000 Recovery Act loans guaranteed within 5 States, that contain cities with populations expanding into rural areas, were located in non-rural areas.

Federal regulations define a rural area as: (1) non-urban areas which: (i) have a population not in excess of 10,000 if it is rural in character or; (ii) have a population in excess of 10,000 but not in excess of 20,000, is not contained within a Metropolitan Statistical Area (MSA); and (2) an area classified as a rural area prior to October 1, 1990, (even if within a MSA), with a population exceeding10,000, but not in excess of 25,000, which is rural in character. The criteria for (2) will only remain in effect until the United States Census Bureau releases year 2010 census data.[108]

Rural Development guidance requires field offices to update all areas under their jurisdiction every 5 years to identify areas that no longer qualify as rural and every 3 years in areas experiencing rapid growth or in eligible communities within MSAs. The field staff is required to use this information to verify that a loan applicant's home is located in a rural area.[109] The State Director is responsible for implementing re-designations based on the decennial United States Census and any biannual updates and ensuring that the public has access to these results. Rural Development field offices are required to maintain a master file of perpetual maps or handouts with information about ineligible areas.[110] Agency instructions require State offices to complete State Internal Reviews (SIR), which are comprehensive evaluation reviews of the delivery of program and administration functions in field offices and centralized program functions within a State, every 5 years.[111] Determining if a field office conducted the required periodic rural area designation update is included within the SIR process.

We analyzed Census populations, Census tract maps,[112] and city boundary maps to determine the population of the areas where the homes for all 100 of our sample loans were located. Our objective was to verify that the homes were located in areas that met the regulatory requirements. We determined that 39 homes were located within cities, counties, or zip codes with year 2000 Census populations over 20,000. For these loans, we contacted Rural Development

[108] 7CFR3550.10, dated May 22, 1995. This citation has been paraphrased for brevity.
[109] 7CFR1980.313(a), dated May 22, 1998.
[110] RD Direct SFH Loans and Grants Handbook, HB-1-3550 Paragraph 5.3C, revised December 17, 2009.
[111] RD Instruction 2006-M, section 2006.609.
[112] We obtained the year 2000 actual Census populations and year 2009 Census population estimates.

officials in 16 States and Puerto Rico to confirm that the homes were located in rural areas and obtain documentation of their rural designation updates. Field staff in 5 States informed us that they had not completed updates of all rural areas since the year 2000. Thus they could not confirm that those areas retained a rural designation.

Rural Development State officials provided several reasons for not updating the rural area designations. Officials in one State said they began to do their rural area designation updates in 2008 and 2009 and knew that they were going to lose some of their rural areas in the northern part of the State. However, they said that the RHS officials instructed them to wait until the 2010 Census data was released to perform their designation updates. In contrast, RHS officials told us that two States were not performing their rural designation updates, so they instructed them to do so. RHS officials said the field staff was very busy during the Recovery Act time period. We understand that performing rural area updates during the Recovery Act time period would have required more resources than the States had available. However, we also believe that had the updates been performed according to the 3 and 5-year cycle, this information would have already been available and accurate prior to release of the Recovery Act. Another State official said that, by definition, the rural area we were questioning could retain a rural status until the United States Census Bureau released 2010 Census data as long as the population remained below 25,000. However, our analysis disclosed that the United States Census Bureau's population estimates for that area exceeded 25,000 by the year 2005. According to the updated maps, this area is no longer considered a rural area. We concluded that this State should have performed its rural area designation reviews on the 3-year cycle since it was experiencing periods of growth in population.

Based on the information provided from the field staff, we concluded that four loans were guaranteed for homes possibly located in ineligible areas. All four homes were located within the city limits and census tracts of cities with populations that exceeded 25,000 based on the July 2006 Census estimates. According to year 2009 Census estimates, the population of the cities where these homes were located all exceeded 38,000. One of the four homes is located in an area that is now officially considered non-rural by the Rural Development eligibility mapping website, "USDA Income and Property Eligibility Site."[113] Since the rural area maps were not up-to-date when Rural Development guaranteed the loans, we are unable to definitively conclude that the homes were located in non-rural areas at that time.

In order to ensure that rural area designation updates are conducted by field staff, Rural Development included a question addressing this issue in the program review for the field offices, or SIR guide. The SIRs are completed on a 5-year cycle. Since the rural area updates are completed on a 3 or 5-year cycle, the reviews and updates do not always coincide with each other. Thus, both cycles occur simultaneously and there is the potential that missed updates can remain undetected by field staff performing the reviews. Based on our analysis, we concluded that the SIR process was an untimely and ineffective control to ensure that the rural area designation updates were being completed as required by field staff. Therefore, we recommend that Rural Development institute an effective control to ensure that updates of the designated rural areas are performed in a timely manner. One alternative for achieving this is to alter the

[113] Http://eligibility.sc.egov.usda.gov/eligibility/welcomeaction.do.

SIR cycle to coincide with the rural area designation update cycle or conduct a supplemental SIR specifically for the rural area updates. We recognize that this alternative could be difficult to implement since it would require additional resources. Another alternative could be to implement a tracking system that generates a reminder every 3 to 5 years for the field staff that it is time to conduct the rural area designation updates

Recommendation 24

Institute effective controls to ensure that required periodic updates of designated rural areas are performed in a timely manner.

Agency Response

The agency's response stated a requirement will be included within the annual performance goals for each State Director beginning in Fiscal Year 2012.

OIG Position

We accept management decision for this recommendation.

Finding 8: Compensating Factors Used to Justify Loans Were Inadequate or Not Documented

Rural Development guaranteed loans to 30 borrowers in our sample whose debt ratios exceeded regulatory requirements, and justified this by using compensating factors that were either insufficient, unacceptable, or were not documented by the lenders. We attributed this condition to inadequate agency guidance for loans processed manually by field staff, and to the agency not requiring lenders to comply with agency regulations for loans processed through GUS. Borrowers with high debt ratios are at greater risk of default, and expose the Government to unnecessary losses. To date, 9 of the 30 borrowers have been delinquent on their loan payments.[114]

Federal regulations require agency concurrence when an applicant’s PITI and/or total debt ratio exceeds 29 or 41 percent, respectively. The lenders’ requests for concurrence must include the compensating factor(s) that justify and mitigate the risks associated with loans that do not comply with all of the agency’s financial criteria.[115] Rural Development AN 4435 states that debt ratio waivers can be granted for applicants with legitimate compensating factors and provides examples of those factors.

Rural Development guaranteed 33,673 Recovery Act loans with excessive debt ratios which required compensating factors to justify waiving the regulatory requirement. This represented

[114] OIG extracted this data from Rural Development’s Delinquency Data Model for Single Family Housing as of August 31, 2011.
[115] 7CFR1980.345(c)(5), dated May 22, 1995.

41 percent of the 81,510 loans guaranteed with Recovery Act funds. [116] Within our sample of 100 loans, there were 40 (13 manual and 27 GUS submissions) that required compensating factors. Those numbers correspond closely to the number of loans with high debt ratios in the overall universe. Our concern with these loans is that Rural Development has undertaken too much risk in guaranteeing them. We identified several weaknesses with the agency's policies and guidance. These weaknesses involved the compensating factors used to justify loans processed manually by Rural Development field staff and the lack of documentation for the compensating factors used by GUS when loans are approved by that system. The following sections describe our concerns in detail.

Compensating Factors Were Inadequate for Manually Submitted Loan Applications

We found that 9 of the 13 manually submitted loans which required ratio waivers contained compensating factors that did not mitigate the borrowers' weak financial condition. We observed that lenders utilized the suggested compensating factors from the agency's guidance but did not always provide supporting documentation. Our analysis of the guidance found that the suggested examples for compensating factors were not well developed or clearly defined. Other examples were not "compensating factors" at all, but were basic eligibility requirements that every borrower must meet to qualify for a loan guarantee. Based on our analysis in Finding 1, we considered 3 of the 9 manual loans that required a waiver to be ineligible or risky because of the borrower's questionable repayment ability. In addition, 2 of the 9 loans with ratios above the program limits have been delinquent at some point since they were guaranteed by Rural Development.[117]

Based on our analysis, we concluded that one of the compensating factors in the agency's guidance was not well developed. RD AN 4435 states that "No or low "payment shock" reflecting a minimal increase in housing expenses or current rent is comparable to proposed PITI (100 percent increase in payment or less)." This factor's use of the phrases "no or low" and "minimal increase in housing expenses," is very similar to other Federal guaranteed housing programs (FHA and VA). However, the added statement referencing a "100 percent increase" contradicts the rest of the guidance for the factor.

FHA requires a borrower to have demonstrated the ability to pay housing expenses greater than or equal to the proposed monthly housing expenses over the past 12 to 24 months. Similarly, the VA guaranteed program requires a borrower to have little to no increase in shelter expense. However, Rural Development's statement that 100 percent increase is acceptable allows borrowers to double their current housing expense, which can be a significant increase. One lender in our sample submitted a waiver citing "no or low payment shock" as a compensating factor for a loan they calculated with a 34 percent PITI and 47 percent total debt ratio. The prior housing expense for the borrower was $1,360 and the future housing expense was over $1,800. This amounts to a 32 percent increase and added over $400 in expenses each month for that

[116] OIG extracted this data from Rural Development's Data Model for Single Family Housing as of October 19, 2010. This includes all Recovery Act loans closed from March 2009 through September 2010.
[117] OIG extracted this data from Rural Development's Delinquency Data Model for SFH as of August 31, 2011.

borrower. We do not consider this amount to be a low or minimal increase, and it does not seem to be a sound reason to justify making a loan to a borrower already in a weak financial situation.

We also concluded that several factors listed in RD AN 4435 are unclear and need to be better defined by RHS officials. One factor cited in the guidance is "an ability to accumulate savings with regular deposits." The AN does not describe how much in savings or what kind of savings pattern should exist to meet this requirement. For example, one lender listed "savings pattern" as a compensating factor to justify making the loan. However, the three bank statements in the loan file showed a decrease in account balance over that time period. We do not know if the borrower had a better savings history prior to that time period, because the documentation used by the lender did not support the use of that compensating factor. The AN also considers "cash reserves available post closing as a compensating factor," but it does not describe a benchmark such as a percentage of income. One lender used this factor, but the borrower only had a little over one month of housing expenses in reserve.

There are 2 compensating factors within RD AN 4435 that are also basic eligibility requirements; specifically, that a borrower has a good credit score and employment lasting 2 or more years. We question the agency's use of basic eligibility requirements as compensating factors. FHA and VA guaranteed loan policy does not allow these items as compensating factors. Rather, VA procedures state that valid compensating factors should represent unusual strengths rather than mere satisfaction of basic program requirements, and factors should logically be able to compensate, to some extent, for the identified weakness in the loan.[118] Further, neither the FHA nor VA programs consider a credit score above a set number to be a compensating factor.[119] RHS officials should reconsider accepting basic program eligibility requirements as compensating factors.

During our Phase 1 audit,[120] we reported that field staff approved lender requests for waivers of debt ratio requirements based only on a description of the compensating factors which could be created or exaggerated to justify approving the loan guarantee. We recommended that lenders be required to submit supporting documentation for all ratio waivers. To address this concern, RHS officials issued a Memorandum with a statement that supporting documentation was required for ratio waivers. The following three examples from Phase 2 were all approved after issuance of the Memorandum. We concluded that RHS officials did not effectively address our Phase 1 recommendation which required lenders to provide supporting documentation for compensating factors.

