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

DATE: December 6, 2010

AUDIT NUMBER: 04703-0002-Ch (1)

TO: Dallas Tonsager
Under Secretary
Rural Development

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

SUBJECT: Rural Development Guaranteed Single Family Housing Loans Made by Lenders to Ineligible Borrowers

The American Recovery and Reinvestment Act of 2009 (the Recovery Act) included over $10 billion in funds to guarantee single family housing loans in rural areas. Those funds were authorized through $133 million in budget authority[1] for Rural Development's Section 502 Single Family Housing Guaranteed Loan Program. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of the funds. On February 18, 2009, the Office of Management and Budget (OMB) 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] On March 20, 2009, Rural Development began distributing those funds, using existing policies, procedures, and internal controls to distribute and ensure the accountability of Recovery Act funds.

The Rural Housing Service, an agency within the Rural Development mission area, was responsible for distributing Recovery Act funds through the Section 502 Single Family Housing Guaranteed Loan Program. Under this program, the agency guarantees the repayment of single family housing loans made by private lenders to low- and moderate-income borrowers in rural areas. The agency's guarantee substantially reduces a lender's risk of loss because the government will reimburse up to 90 percent of the outstanding principal and interest if a borrower defaults on a loan.

Our role, as mandated by the Recovery Act, was to evaluate agency activities and to ensure that funds were used in accordance with the underlying legislation and Federal regulations. Accordingly, we initiated this audit in December 2009 to determine if lenders and agency officials had met those requirements in providing loans and loan guarantees to borrowers. To

---

[1] Budget authority is the potential cost of a program and is the funding amount that the government may not recover.
[2] On April 3, 2009, OMB issued "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009."

accomplish this objective, we randomly selected 100 loans[3] from the portfolio of over 81,000 loans made by lenders across the nation, as of December 31, 2009, which were guaranteed by Rural Development with Recovery Act funds. This audit focused on compliance with eligibility requirements during the loan origination process. We also recently initiated an audit that will focus on lender servicing actions and loss claims submitted by lenders after borrowers default on their loans.

We are still conducting follow up audit work with lenders, borrowers, employers of borrowers, and agency officials. Thus, the conclusions in this report are based on our preliminary analysis and discussions with your staff, and could vary from the results presented in our final report. However, because of the statistical projections associated with our preliminary findings, it is our intent through this memorandum to inform you of our results, so that your staff has an opportunity to address the issues identified in this report.

Our preliminary analysis of the 100 loans identified 28 loans where lenders had not fully complied with Federal regulations or Recovery Act directives in determining borrower eligibility. We found borrowers with annual income that exceeded program limits, borrowers that did not meet repayment ability guidelines, borrowers who had the ability to secure credit without the need for a government loan guarantee, borrowers who obtained loan guarantees even though they already owned adequate homes within their local commuting areas,[4] and borrowers who purchased homes with swimming pools.[5] For each of these categories the agency's guarantee precluded other eligible applicants from receiving loans. In our judgment, the borrowers that did not meet repayment ability guidelines also have a higher risk of becoming delinquent and defaulting on their loans. Based on the sample results, we estimate that 27,206 loans (over 33 percent of the portfolio) may be ineligible with a projected total value of \$4.0 billion.[6]

Rural Development exhausted its appropriations for this program (both Recovery Act and existing program) during the spring of 2010 and lenders then accumulated applications for future funding. Agency officials informed us in September 2010 that lenders had accumulated applications amounting to over \$1.6 billion. Based on our statistical projection above, we concluded that the backlog of accumulated applications could have been reduced, and maybe eliminated, if lenders had properly determined the eligibility of all applicants who received guarantees with Recovery Act funds. In September 2010, agency officials informed us that they received additional funding to guarantee the accumulated backlog of loan applications, which they estimated at about \$2.2 billion.

---

[3] We chose a sample size of 100 because we expected a moderate error rate and wanted the ability to report findings for attributes with a +/-10 percent precision (confidence interval) at a 95 percent confidence level.

[4] 7CFR1980.346(a), dated May 22, 1995, states that an applicant must be a person who does not own a home in the local commuting area or owns a home that is not structurally sound or functionally adequate.

[5] Public Law 111-5, Division A, Title XVI, Section 1604, dated February 17, 2009, stipulated that Recovery Act funds shall not be used for swimming pools. A March 2009 memorandum from the Secretary of Agriculture emphasized Section 1604 of the Recovery Act.

[6] We are 95 percent confident that between 18,206 (over 22 percent) and 36,207 (over 44 percent) loans were ineligible for one or more reasons and the total value of those loans are between \$2.5 and \$5.4 billion.

Our audit also disclosed instances where agency policies and guidance were unclear, inadequate, or insufficient. We will not address the specific details of those issues in this report because our work is not yet complete. However, the issues will be included in our final report, as well as additional recommendations to assist agency officials with strengthening the program to ensure the consistent application of rules by lenders. The same is true for agency oversight efforts, which may be a contributing factor for the problems noted in this report.

We provided the 28 borrower case files to agency national officials and discussed our analyses and preliminary conclusions with them on the following dates: June 30 and July 1, 2010; August 11 and 12, 2010; September 21 and 22, 2010; and November 3, 2010. The officials agreed with our conclusions for 10 of the 28 eligibility cases. Those 10 cases involved borrowers who earned more than the allowable annual income for the applicable area, borrowers who had questionable ability to repay their loans, borrowers who had the ability to secure credit without a government loan guarantee, and borrowers who had purchased homes with swimming pools. They also generally agreed that corrective actions were needed in those areas to prevent loan guarantees from being provided to ineligible borrowers in the future. They did not agree with our conclusions for 18 loans, including all 4 of the loans related to borrowers who already owned homes in their local commuting areas and did not meet the exceptions to the rule that would have allowed loan guarantees to be made.

