UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

MAY 11 2009

REPLY TO
ATTN OF: 04703-0001-Ch

TO: Cheryl L. Cook
Acting Under Secretary
Rural Development

FROM: Robert W. Young
Assistant Inspector General
for Audit

SUBJECT: Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (1)

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 April 28, 2009, Rural Development had obligated over $3.3 billion to guarantee almost 28,000 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 first in a series that will report on our oversight activities during the initial phase of this audit. Issues identified in these memoranda will be compiled into a final report at the conclusion of our audit. During this initial phase, we identified an internal control weakness related to the agency's Guaranteed Underwriting System (GUS).

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 authority of the Recovery Act. We visited four Rural Development area offices in two States

[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.

to examine borrower files and observe the loan note guarantee process. During this initial phase, we did not perform testing to verify lender compliance with agency policies and procedures.

In January 2007, Rural Development implemented GUS, an automated underwriting system, to streamline the process used by lenders to submit loan guarantee applications. Agency statistics indicate that loan guarantee applications processed through GUS have a lower default rate than applications processed manually by agency officials. However, those statistics were from a period when fewer lenders participated in the program. Since the agency has seen a significant increase in lender use of GUS in the past few months, default rates may rise in the future as more lenders use the system. According to agency national officials, approximately 40 percent of all applications for loan guarantees involving Recovery Act funds have been processed through GUS, compared to a historical average of 25 percent. A Rural Development official stated that GUS is the foundation of the agency's loan origination process, and the agency plans to increase its use in the future.

The internal control weakness we identified relates to the documentation requirements for lenders who submit loan guarantee applications through GUS. We found lenders do not submit documentation that supports the eligibility of borrowers for applications accepted by GUS. For example, while lenders are required to maintain supporting documents, they do not provide evidence such as employer earning statements that supports borrower income to agency officials. This type of evidence is provided when applications are manually processed by agency officials. Thus, lenders are able to enter inaccurate borrower information into GUS with minimal risk of detection by agency officials prior to approving a loan guarantee.

In our view, the risk that lenders could exploit this weakness is significant enough that agency officials should take action to mitigate the potential for abuse. However, as stated above, we have not yet performed tests to determine if lenders have taken advantage of the weakness. 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 simply that the weakness could be exploited by lenders using the system to submit substandard loans to Rural Development.

During our site visits, we were informed by agency field staff of instances where lenders had modified borrower information multiple times before submitting loan applications for approval through GUS. In our view, this was done by lenders, at least in some instances, in an effort to overcome GUS' eligibility controls that were designed to prevent the submission of substandard loan applications. We considered this activity to be suspicious, as did agency officials. GUS will provide lenders with a preliminary decision of potential acceptance or rejection ("refer") during this process. Lenders are required to submit documentation to agency officials for all final submissions with a refer designation. Our concern is that lenders will adjust borrower eligibility information in an attempt to gain improper acceptance from GUS and to avoid having to submit supporting documentation.

We discussed our conclusions regarding this weakness in detail with agency national officials on April 28, 2009. They generally agreed with our conclusions and agreed to implement our corrective actions. During the meeting, we recommended several measures that would mitigate this internal control weakness. The recommendations included:

(1) Perform additional compliance reviews of lender files to verify the existence and accuracy of information submitted via GUS;

(2) Require lenders to provide supporting documentation for a random sample of loans submitted via GUS, prior to loan guarantee approval; and

(3) Limit the number of preliminary modifications on each individual borrower application submitted through GUS that resulted in “refer” outcomes.

Please provide a written response within 5 days outlining your proposed corrective action for this issue. 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.

USDA Rural Development

United States Department of Agriculture
Rural Development

MAY 14 2009

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Acting Under Secretary
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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 loans originated through the Guaranteed Underwriting System (GUS). In addressing the OIG concerns, we propose the following new actions:

1. **Effective May 18, 2009, we will suspend the use of American Recovery and Reinvestment Act (ARRA) loan funds for new conditional commitment requests, so we can revise GUS quality control processes currently in place.** We are erring on the side of caution with this action, as we have no indication that the ARRA loan funds or that GUS are being used improperly. Our goal is to adopt recommendations from OIG and do our utmost to ensure the ARRA funds are being expended in a manner that minimizes the risk of improper use.

2. **We are developing additional quality control standards.** We are incorporating a pre-loan closing review of 5 percent of GUS submissions for each GUS approved lender. Field office staff will perform this work with guidance from the National Office. GUS will be modified to flag 5 percent of all loans for review. In addition, GUS loans that receive an "Accept," and have a total debt ratio higher than 50 percent, will require lenders to submit all supporting documentation for Agency review. Also, lenders who submit same-loan requests through GUS, ten or more times, will be required to submit all

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supporting documentation to the Agency. We expect the GUS modifications to be effective within 4 to 8 weeks. Until then, the use of ARRA funds will be suspended as described above.

3. **We have drafted, and will issue, additional quality control procedures to supplement current internal control processes for all manually underwritten conditional commitment approvals, including loans processed through GUS system.** A second level review of a random sample of conditional commitment approvals will be performed by a designated Agency employee. The review will have increased emphasis on a number of risk factors including the approval of ratio waivers exceeding certain thresholds.

4. **We will increase compliance testing conducted after loan closing with a focus on GUS loan origination quality.** Reviews will concentrate on the participating lenders that originate a high volume of GUS loans or that may have certain GUS loan performance metrics. This work will be delivered, via an ARRA procurement/contract, and will compliment a host of ongoing compliance work conducted by the National Office and field office staff.

5. **We plan to use regularly appropriated funding and disaster funding (where appropriate) in place of ARRA funds, so that the situation should be seamless to the public and to lenders.** We plan to resume using ARRA funds when the new GUS standards described above are operational. Our estimate is that we will need 4 to 12 weeks to institute the new processes, with the proposed procurement/contract process taking the longest. Please note that the procurement action may not be fully in place by the time we resume using ARRA funds; this is due to the intensive effort and associated time it will take to complete the procurement action.

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

We look forward to continue working with the OIG toward exercising the greatest 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 Joaquin Tremols at (202) 720-1465, or joaquin.tremols@wdc.usda.gov.