- Rural Development's file for one loan included documentation that a lender's waiver request was approved by Rural Development. However, there was no actual waiver request or discussion of compensating factors from the lender. The lender's loan file also did not include the request, and the lender was unable to find or provide us with the compensating factors used on this loan.

[118] VA Pamphlet 26-7, Revised Chapter 4, Topic 10, dated April 10, 2009.
[119] HUD 4155.1 Chapter 4, Section F, dated March 1, 2011. VA Pamphlet 26-7, Chapter 4, Topic 10, dated April 10, 2009.
[120] Audit Report 04703-01-Ch, *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (Phase 1),* dated September 2009.

- One lender used “Potential for increased earnings” as a compensating factor to justify a PITI ratio of over 34 percent and a total debt ratio of almost 47 percent. We did not locate any documentation within the loan file that supported the “potential for increased earnings.” We also checked the VOEs, but these indicated that the date of future pay increases were unknown.

- Rural Development’s loan file included a letter that stated the borrower would reduce his total debt ratio of 55 percent by paying off two significant liabilities using an $8,000 tax refund. The agency’s file included a credit report and bank statement that showed the refund was received a month before the application, but there was no evidence that the borrower paid off both accounts. This borrower has been delinquent on the loan.[121]

In our discussions with RHS officials, they agreed that the compensating factors included with lender requests must be descriptive and properly supported in the files. In addition, RHS officials noted that they were emphasizing the importance of clear documentation in their ongoing lender training, and they plan to stress this area at a conference with Rural Development field staff later this year. We agree that training will help. We also recommend that the compensating factors discussed above be enhanced or better defined. To be effective, compensating factors should go above and beyond minimum eligibility considerations, and adequate evidence must be provided to justify making the loan guarantee. We also recommend that RHS officials modify the field staff review process to ensure that documentation to support the compensating factors is included within the loan application.

Agency Policy Does Not Require Ratio Waivers for Loans Processed Through GUS

Our statistical sample included 50 loans submitted through GUS. Lenders calculated repayment ratios above the regulatory limits for 27 of these loans. However, 21 of the 27 loan files did not contain documentation to support the decision to approve the loan. This occurred because the agency does not require lenders to comply with its regulations for loans submitted through and approved by GUS. Therefore, we could not determine what factors GUS used to approve the loan guarantee.

Our concern is that almost 21,000 loans approved by GUS had debt ratios that exceeded the agency’s requirements and lacked the justification for approving the guarantee. Based on our analysis in Finding 1, we considered 6 of the 21 loans to be ineligible or risky because the borrowers lacked sufficient repayment ability. In addition, the borrowers for 7 of the 21 loans[122] have been delinquent at some point since loan closing.[123]

Federal regulations require agency concurrence when an applicant’s PITI and/or total debt ratio exceeds 29 or 41 percent, respectively.[124] RD AN 4470 does not require lenders to submit a ratio

[121] OIG extracted this data from Rural Development’s Delinquency Data Model for Single Family Housing as of August 31, 2011.
[122] There are 3 loans that are included in both categories of ineligible or risky for repayment ability and delinquency.
[123] OIG extracted this data from Rural Development’s Delinquency Data Model for Single Family Housing as of August 31, 2011.
[124] 7CFR1980.345(c)(5), dated May 22, 1995.

waiver request for loan applications with GUS "Accept" determinations when the repayment ratios exceed the program's limits.[125] Therefore, the lack of documentation to support a GUS determination violates the regulatory requirements for agency concurrence on ratios that exceed the program limits.

We were unable to determine why GUS approved these loans when they contained multiple areas of insufficiency. For example, a GUS-approved loan for a borrower in our sample who only had $841 in cash also had the following characteristics that do not adhere to agency requirements: a PITI ratio of almost 38 percent; a total debt ratio of almost 49 percent; and credit scores of 648, 659, and 681 for 3 co-borrowers. RHS officials said that it was the lender's choice to approve a loan and they understood the logic in making this loan. We disagreed that this loan was eligible for the program. In this case, the borrowers have been consistently delinquent in making payments on the loan. Since GUS did not document why this loan was approved, we could not evaluate the reasons for approving it despite excessive debt ratios, low credit scores, and minimal cash reserves.

We asked RHS officials if GUS could be modified to provide the compensating factors it considered to mitigate the risk involved with high repayment ratios. They stated GUS loans are accepted based on a cumulative score and not on individual factors. They voiced concern that providing the factors GUS uses to evaluate applications would present an opportunity for lenders to identify the requirements for loan approval and possibly take advantage of the system.

RHS officials explained that the decision-making process built into GUS considers certain factors, such as credit score and cash reserves, when making a determination. They have done analysis on the GUS "Accept" loans and determined that the loans are generally successful. If GUS returns a result of "Accept," the applicant shares credit characteristics closely associated with historically successful homeownership. Our audit did not focus on the underlying calculations and algorithms that GUS used to form its decisions. We assessed the controls for the guarantee approval process prior to input and after a determination was made by the system. However, if the agency does not enforce its regulations for GUS-approved loans, it will be accepting lower quality loans with too much risk

Recommendation 25

Modify existing guidance to strengthen acceptable compensating factors. Basic program eligibility considerations should not be allowed as compensating factors. Include additional guidance to illustrate or define requirements.

Agency Response

The agency's response stated that modifications will be made to guidance. These revisions will be accomplished with the publication of the new regulations and handbook which will be published by September 30, 2012.

[125] RD AN 4470, Underwriting and Closing Loans – Documentation Matrix, dated August 18, 2009.

OIG Position

We accept management decision for this recommendation.

Recommendation 26

Notify lenders that they are required to maintain supporting documentation for GUS-approved loans when repayment ratios exceed regulatory limits.

Agency Response

The agency's response stated that the "GUS Underwriting Findings Report," AN 4557 "Guaranteed Underwriting System," and AN 4543 all provide guidance on documentation. This guidance will be permanently included in the publication of the new regulation and handbook by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 27

Include verification of documentation to support compensating factors into the review process for Rural Development field staff. Only fully documented compensating factors should be allowed for higher risk guaranteed loans.

Agency Response

The agency's response stated loans that receive a GUS "Accept" recommendation do not require the lender to submit a separate waiver request and/or documentation to support a waiver. By use of FHA's modified Technology Open to Approved Lenders (TOTAL) scorecard, GUS evaluates the amount of risk involved through the data provided, which includes credit history, income, assets, and collateral to determine acceptability with guidance. Lenders must retain all supporting documentation for the data entered into GUS as provided by the "GUS Underwriting Findings Report" and AN 4557. For manually underwritten loans, the agency published AN 4543, which identifies verification of documentation to support compensating factors. Permanent guidance will be incorporated in the publication of the new regulation and handbook. The ANs will be renewed until publication of 7CFR3555 by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Section 4: Application Controls Can Be Improved

Finding 9: Guaranteed Loan System Contains Inaccurate Data

We found numerous errors when comparing Guaranteed Loan System (GLS) data, input by the Rural Development field staff and transferred from GUS, to the supporting lender files for the 100 loans in our sample. Overall there were 612 errors in data pertaining to borrower, loan, and property information. Rural Development's application controls over the data entry process were inadequate to ensure that accurate data were captured within GLS. Further, RHS officials stated that field staff was required to reconcile data within GLS, but acknowledged this action has not always been done. As a result, Rural Development does not have the best available data for reporting program accomplishments, processing loss claims, and selecting lenders for review.

OMB guidance states that application controls should be designed to ensure that transactions are accurately processed and that the data are valid and complete; reconciliations or comparisons of data should be included in the regular duties of personnel.[126] OMB guidance also states that agencies should establish procedures to validate the accuracy of information submitted on a statistical basis and/or risk-based approach. Agencies should capture, validate, report, and evaluate information regarding the loan and loan guarantee award to assess and report performance against expected results consistent with Recovery Act reporting requirements.[127]

To test the application controls of GLS, we selected 41 specific data fields that involved essential borrower and loan information for each of our 100 sample loans. For example, our verification included such fields as borrower name and address, annual and repayment income, PITI and total debt ratios, date of approval, loan amount, and interest rate. We found 612 discrepancies by comparing the data from the GLS data warehouse[128] to documentation within the Rural Development and lender loan files. We determined that no loan in our sample was completely supported by documentation in the lender file since each loan contained at least one discrepancy. We identified errors and discrepancies with the following data: borrower name and address, count for the number of individuals in the household, repayment ratio, and application date.

A Rural Development State official said that they do not review the data within GLS to ensure accuracy or generate reports to validate the data. Further, Rural Development field staff said that they do not verify the data within GLS that is transferred by lenders from GUS. However, two field officials informed us that they do generate an "unclosed obligation report" with basic loan information after the loan has closed simply to verify the loan amount is still accurate prior to issuing the loan note guarantee.

We discussed the data discrepancies with RHS officials who said that the field staff should be checking the accuracy of the data entered into GLS. They have discussed this issue with the field staff in the past and plan to address it with training. RHS officials acknowledged that GLS

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[126] OMB Circular A-123, Management's Responsibility for Internal Control, dated December 21, 2004.
[127] OMB M-9-10, dated February 19, 2009.
[128] Data models were prepared by Rural Development from the Data Warehouse (RDDW) for OIG. RDDW houses data from GLS.

was built in 1999 without the technology to perform logical tests or create edit checks on actual numbers. The edit checks only test the number of digits in a field and they cannot restrict numbers above or below a certain level. The only type of review that can be performed is a physical review by the field staff or the compliance review contractor.

RHS officials assured us, however, that the Central Servicing Center conducts quality checks on the data when a loan is submitted for a loss claim and the contractor that performs compliance reviews also validates the data fields that they use for performing their risk analysis when examining lender loan files. The contractor is also supposed to check for inaccurate and zero household counts when conducting their reviews. Since data verification is being completed during the national lender compliance review process, we recommend that the agency incorporate verification of data into both the National and State Lender Compliance Review Guides to retain consistency among all lender compliance reviews.

Additionally, per the National Office Compliance Review Guide, the agency selects lenders for compliance reviews using GLS data to determine the type of review to be performed. The loans are selected for review based on a variety of criteria including high repayment ratios and income data, all of which are stored in the data warehouse. Therefore, the agency is using unreliable data from the system to select lenders for compliance reviews.

Rural Development officials also rely on GLS data when processing loss claims submitted by lenders. According to the Guaranteed Loans Loss Mitigation Desk Procedures manual, certain data fields are automatically uploaded from GLS to initiate the loss claim process. These fields include: borrower identification and name, property address, origination date, and origination loan amount. Therefore, the loss claim process could also be affected by the inaccurate data in GLS

Recommendation 28

Implement procedures to verify that post-loan closing data input into GLS is valid and complete or perform reconciliations to ensure that the most current and accurate information is recorded within the system.

Agency Response

The agency's response recognized the necessity to emphasize and collect accurately represented data. The agency will revise the national and State LCR guides to check for accuracy of GLS data input. Both guides will be revised by September 30, 2012.

In a supplemental email response dated September 29, 2011, RHS officials addressed our concern that additional reviews were necessary. They stated that centralizing the program functions in each State will allow for a representative sample of second level reviews of loan applications, including data entry into GLS. Centralization will occur by October 1, 2012.