The following sections describe in detail our concerns in each area. (Note: the cumulative number of loans listed in each section is greater than 28 because some loans fell into more than one ineligibility category.)

Borrowers' Income Exceeded Eligibility Limits

We concluded that 12 borrowers in our statistical sample were ineligible because their income exceeded Rural Development's established income limits. We found that lenders did not include the wages, salaries, overtime pay, or bonuses of borrowers in calculating annual income used to determine eligibility to participate in the program. Rural Development field staff did not take exception to these cases when reviewing applications during the loan guarantee approval process. Further, Rural Development officials did not verify annual income calculations made by lenders for loans accepted by the Guaranteed Underwriting System.[7] Thus, when the agency guaranteed the loans, they prevented other eligible applicants, who were held up due to the lack of funds, from being considered for loans. Based on our sample results, our preliminary projection is that 13,665 loans (almost 17 percent of the portfolio), with a projected total value of $2.2 billion, may have been guaranteed with Recovery Act funds for borrowers whose income exceeded program limits.[8]

[7] The Guaranteed Underwriting System is an automated underwriting system developed by Rural Development for use by lenders to submit loan guarantee applications.

[8] We are 95 percent confident that between 6,405 (almost 8 percent) and 20,932 loans (over 25 percent) were ineligible due to borrowers' income exceeding the income limit and the total value of those loans is between $986 million and $3.4 billion.

Federal regulations require lenders to determine the total annual income, adjusted for the number of household members, for all adult members of each household.[9] Lenders are to include sources of income such as wages, salaries, overtime pay, commissions, tips, bonuses, and unemployment compensation. Income such as overtime pay must be dependable, based on verification with the employer and the applicant's history over the previous 24 month period.[10] Finally, lenders are to ensure that adjusted annual income does not exceed agency limits for the applicable county.[11] Applicants whose annual income exceeds the applicable limits are not eligible to participate in the program.

We identified four instances where lenders omitted overtime or extra pay, two instances where lenders did not use current wage or salary information, two instances where lenders failed to include borrower salary increases, one instance where the lender used the wrong household size in its calculations, one instance where a lender excluded income from an outside business, and two instances where lenders excluded income from a borrower or another household member. Agency national officials agreed with our conclusions for 6 of the 12 cases. For the cases where they disagreed, it was generally because they thought lenders were correct in taking a conservative approach in the handling of overtime pay or special pay when determining annual income or because they relied on information provided directly from employers.

We disagreed with the agency's position because in each of the six cases there was information provided by either the borrower or the borrower's employer that should have led the lender to include the other source of income. For instance, one lender's file contained an earnings statement for the borrower that showed a substantial amount of overtime pay for the year. The lender did not include the overtime pay in the calculation of annual income because, according to a lender official, they took a conservative approach that used only the number of regular hours worked by the borrower, multiplied by the borrower's base rate of pay. However, the verification of employment form clearly stated that the overtime pay would continue into the future. The lender did not contact the employer. We did contact the employer and confirmed that the overtime pay was substantial, had occurred for several years, and would continue into the future.

We discussed this case with the Rural Development loan specialist who approved the loan guarantee. The specialist stated that she only confirmed that the borrower's verification of employment was on file, and that income listed on Form RD 1980-21, *Request for Single Family Housing Loan Guarantee*, was not over the limit for the county. We presented her with our calculation for the borrower's annual income, along with the supporting evidence, and she stated that the lender had taken a conservative approach in determining the borrower's annual income. Agency national officials disagreed with our conclusion because the employer had not included overtime pay on the verification of employment form for prior years, which would have demonstrated a history of dependable income. They maintained this position after we pointed out that (1) the lender had inaccurately completed the form, and (2) we had obtained information

---

[9] 7CFR1980.348, dated May 22, 1995.

[10] 7CFR1980.347, dated May 22, 1995.

[11] 7CFR1980.345 (a), dated May 22, 1995.

from the employer that the borrower had received the overtime pay in prior years and was expected to continue earning it in future years. The national officials stated that the lender did not have time to resolve this type of conflicting information and the agency did not expect them to do so. We noted other instances where field staff reviews did not verify the accuracy of lender computations and the inclusion of all sources of income reported on Form RD 1980-21.

Finally, Rural Development requires lenders to submit information related to a borrower's annual income to agency field officials for 5 percent of all loans submitted through the agency's Guaranteed Underwriting System. Thus, agency field officials would not be aware if the annual income calculation was incorrectly computed by a lender for the majority of loans processed through that system. For instance, as described earlier, agency officials would not detect a situation where a lender omitted overtime pay listed on a borrower's earnings statement, but not listed on the borrower's verification of employment form. We have not formulated our final conclusions in this area. However, in our view, Rural Development should review its oversight policies and procedures in the income eligibility area. We also recommend that they remind field officials about the correct methods for determining annual income for borrowers.

