U.S. Department of Agriculture
Office of Inspector General
Washington, D.C. 20250

DATE: May 28, 2010

REPLY TO
ATTN OF: 04703-2-KC (1)

TO: Dallas Tonsager
Under Secretary
Rural Development

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

SUBJECT: Single-Family Housing Direct Loans Recovery Act Controls – Phase II

The American Recovery and Reinvestment Act of 2009 (Recovery Act) included $1 billion for the Rural Housing Service (RHS) to provide single-family housing direct loans to borrowers.[1] Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of funds. The Office of Management and Budget subsequently 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.[2]

RHS, an agency within the Rural Development mission area, is responsible for distributing Recovery Act funds through the Section 502 Single-Family Housing (SFH) Direct Loan Program.[3] These loans are available for very-low and low income households that cannot qualify for other credit to obtain homeownership. Applicants may obtain 100 percent financing to purchase an existing dwelling, purchase a site and construct a dwelling, or purchase newly constructed dwellings located in rural areas. As of May 18, 2010, RHS had obligated approximately $883 million in direct loans to about 7,000 very-low and low income borrowers.

Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure agencies expend funds in a manner that minimizes the risk of improper use. During this phase, we determined that Rural Development SFH Direct Loan Program controls could be improved to detect, reduce, and prevent improper payments. This Fast report is the first in a series that will report on our oversight activities regarding SFH direct loans. Issues identified in these Fast reports will be compiled into a final report at the conclusion of our audit.

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[1] The American Recovery and Reinvestment Act, Public Law 111-5, was signed into law on February 17, 2009. The program level increased to about $1.56 billion due to changes in subsidy rates for fiscal year 2010.
[2] *Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, February 18, 2009, and *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, April 3, 2009.
[3] SFH Direct Loans are authorized by Title V of the Housing Act of 1949 under Section 502. 7 Code of Federal Regulations Part 3550 provides the policies for the SFH Direct Loan Program.

The objective of our audit is to test the effectiveness of the key controls over the Recovery Act funded Section 502 SFH Direct Loan Program. To accomplish our objective, we examined the results of Rural Development's Improper Payments Information Act of 2002 (IPIA) Risk Assessment review conducted in October 2009. This review serves as one of Rural Development's primary controls to detect, reduce, and prevent improper payments made by field office staff and to assess the effectiveness of internal management policies and compliance with operating procedures. As part of our examination, we reviewed a statistically selected sample of the Recovery Act loan files that Rural Development evaluated as part of the IPIA Risk Assessment. In addition, we interviewed Rural Development National Office officials to discuss Rural Development's controls for detecting, reducing, and preventing improper payments.

During our examination of the IPIA Risk Assessment and the corresponding loan files, we found that Rural Development had difficulties in properly determining whether improper loan making and/or disbursements had occurred by evaluating loan file documentation. Rural Development found that 9 of the 75 (12 percent) Recovery Act borrowers reviewed as part of their IPIA Risk Assessment received improper payments, and incomplete documentation was cited as a problem in 7 of the 9 cases. However, we also found 2 additional improper loan payments in the 16 files we reviewed that Rural Development's review had not identified and disagreed with Rural Development's conclusion that 2 other loans were improper payments.[4] We attributed this primarily to the difficulty in evaluating these loan files. Specifically, Rural Development field personnel were not consistently documenting their final computations supporting borrowers' eligibility with current, updated information. Rural Development officials agreed with this attribution.

We also found that Rural Development Loan Approval Officials were not required to document the scope and timing of their second party reviews in the loan files. Second party reviews should have caught these improper eligibility determinations and prevented the loans from closing until the Loan Originator worked with the applicant to rectify the problems. As a result, we concluded that controls need to be strengthened to improve documentation supporting eligibility determinations and secondary reviews before loan approval in order to detect, reduce, and prevent improper loan payments to SFH direct loan applicants.

Borrower Eligibility Information Not Updated Prior to Loan Closing

Both the Office of Inspector General (OIG) and Rural Development found that loan underwriting decisions were not based upon updated documentation in the loan file. This included documentation supporting the borrower's income and debt or the property's tax and insurance amounts at the time of loan closing. These are the key items Rural Development field personnel use for determining if an applicant has adequate repayment ability.