OIG Position

We accept management decision for this recommendation.

Recommendation 29

Revise the National and State Lender Compliance Review Guides to ensure that the GLS data are supported by documentation provided in the loan files.

Agency Response

The agency's response stated that revisions will be made to the State and National LCR guides by September 30, 2012.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

We conducted our audit of the SFH Guaranteed Loan Program at the RHS national office in Washington, D.C., 34 State offices and Puerto Rico, and 54 Rural Development field offices. Our sample included 65 different lenders that we visited in 65 different locations. We conducted nine borrower visits when additional information or clarification of issues was required during our review. We also visited the company contracted by RHS to perform the nationally-approved lender compliance reviews.

The Recovery Act included almost $10.5 billion in funds to guarantee SFH loans in rural areas. The period of RHS activity covered by our review began on March 20, 2009, the date Congress authorized Rural Development to begin distributing Recovery Act funds, and ended December 31, 2009.

We randomly selected 100 loans[129] using a sample design with 2 strata, based on separate time periods. The first stratum included 73,345 Recovery Act guaranteed loans obligated from March 20 through September 30, 2009. The second stratum included 8,775 Recovery Act guaranteed loans obligated October 1 through December 31, 2009. We randomly selected 60 loans from the first stratum and 40 loans from the second stratum. Coincidentally, our sample was split evenly between loans submitted through GUS and those submitted directly to Rural Development to be processed manually by field staff. Our sample included 98 loans for the purchase of existing homes and 2 loans for refinancing existing mortgages.

To accomplish our objectives, we performed the following procedures:

- Reviewed applicable laws, regulations, and agency procedures related to the program.
- Met with Rural Development field staff to evaluate policies, procedures, review processes, and oversight of field operations. When necessary, we asked certified State appraisers to review appraisals of the homes for our sample loans.
- Met with lenders to obtain and review borrower files in order to verify compliance with agency policies and procedures. We also obtained an understanding of the lenders' quality control requirements and processes for determining borrower eligibility.
- Reviewed original lender documentation for 33 loans and imaged lender documentation for 67 loans. We also reviewed all loan documentation relating to our sample loans retained by Rural Development State and field offices.
- Verified borrower employment information by utilizing State Department of Labor wage matching services made available through Multi-Family Housing agreements in 17 States. We contacted 70 employers when wage matching services were not available.
- Collected and reviewed 2008 through 2011 lender compliance review schedules at the national office and FY 2009 lender compliance review schedules at the State offices to determine the number of lenders typically reviewed. We also analyzed National and State lender compliance review guides and work papers, and interviewed RHS officials to determine how findings were addressed and reported to the national office.

[129] We chose a sample size of 100 because we expected a moderate error rate and wanted the ability to report findings for attributes with a +/- 10 percent precision (confidence interval) at a 95 percent confidence level.

- Visited the contractor's office to analyze 21 judgmentally selected lender compliance reviews and assess the effectiveness of lender oversight. We analyzed the 2008 and 2009 Annual Reports issued by the contractor and selected lender compliance reviews based on findings that, in our view, may have impacted borrower eligibility. We also chose a lender compliance review completed in 2010 to evaluate new review procedures implemented by RHS officials.
- Discussed sample loans and reportable conditions with RHS officials to obtain their positions and responses.

We performed our audit fieldwork from December 2009 through July 2011. 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 applied general and application control steps to GLS; however, we did not perform testing to evaluate GUS and we make no representation on the adequacy of GUS or its determinations. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Abbreviations

AN........................Administrative Notice

CFR......................Code of Federal Regulation

FHA......................Federal Housing Administration

FY ....Fiscal Year

GLS......................Guaranteed Loan System

GUS......................Guaranteed Underwriting System

LCR......................Lender Compliance Review

MSA.....................Metropolitan Statistical Area

OGC.....................Office of General Counsel

OIG ....Office of Inspector General

OMB ....Office of Management and Budget

PITI ....Mortgage Principal, Interest, Real Estate Taxes, and Insurance

QC........................Quality Control

RD........................Rural Development

RDDW ....Rural Development Data Warehouse

Recovery Act ....The American Recovery and Reinvestment Act of 2009

RESPA.................Real Estate Settlement Procedure Act

RHS......................Rural Housing Service

SFH ....Single Family Housing

SIR ....State Internal Review

USDA...................United States Department of Agriculture

VA........................Department of Veteran Affairs

VOE ....Verification of Employment Form

Exhibit A - Summary of Monetary Results

Finding Number	Description	Amount (In Millions)	Category
1	Borrowers Did Not Demonstrate the Ability to Repay Loans	$1,310	Questioned Costs and Loans, No Recovery
2	Borrowers' Income Exceeded Regulatory Limitations	$2,215	Questioned Costs and Loans, No Recovery
3	Loan Guaranteed to Borrowers with Ability to Secure Financing	$713	Questioned Costs and Loans, No Recovery
4	Applicants with Adequate Existing Homes	$481	Questioned Costs and Loans, No Recovery
5	Loan Guarantees Provided for Homes with Swimming Pools	$230	Questioned Costs and Loans, No Recovery
TOTAL		$4,949	

The table above summarizes monetary results by finding and includes a description, dollar amount, and the category of questioned costs. The table illustrates Finding 1 has $1,310 million, Finding 2 has $2,215 million, Finding 3 has $713 million, Finding 4 has $481 million, and Finding 5 has $230 million for a total of $4,949 million in monetary results for ineligible SFH guaranteed Recovery Act loans which are categorized as questioned costs and loans with no recovery recommended.

The cumulative amount of monetary results is greater than the overall projection of $4.16 billion because 5 loans were ineligible for more than one reason, and therefore, are represented in more than one finding.

Exhibit B – Statistical Plan

Sample Design and Results for Audit Number 04703-02-Ch

Recovery Act SFH Guaranteed Loans

Objective:

This sample was designed to support the OIG audit of single family housing guaranteed loans made under the Recovery Act. The audit objective is to determine whether loan guarantees made from Recovery Act funds complied with applicable laws and agency procedures. A stratified sample was chosen to allow projection of error rates and associated dollar amounts for several criteria related to borrower eligibility.

Audit Universe:

Our universe consisted of 82,120 loans that were obligated by Rural Development under the Recovery Act as of December 31, 2009. The loans were spread over 50 States and 3 United States territories. The universe list was extracted from Rural Development's Data Model for SFH by the OIG Data Analysis and Special Projects Division.

Sample Design and Modifications:

After considering several possible designs, we decided to use a stratified sample design with two strata, based on time periods. This stratification, described below, would permit presentation of results for the time periods separately, if required, although the achieved confidence interval within each period would be wider than for the overall stratified sample.

The total sample size was 100 loans. Because the Recovery Act funded loans had to be executed by Rural Development over a relatively short time period, the audit team had no prior work on which to base calculations of sample size. The choice of 100 was appropriate for a simple random sample with an error rate of 30 percent while still achieving absolute precision of +/-10 percent (for attributes) with a 95 percent confidence level.[130]

OIG management wanted to be able to address two non-overlapping time periods, if necessary. Therefore, in the final design selected for this audit, the Recovery Act guaranteed loans were divided between two strata:[131]

[130] For a 95 percent confidence level and an absolute precision of +/- 10 percent, a 30 percent error rate required a simple random sample of only 81 loans. We rounded up to 100, which gave us coverage of error rates up to 50 percent, although we did not expect that level to occur. For error rates lower than 30 percent, precision would be tighter than +/-10 percent.

[131] To date, it was not necessary to separate our results or address the two separate time periods.

(1) Stratum I is represented by all Recovery Act guaranteed loans with obligation dates before October 1, 2009 or FY 2009. There were 73,345 such loans. We drew a simple random sample of 60 loans for review from this stratum;

(2) Stratum II consists of Recovery Act loans made during the first quarter of FY 2010, i.e., October 1 through December 31, 2009. There were 8,775 such loans. We drew a simple random sample of 40 loans for review from this stratum.

We recognized that the stratification would likely cause the confidence interval to be somewhat wider than the targeted +/-10 percent, but OIG considered that acceptable in the interest of being able to report the time periods separately if necessary.[132]

Results:

Results are projected to the audit universe of 82,120 loans, with a total value of about $10.5 billion. Achieved precision, which is indicated by the confidence interval, is reported here for a 95 percent confidence level. All projections are made using the normal approximation to the binomial as reflected in standard equations for a stratified sample.[133] All percentages indicated are percents of the universe of 82,120 loans; for example, 11,661/82,120 = 14.2 percent of the universe, and 21,129/82,120 = 26 percent of the universe.

The summaries below show the results for each of five eligibility criteria, as well as for a composite criterion of loans with at least one eligibility criterion. Measures presented include the projected number and percent of loans with exceptions and the value of the loans having those exceptions. For each criterion estimate, we show the projected amount (point estimate) as well at the upper and lower bounds of a 95 percent confidence interval, and we include the values observed in the sample, by stratum. For each criterion, we include a table of the results following the text.

[132] Specifically, we wanted to be able to report results for the first fiscal year (FY 2009) alone, if necessary. For the stratification chosen, we estimated that a similar sample size would still be appropriate, for several possible outcome combinations of error rate and precision: for example, a 25 percent error rate with +/- 10 percent absolute precision, or a 30 percent error rate with +/- 11 percent absolute precision.
[133] Scheaffer, Mendenhall, Ott, Elementary Survey Sampling, Fourth Edition (Chapter 5), Duxbury Press, c1990.

Exhibit B – Statistical Plan

Criterion: Insufficient Repayment Ability

Based on the sample results, we project that between 4,935 and 18,378 loan guarantees were made to borrowers who lacked sufficient repayment ability. The point estimate is that 11,661 such loan guarantees were made, representing 14.2 percent of the universe of loan guarantees. Achieved precision[134] was +/- 8.2 percent of the universe of loan guarantees. In addition, we project that the value of such loan guarantees is between about $441 million and $2.2 billion, with a point estimate of about $1.3 billion.

Criterion: Insufficient Repayment Ability					
Measure	Point Estimate (Projection)	95 Percent Confidence Interval		Raw Data (Exceptions Observed in Sample)	
		Lower Bound	Upper Bound	Stratum 1	Stratum 2
Number of Loans with Exception	11,661	4,935	18,378	9	3
Fraction of Universe [for raw data, fraction of sample]	14.2 percent	6.0 percent	22.4 percent	[15 percent]	[5.5 percent]
Value of Loans	$1.31 billion	$441 million	$2.2 billion	$1.006 million	$0.365 million

[134] Achieved precision equals one-half the difference between the lower bound and the upper bound of the confidence interval. For example, (18378 – 4935) / 2 = 6721.5. Expressed as a fraction of the universe, this is 6721.5 / 82120 = 8.2 percent.

Exhibit B – Statistical Plan

Criterion: Income Exceeded Program Limits

Based on the sample results, we project that between 6,405 and 20,932 loan guarantees were made to borrowers with income that exceed the program's limits. The point estimate is that 13,665 such loan guarantees were made, representing 16.6 percent of the universe of loan guarantees. Achieved precision was +/- 8.9 percent of the universe of loan guarantees. In addition, we project that the value of such loan guarantees is between about $986 million and $3.4 billion, with a point estimate of about $2.2 billion.

