U.S. Department of Agriculture

Office of Inspector General

Single-Family Housing Direct Loans Recovery Act Controls – Phase I

Audit Report 04703-1-KC
November 2009

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

DATE: November 5, 2009

REPLY TO
ATTN OF: 04703-1-KC

TO: Dallas Tonsager
Under Secretary
Rural Development

Tammye Trevino
Administrator
Rural Housing Service

THROUGH: John Purcell
Director
Financial Management Division

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

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

This report presents the results of our audit of the internal controls over the Section 502 Single-Family Housing Direct Loan Program as part of the American Recovery and Reinvestment Act of 2009. The report compiles the results of our work that we reported to you in three Fast Reports during the period June 26, 2009, to July 2, 2009. Excerpts of your responses, along with the Office of Inspector General's position, are incorporated into the report.

Based on your responses, we were able to reach management decision for all recommendations in the report. Please follow your agency's internal procedures in forwarding documentation for final action to the Office of the Chief Financial Officer. In accordance with Departmental Regulation 1720-1, all final actions need to be completed within 1 year of each management decision.

We appreciate the courtesies and cooperation extended to us by members of your staff during this audit.

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Executive Summary

The Recovery and Reinvestment Act of 2009 (Recovery Act) was signed into law on February 17, 2009. The purposes of the Recovery Act include preserving and creating jobs, promoting economic recovery, and assisting those most impacted by the recession. The Recovery Act included $1 billion for the Rural Housing Service (RHS) to provide single-family housing (SFH) direct loans to borrowers for fiscal years 2009 and 2010. These loans are directly funded by the Government and are available for very-low and low income households who cannot qualify for other credit to obtain homeownership.[1] These loans are commonly referred to as Section 502 direct loans.

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.[2] According to guidance issued by the Secretary of Agriculture, agencies shall develop transparent, merit-based criteria that will guide their discretion in committing, obligating, or expending funds under the Recovery Act.

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. We are using a multi-phase approach in performing our review of the Recovery Act funded Section 502 SFH Direct Loan Program. The objectives of Phase I were focused on reviewing Rural Development's management controls to ensure the Section 502 SFH Direct Loan Program was timely and effectively implemented to: (1) ensure Rural Development field offices have sufficient and competent staff to timely and properly process the increase of Section 502 direct loans due to the additional funding provided by the Recovery Act, (2) monitor performance goals established by Rural Development to measure the program's effectiveness in meeting the purposes of the Recovery Act, and (3) evaluate compliance activities in relation to overseeing Recovery Act funding requirements.

In Phase I, we also reviewed the design of loan processing controls over Section 502 SFH direct loans, such as application processing, borrower and property eligibility determinations, and loan disbursements. We did not find any deficiencies in the design of these controls as part of our Phase I review. In Phase II, we plan to focus on testing the effectiveness of these controls in the Section 502 SFH Direct Loan Program.

During this initial phase, we (1) determined that State offices are not fully utilizing funds for administrative costs provided by the Recovery Act to mitigate staff shortages, (2) identified additional performance measures that Rural Development could be tracking and reporting to

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[1] Very-low income is defined as below 50 percent of the area median income (AMI), and low income is between 50 and 80 percent of AMI.
[2] On April 3, 2009, OMB issued *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*.

better define its accomplishments in meeting the goals of the Recovery Act, and (3) found that Rural Development does not perform adequate compliance activities to review the quality of loan underwriting for its SFH direct loans to ensure it properly and prudently uses Section 502 SFH Direct Loan Program funds, including Recovery Act funds.

We issued three Fast Reports, two dated June 26 and one dated July 2, 2009, to the Under Secretary for Rural Development describing the above mentioned concerns. In early July, Rural Development responded in writing to the Fast Reports and generally agreed with the findings and recommendations.

Rural Development officials began taking corrective actions to resolve those concerns during the course of the audit and provided an update on the actions taken to date on September 14, 2009. Rural Development (1) issued additional guidance, dated August 21, 2009, on the appropriate use of the Recovery Act administrative funding and directed State and National office officials to implement internal plans and strategies to deliver program activities with Recovery Act funds, (2) designed two additional performance measures to better track and report the agency's accomplishments in meeting the objectives of the Recovery Act, and (3) modified procedures to require State offices to submit reports on the results of their first-year delinquency reviews and monitoring efforts.

Recommendation Summary

Rural Development needs to (1) require State offices to develop and implement an effective plan to use the available administrative funding that ensures Recovery Act funded Section 502 direct loans will be timely and properly processed, (2) establish additional performance measures to better reflect the agency's success in meeting the purposes and principles of the Recovery Act, and (3) develop a formal process for monitoring and ensuring that each State performs underwriting reviews of delinquent loans at least quarterly.