Borrowers with Questionable Repayment Ability

Rural Development guaranteed eight loans to borrowers whose ability to repay their loans was questionable. We concluded that the borrowers had total debt ratios or ratios of debt to mortgage principal, interest, real estate taxes, and insurance (PITI) that exceeded program limits. We attributed this to lenders using unstable or inconsistent earnings, or using only a borrower's most recent earnings, rather than a longer time period, as qualifying income. Overall, the eight loans have a higher risk of future servicing actions and of potential losses due to borrower default. Our review of the recent payment status for the eight ineligible loans disclosed that four borrowers were currently, or had been, delinquent on their loans. One of the four borrowers had defaulted and the lender filed a loss claim of almost $55,000 for that borrower on an $80,000 loan. Another borrower was more than 180 days delinquent on the loan.[12]

Federal regulations require lenders to determine if applicants have an adequate ability to repay loans.[13] In making that determination, lenders must calculate a borrower's total debt ratio and the borrower's monthly obligation PITI.[14] The total debt ratio must be less than or equal to 41 percent and the ratio of PITI to income must not exceed 29 percent for an applicant to be eligible for a loan guarantee.[15] However, if an applicant's total debt or PITI ratio exceeds the limits, lenders can request a waiver of the requirement based on compensating factors. Those factors include, but are not limited to, significant accumulated savings and a similar percentage

[12] OIG extracted this data from Rural Development's Delinquency Data Model for Single Family Housing as of October 31, 2010.

[13] 7CFR1980.345(b) and (c), dated May 22, 1995.

[14] 7CFR1980.345(c), dated May 22, 1995.

[15] 7CFR1980.345(c)(3), dated May 22, 1995.

of income to current housing expenses. A low total debt ratio, by itself, does not compensate for a high PITI ratio.[16] A credit score above 660 can be a compensating factor if no additional risk factors are present.

A critical component of both ratio calculations is qualifying income, which must be adequate and dependable to determine a borrower's repayment ability.[17] Federal regulations state, in part, that qualifying income may be different than "adjusted annual income" which is used to determine eligibility to participate in the program. It is not uncommon for qualifying income to be lower than adjusted annual income. When considering qualifying income, lenders must determine if there is a historical basis to conclude that the income is likely to continue. Typically, income of less than 24 months duration should not be included in qualifying income.[18]

For the eight loans, we considered the borrowers' financial condition to be questionable enough that, in our judgment, they were ineligible to receive a government loan guarantee. We discussed each of the eight cases with agency national officials. Most of the eight cases involved applicants who had work histories of less than 24 months or who had successive jobs in different industries during a short period of time. Agency national officials agreed with our conclusions for one of the eight cases. They disagreed on seven cases because, in their view, lenders used appropriate judgment in determining qualifying income. That judgment included other factors to mitigate risk concerns, such as a credit score greater than 660, which would mitigate all risk. They also noted that current income would be used in almost every instance to determine qualifying income.

We, however, used a more conservative approach that included a borrower's 2-year work history. Our approach followed the standards established by Federal regulations, which state that qualifying income should typically include a 24-month time period.[19] In fact, several lenders with loans in our sample, including one of the largest lenders in the country, used a 24-month period to determine borrowers' qualifying income. This method, in our view, is a more prudent method to ensure that qualifying income is adequate and dependable. We also considered other factors, such as a credit score, when formulating our conclusions. In fact, for six of the eight cases in this category, the borrowers' credit scores were lower than the 660 level cited in agency regulations as an acceptable compensating factor.

The following examples illustrate our position concerning borrowers with questionable repayment ability:

- One lender based qualifying income for a loan solely on the applicant's current job, which began only 2 months before the application date. That income amounted to $2,539 per month. The applicant had a very limited work and credit history, and earned significantly less during the 2 previous years of her work history. The applicant had

[16] 7CFR1980.345(c)(5), dated May 22, 1995.
[17] 7CFR1980.345 (b), dated May 22, 1995.
[18] 7CFR1980.345(c)(2)(i), dated May 22, 1995.
[19] 7CFR1980.345(c)(2)(i), dated May 22, 1995.

worked about 2 years at three different jobs, with employment at each position ranging from 2 to 14 months. We calculated the borrower's qualifying income to be $1,639 per month, using a 2-year period. Under this method, the borrower's debt ratios were over 37 percent for the PITI ratio and 46 percent for the total debt ratio. The borrower is currently delinquent on the loan.

- Another lender also based qualifying income for a loan on the applicant's current job. In this instance, the applicant had worked fulltime at his current job for 5 months. In the 24 months prior to obtaining this loan, the applicant moved from one State to another and worked for three different employers. The applicant held these jobs for periods ranging from 3 to 13 months, and current income at the time of application was higher than previous positions. Based on the applicant's most recent job earnings of $3,167 per month, plus other household income of $861, the lender determined the debt ratios to be almost 36 percent for the PITI and 49 percent for the total debt ratio. However, we calculated the borrower's qualifying income to be $2,253 per month, using a 2-year period. Using this method, the borrower's debt ratios were significantly higher at more than 48 percent for the PITI, and nearly 63 percent for the total debt ratio. The borrower is currently delinquent on the loan.

Based on our sample results, our preliminary projection is that 8,779 loans (almost 11 percent of the portfolio), with a total value of $1.1 billion, may have been provided to borrowers we considered to be ineligible due to questionable work histories and excessive debt ratios.[20] Our concern is that these loans will be more likely to require servicing actions and possibly default because borrowers have questionable repayment ability.

We have identified 10 other loans that were sufficiently questionable that they also may be at risk for future servicing actions. The lenders had generally determined qualifying income for those borrowers based on the most current wages, even though in many instances these wages had only been paid for two to three months. Our review of these cases is continuing and may be presented in our final audit report. Overall, we are concerned with these borrowers' ability to repay the loans. We recently received the payment status for the 10 questionable loans, and the 8 ineligible loans, and found that 8 borrowers had been, or were, delinquent on their loans. As stated earlier, one borrower had defaulted on the loan.[21]

We have not formulated our final conclusions and recommendations in this area. However, in our view, Rural Development should review its policies regarding the determination of qualifying income and the agency's procedures for ensuring that lenders adhere to those requirements. In our view, this would improve the quality of loans guaranteed by the agency and, thereby, reduce the number of loans at risk for future servicing actions and default.