Criterion: Income Exceeded Program Limits					
Measure	Point Estimate (Projection)	95 Percent Confidence Interval		Raw Data (Exceptions Observed in Sample)	
		Lower Bound	Upper Bound	Stratum 1	Stratum 2
Number of Loans with Exception	13,665	6,405	20,932	11	1
Fraction of Universe [for raw data, fraction of sample]	16.6 percent	7.8 percent	25.5 percent	[18.3 percent]	[2.5 percent]
Value of Loans	$2.215 billion	$986 million	$3.4 billion	$1.796 million	$0.09 million

Exhibit B – Statistical Plan

Criterion: Borrower Qualified for Conventional Financing

Based on the sample results, we project that between 829 and 10,273 loan guarantees were made to borrowers who had the ability to secure financing with reasonable terms and conditions directly from lenders, without government assistance. The point estimate is that 5,551 such loan guarantees were made, representing 6.7 percent of the universe of loan guarantees. Achieved precision was +/- 5.8 percent of the universe of loan guarantees. In addition, we project that the value of such loan guarantees is between about $50 million and $1.4 billion, with a point estimate of about $713 million.

Criterion: Borrower qualified for conventional financing					
Measure	Point Estimate (Projection)	95 Percent Confidence Interval		Raw Data (Exceptions Observed in Sample)	
		Lower Bound	Upper Bound	Stratum 1	Stratum 2
Number of Loans with Exception	5,551 loans	829 loans	10,273 loans	4	3
Fraction of Universe [for raw data, fraction of sample]	6.7 percent	1 percent	12.5 percent	[6.7 percent]	[7.5 percent]
Value of Loans	$713 million	$50 million	$1.4 billion	$0.53 million	$0.31 million

Exhibit B – Statistical Plan

<u>Criterion: Borrower Owned Housing in Area</u>

Based on the sample results, we project that between four (observed in sample) and 6,299 loan guarantees were made to borrowers who already owned adequate housing in the local commuting area. The point estimate is that 2,882 such loan guarantees were made, representing 3.5 percent of the universe of loan guarantees. Achieved precision was +/- 4.1 percent of the universe of loans, with the lower limit constrained by the actual number observed in the sample. In addition, we project that the value of such loan guarantees is between about $0.7 million and $1.0 billion, with a point estimate of about $418 million.

Criterion: Borrower owned housing in area					
Measure	Point Estimate (Projection)	95 Percent Confidence Interval		Raw Data (Exceptions Observed in Sample)	
		Lower Bound	Upper Bound	Stratum 1	Stratum 2
Number of Loans with Exception	2,882 loans	4 loans (observed)	6,299 loans	2	2
Fraction of Universe [for raw data, fraction of sample]	3.5 percent	-	7.7 percent	[3.3 percent]	[5 percent]
Value of Loans	$418 million	$0.7 million (observed)	$1.0 billion	$0.32 million	$0.42 million

Exhibit B – Statistical Plan

Criterion: Home Had a Swimming Pool

Based on the sample results, we project that between three (observed in sample) and 4,131 loan guarantees were made for homes with swimming pools. The point estimate is that 1,659 such loan guarantees were made, representing two percent of the universe of loan guarantees. Achieved precision was +/- 3 percent of the universe of loan guarantees, with the lower limit constrained by the actual number observed in the sample. In addition, we project that the value of such loan guarantees is between about $0.5 million and $522 million, with a point estimate of about $230 million.

Criterion: Home had a swimming pool					
Measure	Point Estimate (Projection)	95 Percent Confidence Interval		Raw Data (Exceptions Observed in Sample)	
		Lower Bound	Upper Bound	Stratum 1	Stratum 2
Number of Loans with Exception	1,659	3 loans (observed)	4,131 loans	1	2
Fraction of Universe [for raw data, fraction of sample]	2 percent	-	5 percent	[1.7 percent]	[5 percent]
Value of Loans	$230 million	$0.5 million (observed)	$522 million	$0.11 million	$0.46 million

Exhibit B – Statistical Plan

Criterion: Loans with At Least One Eligibility Exception

Based on the sample results, we project that between 21,129 and 39,492 loan guarantees were made for loans with at least one eligibility exception among the individual criteria listed above. The point estimate is that 30,310 such loan guarantees were made, representing 37 percent of the universe of loan guarantees. Achieved precision was +/- 11 percent of the universe of 82,120 loan guarantees. In addition, we project that the value of such loan guarantees is between about $2.7 billion and $5.6 billion, with a point estimate of about $4.16 billion.

Criterion: Loans with at least one eligibility exception					
Measure	Point Estimate (Projection)	95 Percent Confidence Interval		Raw Data (Exceptions Observed in Sample)	
		Lower Bound	Upper Bound	Stratum 1	Stratum 2
Number of Loans with Exception	30,310 loans	21,129 loans	39,492 loans	23	10
Fraction of Universe [for raw data, fraction of sample]	37 percent	26 percent	48 percent	[38 percent]	[25 percent]
Value of Loans	$4.16 billion	$2.7 billion	$5.6 billion	$3.16 million	$1.34 million

USDA'S

RURAL DEVELOPMENT

RESPONSE TO AUDIT REPORT

United States Department of Agriculture
Rural Development

September 28, 2011

SUBJECT: Controls over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (Phase 2)
(Audit No. 04703-002-CH)

TO: Gil Harden
Assistant Inspector General for Audit
Rural Development

Attached for your review is the Rural Housing Service, Single Family Housing, September 28, 2011, response to the above subject Official Draft Audit Report dated August 18, 2011.

This response is being submitted for inclusion in the final report and your consideration to reach management decision on the recommendations.

If you have any questions, please contact Arlene Pitter Bell of my staff at 202-692-0083.

/s/ John M. Purcell

JOHN M. PURCELL
Director
Financial Management Division

Attachment

1400 Independence Ave, S.W. • Washington, DC 20250-0700
Web: http://www.rurdev.usda.gov

Response to OIG Official Draft dated August 18, 2011
Controls Over Eligibility Determinations for SFH Guaranteed Loan Recovery Act Funds (Phase2)-04703-Ch

Background

The USDA has guaranteed more than 800,000 loans since the Housing and Community Development Act of 1987 authorized the original 3-year demonstration program that enabled borrowers to obtain government guaranteed loans from private lenders for the purchase of single-family homes in rural areas. [1] Under the auspices of the Rural Housing Service, portfolio management discipline has become increasingly robust and the Agency has compiled a superior record of portfolio performance. Foreclosure rates in the Single Family Housing Guaranteed Loan Program (SFHGLP) portfolio are typically lower than FHA portfolio, despite the higher default risk associated with loans to low-income families.

A portion of that successful performance is attributable to the rigorous standards that undergird Rural Development's application process. As the OIG report rightly notes, "Of the U.S. Government's three major guaranteed housing programs, Rural Development distinguishes itself as the most restrictive program due to its stringent eligibility requirements."

At least as important to default risk management is the technology RHS employs to minimize foreclosure-related costs and family dislocation. The rules-based decision engine in the Guaranteed Underwriting System (GUS) automated underwriting recommendation software evaluates default risk using an algorithm that considers the Fair Isaac Corporation (FICO) score, the monthly housing-expense ratio, borrower reserves, the loan-to-value ratio and the loan term.

This larger focus on managing default risk does not diminish the importance of individual eligibility requirements or the necessity of adherence; RHS appreciates the risk sensitivity that informs the OIG analysis. However, we believe the majority of the OIG error findings are without basis--no mistakes were made by program lenders in most of these cases, and the issues cited are largely interpretive and in no way compromise the quality of our lending program. Our long lending experience indicates that when common interpretations of eligibility requirements, i) are consistent with the RHS portfolio management discipline; ii) are successfully applied in the private sector; and iii) contribute to the achievement of program objectives, lenders are right to consider their use.

[1] In 1990 the guaranteed program was made permanent with the enactment of the Cranston-Gonzalez National Affordable Housing Act.

The American Recovery and Reinvestment Act of 2009 (Recovery Act) was signed into law during a time of financial crisis reminiscent of the Great Depression from the early 1900's. The housing and financial crisis addressed by the Recovery Act took place during a period when confidence in the American financial system was shaken, the commercial credit markets were frozen, and private sector lenders would not make home mortgage loans without backing from the Federal Government. Demand for the SFHGLP increased commensurate with the crisis.

While we agree with the OIG that there is room for improvement in monitoring the SFHGLP lenders, we do not agree with their estimate that 30,310 loans or 37 percent of the portfolio representing $4.2 billion of the appropriated Recovery Act funding was used inappropriately. We continue to respectfully disagree with how OIG came to its conclusions and believe that the findings are based on their misinterpreting agency policies and procedures, as we will explain in the following paragraphs. The majority of the loans that OIG maintained as being made to ineligible applicants were indeed originated within the scope of the program's policies and procedures. Our ongoing trend analysis and internal reviews indicate that less than 5 percent of all loans, including those made under the Recovery Act; contain elements that may be ineligible.

Further, we not believe the deviations cited will meaningfully impact foreclosure rates. OIG provides no statistical correlation between what it terms the less "conservative" eligibility requirements RHS is said to employ, and higher default rates in the RHS portfolio. Maintaining foreclosure rates that are low by comparison to FHA remains a key focus of our Guaranteed program.

We also take strong exception to the OIG's historic inferences with regard to Recovery Act lending practices. The OIG indicated that Rural Development exhausted its regular and Recovery Act appropriations during the Spring of 2010, and that a backlog of $1.6 billion in applications would have been avoided if ineligible guarantees were not made. It is true that until March of 2010 the SFHGLP was obligating loan guarantees at a pace of about $2 billion a month until funding was exhausted. Lenders had sufficient notice in advance pertaining to the exhaustion of funds, however, and stopped taking or processing SFHGLP loan applications when funding ran out in May. As a result, mortgage lending in rural America ceased except in rare and isolated circumstances.

There was no backlog of applications as referred to by the OIG because lenders stopped SFHGLP activity. Funding was restored for the SFHGLP later in the year after Congress passed HR 4899 which was signed into law on July 29, 2010 (See P.L. 111-212, sec. 102). The Agency subsequently notified the public that funding would become available as soon as the allocation process was completed, and by the time funds actually became available lenders had accumulated a backlog of about $1.6 million in loan applications. Thus, the backlog referred to by the OIG was not the result of obligating ineligible guarantees.

We agree with the OIG that of the U.S. Government's three major guaranteed housing programs, the SFHGLP is the most restrictive program due to its stringent requirements. We add that the SFHGLP continues to outperform other comparable mortgage programs, as noted below.

Repayment Ability

Citing 12 of the 100 loans sampled, the OIG contends that more than 14 percent of Recovery Act loans guaranteed under the SFHGLP had questionable repayment ability attributable to the relaxation of income requirements used in loan calculations. The agency consulted with the Office of General Counsel (OGC) concerning the methods used by lenders and the agency in calculating repayment income, and the alternate methodology used by the OIG. OGC concluded that lenders and the agency "could reasonably find repayment ability in those cases" cited by the OIG. OGC indicated that the OIG method of calculating income "is not legally required and cannot be used to find the borrowers ineligible." Thus, neither the agency nor the Office of General Counsel agrees with the OIG contention that the repayment ability of the borrowers in question was due to lender miscalculation of income.

