United States Department of Agriculture
Office of Inspector General
Washington, D.C. 20250

DATE: August 19, 2011

AUDIT NUMBER: 04703-3-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 – Compliance Review of Borrowers' Eligibility Determinations

The American Recovery and Reinvestment Act of 2009 (Recovery Act) provided the Department of Agriculture (USDA) with $28 billion in funding.[1] Of this amount, $1 billion was allotted to fund Single-Family Housing (SFH) Direct Loans to borrowers.[2] The Rural Housing Service (RHS), an agency within the Rural Development mission area, was responsible for distributing Recovery Act funds through the Section 502 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 a home, or purchase a site and construct a home, in rural areas.

Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of 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.[4] OMB issued additional guidance on April 3, 2009, to clarify existing requirements and establish additional steps that must be taken to

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[1] Public Law 111-5, February 17, 2009.
[2] The program level increased to approximately $1.56 billion, due to changes in the subsidy rate for fiscal year 2010.
[3] SFH Direct Loans are authorized by Title V of the Housing Act of 1949, Section 502. Program policies are provided in 7 Code of Federal Regulations, Part 3550.
[4] Office of Management and Budget Memorandum M-09-10.

facilitate the accountability and transparency objectives of the Recovery Act. Moreover, OMB emphasized that, due to the unique implementation risks of the Recovery Act, agencies must take steps, beyond standard practice, to initiate the additional oversight mechanisms.[5] USDA's Office of Inspector General (OIG) was charged with the responsibility of overseeing RHS' and other agencies' activities in order to ensure Recovery Act funds are spent in a manner that minimizes the risk of improper use.

The objective of this compliance review phase is to determine if Rural Development field staff complied with the agency's established internal control procedures at loan origination and closing to ensure homes and program participants who received Recovery Act funds met eligibility guidelines. In our review, we statistically selected 100 loans from a universe of about 8,100 Recovery Act loans, totaling over $1 billion, that had closed as of June 30, 2010.[6] We reviewed loan file documents to determine if field personnel followed policies and procedures and made proper eligibility determinations regarding borrowers and the homes they purchased. We identified 18 out of the 100 loans we reviewed where we questioned borrower eligibility determinations because field personnel had not fully complied with one or more of Rural Development's established internal control procedures. We believe these loans have a higher risk of future servicing actions and of potential Government losses due to borrower default. As of May 2011, 3 of the 18 questioned loans were already under a servicing action (moratorium or delinquency workout agreement) and a fourth borrower had declared bankruptcy.[7]

We found these approved borrowers (1) had no history of stable and dependable income, (2) had a credit history that did not indicate the ability and willingness to repay a loan, and (3) did not meet repayment ability guidelines. Based on our overall sample results, we estimate that 1,450 loans (18 percent of the universe), with a projected total value of $173 million, may have similar issues that would have resulted in ineligible borrowers or those with higher risk of default receiving loans.[8]

Rural Development field-level personnel determined these borrowers as eligible because they were not sufficiently trained on how to conduct and document proper determinations, and did not have an effective second party review process in place to catch errors. Further, the handbook for the SFH Direct Loan program, HB-1-3550, is over 700 pages long. Given the length and complexity of the handbook, we believe field personnel cannot maintain familiarity with all of its content, and require additional training to effectively and accurately implement its policies and procedures.

Our work was conducted as part of an ongoing audit that is being performed in accordance with generally accepted government auditing standards. We have issued this interim report to

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[5] Office of Management and Budget Memorandum M-09-15.

[6] We chose a sample size of 100 because we estimated a moderate error rate and wanted the ability to report findings for attributes with a +/- 8 percent precision (confidence interval) at a 95 percent confidence level.

[7] A moratorium is a period of up to 2 years during which scheduled payments for principle, interest and deposits to the escrow account are not required, but are subject to repayment at a later date. A delinquency workout agreement is an agreement establishing a new repayment plan for a borrower who has delinquent agency debt.

[8] We are 95 percent confident that between 837 (about 10 percent) and 2,063 (about 26 percent) loans would be ineligible for these borrower-related issues. Those loans are valued between $95 million and $251 million.

proactively disclose some key findings. This report focuses on borrower eligibility issues related to risk, and does not address other control issues we may identify during the course of the entire audit. Because the conclusions in this report are based on our preliminary analysis, these findings could vary from the results presented in our final report.