Agency Response

Agency national officials generally agreed with our findings and recommendations. The agency responses are posted on our website with the applicable Fast Report. The responses can be found at http:/www.usda.gov/oig/recovery/recovery_reports.htm.

OIG Position

We agreed with the agency's proposed corrective actions and reached management decision on all eight recommendations in the report.

Background & Objectives

Background

The Rural Housing Service (RHS), an agency within the Rural Development mission area, is responsible for distributing Recovery Act funds through the Section 502 SFH Direct Loan Program. These loans are directly funded by the Government and are available for very-low and low income households who 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. Mortgage payments are based on the household's adjusted income. These loans are commonly referred to as Section 502 direct loans.[3]

Rural Development's mission is to increase economic opportunity and improve the quality of life for all rural Americans. Rural Development has an $86 billion portfolio of loans and administers nearly $16 billion in program loans, loan guarantees, and grants through its programs each year. The Rural Development mission area administers the Section 502 SFH Direct Loan Program through the RHS National Office in Washington D.C., and its network of State, area, and local offices. RHS helps rural communities and individuals by providing loans and grants for housing and community facilities such as fire and police stations, hospitals, libraries, and schools. As of August 2009, the Section 502 SFH Direct Loan Program portfolio consisted of almost 278,000 loans with an unpaid balance of about $14 billion.

The RHS National Office is responsible for establishing policy, procedures, and internal controls for the program.[4] In the field, RHS operations are carried out through 47 State and 481 area and local Rural Development offices, which are responsible for issuing direct loans to borrowers. The Rural Development Centralized Servicing Center, located in St. Louis, Missouri, services all RHS SFH loans.

Section 502 direct loan applicants must have very-low or low incomes. Very-low income is defined as below 50 percent of the area median income (AMI), and low income is between 50 and 80 percent of AMI. Families must be without adequate housing, but be able to afford the mortgage payments, including taxes and insurance, which are typically within 22 to 26 percent of an applicant's income. Applicants must be unable to obtain credit elsewhere, yet have reasonable credit histories.

Section 502 direct loans are financed for up to 33 years (38 for those with incomes below 60 percent of AMI and who cannot afford 33-year terms). RHS sets the promissory note interest rate based on the Government's cost of money. However, that interest rate is modified by payment assistance subsidies. Under this program, housing must be modest in size, design, and cost. Modest housing is property that is considered modest for the area, does not have market value in excess of the applicable area loan limit, and does not have certain prohibited features

[3] Section 502 direct loans are authorized by Title V of the Housing Act of 1949 under Section 502.
[4] 7 Code of Federal Regulations Part 3550 provides the policies for the Section 502 SFH Direct Loan Program. 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 describes loan processing policies and establishes procedures for originating Section 502 direct loans.

(in-ground swimming pools). According to procedure, Rural Development officials must approve or deny an applicant's eligibility for a loan within 30 days of the Rural Development office's receipt of the application.

The $1 billion included in the Recovery Act for the Section 502 SFH Direct Loan Program for fiscal years 2009 and 2010 about doubles the program's 2009 appropriated funding of $1.1 billion. According to the Recovery Act, not more than 3 percent of the funds can be used for administrative costs to carry out loan activities.

Objectives

The objectives of Phase I were to review Rural Development's management controls to ensure the Recovery Act funded Section 502 SFH Direct Loan Program was timely and effectively implemented to: (1) ensure Rural Development field offices have sufficient and competent staff to timely and properly process the increase of Section 502 direct loans due to the additional funding provided by the Recovery Act, (2) monitor performance goals established by Rural Development to measure the program's effectiveness in meeting the purposes of the Recovery Act, and (3) evaluate compliance activities in relation to overseeing Recovery Act funding requirements.

Section 1: Efficient Use of Resources

Finding 1: Rural Development Should Optimize Use of Available Resources

We reviewed management controls pertaining to whether Rural Development field offices have sufficient and competent staff to timely and properly process the increase of Section 502 direct loans due to the additional funding provided by the Recovery Act. We determined that State offices are not fully utilizing funds for administrative costs provided by the Recovery Act to mitigate staff shortages. We also found areas where Rural Development could better optimize the use of current field office staff. The lack of sufficient staff provides reduced assurance that controls will function as intended.

Rural Development's SFH Direct Loan Program has almost doubled due to the $1 billion in funds it received for fiscal years 2009 and 2010 from the Recovery Act above its fiscal year 2009 funding of $1.1 billion. In its Recovery Act Plan, Rural Development reported that the number of field staff administering the SFH Direct Loan Program has declined making timely delivery of the additional funds a challenge for area offices. We conducted our audit of the Section 502 SFH Direct Loan Program at the Missouri and Kansas Rural Development State Offices in Columbia, Missouri, and Topeka, Kansas.[5] Missouri State office officials told us they lost 7 of 65 SFH staff positions since October 2006; officials from Kansas said they lost 13 of 37 similar positions in the same timeframe. According to the State office officials, this was due to overall budget reductions and greater emphasis placed on the delivery of business and community loans, and guaranteed loans over recent years.