With regard to the specific cases cited, the loans were made from March, 2009 through December, 2009 and many of them are already more than 2 years old. Default rates are known to decline as borrowers move beyond the early years of the loan term. It stands to reason that if these loans lacked repayment ability they would have defaulted within the first year because borrowers would not have been able to repay their mortgage loan installments. The concept is simple: if a borrower does not have the ability to repay a loan when it is granted they will quickly find they are unable to keep up with their loan payments and become delinquent. To date, the Recovery Act portfolio is performing similarly to if not better than the rest of the SFHGP portfolio. With a total delinquency rate of 10.17 percent[2], the SFHGLP is performing significantly better than other comparable housing programs (see Chart 1 below[3]).

[2] Loans 30+ days delinquent, excluding foreclosures, also known as DQ1+ loans.
[3] Sources are the Mortgage Bankers Association quarterly publication "National Delinquency Survey" for June, 2010 and USDA Rural Development portfolio records.

Chart 1

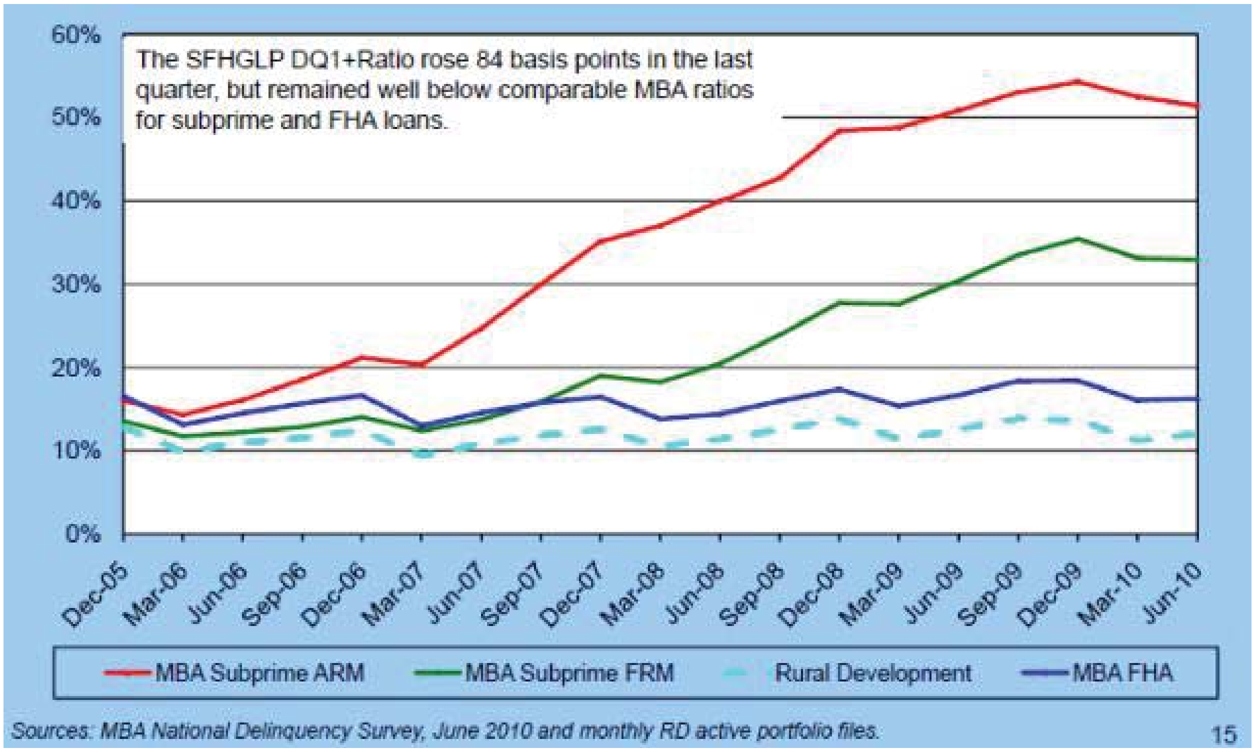

Chart 1 provides an illustration of statistical data compiled by the Mortgage Banker's Association (MBA) as part of the National Delinquency Survey in June 2010. Chart 1 also includes Rural Development delinquency data based on active loans within the guaranteed loan portfolio. All data reported is for loans that are in a DQ +1 status, meaning they are at least thirty days delinquent.

Chart 1 plots the delinquency percentage from zero percent up to sixty percent, during the time frame of December 2005 to June 2010. A line graph was used to illustrate the up/down or rise and descent of loan delinquency.

Four loan types are reflected in Chart 1; MBA Subprime Adjustable Rate Mortgages or ARM's, MBA Subprime Fixed Rate Mortgages, Rural Development Guaranteed loans and MBA FHA loans.

The MBA Subprime ARM is the first loan category and is represented by a red line. In December 2005 the delinquency rate for Subprime ARM's was about 15%. From December 2005 to December 2006 the delinquency rate steadily increased to approximately 22%. From December 2006 to March of 2007 the delinquency rate decreased to 20%, but from March 2007 to December 2007 delinquency abruptly spiked to 35%. From December 2007 to June 2008 delinquency had steadily climbed to 40%. Within a one year time frame of June 2008 to June 2009 delinquency continued to climb to 50%. From June 2009 to December 2009 the highest delinquency rate of 55% was reported. December 2009 to June 2010 the delinquency slowly dropped to approximately 52%. To summarize MBA data for subprime adjustable rate mortgage DQ 1 loans, delinquency began at 15% in December 2005 and continued to rise well above 50%.

The MBA Subprime Fixed Rate Mortgages is the second loan category and is represented by a green line. The subprime fixed rate mortgages reflect a delinquency rate of approximately 12% in December 2005. There was little change in the reported delinquency rate until March 2007 when the delinquency rate began to increase to 18% in December 2007. Delinquency rates decreased slightly per the chart, but then began a rapid increase from March 2008 to December 2008 when the delinquency rate reported was 28%. Delinquencies stayed level until March 2009 when they began rising again to hit the highest delinquency rate reported in December 2009 at 35%. From December 2009 to June 2010 delinquencies began to drop to 32%. To summarize MBA data for subprime fixed rate mortgage DQ 1 loans, delinquency began at 12% in December 2005, continued to slowly rise and then spike in December 2008 at 28%, followed by another spike in December 2009 up to 35%, then decline and level off in June 2010 at 32%.

Rural Development Single Family Housing Guaranteed Loans is the third category represented by a dotted light blue line. In December 2005 the delinquency rate approximately 12%. From December 2005 until June 2010 the delinquency rate for guaranteed loans dipped to a low of 9% in March 2007, and reported the highest delinquency of 13% in December 2008. To summarize Rural Development guaranteed DQ 1 loans, from December 2005 to June 2010 the delinquency rate of guaranteed loans did not deviate significantly between the low of 9% in March 2007 to the highest rate of 13% in December 2008. In June 2010 the delinquency rate was approximately 12%, exactly where it was in December 2005.

FHA loans are the forth category represented by a blue line. In December 2005 the delinquency rate was 16% where it dropped to 13% by March 2006. From March 2006 to December 2006 delinquency rose to 18%, followed by a drop to 13% in March 2007. Delinquency steadily increased back to 18% in December 2008, followed by a drop to 15% in March 2009. Following the March to December pattern displayed by the chart, delinquency again rose to 19% in December 2009. By March 2010 delinquency had dropped back to 16% and remained to June 2010. To summarize FHA DQ 1 loans, the delinquency rate did not deviate significantly between the low of 13% in March 2007 and the highest rate of 19% in December 2009. By June 2010 delinquency returned to the December 2005 rate of 16%.

When the above date is illustrated on Chart 1 it clearly shows that subprime adjustable rate mortgages began with a 15% delinquency rate and continuously rose each year, well above the delinquency rates of the other loans. Subprime fixed rate mortgages in December 2005 actually had lower reported delinquency rate than FHA, but their delinquencies began rising in March 2007 where they continued to climb well above FHA. FHA mortgages experiences slight deviations from December 2005 to June 2010 but remained relatively flat with no significant spikes or drops. Rural Development guaranteed loans remained quite flat and reported delinquency rates of 13% or less.

The caption on Chart 1 states “The Single Family Housing Guaranteed Loan Program (SFHGLP) DQ + 1 Ratio rose 84 basis points in the last quarter, but remained well below comparable MBA ratios for subprime and FHA loans.”

Chart 1 is page 15 of the Early Payment Delinquencies Analysis prepared for Rural Development.

The OIG report states that 6 of the 12 cited borrowers “were currently, or had been, delinquent on their loans” whereas the agency found that only 4 of the loans were in a delinquency status. Of those, 2 were 30 days delinquent or behind by only 1 monthly payment. The agency found that 2 of the loans cited by the OIG had been delinquent over the holiday season but had repaid the past due amount and were now current. It is not uncommon for SFHGLP loans, made to low and moderate-income households, to miss one payment and become delinquent around the holiday season or the beginning of school due to conflicting financial demands. The long established trend is that some borrowers are late with their payments in December but the loans become current after the holidays.

Chart 2 below illustrates the SFHGLP delinquency trends from February of 2007 through August of 2011. The reader may note that first year delinquency for the SFHGLP, typically a harbinger or forecaster of total delinquency, has been trending down.

Chart 2

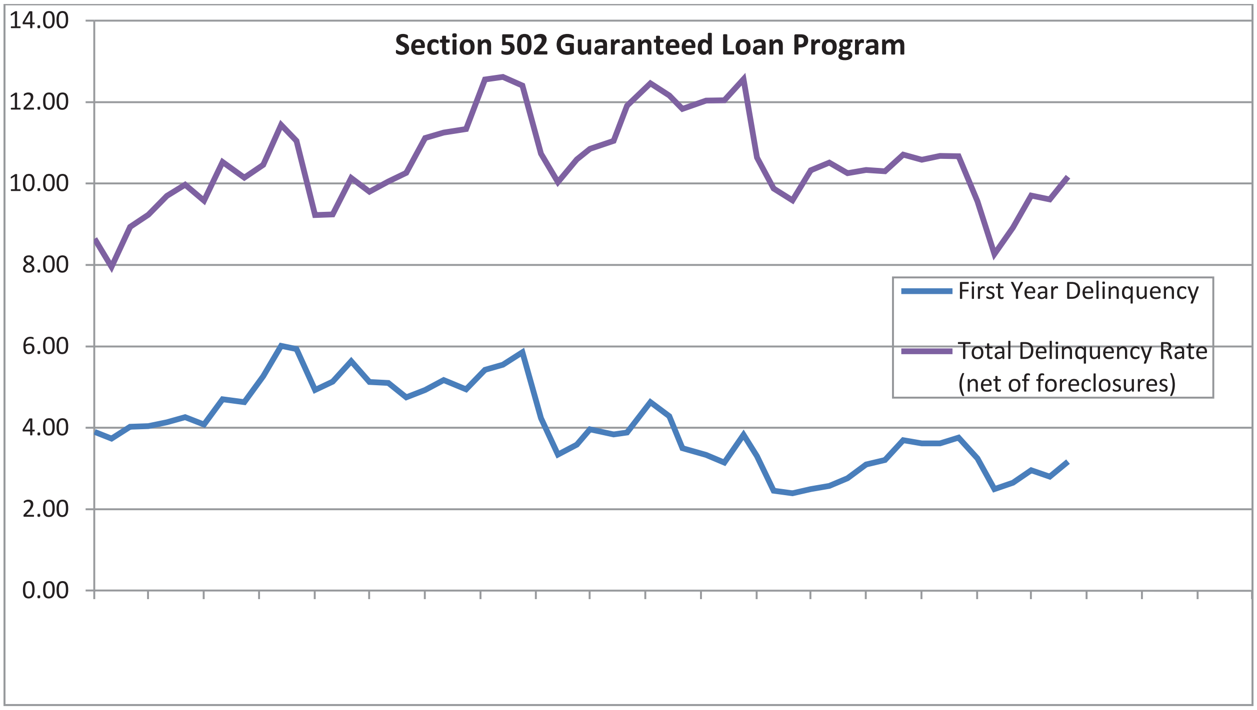

Chart 2 provides an illustration of the SFHGLP total delinquency rate (net of foreclosures) trends from February 2007 through August 20011. The chart also illustrates the first year delinquency rate trends for the same time period.