According to Rural Development's Field Office Handbook for processing SFH direct loans, the primary consideration in determining whether an applicant can afford to purchase a home

[4] After finding these 4 discrepancies in the first 16 of the 34 sampled IPIA Risk Assessment loan files, we terminated our review of the IPIA Risk Assessment loan files and concluded that we could not rely on the error rate determined by Rural Development for our Phase II sample loan file reviews.

is the applicant's repayment income.[5] The Agency bases underwriting decisions on an analysis of the percentage of income the applicant would be required to spend on housing costs and the applicant's total debt if the loan is approved. The principal, interest, taxes, and insurance (PITI) ratio compares the amount the applicant must spend on these housing costs to the applicant's repayment income.[6] The total debt (TD) ratio compares applicant debt to repayment income.[7] Borrowers must meet the Agency's standards for both ratios, and these ratios are calculated on the Eligibility Summary document.

OIG and Rural Development found that the loan files did not always contain a final Eligibility Summary and/or the corresponding Payment Assistance Method Calculation Spreadsheet with the correct income, debt, taxes, and/or insurance at loan closing.[8] The loan files contained those documents when the loan was approved/obligated, but those documents were not updated before loan closing. According to Rural Development's Field Office Handbook, the applicant's circumstances may have changed since loan approval/obligation and must be reviewed as part of closing preparations. After all reverifications have been completed, the Loan Originator will print out and sign a new Eligibility Summary and place it in the applicant case file.

Rural Development requires a checklist to be included in the loan file as a processing aid for field staff.[9] However, that checklist has been ineffective in ensuring that key information is updated, recalculated, and reviewed prior to loan closing. The checklist does not have a place for the Loan Originator to document that this information has been updated and reviewed at closing or for the Loan Approval Official to verify it has been done by the Loan Originator. We believe Rural Development should enhance the current checklist to include re-computing eligibility at/or near closing based on the current information available.

Scope and Timing of Second Party Reviews Not Documented

In our review of the loan files, we noted that the files did not always contain documentation of the scope and timing of second party reviews during the approval process. According to HB-1-3550, the Loan Approval Official should review all of the documents contained in the case file to ensure that they are completed properly and confirm that the Loan Originator's underwriting decision is sound. However, Rural Development's Field Office Handbook does not specify how the Loan Approval Official should document the scope and timing of that

[5] Rural Development Handbook HB-1-3550, Direct Single Family Housing Loans and Grants, Field Office Handbook, dated January 23, 2003, and associated Special Procedural Notices.
[6] Very low income applicants are considered to have repayment ability if they do not have to pay more than 29 percent of repayment income for PITI expenses. Applicants with incomes above the very low-income limit are considered to have repayment ability if they do not have to pay more than 33 percent of repayment income for PITI expenses.
[7] Applicants, regardless of income, are considered to have repayment ability when they do not have to spend more than 41 percent of repayment income on total debt.
[8] The Payment Assistance Method Calculation Spreadsheet is used to determine if a borrower is eligible for payment assistance. Payment assistance is an available subsidy that could reduce the monthly installment on the note to an amount equal to what it would be if the note were amortized to as low as one percent, depending on the loan amount and the size and income of the family.
[9] Rural Development Handbook HB-1-3550, Attachment 3-G, 502 Single Family Housing Checklist.

review and confirmation in the loan file.[10] Several States have developed forms and certifications for the review; however, there is no national procedure.

We believe the second party loan file review and approval process needs to be consistently documented in the loan file (1) as verification that the file contained all the current, updated information to justify the final eligibility computations and initial approval, and (2) as evidence the Loan Approval Official reviewed and verified that information when approving the loan. We believe Rural Development should develop and implement an approval checklist that includes space to re-compute eligibility, identify who updated key documents and when, along with space to identify who reviewed those documents and when.