In the Missouri and Kansas Rural Development State Offices, officials we interviewed also foresee difficulties in processing the direct loans funded by the Recovery Act due to the shortage of qualified, experienced staff. They are concerned about the potential for backlogs of loans waiting to be processed, the loss of customers due to untimely delivery of services, employee burn-out from working too many hours, and the overall quality of loan-making decisions. Rural Development's Recovery Act Plan further stresses that the lack of personnel could threaten effective disbursement of the Recovery Act funds.

We discussed potential remedies to staff shortages with Rural Development officials in the Missouri and Kansas State offices. We found that (1) neither State has implemented an effective plan to use the available administrative funding provided by the Recovery Act to mitigate staffing concerns, and (2) duties assigned to field office personnel could be redirected to optimize the use of current staff resources. Addressing these issues could assist Rural Development in timely processing Section 502 direct loan applications to effectively deliver the Recovery Act funds.

[5] To meet our limited timeframes, we judgmentally selected the Missouri and Kansas Rural Development State Offices because of their close proximity to our office in Kansas City, Missouri. Rural Development National Office officials confirmed that the conditions we found in Missouri and Kansas were representative of other States.

Use of Funding for Administrative Costs

One potential remedy to staff shortages is the effective use of Recovery Act funds allocated for administrative expenses. The Recovery Act authorized Rural Development to utilize up to 3 percent, or approximately $130.8 million, to cover related administrative expenses. This funding can be used to contract for services, travel, and purchase computer or communications equipment. It can also be used to hire additional personnel to administer the SFH Direct Loan Program. As of June 11, 2009, however, Rural Development had only allocated to State offices and agency administrators about $15.15 million (less than 12 percent) of the approximately $130.8 million authorized for administrative costs. National office officials told us they were holding the remaining $115.65 million (about 88 percent) in reserve for future requests.[6]

The Kansas State office received $212,000 and the Missouri State office received $430,000 for administrative costs associated with distributing Recovery Act loans. As of June 25, 2009, Missouri had spent only $14,000, or about 3 percent (mostly on overtime and travel expenses), and Kansas had not spent any of its allocation. This was primarily because neither State office had been required to develop or implement a plan for utilizing these funds that would mitigate staffing concerns and ensure Recovery Act direct loans would be timely and properly processed. Officials in both State offices told us that the real demand is for more experienced and skilled field staff to originate and process loans. Although National office officials budgeted almost half (46 percent) of the total administrative costs for hiring temporary Federal employees and other contractor services, such as loan packaging, Missouri and Kansas officials do not believe these are viable options.

State officials told us that hiring and training new staff is not a good option because of the time needed to announce the jobs, interview candidates, process the job offers, do background checks, and train new staff. Coordinating this lengthy process would also take valuable time away from experienced staff desperately needed in the field. Further, they worry that newly trained staff would not be experienced enough to make quick decisions on loan eligibility. Missouri and Kansas officials also contend that contracting for services is not optimal. They explained that by the time a contract is let, security procedures are met, and the staffs are trained, especially in all the facets of loan packaging, the Recovery Act monies would already be spent. As noted above, as of June 25, 2009, we were told that the Kansas State office had not spent any of the administrative funds. The Missouri State office was in the process of hiring one temporary administrative staff at about $25,000 and working on hiring one retired annuitant. Neither State was satisfied that they had an effective plan to mitigate the staff shortages, and neither had received any guidance from the National office on a viable solution.

We discussed the States’ use of the 3 percent allocation with Rural Development National Office officials on June 11, 2009. National office officials provided us with copies of the guidance they issued to States and agency administrators to track and reconcile the Recovery Act administrative funds. State directors and agency administrators are instructed to monitor obligations and ensure the funds are being effectively utilized within the limits provided by the

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[6] In a memorandum from the Acting Under Secretary dated April 20, 2009, Rural Development allocated a total of $2 million to agency administrators and a total of $13.15 million to the States, leaving a balance of $115.65 million in reserve.

Recovery Act. National office officials stated that the program is in its infancy and very little of the 3 percent administrative cost allocation has been expended to date, although a process is in place for requesting additional funds. However, each State director and agency administrator assumes full control and responsibility for timely and effectively utilizing these funds.

In our follow-up discussion on June 26, 2009, Rural Development National Office officials also recognized that effectively using the available administrative funds to mitigate staff shortages is critical. They added that the guidance they had provided to States in the past had only focused on the restrictions for using the administrative funds and tracking the expenditures in the financial systems. They agreed that Rural Development should get more involved in reviewing how the States plan on using the administrative funds and potentially provide additional guidance to State offices. The National office officials also emphasized that this issue raises a concern that relates to all Rural Development programs that received Recovery Act funding, and States should provide a comprehensive plan for using their administrative funds. Although we are only addressing the Section 502 SFH Direct Loan Program in this report, we agree this is a cross-cutting issue. Since it may affect several Rural Development programs, we also agree the appropriate resolution may be addressed on a more comprehensive basis.

