UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

Date: June 10, 2009

REPLY TO
ATTN OF: 04703-0001-Ch

TO: Dallas Tonsager
Under Secretary
Rural Development

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

SUBJECT: Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (5)

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 June 3, 2009, Rural Development had obligated over $4.3 billion to guarantee over 36,000 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 fifth one to report on our oversight activities related to rural housing guaranteed loans. This memorandum describes a condition where Rural Development could be exposed to greater losses because of overstated property values. 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 note 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 note guarantee process. We did not perform testing to verify lender compliance with agency policies and procedures.

Rural Development, through the Single-Family Housing Guaranteed Loan Program, can guarantee a loan up to 102 percent of the purchase price of a residential property. Since loans are financed at this level, the agency is likely providing guarantees on loans where borrowers owe more than their homes are worth. Moreover, this situation could be magnified if the value of property is overstated when it is purchased by borrowers. Under such conditions, the agency could incur losses if borrowers default before they have attained equity in the property.

To ensure that the purchase price of a property approximates its fair market value at the time of loan closing, the agency requires lenders to obtain an independent appraisal from a licensed or certified appraiser. The appraisals are to be performed in accordance with criteria established by the Appraiser Qualification Board of the Appraisal Foundation.[3]

It is imperative that appraisals accurately reflect the value of the underlying property. This is especially true in a declining market since it would reduce potential losses to the agency if borrowers defaulted on their loans. During our review at agency area offices, we noted that 29 of the 33 appraisals we examined indicated a stable housing market. This contradicts statistics reported by the National Association of Realtors, which show a declining housing market, of varying degrees, across the nation.[4] In our view, most of the appraisals should have factored declining market conditions into the assessment of property value. The reason for our conclusion is that even a 10 percent decline in home values could expose the agency to potential losses on loans that were financed at 100 percent or more of property value.

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

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

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

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

As stated above, we have not yet performed tests to determine if Rural Development is at risk for significant losses. As a result, we have no conclusions on the overall extent of potential losses that are, or may be, occurring in the program. Our concern is solely that Rural Development could incur losses if borrowers default on loans before they have gained sufficient equity in their property to offset overstated property values when loans were made.

We discussed this issue in detail with agency national office officials on April 29, 2009. At that time, we recommended that agency national officials conduct an analysis of the guaranteed loan portfolio that had been funded by the Recovery Act using internal appraisers to determine the extent, if any, of potential losses the agency may be exposed to because of overstated property values. The national officials generally agreed with our conclusion and agreed to determine the most appropriate form of action considering the circumstances. Agency national officials should also consider requiring appraisals to factor in current market conditions, such as the existence of any distressed sales.

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

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

June 17, 2009

TO: Robert W. Young
Assistant Inspector General for Audit

ATTN: 04703-0001-Ch

FROM: Dallas Tonsager ***(Signed by Dallas Tonsager)***
Under Secretary
Rural Development

THROUGH: Tammye H. Trevino ***(Signed by Tammye H. Trevino)***
Administrator
Housing and Community Facilities Programs

SUBJECT: Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (5)

We are in receipt of your letter on the subject. The Office of Inspector General (OIG) has been briefed on the existing controls and oversight for Single Family Housing Guaranteed loans (SFHG), including those pertaining to appraisals. Rural Development requires lenders use an appraiser that is properly licensed or certified, as appropriate, to make residential real estate appraisals in accordance with the criteria set forth by the Appraiser Qualification Board and Appraisal Standard Board of the Appraisal Foundation. The Appraisal Foundation is the parent organization of the two boards which promulgate and maintain the Uniform Standards of Professional Appraisal Practices (USPAP). To address the OIG concerns, we propose the following new actions:

1. **Adoption of Fannie Mae Form 1004MC / Freddie Mac Form 71, "Market Conditions Addendum to the Appraisal Report."** The Market Conditions Addendum (Form 1004MC) is designed to enhance the transparency of market trends and conditions reported made by the appraiser. The form provides the appraiser with a structured format for reporting market conditions that is easily identified. In addition, the form also requires the appraisers to analyze the effect that foreclosure sales (real estate owned sales) have on current market trends. The form which was

recently adopted by the Federal Housing Administration and Veteran Affairs can be found as follows: https://www.efanniemae.com/sf/formsdocs/forms/pdf/sellingtrans/1004mc.pdf. We note that market trends and conditions in rural areas vary significantly and that deducing overall market declines nationwide, largely influenced by metropolitan area sales activity, have impacted rural areas similarly may not be supportable.

2. **Technical Desk Review by Agency State Licensed/Certified Appraisers:** We have identified additional quality control measures that will be effective July 1, 2009. On a bi-weekly, basis we will conduct post conditional commitment reviews for a random sample of SFHG obligations. As part of the review, Rural Development plans to require a technical desk review of the appraisal. The technical desk review will be conducted by an Agency licensed/certified appraiser and must be completed in accordance USPAP.

When appraisals are ordered by lenders, or third party originators like mortgage brokers, it is important that the rules of USPAP are not violated. USPAP requires an analysis of the sales contract and the analysis must be reported in the "Contract" section of the Uniform Residential Appraisal Report. It is required in order to provide a thorough and credible analysis of the subject property value.

Rural Development generally requires that not less than three comparable sales, less than 12 months old be used, unless the appraiser provides documentation that such comparables are not available in the area. USPAP also contains principles for choosing comparable sales data which must be adhered to as part of the appraisal analysis. Considering the fact that Rural Development only provides assistance in rural areas where recent sales data may be limited, it is possible that comparables may be older than 12 months since sales activity may be slower, depending on the marketplace.

Use of foreclosure sale, or distressed sale, comparable data in a purchase transaction appraisal analysis may be appropriate in some markets, but only if those kinds of comparables represent the best comparable sales data; a determination made on a case-by-case basis by the appraiser.

We should note that the Federal Reserve Bank recently published a study titled "Is Rural America facing a Housing Bust?", in which they concluded that, "unlike metro areas, housing markets in rural areas of the country have suffered only a glancing blow from declining home values." Because of the fundamental difference between rural and metropolitan areas, the Federal Reserve concluded that "any future home price declines in rural America are likely to be much less severe than in the cities." (See the Federal Reserve Bank of Kansas, The Main Street Economist Regional and Rural Analysis, 2008).

We look forward to continue working with the OIG toward exercising due diligence in obligating funds under the American Recovery and Reinvestment Act of 2009, as well as other appropriations.

If you have questions regarding this memorandum, please contact the Guaranteed Loan Division at 202-720-1452.

Attachment