In conclusion, we believe that strengthening these controls will help Rural Development detect, reduce, and prevent improper payments. We discussed these issues with Rural Development National Office officials on January 27 and February 3, 2010. They agreed with these issues and confirmed that there is no established procedure as to how Loan Approval Officials should document the scope and timing of their second party reviews. They mentioned that they were in the process of developing an underwriting compliance tool to improve documentation and gain consistency in the underwriting process. According to Rural Development National Office officials, this tool will guide Loan Approval Officials to ask the right questions while reviewing a loan and to make sure all documents are in the file and are updated and signed before closing.

We recommend that the Rural Development National Office:

Strengthen controls to ensure borrower eligibility is updated and re-verified as part of closing based on the current information available, as required by Field Office Handbook procedures. This could be accomplished by enhancing the loan file checklist to document who updated and reverified the information and when.

Revise procedures to require Loan Approval Officials to document the scope and timing of their second party review of eligibility determinations. This could include a standard calculation form or checklist in the loan file with space to re-compute eligibility, identify who updated key documents and when, and identify who reviewed those documents and when.

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, Director, Rural Development and Natural Resources Division, at (202) 690-4483.

[10] Form RD 3550-25, Loan Closing Instructions and Loan Closing Statement, does have a place to indicate which Rural Development official verified the borrower's income and credit, but it does not indicate which documents that official reviewed and when to verify the income and credit.

USDA’S

RURAL HOUSING SERVICE

RESPONSE TO AUDIT REPORT

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

July 8, 2010

TO: Gil H. Harden
Assistant Inspector General for Audit

FROM: Dallas Tonsager /s/
Under Secretary
Rural Development

SUBJECT: Single Family Housing Direct Loans Recovery Act Controls – Phase II
04703-2-KC (1)

This replaces our June 7, 2010 response to your memorandum dated May 28, 2010, in which you requested a response to your recommendations contained in the subject report. The recommendations resulted from your audit of the controls associated with the Section 502 Single Family Housing (SFH) Direct Loan Program.

In this review, OIG looked at a statistically selected sample of the Recovery Act loan files that the Agency evaluated as part of the Improper Payment Information Act of 2002 (IPIA) risk assessment. OIG noted weaknesses regarding the loan review and approval process, specifically a lack of consistent documentation in the loan file that all information is current and that the Loan Approval official reviewed and verified the information when approving the loan.

As indicated in our discussions with the OIG auditors, the Single Family Housing Direct Loan Division is working on an underwriting compliance tool to improve documentation and gain consistency in the underwriting process. The tool will guide Loan Approval Officials to ask the right questions while reviewing a loan and assure that documents in the file are appropriately authenticated and current. Implementation of this tool will address the concerns raised in the subject report.

While we generally agree with the findings and conclusions, we do not agree with footnote 4 and the accompanying statement. In particular, we are concerned with the characterization that OIG "could not rely on the error rate determined by Rural Development for our Phase II sample loan file reviews." For example, of the two cases where OIG disagreed with the Agency's conclusion, one was based on the reviewer's finding of a relatively minor miscalculation resulting in a small discrepancy in the amount of assistance for which the borrower qualified.

We instructed our reviewers to review for <u>any</u> possible improper payment. However, in the final IPIA report, we identified this case and stated that it was not included in the improper payment amount because it was below the threshold. The other case was determined to be an improper payment by our reviewer because there were contract repairs over $2000 involved and Davis Bacon wages were not considered. The contract in question was funded from another source. The OIG auditors questioned our conclusion since there were no ARRA funds involved in the repair contract. RD AN No. 4449 (1940-C), "Application of Davis-Bacon Wage Rate Requirements to Projects Funded with American Recovery and Reinvestment Act Funds" dated June 15, 2009, contains the following:

> **Application of Davis-Bacon to Entire Projects:** Note that the DOL requires that if a project is funded in whole or in part using ARRA funds, Davis-Bacon requirements apply to the entire project, including contracts funded using non-ARRA funds. For example, if a public body received funds for a project for owner-construction/force account work using all employee labor, but executed a contract with a plumber using non-ARRA funds not usually subject to Davis-Bacon requirements, the contract with the plumber would be subject to Davis-Bacon requirements because the work was part of an ARRA funded project.

We believe it is not appropriate to consider these two cases as discrepancies.

If you have any questions regarding this memorandum, please contact the Single Family Housing Direct Loan Division at 202.720.1474.