---

[20] We are 95 percent confident that between 2,751 (over 3 percent) and 14,806 loans (over 18 percent) were provided to borrowers that did not demonstrate adequate repayment ability and the total value of those loans is between $284 million and $2.0 billion.

[21] OIG extracted this data from Rural Development's Delinquency Data Model for Single Family Housing as of October 31, 2010.

Borrowers Had the Ability to Secure Financing with Reasonable Terms and Conditions Directly from Lenders without Government Assistance

Six borrowers in our statistical sample possessed sufficient resources to obtain loans directly from private lenders without a government guarantee. Several lenders offered the borrowers all of the credit options available to them for financing, including the lenders' own credit. Some lenders were unaware that a borrower's inability to secure private financing was a requirement for the program. Based on our sample results, we project that Recovery Act funds may have been used to guarantee 5,330 loans (over 6 percent of the portfolio) with a total value of $694 million to borrowers who were qualified to receive financing directly from lenders.[22]

The overall objective of the Single Family Housing Guaranteed Loan Program is to assist eligible households to obtain housing with loans that otherwise would not have been made without a guarantee.[23] Additionally, Federal regulations state that an applicant must be without sufficient resources to obtain the necessary housing and be unable to secure the necessary conventional credit without an agency guarantee upon terms and conditions that the applicant could reasonably be expected to fulfill.[24] Rural Development requires applicants and lenders to provide a certification statement on Form RD 1980-21, *Request for Single Family Housing Loan Guarantee*, which is a required document for every loan application. The applicant certifies that "I am unable to provide the housing I need on my own account and I am unable to secure the credit necessary for this purpose from other sources upon terms and conditions which I can reasonably fulfill." The lender certifies that "the applicant is unable to secure the necessary conventional credit without a Rural Development guarantee upon terms and conditions which the applicant could reasonably be expected to fulfill."

Agency national officials agreed with us on 2 of the 6 loans only when it was apparent from the documentation that those borrowers had funds available to make a 20 percent down payment, repayment ability that included a 28 percent PITI ratio and a 36 percent total debt ratio, and a good credit score. For the other four loans, they maintained that there were little to no conventional loans approved during the time period when Recovery Act funds were used to guarantee loans and those borrowers did not have cash reserves for a 20 percent down payment. They acknowledged that agency regulations do not define conventional credit, but were resolute that conventional credit meant having a 20 percent down payment and the same terms and conditions as the agency's program. However, when we questioned the lenders for the six loans, they all indicated that they would have financed a loan for the borrowers without the guarantee. Two lenders actually offered bank loans to borrowers, who declined them because the Single Family Housing Guaranteed Loan Program had more appealing terms and conditions. In general, the lenders we spoke with during the audit disputed the agency official's claim that lenders required a 20 percent down payment. In fact, most lenders told us that they allowed anywhere between 5 to 20 percent during the Recovery Act time period.

---

[22] We are 95 percent confident that between 624 (almost 1 percent) and 10,035 loans (over 12 percent) were provided to borrowers who qualified for financing directly from lenders and the total value of those loans is between $32 million and $1.4 billion.

[23] 7CFR1980.301(b), dated May 22, 1995.

[24] 7CFR1980.346(b), dated May 22, 1995.

We also found that some lenders were not aware of, or misunderstood, agency regulations. For example, we asked one lender about conventional credit because the borrower had cash assets of $52,000 listed on the application, which was significantly more than the amount needed for a 20 percent down payment for a loan. The lender stated that "according to USDA, this was no longer a requirement," and added that "if you ask an area specialist they will tell you that it is no longer a requirement." We asked another lender the same question about a borrower who had $44,000 in cash assets. The lender informed us that they required a 10 percent down payment, which the borrower had available. However, the lender's policy was to provide potential borrowers with all available options and allow the borrower to select the choice that best suited their needs. In this case, the lender stated that the "the borrower elected to take the USDA program as he did not want to make a 10 percent down payment." The lender added that the builder who referred the borrower to the lender had advertised the USDA program because it did not require a down payment. The lender also stated that the Federal Housing Administration program was available, but considered the USDA program a better option for the borrower.

We questioned borrowers during the course of our audit about financing options offered by lenders. They confirmed the information provided by the lenders and provided several reasons for selecting the government guarantee, rather than conventional credit offered by the lenders. The reasons included: (1) no requirement for a down payment, (2) no private mortgage insurance, (3) a lower interest rate, and (4) no requirement to attend first time home buyer classes. In making these statements, the borrowers contradicted their certifications that they could not obtain credit elsewhere that they made on Form RD 1980-21.

Rural Development had no policy and procedures to verify that a borrower was qualified to obtain financing from a private lender without the need for government assistance through a loan guarantee. The agency needs such a policy, as well as procedures and internal controls to verify compliance with that policy, to ensure that it is approving loan guarantees only for borrowers who are unable to obtain conventional credit from lenders.

Borrowers with Structurally Sound and Functionally Adequate Existing Homes Received Loan Guarantees

Rural Development guaranteed loans to four borrowers in our statistical sample who already owned homes within their local commuting areas, and there was no evidence that their existing homes were inadequate. Federal regulations state that "The applicant must be a person who does not own a home in the local commuting area or owns a home which is not structurally sound or functionally adequate." [25] Based on the sample results, we project that 2,882 loans (almost 4 percent of the portfolio), with a total value of $481 million, may be ineligible because the borrowers already owned homes within their local commuting areas.[26]

---

[25] 7CFR1980.346(a), dated May 22, 1995.