We discussed our findings on the 18 loans with Rural Development national office officials on May 18, 2011, and through followup communications during June 2011. The agency officials agreed that the instances we found did not appear to be in accordance with Rural Development regulations or HB-1-3550 requirements.[9] The following three sections detail the cases where we questioned the eligibility determinations that increased risk to the program:

Borrowers Did Not Have a History of Stable and Dependable Income

We identified 8 of 100 loans in our sample, totaling about $922,000, where we questioned the borrowers' eligibility because they did not have a history of earning stable income.[10] Of the eight, five did not have stable wage-based employment income and three did not have stable self-employment income. In all of these cases, borrowers were incorrectly approved for loans because field-level personnel had inconsistently interpreted how proper eligibility determinations should be conducted for the SFH Direct Loan program, and, consequently, developed their own methods for conducting their determinations.

Rural Development's previous experience has shown that applicants with stable jobs are more likely to repay the loan.[11] According to the program handbook, an applicant must show a history of receiving stable income, and a reasonable expectation that the income will continue. This is demonstrated by a 2-year history of stable income. If an applicant's income source (such as wages, salary, overtime, tips, etc.) is unstable and undependable, the income must be excluded from the repayment income.[12] Additionally, self-employed borrowers must submit signed copies of their last two complete Federal Income Tax Returns, along with the appropriate schedules, as well as an additional form that verifies their current income and expenses.[13]

Regarding wage histories, in one case, we identified that the loan file included documentation that showed the borrower had worked at her current job for only 5 months, as of March 2009, and the employer indicated on a form that the borrower's probability of continued employment was "good."[14] The tax return in the file showed the borrower made about $4,300 in 2008, and there was no information on how much the borrower made in 2007. At the same time, the borrower's Form W-2, *Wage and Tax*

[9] As requested during our May 18, 2011, meeting, we provided these officials with additional details for them to determine if the cases appeared to comply with agency requirements.
[10] In one of these loans, we questioned the eligibility in both the stable income and the ratio categories. Therefore, it is addressed twice in the findings of this report (totaling 19, versus 18 questionable loans). However, we only counted it once in our total projections.
[11] HB-1-3550, Attachment 3-D, page 2.
[12] HB-1-3550, page 4-5.
[13] HB-1-3550, Attachment 4-C, page 1.
[14] Form RD 1910-5, Request for Verification of Employment.

Statement, for 2005 and 2006 showed that the borrower made less than $1,000 for both of those years. Based on this information, Rural Development improperly determined this borrower to have stable and dependable income and approved the loan in April 2009. A Rural Development State Internal Review later found that the borrower subsequently lost her job and has been unable to make her mortgage payments. The borrower subsequently has declared bankruptcy.

We discussed this case with the field personnel who made the loan. A loan officer said that the eligibility determination relied primarily on the employer's indication that the borrower had a "good" probability of continued employment as sufficient evidence of stable income. Rural Development's national office officials agreed that it appears this borrower did not have stable and dependable income, as the applicant had only held her current job for 5 months and had a sporadic work history prior to that.

We identified three other cases where borrowers had similar short-term employment histories (four to nine months). When we questioned field office personnel on how to prevent occurrences similar to the above four cases in the future, loan officers commented that the national office needs to provide training on scenarios such as these to help them determine whether a borrower's income is stable and dependable. In the fifth wage income case, we found an approved loan for a borrower who was receiving unemployment compensation. The responsible loan officer believed that, in most cases, unemployment compensation is more stable and dependable than job wages. However, national office officials agreed that the determination should have been questioned because unemployment benefits expire after a certain period of time.

Regarding self employment income, we found one loan file that showed the borrower's income declined 30 percent from 2007 to 2008. The file also contains a note stating that the borrower had to sell his previous house in 2008, due to declining business income. Further, although the borrower should have been required to submit updated income information before the loan closed in March 2010, we found no information on the borrower's 2009 business income and expenses in the loan file. As of May 2011, this loan is currently being serviced under a moratorium.

Field personnel who made the loan said they did not require updated documentation because they rely on the last 2 years of tax returns to determine eligibility. However, national office officials stated that the field office should have asked for more documentation to determine if the declining income was a general trend, and agreed that the determination was questionable.