Efficient Use of Field Office Staff Resources

A second remedy to mitigate staff shortages is to optimize the use of current field office staff by reviewing and redirecting the workflow. For example, Rural Development officials in both Missouri and Kansas told us that experienced field staff spend a great deal of time on general tasks such as scanning and shredding guaranteed loan files, when their time could be better spent on processing new Section 502 direct loans under the Recovery Act. State officials explained that guaranteed loan files are scanned in order for Rural Development's Centralized Servicing Center (CSC) to have immediate access to the pertinent information needed to process loss claim requests from the lenders. After the files are scanned and sent to CSC, field office personnel must shred and dispose of any supporting paper files due to the personal information they contain and because space in the field offices is limited.

Specifically in Missouri, one area program coordinator (APC) along with the program technicians in four other area offices are responsible for scanning and shredding the guaranteed loan files for all 6 area and 22 sub-area offices. With the increase in the number of direct and guaranteed loans to be processed due to Recovery Act funding, only the APC is currently scanning guaranteed loan files and a backlog is growing. In Kansas, there are 10 program technicians in 5 area offices whose duties include scanning and shredding guaranteed loan files. According to Missouri and Kansas State office officials, the scanning and shredding takes valuable time away that the program technicians would normally spend on preparing the paperwork needed for the loan specialists to review and approve direct loans.

Even before the Recovery Act funding, these field office personnel were unable to keep up with the mounting number of guaranteed loan files to be scanned. During site visits to two field offices in Missouri, we noticed large backlogs of guaranteed loan files that needed to be scanned and sent to CSC, and other large piles of previously scanned guaranteed loan files that still needed to be shredded. Kansas State office officials also told us that statewide there is a backlog of thousands of guaranteed loan files to be scanned and shredded from prior fiscal years. With the Recovery Act providing an additional $10.5 billion in funding for Section 502 guaranteed loans, this problem will only be exacerbated.

According to Missouri and Kansas Rural Development State Office officials, scanning a file can take about 15 to 20 minutes at a field office, but CSC can use high speed scanners to scan two files per minute. Rural Development officials in both Missouri and Kansas agreed that sending the guaranteed loan files to CSC for scanning and shredding would free up considerable time in the field that could be devoted to the delivery of new Section 502 direct loans.

When we discussed this issue with Rural Development National Office officials on June 4, 2009, the officials agreed that the shredding and scanning of SFH loan files is a problem that needs to be resolved. Some initial discussions had taken place in the past year; however, no formal corrective actions have been put into place to address the situation. In our follow-up meeting on June 26, 2009, National office officials agreed that the scanning and shredding of guaranteed loans in State area and sub-area offices would be reviewed and addressed. The Rural Development officials also agreed to review and consider other creative approaches to optimize the use of current staff resources and provide guidance to State and field offices.

With its current staffing, Rural Development's Section 502 SFH Direct Loan Program is challenged to meet increased loan processing needs created by the Recovery Act. Without action, the current Rural Development field office staffs may be unable to timely and accurately process these loans, which could lead to incorrect loan approvals, incorrect loan rejections, employee burnout, and untimely service to borrowers. It also threatens effective implementation and possible loss of Recovery Act funds.

After our discussion with Rural Development National Office officials, we issued a Fast Report to Rural Development dated July 2, 2009. In the Fast Report, we made three recommendations as outlined below.

Recommendation 1

Require State offices to develop and implement an effective plan to use the available administrative funding that ensures Recovery Act funded Section 502 direct loans will be timely and properly processed.

Agency Response

On July 10, 2009, Rural Development responded to our Fast Report stating that it will direct State offices to develop internal spending plans regarding the initial allocation of Recovery Act administrative funds. In general, those initial allocations were intended to cover overtime and other initial costs. Rural Development will provide additional guidance to the National office and States in August 2009, related to procurement, hiring, and information technology activities for Recovery Act funded activities. Implementation of those plans will be the responsibility of the State Directors. However, Rural Development will ensure that Recovery Act administrative funds are properly managed and documented, in accordance with the Recovery Act. Any requests for additional funding related to Recovery Act requirements will need to be justified in writing through the existing request process.

On September 14, 2009, Rural Development provided an update on the actions taken to date. Rural Development issued additional guidance to State Directors and Agency Administrators, dated August 21, 2009, on the appropriate use of the Recovery Act administrative funding. This guidance also directed State and National office officials to implement internal plans and strategies to deliver program activities with Recovery Act funds.

OIG Position

We accept management decision for this recommendation.