[26] We observed 4 instances of this condition, with a total value of $737,810. Because this number is within the 95 percent confidence interval, we are reporting the lower bound as the actual observation. The upper bound, for the 95 percent confidence interval, is 6,299 loans (almost 8 percent), totaling $1.0 billion.

Agency officials interpreted the regulation to mean that as long as an applicant sold an existing home before purchasing a new home, the applicant was in compliance with the regulations. We disagreed with agency officials' interpretation of the regulation because, in our view, the language is clear; applicants must not own an existing home in the local commuting area at the time of the application for a loan unless the existing home is structurally unsound or functionally inadequate. The borrowers for all four loans in our sample had adequate existing homes at the time of the application for a loan guarantee. This position is supported by agency officials' statements made during the rulemaking process in 1995 during the last regulatory revision. In addressing the eligibility issue of home ownership, agency officials at the time stated "an applicant that already owns an adequate dwelling is not eligible." Based on a comment received during the rulemaking process, agency officials at the time also revised the regulation by adding "an applicant could meet the ownership requirement as long as he or she does not own a home in the local commuting area."

The agency national officials also disagreed with our position because it would relegate the program to one solely for first time home buyers, which is not the intent of the program. We disagree with this statement since the regulation has two exceptions that would allow applicants with existing homes to participate in the program. Those exceptions allow for homes that are not structurally sound or functionally adequate. However, for the four borrowers in our sample, there was no documentation in the loan files that indicated the borrowers' previous homes met these exceptions. The agency also had no policy or procedures to ensure that such documentation existed prior to approving a loan guarantee. Further, agency regulations state that the basic objective of the program is to assist eligible households in obtaining adequate, but modest, decent, safe, and sanitary dwellings for their own use in rural areas by guaranteeing sound loans.[27] The four borrowers we cite in this category, to our knowledge, already had modest, decent, safe, and sanitary dwellings when they applied for the loan guarantees. In some instances, the borrowers appeared to be moving strictly for personal reasons. For instance, one borrower moved just a few miles to a home on a lake. Plus, all four of the borrowers' prior homes were financed without government assistance.

Borrowers Received Loan Guarantees to Purchase Homes with Swimming Pools

We identified three homes in our statistical sample with swimming pools, which was specifically prohibited by the Recovery Act. We attributed this, in part, to the agency's failure to notify lenders of the prohibition and to provide clear instruction to its field staff. Based on our sample results, we project that 1,659 loans (over 2 percent of the portfolio), with a total value of $230 million, were ineligible because the borrowers purchased homes with swimming pools.[28]

The Recovery Act stipulated that "None of the funds appropriated or otherwise made available in this Act may be used by any State or local government, or any private entity, for any casino or

---

[27] 7CFR1980.301(b), dated May 22, 1995.

[28] We observed 3 instances of this condition, with a total value of $563,977. Because this number is within the 95 percent confidence interval, we are reporting the lower bound as the actual observation. The upper bound for this confidence interval is 4,131 (over 5 percent) totaling $522 million.

other gambling establishment, aquarium, zoo, golf course, or swimming pool."[29] In March 2009, the Secretary of Agriculture issued a memorandum that informed staff that Section 1604 of the Recovery Act applied to Federal departments. The Acting Administrator, Rural Housing Service, issued an Administrative Notice in May 2009 that stated, "…without exception, no swimming pools are permitted for loans obligated using Recovery Act funds."

We questioned officials from each of the three lenders who made the loans. Those officials all stated they were unaware that homes with above-ground swimming pools were prohibited from receiving Recovery Act funds (they were aware that in-ground pools are prohibited by agency regulations). This was also the case for Rural Development field staff. We were repeatedly told by field officials that above-ground pools were allowed, which is accurate for funds obligated with regular annual appropriations. Also, there was a question and answer section on the agency's website, which stated that the prohibition did not apply to above-ground pools for Recovery Act funds. We checked the website and confirmed their statements. We concluded that the question and answer section contradicted the Administrative Notice, issued by the Acting Administrator in May 2009. We also noted that a different section of the website stated that Recovery Act funds were not to be used to finance any property that included a swimming pool.

We discussed this issue with agency national officials and they acknowledged not providing guidance or written notification directly to lenders. Instead, they relied on field staff to detect above-ground pools by examining appraisals provided by lenders in the underwriting package. We questioned the sufficiency of such a review because only one appraisal for the three loans noted that an above-ground swimming pool existed on the property. Agency national officials also stated that they had sufficiently informed field staff about the prohibition to use Recovery Act funds for swimming pools. In the future, agency national officials need to ensure that all parties are made aware of program requirements, and that clear instructions are provided to Rural Development field staff.

As stated earlier, we discussed these issues in detail with members of your staff on several occasions. During those meetings, they agreed that corrective actions were needed to improve the overall guaranteed loan program, based on our audit of loan-making activity funded by the Recovery Act. We recommend that agency officials:

1. Take appropriate actions and measures concerning the ineligible loans.

2. Notify field staff and lenders about the regulatory issues included in this report and emphasize the need for compliance with those regulations.

3. Review and revise, as necessary, the agency's policies regarding income eligibility, qualifying income, and borrower ability to obtain conventional credit without loan guarantees. In addition, strengthen the oversight procedures used by field staff to verify compliance with those regulatory requirements.

---

[29] Public Law 111-5, Division A, Title XVI, Section 1604, dated February 17, 2009.

4. Require lenders to maintain documentation that borrowers' existing homes were either inadequate or structurally unsound.

