UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

MAY 2 2 2009

REPLY TO
ATTN OF: 04703-0001-Ch

TO: Dallas Tonsager
Under Secretary
Rural Development

FROM: Robert W. Young
Assistant Inspector General
for Audit

Robert W. Young

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

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

The Rural Housing Service, an agency within the Rural Development mission area, is responsible for distributing Recovery Act funds through the Section 502 Single-Family Housing Guaranteed Loan Program. As of May 13, 2009, Rural Development had obligated over \$4 billion to guarantee over 34,000 loans. Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure funds are expended in a manner that minimizes the risk of improper use. This memorandum is the fourth one to report on our oversight activities related to rural housing. This report relates to the procedures used by agency field staff when reviewing and approving applications for loan guarantees. This issue, along with the others identified in these memoranda, will be compiled into a final report at the conclusion of our audit.

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

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

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

During our visits to agency field offices, we observed that agency loan specialists routinely performed all functions in the loan guarantee process with no supervisory review prior to issuance of the guarantee. These functions included the review of loan guarantee applications for completeness and borrower eligibility, the approval of the applications for guarantee, and the input of applications into the agency's system of records (the Guaranteed Loan System) where the obligation of funds will occur.[3] The agency does not require a segregation of duties or supervisory (or second party) review prior to issuance of the loan guarantee.[4] This creates a situation where agency loan specialists and other field staff could fail to detect lender errors or collude with lending officials to guarantee substandard loans.

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

Based on our observations and discussions with area office officials, field staff were processing up to three times as many applications as usual. According to the loan specialists we interviewed during our visits, it typically takes about two hours to fully process a manually submitted application and about a half-hour to fully process an application submitted via the Guaranteed Underwriting System (GUS). Thus, in a normal day, with a combination of manual and GUS processed applications, a loan specialist may process somewhere in the range of 4 to 10 loan applications. In one office we visited, the loan specialist stated he was involved in processing partially or fully 10 applications in approximately 4 hours.

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

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[3] Rural Development Instruction 1980.354, dated June 21, 1995.
[4] The agency conducts periodic second party reviews after issuance of a loan guarantee. Area Directors review a sample of loan guarantees on a quarterly basis. The agency's Management Control Review and State Internal Review processes review guaranteed loans on a five year rotational basis.

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

In our view, the risk that employees will not adequately review loan guarantee applications is significant enough that agency officials should take action to prevent potential errors or abuse. However, as stated above, we have not yet performed tests to determine if agency field staff actually approved substandard loans. As a result, we have no conclusions on the overall extent of abuse that is, or may be, occurring in the program. Our concern is that agency field staff could fail to detect errors or collude with lender officials to approve guarantees for substandard loans.

We discussed this issue in detail with agency national office officials on April 29 and May 18, 2009. Agency officials generally agreed with our concerns and agreed to implement corrective action. One recommendation we made was that agency officials needed to implement a second party review of applications prior to issuance of the guarantee. In the agency's May 14, 2009, response to our first report on Recovery Act oversight activities (dated May 11, 2009), the agency stated it will implement a second party review of guaranteed loan applications. According to agency national office officials, a random sample of applications for loans that have not been closed will be selected for second party review on a bi-weekly basis.

We also recommended that the agency implement segregation of duties in offices where it was feasible based on staffing levels to ensure the accuracy of all applications versus just a sample. However, agency national office officials are confident that the second party review will adequately address our concerns with the procedures used by agency field staff when reviewing and approving applications for loan guarantees. Furthermore, they stated that the segregation of duties was impractical because of the limited staffing that is available and it would be difficult to implement when the field staff are so busy. In our opinion, segregation of duties is a preventive control activity common to all agencies as described by General Accountability Office (GAO). Furthermore, GAO emphasized no one individual should control all key aspects of a transaction or event[5]. Since we have not performed testing of guaranteed loans made under the Recovery Act, we cannot reference errors or mistakes attributable to non-segregation of duties. However, the risk remains and is more of a concern in the acknowledged, busy servicing environment.

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

cc: Director, Financial Management Division

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

United States Department of Agriculture
Rural Development

TO: Robert W. Young
Assistant Inspector General for Audit

ATTENTION: 04703-001-Ch

JUN - 1 2009

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

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

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

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

Memorandum 3

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

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

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

Memorandum 4

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

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

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