The chart contains two lines. The first line in the chart represents the "total delinquency rate (net of foreclosures)." The chart shows that the total delinquency rate was slightly above 8 percent in February 2007, and increased to 10.5 percent November 2007, than decreased to 9.22 percent by February 2008. Beginning in May 2008, the delinquency rate increased to 9.88 percent and peaked November 2008 to an all time high of 12.55 percent. In February 2009 the total delinquency rate decreased to 10.73 percent, and remained steady until November 2009 when it increased to 12.46 percent. In February 2010, the total delinquency rate decreased to 10.63 percent and remained steady until February 2011, when it decreased to 9.56. The total delinquency rate for August 2011 was 9.92 percent.

The second line in the chart represents the "first year delinquency rate." In February 2007, the first year delinquency rate was slightly below 4 percent and slowly ticked up to 5.2 percent in November 2007. The first year delinquency rate decreased to 4.93 in February 2008, but gradually increased to 5.43 by November 2008. In November 2009, the first year delinquency rate decreased to 3.33 percent and continued to decrease until May 2010, when it was at an all time low of 2.5 percent. The first year delinquency rate has remained fairly steady since February 2011, when it was 3.25 percent and 3.08 percent for August 2011.

The agency's published guidelines on calculating repayment income are consistent with commercial banking principles and mortgage industry standards, which considers the borrowers current verified income. For example, if an applicant such as a school teacher or nurse has recently finished college and obtained a job in their profession, it is industry standards to only consider current verified income when calculating repayment ratios. In such circumstances, use of the historical income would not accurately represent the applicant's ability to repay a loan. Nevertheless, the agency agrees that the guidelines can be improved and will take the steps necessary to do so.

Income Limits

Similar to repayment income, the OIG concluded that more than 16 percent of the Recovery Act portfolio (12 borrowers of the 100 reviewed) had incomes that exceeded moderate income levels. Once again, the agency does not agree with the OIG conclusions in most of the cases cited. For example, the income verification for one borrower indicated he works an average of 239 days per year. However, the OIG calculated the borrower's income over a 12 month period, even though the employer indicated he only works 239 days per year. OIG calculation resulted in a projected income that was approximately $22,000 more than the borrower had earned in the previous year, and erroneously concluded the borrower's income was over the allowable limit.

The agency does agree with the OIG's recommendation that further training would be beneficial. Indeed, the agency recently embarked on a nationwide training campaign to ensure lenders were familiar with how the agency calculates repayment and income limit eligibility. The training sessions, each attended by almost 200 private sector program participants, were held at the following locations and dates in 2011:

- Dallas, TX – April 25 and 26
- Minneapolis, MN – May 11 and 12
- Salt Lake City, UT – June 7 and 8
- Atlanta, GA – June 21 and 22
- San Francisco, CA – July 12 and 13
- Manchester, NH – July 20 and 21

In addition to the lender training, Field staff was provided training in a nationwide policy meeting held the week of August 8, 2011 in Kansas City.

Aside from the face-to-face classroom style training described above, the agency offers regular webinar training sessions several times each month. Hundreds of lenders and field staff attend the recurring webinar training sessions designed to educate audiences about SFHGLP eligibility and underwriting requirements.

Need for Guarantees

The OIG stated that 7 percent (7 out of the 100 cases reviewed) of the Recovery Act loans were made to borrowers who could have obtained a private sector loan. We disagree. The loans were made during the height of the housing and economic crisis when capital markets were frozen and residential loan activity had stalled. Lenders were not making loans without the assurance of a secondary market execution, which was only being provided if the loan funds could be guaranteed. The Recovery Act funds provided this mechanism.

The basis for this finding is that some lenders answered, when asked by the OIG, that they may have offered loans with adjustable interest rates, balloon payments, the potential for negative amortization, a requirement for private mortgage insurance, or other features either riskier to the borrower or with higher monthly payments than those under the SFHGLP. However, we are not aware of a lender stating that they would have offered the applicant the same rates and terms, if the guarantee weren't available. In every case when a guaranteed loan was made, the lender certified in writing that: "The applicant is unable to secure the necessary conventional credit without a Rural Development guarantee upon reasonable rates, terms and conditions which the applicant could reasonably be expected to fulfill."
Nevertheless, the Agency published an Administrative Notice (AN) clarifying that applicants who qualify for conventional credit should not receive a guarantee. The definition of conventional credit used in the AN is one that was prevalent when the regulation was published in the early 1990's. To qualify for conventional credit, all the following conditions must be present:

- The applicant must make a down payment of no less than 20 percent of the purchase price;
- The applicant must be able to pay all closing costs out of pocket;
- The applicant must have qualifying debt-to-income ratios not greater than:
    - 28 percent for the mortgage loan payment (principal, interest, taxes and insurance), and
    - 36 percent for total monthly debt obligations;
- The applicant must have a good credit history consisting of at least two credit bureau trade lines open and paid as agreed for at least a 24- month period, to include that:
    - No trade line be currently 30 days or more past due;
    - No trade line has been 60 days or more past due over the past 24 month period;
    - There not be any foreclosure or bankruptcy over the past 36-month period;

- The conventional mortgage loan term was for a 30-year fixed rate loan term without a condition to obtain private mortgage insurance (PMI).

The enabling statute for the SFHGLP was the Cranston-Gonzalez National Affordable Housing Act of 1990. Cranston-Gonzalez amended the Housing Act of 1949 by creating the SFHGLP for the express purpose of enticing lenders to lend in rural areas and small communities that were not adequately served by affordable mortgage financing. The Act provides low to moderate income households the ability to purchase modest homes located in rural areas where conventional credit is typically not an option due to remoteness of the area and the lender's uncertainly of how to liquidate the collateral if the loan should default. In addition, other Government housing programs such as those under Housing and Urban Development (HUD) typically do not serve rural areas very well. For example, HUD's Federal Housing Administration (FHA) insures only 7.76 percent of its loans in non-metro areas with a rural population of less than 20,000 while the SFHGLP guarantees 42.23 percent of its loans in such areas

Above-Ground Swimming Pools

The OIG identified 3 loans with above-ground swimming pools. Above ground pools are considered in the real estate industry to be chattel as opposed to in-ground swimming pools which are affixed to and part of the real estate. Nevertheless, all loans found with any type of swimming pool were de-obligated from Recovery Act funds and re-obligated with non-Recovery Act funds.

Adequate Housing

The OIG stated that 4 percent (4 loans out of the 100 sampled) consisted of borrowers who already had an existing home at the time they applied for a guaranteed loan, but sold the home prior to obtaining the guaranteed loan. According to the OIG, these borrowers should have been deemed ineligible because there was no determination made whether the sold home was structurally sound or functionally inadequate. The agency does not agree that these borrowers were ineligible or that the guarantees were issued outside the scope of its regulations.

The applicable regulation 7 CFR 1980-D, section 1980.346 (a) states "an applicant must be a person who does not own a dwelling in the local commuting area or owns a dwelling which is not structurally sound, or functionally adequate."

To prevent undue hardship on the applicant, this regulation permits the applicant to purchase a new home with the guaranteed loan if they own a home outside of the commuting area or if their current home is structurally unsound. However, OGC supports the agencies opinion that the regulations do not prohibit the purchase of a new home in the local commuting area as long as the existing home is sold and closing takes place before the closing of the guaranteed loan. This opinion holds true whether or not the existing home was structurally sound. Thus, if the applicant does not own two homes in the local commuting area at the same time, there is no violation of the regulations, as there is no requirement that the applicant be a first time homeowner.

It is standard practice for applicants to sell their existing home while in the process of purchasing their new home and obtaining a new loan. The agency interpretation of the regulation is sensible given the fact that most applicants would not be able to purchase a new home without selling their current home. Both the OIG and program staff agreed that program regulations allow a homeowner with a home that is outside of the commuting area to purchase a home with the 502 guarantee program within their commuting area before this current home sells. This is to provide relief from commuting to work while the home is being marketed. Therefore, as OGC opined, if a home is within the commuting area, the second home cannot be closed until the first home is sold.

One of the cases OIG cited in violation of the regulations involves a recently divorced mother of three children. In divorce scenarios, it is frequently necessary to sell the prior home because the individual ex-spouse can no longer afford to make loan payments which had previously been joint obligations. The divorced single parent in this case had no savings and would not have been able to divest herself of her former marital home and purchase a home for herself and her three children without an agency guarantee. The Agency believes if the borrower had been denied a guarantee, she and her dependent children may not have had any affordable housing alternatives.

Another OIG case involved a household confronted with the painful reality of job loss. The resulting income shortfall created the need to “downsize” the household’s living arrangements. The borrowers netted only $4,891 from the sale of their old home. This covered only part of the closing costs for their new home and the household was not able to make any down-payment. The Agency believes, if the borrowers had been denied a guarantee, the family would have lost its old home to foreclosure and would not have had any affordable housing alternatives.

The other cases cited by the OIG featured similar scenarios. It is true that the old homes may have been structurally sound and functionally adequate. Nevertheless, the Agency believes it legally permissible for the homes to be sold while the applicants were in the process of obtaining their new home with a guarantee. OGC has concurred with the agency, and Agency staff believes these loans fully met the intent of the program and the Recovery Act.

The purpose of the Recovery Act was to stimulate the economy during a financial crisis. To prevent households from purchasing new homes because they were in the process of selling their existing homes would have stifled commerce with an adverse effect on the economy. The process of selling and purchasing homes provides or maintains jobs for thousands of construction workers, architects, engineers, banking professionals, real estate brokers, home inspectors, real estate appraisers, title closers, carpet layers, hardware stores, kitchen and bathroom remodelers, landscaping professionals, telephone and utility company workers, and all those who service or supply the housing industry. The OIG interpretation of the regulation actually runs contrary to the purpose of the Recovery Act.

The OGC opinion mentioned above is attached to this response and incorporated by reference.

Lender Compliance Reviews

The OIG stated in their report that the agency could have implemented better lender compliance reviews as early as April of 2009 (page 45 of OIG report).

The Agency maintains that during the Recovery Act period it followed all applicable policies and procedures according to applicable regulations. Nevertheless, the Agency agrees that existing policies including the lender oversight process can be improved. In addition, the Agency will strengthen lender documentation requirements, the review and reclassification of eligible rural area designations, and the accuracy of information entered into agency systems and databases.