Recommendation 2

Monitor and ensure State offices utilize the administrative funds in accordance with their State plan to mitigate staff shortages and timely and properly deliver Section 502 direct loans.

Agency Response

On July 10, 2009, Rural Development responded to our Fast Report stating that it will ensure that Recovery Act administrative funds are properly managed and documented, in accordance with the Recovery Act. Rural Development will provide additional guidance to the National office and States in August 2009, related to procurement, hiring, and information technology activities for Recovery Act funded activities.

On September 14, 2009, Rural Development informed us that it had issued a memorandum to State Directors and Agency Administrators, dated August 21, 2009, regarding the management and documentation of Recovery Act funded activities. The memorandum included specific details on using and documenting Recovery Act funds for travel, personnel issues, procurement activities, purchase card, and information technology equipment. It also provided specific guidance on recruiting and tracking temporary employees to offset staffing shortages that might negatively impact the delivery of Recovery Act funds.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Consider additional ways to optimize the use of current staff resources and provide guidance to State offices.

Agency Response

On July 10, 2009, Rural Development responded to our Fast Report stating that it will contact State offices regarding the need to strategically deploying existing and temporary employees to maximize effective delivery of Rural Development programs. To the maximum extent possible, State personnel will focus on program delivery while temporary employees will provide support functions.

On September 14, 2009, Rural Development informed us that it had issued a memorandum to State Directors and Agency Administrators, dated August 21, 2009. The memorandum required State and National office officials to develop a plan that included internal operating strategies that maximize the efficient use of current staffing resources regardless of the employee status.

OIG Position

We accept management decision for this recommendation.

Section 2: Performance Measures

Finding 2: Rural Development Needs to Establish Additional Performance Measures

We noted that Rural Development established only one measure of performance for Recovery Act-related Section 502 direct loan activity, which was to "increase the number of homeowners."[7] According to Rural Development's American Recovery and Reinvestment Act Implementation Plan (Recovery Act Plan), this will be measured by loan obligations. National office officials told us this measure has historically been used because it is easily tracked and quantified. From our interviews with Rural Development State officials, we identified several additional performance measures which potentially might better reflect the agency's success in meeting the goals of the Recovery Act, specifically, "to promote economic recovery and to assist those most impacted by the recession," such as:[8]

- Increase in the number of loans for purchasing existing new homes, to boost development in rural areas;
- Increase in the number of home buyers moving from rental properties, to encourage permanent residencies in rural communities;
- Increase in the number of rural home buyers moving from cities or suburbs, to lift the economy in rural communities hardest hit by the recession;
- Increase in the number of refinances, to ease payments for economically distressed low and very-low income homeowners in rural areas;
- Increase in the ratio of loans closed within 30 days to the number of loan applications, to measure the timely disbursement of Recovery Act funds to rural homeowners; and
- Stability or decline in first year delinquency rates, to measure whether Recovery Act loans were made to borrowers most eligible to become successful homeowners.

We were unable to determine if appropriate data are available in Rural Development's current financial and/or program systems to track these additional performance measures. If not, Rural Development would need to also develop procedures or systems to collect and track the appropriate data as early as possible.

We discussed this issue with Rural Development National Office officials on June 4, 2009. We were told that when the SFH section was asked for performance measure recommendations, they only suggested measures for which data were already reported using the systems currently in place. State Rural Development officials agreed that additional performance measures, like the list previously presented, would better measure the success of the SFH Direct Loan Program going forward. State officials also added that tracking and reporting the performance of Recovery Act loans separately from regular-funded loans would provide a better measure of the success of the Recovery Act alone. We also discussed these issues with Rural Development National Office officials on June 26, 2009, and they generally agreed with our findings.

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[7] *Rural Development American Recovery and Reinvestment Act Implementation Plan*, page 41.
[8] *American Recovery and Reinvestment Act,* H.R. 1, Section 3, Purposes and Principles, paragraphs a(1) and a(2).

After our discussion with Rural Development National Office officials, we issued a Fast Report to Rural Development dated June 26, 2009. In the Fast Report, we made three recommendations as outlined below.

Recommendation 4

Establish additional performance measures to better reflect the agency's success in meeting the purposes and principles of the Recovery Act, specifically, "to promote economic recovery and to assist those most impacted by the recession."

Agency Response

On July 2, 2009, Rural Development responded to our Fast Report stating that it agreed that additional measures to track Rural Development's success in meeting the objectives of the Recovery Act would be beneficial for the program. Rural Development stated that additional performance measures could be developed using existing resources that conformed to the SFH Direct Loan Program mission and the Recovery Act objectives. Rural Development agreed to establish at least two additional measures for Recovery Act loans.

On September 14, 2009, Rural Development reported to us that it had designed two additional performance measures to better track and report the agency's accomplishments in meeting the objectives of the Recovery Act. Rural Development was in the process of modifying the Recovery Act Plan to include the additional performance measures.