5. Develop policy and procedures to ensure that field staff verify the existence and adequacy of documentation related to instances where borrowers had existing homes prior to obtaining a loan guarantee from Rural Development.

Please provide a written response within 5 business days outlining your proposed corrective action regarding these matters. 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.

USDA'S

RURAL DEVELOPMENT

RESPONSE TO AUDIT REPORT

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

December 28, 2010

TO: Gil H. Harden
Assistant Inspector General for Audit
Office of Inspector General

FROM: Dallas Tonsager /s/ *Cheryl Cook*
Under Secretary
Rural Development

SUBJECT: Controls over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (Phase 2)
Audit Number: 04703-0002-Ch (1)

We are in receipt of your Preliminary Findings Report dated December 6, 2010, on the subject audit. The Office of Inspector General (OIG) conducted a preliminary analysis of the Single Family Housing Guaranteed Loan Program (SFHGLP) use of the American Recovery and Reinvestment Act of 2009 (Recovery Act) funds. The OIG sample consisted of 100 loans and the audit concluded that 28 loans may have been ineligible for assistance under the Recovery Act.

The Recovery Act was enacted in February 2009 to provide near immediate assistance to those most directly impacted by the economic crisis facing the country at that moment, and to promote longer-term economic recovery through job creation and investment in infrastructure. For USDA's Rural Housing Service (RHS or Agency), one of three agencies making up the Rural Development Mission Area, the Recovery Act provided additional funding both for loans made directly by USDA Rural Development staff and for loans made by private lenders for which USDA provided lenders with a 90% guarantee against loss. This reduced risk allowed lenders to offer eligible rural applicants more favorable interest rates and other loan terms. The purpose of Audit Number 04703-0002, and an earlier audit conducted in 2009, 04703-0001, is to determine the extent to which home loan applicants whose lenders pursued a loan guarantee from USDA were eligible to participate in the loan guarantee program according to RHS regulations.

Under the Credit Reform Act of 1990, funding for direct loan and loan guarantee programs is based on risk factors related to the likelihood of borrowers defaulting on their loans, thereby creating a direct loss in the case of loans made by USDA or an eventual payout on a loan guarantee in the case of private lenders' loans guarantee by USDA. If defaults increase, risk increases, too, and the same amount of funding from Congress the next year could not support the same size loan program. Thus, USDA has a vested interest in making sound loans in order to stretch available funding as far as possible.
Under the Recovery Act, Congress provided $133 million to RHS to support $10.47 billion worth of home loan guarantees. In order to begin stimulating the housing sector of the economy as quickly as possible, the Agency responded by obligating 18,298 guaranteed loans for a total of $2.1 billion within 10 days of receipt of the Recovery Act funds. By September 30, 2010, over 80,000 families had received guaranteed loans.

Although the Agency determined the immediate use of Recovery Act funds was necessary to alleviate the housing crisis by funding pending applications, the Agency also acknowledged the need for accountability and transparency in the expenditure of the funds. Beginning May 11, 2009, a series of five Fast Reports from OIG that collectively became Audit 04703-001-Ch (Phase 1) were issued to the Agency identifying potential shortcomings.

Rural Development was deeply concerned about the shortcomings identified by OIG in the first audit, and suspended the use of Recovery Act funds from May 18, 2009 through June 30, 2009, to allow for implementation of OIG's recommendations and to establish better procedures for Rural Development staff in the field. With OIG concurrence, the Agency took the following steps:

1. May 18, 2009, acted immediately on internal weaknesses indentified in OIG Audit 04703-017-Ch (Phase 1) by suspending the use of Recovery Act funds to allow for implementation of new quality control procedures. According to the preliminary findings report of the 28 ineligible loans identified by OIG, 11 loans were made prior to suspension of Recovery Act funds.

2. May 27, 2009, (a) informed field staff of impending changes that are necessary to ensure compliance, safety, and soundness of the portfolio of loans to be funded through the Recovery Act; and (b) informed lending partners that the record high volume may impact turnaround time for issuance of conditional commitment and loan note guarantees.

3. June 12, 2009, released a notice to lending partners informing them of impending changes to the Guaranteed Underwriting System (GUS) to ensure that loans funded under the Recovery Act are documented in a manner that minimizes the risk of improper use of GUS.

4. June 24, 2009, released a memorandum to field staff that implemented the following quality control procedures for loans obligated with Recovery Act funds:

    a. **GUS Loans receiving an "Accept" Underwriting Recommendation**. Full documentation must be provided prior to issuance of the Conditional Commitment when: 1) the Total Debt Ratio (TDR) is 50 percent or higher, 2) multiple loan underwriting submissions exceed 10 for the same borrower, 3) the application is selected at random (as part of a 5 percent sample), and 4) the borrower or co-borrower were associated with multiple applications within the past 12 months.

   b. **Ratio Waiver Requests**. Second level approval must be obtained prior to issuance of the Conditional Commitment if the Principal, Interest, Taxes and Insurance (PITI) exceeded 35 percent and/or the TD ratio exceeded 45 percent of monthly repayment income. The second level reviewer must have loan approval authority and be very knowledgeable of SFHGLP procedures as outlined in RD Instruction 1980-D, Administrative Notices and applicable Unnumbered Letters.
   c. **Post Conditional Commitment Approval Review**. Required a random sample of Recovery Act loans on a bi-weekly basis.
   d. **Appraisal Reviews**. Implemented additional technical desk reviews required by Agency licensed appraisers for a random sample of recovery act loans.