In the other two self-employment cases, we found only 1 year of tax returns supporting the borrowers' self-employment income levels. In both cases, field office personnel gave the borrowers an unauthorized exception to the handbook's 2-year tax return requirement. When we discussed these cases with Rural Development field personnel in the offices that made these loans, one loan officer said they only require 1 year of tax returns if the borrower has good overall credit. The other loan officer said that they rely on 1 year of tax returns if the borrower has been self-employed for only 1 year. Rural Development national office officials agreed that Rural Development's procedures require 2 years of tax returns for self-employed individuals and agreed that these borrowers did not appear to have stable and dependable income. Field office personnel again attributed these errors to lack of specific training on these types of scenarios.

Borrowers Did Not Demonstrate a Reliable Credit History

We identified 4 of 100 loans in our sample, totaling about $535,000, where we questioned the borrowers' eligibility because they did not demonstrate a history of reliable credit. Two borrowers had an overall history of adverse credit and two borrowers were listed as having delinquent Federal debts in the Credit Alert Interactive Voice Response System (CAIVRS).[15] This occurred because the loan approving officials did not ensure loan originating officials adequately supported their decision to accept the borrowers' credit histories. Loan approval officials should review all of the documents in a loan file to ensure that they are complete and that the loan originator's decision is sound.[16] These are known as second party reviews. However, the handbook currently provides no further guidance on how to document the scope and timing of their second party reviews in the loan files.

Applicants must demonstrate a credit history that "indicates ability and willingness to repay a loan."[17] Rural Development requires that any applicant with a credit score below 640 to be subject to further credit analysis, unlike applicants with a credit score of 640 or higher.[18] The credit analysis brings other information, such as past late payments or collection notices, into the eligibility determination. Loan officers should also check to see whether an applicant is listed in CAIVRS as having delinquent Federal debt. Except in very unusual circumstances, an applicant who is delinquent on a Federal debt is not eligible for a SFH Direct Loan. If the applicant does not notify the agency within 30 days that the CAIVRS problem has been resolved, the application must be rejected.[19]

For two loans in our review, the borrowers' overall credit history did not demonstrate the ability and willingness to repay the loan, and field office personnel did not provide adequate documentation to support their decision to waive the adverse credit. For example, in one case, the borrower had a credit score of 567, was 30 days late on four rent payments in the prior 24 months, and had a history of other problems, such as collections and past due accounts. We also identified two loans where the borrowers were listed in CAIVRS. The loan files had no documentation to show that the delinquent debt problems in CAIVRS were resolved. In both cases, the loan approving officials did not adequately question the CAIVRS reports in the loan files.

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[15] CAIVRS is a Federal government database of delinquent Federal debtors that allows agencies to reduce risk to Federal loan and loan guarantee programs. CAIVRS alerts participating Federal lending agencies when a credit applicant has a Federal lien, judgment, or a Federal loan that is currently in default or foreclosure, or has had a claim paid by a reporting agency.

[16] HB-1-3550, page 8-1.

[17] HB-1-3550, page 4-1

[18] HB-1-3550, pages 4-48 and 4-49.

[19] HB-1-3550, page 4-46.

Field office personnel essentially told us loan approving officials did not require additional documentation to support their decisions to approve these borrowers. Loan approving officials did not adequately review and were not required to document the scope and timing of their secondary review of each borrower's credit history. Rural Development national office officials agreed that the credit history of these borrowers was questionable and affirmed that applicants with unresolved CAIVRS issues are ineligible for a loan.

Borrowers' Repayment Ability Ratios Did Not Meet Guidelines

We questioned the borrowers' eligibility in 7 of 100 loans in our sample, totaling about $779,000, because their repayment ratios exceeded Rural Development's established limits.[20] As of May 2011, two of the seven loans are being serviced under a delinquency workout agreement. These seven borrowers exceeded the repayment ratio limits because Rural Development personnel either miscalculated the borrowers' repayment income or monthly total debt, or did not update the borrowers' information and re-verify their eligibility as part of loan closing preparations. This occurred because of inadequate second party reviews and lack of training in calculating repayment ratios.