Recommendation Summary

The OIG made 29 recommendations in relation to its findings. The OIG Findings, Recommendations and Position and the Agency Response and Request for Management Decision are as follows:

Finding 1: **Borrowers Did Not Demonstrate the Ability to Repay Loans**

Recommendation 1

Take appropriate actions and measures concerning the ineligible loans.

Agency Response

According to Federal regulations, the loan note guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation. Unless the Agency or OIG determines the presence of fraud or misrepresentation, the loan note guarantee remains valid. To hold originating lenders accountable in the future, the Agency implemented an indemnification requirement which was published as a final rule in the Federal Register on May 31, 2011.

OIG Position

OIG has accepted management decision for this recommendation.

Recommendation 2

Notify field staff and lenders about the regulatory issues included in the Fast Report and emphasize the need for compliance with those regulations.

Agency Response

The importance and proper use of Recovery Act funds was relayed to lenders and field staff on many occasions during fiscal years 2009 and 2010. To resolve this recommendation, the Agency shared the Fast Report of December 6, 2010, with field staff and lenders, and re-emphasized the need for compliance with applicable regulations.

OIG Position

OIG accepted management decision for this recommendation.

Recommendation 3

Review and revise, as necessary, the Agency's policies regarding income eligibility and qualifying income. In addition, strengthen the oversight procedures used by field staff to verify compliance with those regulatory requirements.

Agency Response

As recommended, the Agency has reviewed the policies regarding eligibility and qualifying income. The Agency has clarified the income requirements through six regional lender training sessions; a single family housing national policy meeting for field staff; and, by issuance of an Administrative Notice (AN). On May 23, 2011, RD AN 4575, "Single Family Housing Guaranteed Loan Program Origination and Closing-Lender's Documentation" was released and provides detailed guidance for calculating both eligibility and qualifying income. Since AN's are temporary in nature, the Agency proposes to make the guidance permanent by incorporating the content of the AN into a new regulation and corresponding handbook. The AN will be renewed until publication of the 7 CFR 3555 occurs. The new regulation 7 CFR 3555 and related handbook will be published in the Federal Register, and will replace the current regulation 7 CFR 1980-D and related Administrative Notices. The new regulation and handbook will be published by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 4

Require Rural Development field staff to verify lender income calculations by recalculating income and repayment ratios.

Agency Response

Field staff is responsible for reviewing all information submitted by the lender. However, it is the lenders responsibility to properly verify and analyze the applicant's income and employment history to ensure it is in accordance with Agency guidelines. As recommended, field staff will be required to verify lender income calculations by recalculating income and repayment ratios for manually underwritten loans when the repayment ratios calculated by the lender is within 10 percent of the debt ratio limit(s). The revisions will be accomplished with the publication of a new final rule and handbook which will replace the existing regulations. The new regulation and handbook will be published by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 5

Develop and implement standardized procedures for computing repayment income using a historical average, to ensure uniformity and consistency of determinations among lenders.

Agency Response

The Agency has developed a standardized worksheet that lenders may use to document repayment income. AN 4575 provides four options for calculating income (Straight, Average, Year-to-date, and Historical). This worksheet is in line with current underwriting guidelines use by the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac. Using a historical average may not be appropriate for all applications. For example, if an applicant has a history of earning considerably more income in the previous 24 months with a different employer, than present circumstances, the resulting computation could erroneously indicate repayment ability when in fact based upon current verified earnings repayment may not be shown. Since AN's are temporary in nature, the Agency proposes to make the guidance permanent by incorporating the content of the AN into a new regulation and corresponding handbook. The AN will be renewed until publication of the 7 CFR 3555 occurs. The new regulation, 7 CFR 3555 and related handbook will be published in the Federal Register by September 30, 2012, and will replace the current regulation 7 CFR 1980-D and related Administrative Notices. The Agency hereby requests management decision.

OIG Position

Recommendation 6

Develop a standardized form for manually submitted applications and require lender to document and explain both qualifying and eligible income calculations.

Agency Response

AN 4575 provides a standardized worksheet that lenders may use to document annual and repayment income. The worksheet contains a section for lenders to provide a written analysis detailing the annual and repayment income calculations utilized. Since AN's are temporary in nature, the Agency proposes to make the guidance permanent by incorporating the content of the AN into a new regulation and corresponding handbook. The AN will be renewed until publication of the 7 CFR 3555 occurs. The new regulation, 7CFR 3555 and related handbook will be published in the Federal Register by September 30, 2012, replacing the current regulation 7 CFR 1980-D and related Administrative Notices. The Agency hereby requests management decision.

OIG Position

Recommendation 7

Develop a standardized method that requires the lenders to provide the base income pay, year-to-date pay from the most recent paystub(s), and the prior 2 years of income as reported on the borrower's W-2. In addition, require the lenders to input the start date of the borrower's current job. If the start date is within the past 12 months, a new rule should be included in the GUS Underwriting Findings Report for a review of income documentation by Rural Development field staff.

Agency Response

Current regulations allow Lenders to use a standardized form for loan applications, known as the Uniform Residential Loan Application (URLA) (Fannie Mae Form 1003, Freddie Mac Form 65). The form has a blank space for "Years on the job" but does not include a start date. The URLA does not provide spaces for YTD pay or the previous two years of income as noted on a W-2. However, the Agency has issued AN 4575 which provides a standardized worksheet that lenders may use to document annual and repayment income. The worksheet contains a section for lenders to provide a written analysis detailing the annual and repayment income calculations utilized.

Additionally, GUS does not make the lending decision to grant or deny credit. GUS provides an underwriting recommendation to assist the approved lender's underwriter in making a final loan approval decision. The information suggested as an addition to the GUS application pages would be cost prohibitive to develop and would not add the needed value to the GUS underwriting recommendation, as values for capturing the additional requested information do not exist in the present Mortgage Industry Standards Maintenance Organization (MISMO), an electronic commerce standard for the mortgage industry. However, In lieu of the values proposed, the Agency proposes to create a new GUS message that requires a full documentation loan file submission to the Agency when applicants have 12 months or less in their current employment. These changes will be made by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 8

Segregate duties and implement second party reviews in offices where it is feasible based on staffing levels to ensure the accuracy of all applications. Continue the pre-loan closing reviews at smaller offices that are unable to suitably segregate duties among existing staff.

Agency Response

The Agency will issue a directive to Rural Development State Directors, instructing them to centralize all functions relating to the SFHGLP. Segregation of duties will be accomplished by ensuring the loan approval official does not request the obligation of funds in the Guaranteed Loan System (GLS). The same control will apply for entering loan closings into GLS. The Agency will develop specific guidance for the SFHGLP to address internal oversight by next level supervisors and/or second party reviewers. With centralization small offices will be eliminated, however, states will be encouraged to keep staff outside of the centralized office trained and available to assist should there be a backlog of applications. The directive will be issued by December 31, 2011 and all states will complete the centralization of the SFHGLP functions by October 1, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 9

Revise current instructions for income documentation to require the IRS Tax Return for the prior 2 years, the most recent 30 days of paystubs, a completed VOE, and 3 months of bank statements that correspond to income deposits. If the VOE provided is not complete, the lender should follow up with the employer to obtain all answers. Income documentation should be obtained for all household members. In addition, disallow the use of the verbal VOE.

Agency Response

The Agency proposes to revise the current instructions for income documentation by implementing a new control requiring all adult household members sign IRS Form 4506-T, “Request for Transcript of Tax Return” for the previous two tax years at loan application. The tax transcript will validate/confirm previous years reported income for eligibility and repayment purposes prior to the Lender’s request of the Conditional Commitment for Loan Note Guarantee. The transcript is proposed in lieu of the recommended IRS Tax Return. The Agency will continue current income verification requirements which include the option for lender’s to obtain a verbal VOE, only if it is used in conjunction with additional forms of income verification. Specifically, a verbal VOE will be allowed if the lender also provides paycheck stubs covering the most recent 30-day period <u>and</u> W-2 forms for the previous two years; or, a verbal VOE may be used if the lender obtains a computer-generated document accessed and printed from an Intranet or Internet site, <u>and</u> provides W-2 forms for the previous two years. To promote consistency when verbal verifications are used, the Agency has developed a standard form that may be used to record oral verification of employment which will be released with the publication of 7 CFR 3555. The Agency proposes to make IRS Form 4506-T mandatory upon publication of the new regulation. The new regulation 7 CFR 3555 will be published in the Federal Register by September 30, 2012. The Agency hereby request final action.

OIG Position

Finding 2: Borrowers' Income Exceed Regulatory Limits

Recommendation 10

Develop and implement standardized procedures, such as using current earnings statements, to calculate eligibility income to ensure uniformity of determinations for both manual and electronically submitted loan applications.

Agency Response

RD Instructions, 1980-D, section 1980.347 (a) requires current verified income to be used for calculating the eligibility income for the household. The Agency has expanded on this guidance through issuance of RD AN 4575, and by conducting training for both lenders and field staff. Since AN's are temporary in nature, the Agency proposes to make the guidance permanent by incorporating the content of the of the AN into a new regulation and corresponding handbook. The handbook devotes an extensively written technical chapter to income calculations, and will provide nine new attachments to assist lenders in accurately calculating and verifying eligibility and repayment income. The AN will be renewed until publication of the 7 CFR 3555 occurs. The new regulation, 7 CFR 3555 and related handbook will be published in the Federal Register by September 30, 2012 and will replace the current regulation 7 CFR 1980-D and related Administrative Notices. The Agency hereby requests management decision.

OIG Position

Recommendation 11

Require Rural Development field staff to verify the lender's adjusted annual income calculations by recalculating income and determining the number of household members earning income.

Agency Response

Field staff is responsible for reviewing all information submitted by the lender for completeness to determine the proposed loan is to an eligible applicant, for an eligible loan purpose, with a reasonable assurance of repayment ability and sufficient collateral to adequately cover the intended loan. Lenders are required to verify and analyze the applicant's income in accordance with Agency guidelines. In an effort to ensure all household income is considered the Agency proposes to require lenders obtain the IRS tax transcript for the previous two years for all adult household members prior to requesting the Conditional Commitment for Loan Note Guarantee. Further, for manually underwritten loans, the Agency proposes to require field staff to recalculate the income if it is within 10 percent of the applicable income limit. Both proposals will be implemented upon publication of the new regulations, 7CFR 3555 which will be published in the Federal Register by September 30, 2012. The Agency herby requests final action.

OIG Position

Finding 3: Loans Were Guaranteed to Borrowers Who Had the Ability to Secure Financing with Reasonable Terms and Conditions Directly from Lenders without Government Assistance.

Recommendation 12

Review and revise, as necessary, the Agency's policies regarding borrower ability to obtain conventional credit without loan guarantees. In addition, strengthen the oversight procedures used by field staff to verify compliance with those regulatory requirements.

Agency Response

The Agency published Administrative Notice 4594 "Definition of Conventional Credit" on July 26, 2011 to establish clear parameters regarding the ability for borrowers to obtain conventional credit. The AN also strengthens the oversight procedures used by field staff to verify compliance with regulatory requirements. This guidance will be included in the publication of a new final rule and handbook which will replace the existing regulation. The AN will be renewed until publication of the 7 CFR 3555 occurs. The new regulation and handbook will be published by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 13

Modify GUS to notify Rural Development field staff when loan applicants possess the eligibility characteristics for conventional credit. Field staff should then follow up with the lender to ensure that the applicant was not eligible for conventional credit.