5. June 24, 2009, released a second memorandum to field staff reiterating the responsibilities of the approved Lender and Rural Development in requesting and processing applications for SFHGLP loans. Field staff were reminded that communication, documentation and written correspondence regarding applications that were with the approved Lender and not from a third party originator (TPO).

6. June 26, 2009, released a notice to lending partners requiring additional supportive documentation on market conditions in the Appraisal Report. The Agency adopted Fannie Mae/Freddie Mac, Form 1004MC, “Market Conditions Addendum to the Appraisal Report” as a result of an internal weakness identified by OIG Audit 04703-017-Ch (Phase 1).

7. June 29, 2009, conducted a web cast training session for all field staff reiterating the importance of following the quality control procedures when utilizing Recovery Act funds. The webcast was interactive allowing field staff to ask questions and address any concerns relating to the additional quality control procedures.

8. September 2009, entered into a contract to conduct additional compliance testing of Recovery Act loans. Compliance testing focused on lenders originating a high volume of GUS loans, and loans originated by a TPO.

Because the Agency actually stopped Recovery Act implementation in the Single Family Housing loan guarantee program on May 19, 2009 in order to shore up its procedures in accordance with the now-closed first audit, I noted with disappointment that 24 of the 100 samples used in the second audit actually predated May 19, 2009. The Agency already has acknowledged and tried to correct errors that lenders and USDA staff made in those early months of Recovery Act implementation. My hope had been that this second audit would focus on the time period after resumption of the program in July 2009 to help us determine the effectiveness of the improvements described above.

That said, there is enough evidence in the remaining 76 samples of loan guarantees done after July 2009 to conclude that the Agency still has work to do. None of the lender errors identified in the first audit has been completely eliminated, though only one lender appears to have errors both before and after the break in program implementation. A level of risk is associated with the extension of credit regardless of the funding source, but the Agency understood that bringing new lenders into the loan guarantee program required an ongoing commitment to training them and our staff.

I am confident that the overall objective of the Recovery Act was met by stimulating new home construction and home sales in rural America during a time when the housing market was struggling. Not only did the Agency's loan guarantees provide home ownership opportunities to thousands of low, very-low and moderate income households, but also many other rural Americans benefited such as real estate professionals, construction workers, real estate appraisers, home inspection companies, title companies, carpet layers, kitchen and bathroom remodelers, landscaping professionals, telephone and utility workers, as well as home sellers. The Agency is pleased to have assisted in stimulating the economy in rural America, while at the same time making every effort to ensure appropriate use of Recovery Act funds.

OIG PRELIMINARY FINDINGS AND AGENCY RESPONSES:

OIG Preliminary Finding 1: Borrower's Income Exceeded Eligibility Limits

The OIG preliminary report indicates that both lenders and Agency field office employees miscalculated adjusted annual income resulting in the issuance of ineligible loan guarantees. The OIG states that 12 borrowers in the statistical sample were ineligible because their income exceeded the Agency's established income limits. Further, OIG concluded that Rural Development officials did not verify annual income calculations made by lenders for loans accepted by the Guaranteed Underwriting System (GUS). Based on the preliminary projections, OIG concluded that almost 17 percent of the Recovery Act portfolio exceeded the income limits. Five of the 12 samples identified were from prior to May 19, 2009.

Agency Response:

The Agency acknowledges the preliminary finding and OIG interpretation that some borrowers' income may have exceeded the eligibility limits for the SFHGLP.

Agency regulations found at 7 CFR, 1980-D, section 1980.347 provides guidance for calculating annual income. The regulations have been in effect since June 21, 1995, and updated periodically through Administrative Notices and Unnumbered Letters. The regulations state "Annual income determinations will be thoroughly documented in the Lender's case-file. Historical data based on the past 12 months or previous fiscal year may be used if a determination cannot logically be made." The regulations provide guidance on the various types of income that may be included and allow the lender to utilize the most representative calculation of annual income. Due to the many methods of calculation available and the interpretation thereof, it is difficult for all parties – OIG, the Agency and the Lender - to conclude an exact same income figure.

To address this preliminary finding, the Agency proposes to conduct training for lenders that is specific to income calculation. In June 2009, the Agency implemented mandatory training for all new lenders requesting approval for participation in the guaranteed loan program. However, the majority of the lenders participating in the program were approved prior to the mandatory training requirement. The Agency will develop a web-based lender training (similar to the new lender training) that will be posted on RHSLinc website at the training and resource library to be available at the lender's convenience. The training will address the items revealed in the OIG preliminary findings report. The Agency will notify the lenders of the training once it is made available.

Additionally, one of the lenders identified by OIG has centralized their origination processes into one location. The same lender was not utilizing GUS during the Recovery Act period, but is using it now. The Agency is confident that this lender is committed to the success of the SFHGLP, and will ensure that loans are only made to eligible borrowers. Another large lender s recently requested and completed training that was conducted by the national office. The Agency conducted a series of webinars for the lender, which trained over 400 employees on origination and underwriting SFHGLP loans. As a result of this audit, the Agency will continue to provide this type training and will also target lenders that the Agency believes can benefit from such training.

Rural Development recognizes the need for recurrent training of all lenders that participate in the Agency's guaranteed loan programs. The state directors' elements and standards require that they have a monthly training plan for new and current lenders in their loan guarantee programs. State office staff will be reminded via the monthly single family housing teleconference that the national office staff is available to assist in providing training resources or topics to the states in order to address identified concerns in SFHGLP portfolio. New developments, publications, or enhancements to the Agency's automated underwriting system should also be addressed by each state to their database of approved lenders. It is imperative that all directives issued by the national office are distributed by the states to their employees to ensure proper delivery of the guaranteed loan program nationwide.