The primary consideration in determining whether an applicant can afford to purchase a home is the applicant's repayment income. Repayment ratios are based on an analysis of how much of the applicant's income would go towards housing costs and an analysis of the applicant's total debt if the loan is approved. The principal, interest, taxes, and insurance (PITI) ratio compares housing costs to the applicant's repayment income. The total debt ratio compares the applicant's total monthly liabilities (non-housing and housing) to repayment income. Borrowers must meet the agency's standards for both ratios—no more than 41 percent total debt ratio for all applicants, and a PITI ratio of no more than 33 percent for low income and 29 percent for very low income applicants.[21]

We identified four loans where miscalculations of the borrowers' monthly total debt would have resulted in total debt ratios exceeding the 41 percent limit. For example, Rural Development field personnel did not include homeowner's association (HOA) fees as part of the borrowers' total debt. The handbook states that total debt includes regular assessments, such as HOA fees.[22] These miscalculations occurred because of oversights on the part of the loan originating officials and second-party reviewers. Both Rural Development field and national office officials agreed that HOA dues should be included in total debt ratios.

In another two instances, the field personnel miscalculated repayment income, which would have resulted in the repayment ratios exceeding prescribed limits. For example,

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[20] In one of these loans, we questioned the eligibility in both calculations and re-verifications. Therefore, it is addressed twice in this finding of this report (totaling 8, versus 7, cases). However, we only counted it once in the overall results of this section.
[21] HB-1-3550, pages 4-57 and 4-58.
[22] HB-1-3550, page 4-58.

> Rural Development field personnel did not properly subtract business-related debts when computing repayment income for a self-employed borrower.[23] This occurred because field personnel improperly assumed that business debts were already subtracted from the net income figure obtained from the borrower's tax returns. We attributed this to a lack of training in calculating income. We asked field office personnel about the last time they received training on calculating income, and they said it had been up to 6 years since they last received formal training on that topic. Rural Development national office officials agreed that business debts need to be subtracted when calculating repayment income for a self-employed borrower and that training in this area could be beneficial.
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> Since an applicant's circumstances may change between the time the loan is approved and the time of closing, any new information must be reviewed as part of the closing preparation. After all re-verifications have been completed, the loan officers must create a new eligibility summary for the applicant, reflecting any changes of circumstances.[24] We identified two instances where Rural Development personnel did not update and re-verify the borrowers' eligibility at loan closing, which affected eligibility determinations. In both instances, the loan officers conducting the re-verifications continued to use estimated property taxes in their calculations, which did not reflect the actual property taxes that were obtained during closing preparations. If the officers had used the actual property taxes, as was required, the borrowers' ratios would have exceeded the prescribed ratio limits. Field personnel attributed this to oversights on the part of the loan originating officials and the second party reviewers, who did not catch the errors.

In our preceding audit, dealing with National and State level controls, we reported issues similar to those described above. While examining results of State-level reviews, we identified recurring control weaknesses, such as borrowers' incomes not being verified, calculated, or documented properly and adverse credit waivers not being properly justified or documented. We also reported that information was not updated and eligibility was not re-verified at closing, and the scope and timing of second party reviews were not adequately documented.[25]

In response to our prior audit report, Rural Development stated that it is working to implement effective controls to eliminate recurring weaknesses in the SFH Direct Loan Program, and to provide necessary training. Rural Development also said that it would develop an underwriting compliance tool for second party reviews by December 31, 2010. This tool would guide loan approving officials through a series of questions to assist them in evaluating credit risk factors, assessing the applicant's eligibility, and documenting their actions. Finally, Rural Development planned to revise its loan file document checklist, in order to improve the re-verification process and ensure that updated information is assessed before loan closing is completed. The agency said it would complete this revision by September 30, 2010.

On May 18, 2011, we met with Rural Development national office officials and received updates on these initiatives. They stated that a nationwide training for field personnel is scheduled for

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[23] HB-1-3550, Attachment 4-C, pages 1-2.
[24] HB-1-3550, page 8-11.
[25] Fast Reports 04703-2-KC (1) and 04703-2-KC (2), May 28, 2010, and Audit Report 04703-2-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Phase II*, September 24, 2010.

August 2011. Regarding the checklist, officials said that they are still in the process of developing and implementing the new procedures. They are also still in the process of developing the underwriting compliance tool, and said that they would seek to address some of the scenarios and specific deficiencies we identified in this audit (for instance, neglecting to add HOA fees in debt calculations) in the new tool. Rural Development national office officials said the delay in revising the checklist and issuing the underwriting compliance tool is due to the proposed extensive and complex revisions to the handbook. Rural Development officials are revising the draft underwriting compliance tool based on those revisions to the handbook, and they anticipate having the tool in clearance by September 30, 2011.