Agency Response

Multiple characteristics affect an applicant's ability to qualify for conventional credit. GUS cannot be programmed with such a rule that will notify both lenders and field staff when loan applicants possess the eligibility characteristics for conventional credit. GUS also does not have the capability to read the credit report and determine the number of tradelines and their length of history, all of which must be considered to determine if a borrower qualifies for conventional credit.

GUS currently calculates and reports on the "GUS Underwriting Findings Report" many of the characteristics lenders must consider, including housing and debt ratios, months of reserves, a link to the credit report and the representative FICO score utilized for the underwriting recommendation. The Agency proposes to write a new rule to alert lenders and the field when the applicant has enough assets to make a 20 percent downpayment and when the debt ratios are below conventional credit thresholds. The new rule combined with the guidance in AN 4594 "Definition of Conventional Credit" will assist the lender and field staff in their analysis of conventional credit. The AN will be renewed until publication of the 7 CFR 3555 occurs. The revisions to GUS and publication of the new regulation 7 CFR 3555 and related handbook will be accomplished by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 14

Revise existing policies to require lenders to document and verify the borrower's assets, and for Rural Development field staff to ensure that borrowers were unable to secure other reasonable financing.

Agency Response

Extensive training provided in regional lender meetings and employee training at the SFH National Policy Meeting provided detailed information on the verification, calculation and required inclusion of household and borrower assets in the program eligibility and qualifying income calculations. Additionally, Administrative Notice 4543 "Underwriting and Loan Closing Documentation Matrix" includes clarification and guidance for the verification and documentation of assets. The new revision currently in process will strengthen the requirement for disclosure of all assets held by any adult member of the household. The addition of IRS Form 4506-T will provide new due diligence in the event interest and/or dividends are reported by the household members on assets they may not have disclosed at the time of loan application. In separate publications, field staff has been provided with guidance to identify "red flags" while evaluating a GUS application, which also applies to manually underwritten requests. Together with the elements defined in AN 4594, stronger emphasis in the revised and updated renewal of AN 4543 will address the necessity to consider assets in the program eligibility and qualifying income calculation. This guidance will be included with the publication of a new final rule and handbook which will replace the existing regulation. The new regulation and handbook will be published by September 30, 2012. The AN's will be renewed until publication of the 7 CFR 3555 occurs. The Agency hereby requests management decision.

OIG Position

Recommendation 15

Establish an asset limit for the program and require borrowers to contribute a down payment when their liquid or non-liquid assets exceed the limit.

Agency Response

RD Instruction 1980-D and the Housing Act of 1949, as amended, does not support an established asset limitation or a down payment requirement for the SFHGLP and allows for loan amounts not to exceed 100 percent of the appraised value plus the up-front guarantee fee. When applicants are able to obtain conventional credit, based upon the criteria published in AN 4594 "Definition of Conventional Credit" they will be ineligible for a guaranteed loan. This guidance will be included in the publication of a new final rule and handbook which will replace the existing regulation. The AN will be renewed until publication of the 7 CFR 3555 occurs. The new regulation and handbook will be published by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Finding 4: Applicants with Adequate Existing Homes in the Local Commuting Area Received Loan Guarantees

Recommendation 16

Obtain an OGC opinion on the regulatory citation, 7CFR 1980.346(a), as it relates to the overall program in determining borrower eligibility, specifically in relation to the program objective, credit elsewhere provision, and funding limitations.

Agency Response

As requested, Agency officials met with OGC and requested the recommended opinion; however, OGC indicated it has already issued a legal opinion on the regulatory citation based upon an earlier inquiry during the Fast Report process. OGC advised that their opinions must be limited to legal issues, and they have already given an opinion on 7 CFR 1980.346(a), stating that the loans in question were made within the scope of the regulations. As an alternative, OGC offered to review and opine on a policy statement from the Agency as it relates to the overall program in determining borrower eligibility, specifically in relation to the program objective, credit elsewhere provision, and funding limitations. The Agency acknowledge that the regulations could be interpreted the way the OIG interpreted them, however, the past policy has been in accordance with the OGC opinion, which allows an applicant to apply for a new home in the local commuting area, but not allow the closing until the current home is sold. In order to prevent further misinterpretation of a long standing policy, the Agency proposes to request OGC to review a policy statement and issue an opinion. The policy will be clarified based on the OGC opinion, and will be incorporated in the new regulation, 7CFR 3555 which will be published by September 30, 2012. The Agency, hereby requests management decision.

OIG Position

Recommendation 17

Require lenders to maintain documentation that borrowers' existing homes were either inadequate or structurally unsound.

Agency Response

The OGC opinion discussed in Recommendation 16 indicated that under current regulation it is not necessary to document that borrower's existing homes were either inadequate or structurally sound because the applicant sold the existing home prior to purchasing one with a guarantee. The Agency proposes to request OGC to re-review the policy statement mentioned in the Agency response to Recommendation 16. Once OGC issues a legal opinion on the policy statement, the Agency will clarify the policy in the new regulation 7CFR 3555, which will be published in the Federal Register by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 18

Develop policy and procedures to ensure that field staff verifies the existence and adequacy of documentation related to instances where borrowers had existing homes prior to obtaining a loan guarantee from Rural Development.

Agency Response

As with recommendations 16 and 17, this response relies upon the outcome of the OGC opinion over a policy statement. Once OGC issues a legal opinion on the policy statement, the Agency will clarify the policy in the new regulation 7CFR 3555, which will be published in the Federal Register by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Finding 5: Loan Guarantees Provided for Homes with Swimming Pools

Recommendation 19

Take appropriate actions and measures concerning the ineligible loans with regards to swimming pools.

Agency Response

The Agency issued guidance to field staff that properties with swimming pools were not permitted to receive loan guarantees utilizing Recovery Act funds. An AN was published which officially superseded any informal bulletin board postings. The AN served as official notice to both the field and to lenders which clearly indicated that no Recovery Act funds should be used for properties with swimming pools. As a result of this finding, the Agency has de-obligated the identified loans with non-Recovery Act funds, through which above-ground swimming pools are permitted.

OIG Position

OIG has accepted management decision for this recommendation.

Finding 6: Agency Oversight of Lender Loan-Making Activities did not Safeguard Recovery Act Funds

Recommendation 20

Revise national and State LCR guides to include coverage of all eligibility areas, including adjusted annual (eligible) income, conventional credit, and applicants who own existing homes.

Agency Response

The Agency will revise the State and National Lender Compliance Review (LCR) guides to include coverage of all eligibility areas, including adjusted annual (eligible) income and conventional credit. The Agency will address existing homes as described for recommendations 16, 17 and 18. Work papers and sampling will be updated in the State and National LCR guides once OGC's legal opinion is known. The LCR guides will be updated by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 21

Establish monitoring controls to ensure that State-approved lender compliance reviews are conducted and submitted as required.

Agency Response

The Agency will include the requirement of meeting monitoring goals in each State Director's performance elements and standards. By including this requirement in the annual performance goals for each State Director, the Agency will establish monitoring controls to ensure that State-approved LCR's are conducted and submitted as required. This requirement will be included in

State Director performance goals beginning in Fiscal Year 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 22

Modify the lender selection process to better identify lenders who have not been reviewed for long periods of time, and lenders who have recently been approved to participate in the program.

Agency Response

The Agency will modify the lender selection process to better target lenders who have been recently approved or have not been reviewed for long periods of time. The LCR guide work papers and sampling will be updated in the State and National LCR guides by September 30 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 23

Establish procedures to summarize the results of concerns disclosed in national and State LCRs at least annually, and provide the results to lenders and field offices as a program notification of problems to look for and address with lenders.

Agency Response

The Agency proposes to publish an annual report summarizing the results of concerns found in national and state lender compliance reviews. A notification will be made to field offices, and lenders will be provided with results specific to each lender as they are reviewed. The first notification will be made by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Finding 7: Recovery Act funded loans may have been guaranteed in non-rural areas

Recommendation 24

Institute effective controls to ensure that required periodic updates of designated rural areas are performed in a timely manner.

Agency Response

Periodic reviews and update to designated rural areas affect multiple program areas and are not specific to the SFHGLP. The Agency instructions for rural area reviews are found in 7 CFR 3550, Single Family Housing Direct Loan Program. To address this finding, the Agency proposes to include this requirement in the annual performance goals for each State Director, beginning in Fiscal Year 2012. The Agency hereby requests management decision.

OIG Position

Finding 8: Compensating Factors Used to Justify Loans Were Inadequate or Not Documented.

Recommendation 25

Modify existing guidance to strengthen acceptable compensating factors. Basis program eligibility considerations should not be allowed as compensating factors. Include additional guidance to illustrate or define requirements.

Agency Response

The agency will modify existing guidance as recommended. The revisions will be accomplished with the publication of a new final rule and handbook which will replace the existing regulation. The new regulation 7CFR 3555 and handbook will be published in the Federal Register by September 30, 2012. The agency hereby requests management decision.

OIG Position

Recommendation 26

Notify lenders that they are required to maintain supporting documentation for GUS-approved loans.

Agency Response

The “GUS Underwriting Findings Report” and AN 4557 “Guaranteed Underwriting System” provide guidance on the documentation that lender’s are required to maintain in their permanent case file. Additionally, AN 4543 cites credit documentation expiration and retention expectations. This guidance will be permanently included in the publication of a new final rule and handbook which will replace the existing regulation. The new regulation and handbook will be published by September 30, 2012. The AN’s will be renewed until publication of the 7 CFR 3555 occurs. The Agency hereby requests management decision.

OIG Position

Recommendation 27

Include verification of documentation to support compensating factors into the review process for Rural Development field staff. Only fully documented compensated factors should be allowed for higher risk guaranteed loans.

Agency Response

Loans that receive a GUS “accept” underwriting recommendation do not require the lender to submit a separate waiver request and/or documentation to support a waiver. By use of the modified TOTAL scorecard, GUS evaluates the amount of risk involved through the data provided, which includes credit history, income, assets and collateral to determine acceptability with SFHGLP policy guidance. Lenders must retain all supporting documentation for the data entered into GUS as provided by the GUS Underwriting Findings Report and AN 4557. For manually underwritten loans the Agency has identified verification of documentation to support compensating factors into the review process for Rural Development field staff through publication of AN 4543. Permanent guidance will be incorporated in the publication of a new final rule and handbook which will replace the existing regulation. Until publication of the 7 CFR 3555 transpires, renewal of AN’s and published guidance will occur. The new regulation and handbook will be published by September 30, 2012. The agency hereby requests management decision.

OIG Position

Finding 9: Guaranteed Loan System Contains Inaccurate Data

Recommendation 28

Implement procedures to verify that post-loan closing data input into GLS is valid and complete or perform reconciliations to ensure that the most current and accurate information is recorded within the system.

Agency Response

True and accurate data is important to overall portfolio management. The Agency recognizes the necessity to emphasize and collect accurately represented data. As recommended, the Agency will revise the National and State LCR guide to check for accuracy of GLS data input. Both guides will be revised by September 30, 2012. The Agency hereby requests management decision.

OIG Position

Recommendation 29

Revise the National and State Lender Compliance Review Guides to ensure that the GLS date is supported by documentation provided in the loan files.

Agency Response

The Agency will revise the National and State LCR guides as recommended. Both guides will be revised by September 30, 2012. The Agency hereby requests management decision.