The first additional performance measure was to increase the percentage of loans closed within 30 days of obligation from 69 percent to 85 percent by September 30, 2009, and to 95 percent by September 30, 2010. For Recovery Act purposes, Rural Development defined timely delivery of funds as a loan that closes within 30 days of obligation. They believe that this measure promotes the immediate delivery of Recovery Act funds, thus furthering quick economic recovery. The percentage of Recovery Act loans closed within 30 days of obligation will be measured on a quarterly basis.

The second additional performance measure was to maintain the new loan delinquency rate for Recovery Act loans at the same level as regular-funded loans. According to Rural Development, first-year delinquency is a measure of sound loan underwriting, and the soundness of Recovery Act loans should be the same as or better than regular-funded loans. Rural Development will measure this on a monthly basis.

On September 1, 2009, Rural Development initiated implementation of these measures in a memorandum to the Deputy Under Secretary. The memorandum explained the two additional performance measures for the Section 502 Direct Loan Program, which were effective immediately.

OIG Position

We accept management decision for this recommendation.

Recommendation 5

Define and collect any new data needed to quantify the additional performance measures established as soon as possible.

Agency Response

On July 2, 2009, Rural Development responded to our Fast Report stating that it will perform a system analysis to identify data that can be used to develop and quantify additional performance measures. According to Rural Development, the process to make system enhancements to capture data that is not currently stored in our computers could be costly and lengthy, and will prevent us from delivering Recovery Act funds in a timely and effective manner. Rural Development believed that additional performance measures could be developed using existing resources.

On September 14, 2009, Rural Development stated that based on the analysis of the type and quality of data available, they concluded that loan obligation and first-year delinquency data was the most relevant and readily available information that could be used to track and report the agency's success in meeting the Recovery Act objectives.

OIG Position

We accept management decision for this recommendation.

Recommendation 6

Track and report these measures for Recovery Act loans separately from regular Section 502 direct loans.

Agency Response

On July 2, 2009, Rural Development responded to our Fast Report stating that it will begin working towards tracking and reporting at least two additional measures for Recovery Act loans separate from regular Section 502 direct loans.

According to Rural Development on September 14, 2009, program type codes were implemented in March 2009 that enabled the agency to identify and track Recovery Act loans. CSC is currently tracking and reporting Recovery Act loan portfolio and delinquency data separately from regular-funded loans. The tracking and reporting of Recovery Act loans separately from regular Section 502 direct loans was put into effect in July 2009.

OIG Position

We accept management decision for this recommendation.

Section 3: Compliance Activities

Finding 3: Rural Development Does Not Perform Adequate Compliance Activities

We found that Rural Development does not perform adequate compliance activities to review the quality of loan underwriting for its SFH direct loans to ensure it properly and prudently uses Section 502 Program funds, including Recovery Act funds. The Missouri and Kansas Rural Development State Offices were not effectively performing loan underwriting reviews of delinquent loans. Officials at both the State offices explained they do not have enough staff to review these loans each quarter, as required. Loan underwriting reviews of delinquent loans can identify whether the basis for loan-making decisions is adequately supported and documented.

Underwriting Reviews of Delinquent Loans

We determined that neither the Missouri nor Kansas State offices are conducting underwriting reviews of delinquent loans as often as required in Rural Development Handbook HB-1-3550. Officials at both the State offices explained they do not have enough staff to review these loans each quarter, as required. Instead, they review loan files as part of the State Internal Review (SIR), which is performed at least once at each field office every 5 years.[9] They also rely on the State average delinquency rate as an indicator of problems. The review of delinquent loans is an important control for assessing the quality of loan-making decisions. For example, loan underwriting reviews have recently found that field office staff did not always document reasons for making exceptions to unacceptable credit indicators, such as low credit scores or high total debt ratios. Allowing borrowers with unacceptable credit to obtain loans can lead to increased delinquency rates in the Section 502 SFH Direct Loan Program.

Attachment 6-C of Rural Development's Handbook HB-1-3550 states that on a quarterly basis, every State office should conduct a review of all field offices with a first year delinquency rate that has remained above the State average for the preceding 3-month period. For field offices that surpass this threshold, State offices should review delinquent loans (especially those involved in foreclosure or bankruptcy) that occur in those field offices during the fiscal year to date.

Missouri Rural Development State Office officials stated that as of March 31, 2009, the first year delinquency rate for Missouri's Section 502 SFH Direct Loan Program was only 2.73 percent, which is well under the National office's 4.5 percent standard; therefore, delinquent loan file reviews were not warranted. However, our review of the delinquency data for Missouri as of March 31, 2009, identified 9 of the 27 Missouri field offices had first year delinquency rates that exceeded the State average. Several of them more than doubled the State average, including Sedalia (7.69 percent), Farmington (7.14 percent), Hillsboro (6.67 percent), and Kirksville (6.25 percent). With the current economy, it is even more important that delinquency rates are closely examined.