In conclusion, we are pleased to see that Rural Development is developing new tools and training for the program. While the August training is a positive first step, Rural Development should provide field personnel with continuing training that specifically addresses scenarios that they encounter in their daily work, and that targets the specific types of problems we found in eligibility determinations. Also, the agency should take a wider look at all of its program administration tools—including the program handbook—to determine whether its guidance can be clarified, and its processes can be strengthened. This would aid field personnel in carrying out accurate and thorough eligibility determinations, which would help protect the program from ineligible borrowers, with potentially higher risk of default, from receiving direct housing loans.

We recommend that the agency officials:

1. Provide continuing and targeted training to field personnel in the areas of: calculating income, determining stable and dependable income, calculating repayment ratios (including steps to take when updating information as part of closing preparations), and determining if the borrower's credit history indicates the ability and willingness to repay a loan. The training should also address how to properly document each of these steps, and should present specific scenarios relevant to the daily work of a loan officer.

2. Review the program handbook sections that address the issues described in this report, and determine if those sections should be revised to provide further clarity to field personnel carrying out the policies and procedures.

3. Ensure that the cited new document checklist and underwriting compliance tool specifically address the issues described in this report (e.g., information is updated and eligibility is re-verified at closing and the scope and timing of second party reviews are adequately documented).

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 Joseph Mickiewicz, Director, Rural Development and Natural Resources Division, at (202) 720-5907.

USDA'S

RURAL DEVELOPMENT

RESPONSE TO AUDIT REPORT

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

August 31, 2011

TO: Gil H. Harden
Assistant Inspector General for Audit

FROM: Dallas Tonsager /S/ Dallas Tonsager
Under Secretary
Rural Development

SUBJECT: Single Family Housing Direct Loans Recovery Act Controls – Compliance Review of Borrowers' Eligibility Determinations- 04703-3-KC (1)

We are in receipt of your memorandum dated August 19, 2011, in which you requested a response to your recommendations contained in the subject report. The objective of this audit was to determine if Rural Development field staff complied with the agency's established internal control procedures at loan origination and closing to ensure homes and program participants who received American Recovery and Reinvestment Act funds met eligibility guidelines. As noted on the preliminary report, the Office of the Inspector General (OIG) has been briefed on current initiatives to improve eligibility determinations and ensure compliance with Section 502 Single Family Housing (SFH) Direct Loan guidelines.

In response to your initial findings that field office personnel need additional training on how to conduct and document accurate eligibility determinations, we agree that enhancing performance tools and providing targeted training will be beneficial for the program. The National Office has already made extensive revisions to the HB-1-3550, Direct Single Family Housing Field Office Handbook, to address most of the issues noted in OIG's report. These revisions strengthen guidance on borrower-related underwriting factors, particularly in areas dealing with income, capacity and credit determinations. Attachment 3-G, 502 SFH Checklist, has also been revised to instruct field staff to re-verify an applicant's eligibility using updated documentation. The revised 502 SFH Checklist requires the Loan Approval Official to record the date of closing and the date of the credit documents in the loan file to ensure that these documents are not more than 120 days old by the closing date. We introduced these Handbook changes during the SFH

National Policy Meeting in August and we expect the procedure notice for these changes to be published no later than September 30, 2011. The National Office will also consider cost-effective training options that are suitable for the subject and accessible to the target audience.

As it relates to ensuring an effective second party review process to validate eligibility determinations, obtain re-verifications before loan closing and document the scope of the Loan Approval Official review, we are developing an underwriting and compliance tool that will assist field office personnel in documenting lending decisions. This performance tool will guide the loan reviewer through a series of questions that should be considered during the underwriting analysis and compliance review. We also anticipate having this tool available by September 30, 2011.

OIG's findings are valuable and assist in identifying and addressing operational weaknesses within the Section 502 Direct Program. However, the National Office would like to conduct a full review of the 18 loans in question to validate the findings noted in the interim report. Since program guidelines provide some flexibility in making eligibility and credit determinations, we believe that a review of these files by staff from the SFH Direct Loan Division in the National Office is necessary and appropriate. The review results will be used to increase understanding of the issues identified and to create specific loan scenarios for training purposes. We kindly ask that you provide us with the account numbers for the 18 loans in question.

We look forward to continuing to work with OIG to improve the delivery and management of the Section 502 SFH Direct Loan program.

If you have any questions regarding this memorandum, please contact Michael Feinberg of the Single Family Housing Direct Loan Division at (202) 720-1474.