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[9] According to Section 2006.609 of RD Instruction 2006-M, dated May 19, 2004, SIRs are comprehensive evaluation reviews of the delivery of program and administrative functions in field offices and centralized program functions within a State. The SIR occurs at each field office at least once every 5 years.

Kansas Rural Development State Office officials began conducting delinquent loan underwriting reviews in February 2009. They had not conducted these reviews until the first-year delinquency rate increased to about 5 percent, which exceeded the National office's 4.5 percent standard. Since performing these reviews, first-year delinquency rates in Kansas have significantly dropped. In interviews, they acknowledged that waiting to perform reviews until the first-year delinquency rate exceeded the national standard was reactive rather than proactive. Even so, the Kansas State office officials told us they will not conduct the next loan underwriting review until about 6 months after the last one, because they do not currently have the staff to conduct these reviews on a quarterly basis.

When we discussed these issues with Rural Development on June 4, 2009, National office officials acknowledged that some States are not performing quarterly loan underwriting reviews as specified in Handbook HB-1-3550. They also stated that the National office does not have a formal process in place to monitor and ensure each State completes the underwriting reviews of delinquent loans as required. Because Rural Development has limited time to distribute Recovery Act funds, we believe the timeliness of compliance activities is essential. Therefore, underwriting reviews of delinquent loans should be conducted on a quarterly basis (as required) as compared to SIRs that occur in each office once every 5 years. The quarterly reviews also focus on the locations with the highest first-year delinquency rates, targeting loans with a high potential risk of failure. We recommend that Rural Development reinforce the importance of loan underwriting reviews and develop a formal process for monitoring and ensuring that each State performs loan underwriting reviews of delinquent Section 502 direct loans at least quarterly.

Nationwide Sample of Recovery Act Direct Loan Files

To overcome the above control deficiency in its State offices, Rural Development needs to establish a compensating control to immediately assess the quality of underwriting for Recovery Act loans. Due to the reported staff shortages in State and field offices, one option would be for Rural Development National Office officials to review a sample of Recovery Act loan files. Completing these reviews and notifying States early on of problems noted will help ensure corrective actions are taken before the Recovery Act funds are exhausted. Quality loan underwriting not only ensures that Rural Development properly and prudently uses Recovery Act funds, it helps ensure continued success of the Section 502 SFH Direct Loan Program.

In our discussion on June 4, 2009, Rural Development National Office officials agreed that pulling samples of Recovery Act direct loan files was needed, and the review should be performed on a nationwide basis. National office officials also told us they planned to perform a nationwide Improper Payments Information Act (IPIA) review scheduled for August 2009. The tentative plan was to randomly select and review 75 Recovery Act loan files as part of the IPIA review. We agree that combining the Recovery Act direct loan file sample with the IPIA review is an efficient strategy to verify the quality of loan underwriting for the Recovery Act loans. We also suggest that this review begin immediately because all 50 States have made loans using Recovery Act funds and Rural Development officials anticipate a surge once appropriated funding for fiscal year 2009 is exhausted. We also discussed these issues with Rural Development National Office officials on June 26, 2009, and they generally agreed with our findings.

After our discussion with Rural Development National Office officials, we issued a Fast Report to Rural Development dated June 26, 2009. In the Fast Report, we made two recommendations as outlined below.

Recommendation 7

Develop a formal process for monitoring and ensuring that each State performs underwriting reviews of delinquent Section 502 direct loans at least quarterly.

Agency Response

On July 2, 2009, Rural Development responded to our Fast Report stating that it would modify Attachment 6-C to account for staff shortages and increased workloads and to heighten the effectiveness of the selection criteria while maintaining the integrity of the process. As outlined in the attachment, the Rural Development National Office routinely holds teleconferences with selected States to discuss their first year delinquency and monitoring efforts. To strengthen this National office monitoring, the attachment will be revised to require the State offices to submit periodic reports on the results of their reviews.

According to Rural Development on September 14, 2009, Attachment 6-C of Handbook HB-1-3550 has been modified to require the State offices to submit periodic reports on the results of their first year delinquency reviews and monitoring efforts. In the new process, the National office will select a sample of delinquent new loans. The list will be generated at least two times (more often if the State's new loan delinquency rate warrants) during the fiscal year. State offices will review the selected accounts using a review guide in the revised Attachment 6-C. Upon receiving the list, the State office will have 30 days to review the selected new loans and return the individual review results to the National office. The revised Attachment 6-C was cleared through the agency and was published by the regulations division on September 23, 2009.

OIG Position

We accept management decision for this recommendation.

Recommendation 8

Establish a compensating control to immediately assess the quality of loan underwriting for Recovery Act loans to ensure the proper and prudent use of these funds. Notify States of the review results and follow-up on corrective actions.

Agency Response

On July 2, 2009, Rural Development responded to our Fast Report stating that as a compensating control, Rural Development will be reviewing 75 randomly selected Recovery Act loans as part of the Improper Payments Information Act review. Individual review results will be shared with the appropriate State offices and corrective actions will be monitored. General findings will be shared with all State offices.

According to Rural Development on September 14, 2009, the National office has randomly selected 75 loans to be reviewed as part of the Improper Payments Information Act review. The list has been shared with the States, and the loan files are expected to arrive shortly. Five experienced field staff members will assist National office staff in completing these reviews in a timely and effective manner. Rural Development expects to complete the file review and notify the States of the general findings by November 13, 2009.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

We conducted our audit of the Section 502 SFH Direct Loan Program at the Missouri and Kansas Rural Development State Offices in Columbia, Missouri, and Topeka, Kansas. To meet our limited timeframes, we judgmentally selected the Missouri and Kansas Rural Development State Offices because of their close proximity to our office in Kansas City, Missouri. Because Rural Development National Office officials confirmed that the conditions we found in Missouri and Kansas were representative of other States we determined it unnecessary to continue additional field work in other states. We also accompanied the Missouri SFH Program Director as he performed his scheduled SIR at the Carthage and Neosho sub area offices. We held discussions with Rural Development National Office officials to verify whether the control deficiencies we identified in these offices were representative of the program as a whole.

The period of our audit coverage was Section 502 SFH Direct Loan Program loans funded by the Recovery Act in fiscal year 2009. On March 20, 2009, Rural Development was authorized to begin distributing Recovery Act funds. As of September 16, 2009, Rural Development had obligated about $204 million in direct loans to 1,553 very-low and low income borrowers.

To accomplish our overall objectives, we reviewed the program's policies and procedures, and the design of its internal controls. During this initial phase, we specifically reviewed management controls that ensure Rural Development field offices have sufficient and competent staff to timely and properly process the increase of Section 502 direct loans due to the additional funding provided by the Recovery Act. We interviewed Rural Development National Office officials and program directors, housing specialists, and housing technicians in the Missouri and Kansas State offices to obtain their comments on the current resources available to handle the additional funds for Section 502 direct loans. We also discussed Rural Development's use and oversight of the funding for administrative costs provided by the Recovery Act.

In order to monitor Rural Development's performance goals established to measure the Section 502 Direct Loans Program's effectiveness in meeting the purposes of the Recovery Act, we discussed performance measures in our interviews with Rural Development National and State office officials. We also reviewed performance measures stated in Rural Development's Recovery Act Plan and specifically for its SFH Direct Loan Program.

To evaluate Rural Development's compliance activities in relation to overseeing Recovery Act funding requirements, we interviewed Rural Development National and State office officials about the controls and procedures for making loans using Recovery Act funds. We also discussed Section 502 SFH Direct Loan Program compliance activities with those officials. We compared compliance activities performed on regular and Recovery Act direct loans with the procedures required in Rural Development Handbook HB-1-3550.

To accomplish our audit objectives, we also:

- Identified and reviewed Rural Development published guidance, instructions, handbooks, and regulations that detail the controls and procedures over the Section 502 SFH Direct Loan Program;

- Reviewed Rural Development's Recovery Act Plan for its SFH Direct Loan Program; and
- Obtained and reviewed documents, such as OMB guidance, to gain an understanding of the provisions and requirements related to Rural Development's Section 502 SFH Direct Loan Program.

We performed our audit fieldwork from April through August 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. During this initial phase of our audit, we did not review, analyze, or verify information in the agency's UniFi[10] and MortgageServ[11] systems, and make no representation of the adequacy of the systems or the information generated from them. We plan to perform needed testing during the second phase of our audit.

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[10] A personal computer-based application located in each Rural Development field office that is used by loan originators. UniFi retains applicant information, calculates maximum loans amounts, and generates loan approval and closing forms.

[11] The mainframe-based computer application that is used by the Rural Development field office to electronically communicate with, and transmit information to CSC, and by CSC to service and track a borrower's loan.

Abbreviations

AMI .... Area Median Income
APC............................. Area Program Coordinator
CSC .... Centralized Servicing Center
IPIA............................. Improper Payments Information Act
OIG .... Office of Inspector General
OMB .... Office of Management and Budget
RHS............................. Rural Housing Service
SFH .... Single-Family Housing
SIR .... State Internal Review
USDA.......................... United States Department of Agriculture

Informational copies of this report have been distributed to:

- Administrator, RHS
  - Agency Liaison Officer (4)
- Government Accountability Office (1)
- Office of Management and Budget (1)
- Office of the Chief Financial Officer
  - Director, Planning and Accountability Division (1)