Further, Rural Development plans to hold a National Policy Conference for Agency field staff within the next 6 to 8 months. The policy conference will be specific to the Single Family Housing Guaranteed and Direct Loan Programs. The last single family housing policy conference was held in 2002. Since that time, many new employees have joined the Agency and would benefit from a national training conference. Although the conference is in the planning stage, there will be several sessions on both annual and qualifying income calculation.

The Agency acknowledges the OIG statement that "Rural Development officials did not verify annual income calculations made by lenders for loans accepted by the Agency's automated underwriting system, GUS."

Loans receiving a result from GUS of "refer" or "refer with caution" require lenders to submit all loan documentation for review by the Agency, including all annual income documentation. Loans receiving an "accept" require limited documentation for review by the Agency. As a result of OIG Audit 04703-17-Ch (Phase 1), the Agency implemented additional quality control procedures for GUS loans receiving an "accept" recommendation in the following situations:

1. When the GUS result is "accept" and the total debt ratio is 50 percent or higher;
2. A random sample of 5 percent of all "accept" loans are selected for full documentation;
3. Full documentation is required when the lender submits the same loan request multiple times in GUS, and
4. When the borrower or co-borrower were on another GUS loan applications within the past 12 months.

Although the above revisions to GUS were implemented as a result of the Recovery Act, the changes continue to apply to all SFHGLP GUS submissions and are still in effect. In FY 2010, there were a total of 71,867 Final Accept, GUS submissions. The total number of loans selected for full documentation review is 5,768 loans or about 8 percent during this timeframe.

OIG Preliminary Finding 2: Borrowers with Questionable Repayment Ability

The OIG preliminary report indicates that both lenders and Agency field staff miscalculated qualifying (repayment) income resulting in high risk loan guarantees. The OIG states eight borrowers in the statistical sample had questionable repayment income. Five of the eight loan guarantees identified predated May 19, 2009.

Agency Response:

There are many ambiguities associated with qualifying income therefore making it difficult to conclude an exact figure for every loan file. Qualifying income is used to calculate the principal, interest, taxes, and insurance (PITI) ratio as well as the total debt (TD) ratio. These ratios are used to measure the applicant's ability to repay the mortgage debt associated with the Agency's loan guarantee. The regulation, under 7 CFR 1980-D, section 1980.345(c) (2) (i) states: "Typically, income of less than 24 months duration should not be included in qualifying income." The word "typically" allows flexibility for circumstances in which an applicant's qualifying income can be calculated utilizing a smaller time period. Under the regulation, the lender performs an investigation of the documents supporting income as well as any comments made by employers on the Verification of Income form to arrive at a precise reason to support its underwriting decision. In doing so, the underwriter considers stability and continuity of employment. Working at the same job for 24 months is just one indication. Education and training can result in stable job opportunities for students entering employment. Many low-to-moderate income borrowers may change jobs frequently because it is the nature of the employment available.

Although, not acknowledged in the Agency regulations which were written in 1995, credit scoring is an extremely important factor in evaluating an applicant's repayment ability. An atypically strong credit score is indicative of the applicant's stability in meeting credit obligations regardless of their being less than 24 months on their current job. Consistent with FHA and the mortgage industry, the Agency has permitted applicants with less than 24 months at their current employer to obtain loan guarantees provided they have very strong credit scores.

High credit scores are used industry wide as a legitimate predictor of loan repayment. The Agency's automated underwriting system, "GUS," which utilizes a modified version of the FHA's Technology Open To Approved Lender (TOTAL) scorecard, may render an "accept" underwriting recommendation for applicants that have atypically high credit scores even if they are only a few months in their current job or have other shortcomings. Loans "accepted" by GUS statistically meet the profile of successful homeownership. The TOTAL scorecard is based on empirical data comprising of thousands upon thousands of loans, some of which were successful and some of which were not. If GUS and the TOTAL scorecard return a result of "accept," the applicant shares credit characteristics closely associated with historically successful homeowners.

To mitigate the risk identified in OIG preliminary findings report, the Agency will develop training that is specific to qualifying income. Training will be developed for lenders and Agency field officials. The training will be delivered in the same manner identified in the Agency's response to annual income calculation. In addition to making the training available for all lenders, the Agency will target specific lenders to ensure they take advantage of the training opportunities.

OIG Preliminary Finding 3: Borrowers Had the Ability to Secure Financing with Reasonable Terms and Conditions Directly from Lenders without Government Assistance

The OIG report indicates that six borrowers in the sample, five of which were from the time period after Recovery Act implementation resumed in July 2009, possessed sufficient resources to obtain loans directly from private lenders without a government guarantee.

Agency Response:

7 CFR 1980-D, section 1980.346(b) states: "The applicant must be without sufficient resources to provide the necessary housing and be unable to secure the necessary conventional credit without an RHCDS guarantee upon terms and conditions which the applicant could reasonably be expected to fulfill." Lenders certify to Rural Development that they would not make the guaranteed loan under the same terms and conditions absent the guarantee.

During the economic downturn lenders were making very few, if any, conventional loans without Government backing. The 7 CFR 1980-D was published in 1995 during a very different economic time. In 1995, a conventional loan generally consisted of the following attributes:

1. The applicant's ability to make a 20 percent down payment;
2. A good credit history of at least two trade lines paid as agreed over the past 24 months;
3. A total debt ratio of 36 percent or less;
4. A principal/interest/taxes/insurance ratio of 28 percent or less;
5. The applicant's ability to pay all loan closing costs in addition to the down payment; and
6. No private mortgage insurance.

During the Recovery Act timeframe, 20 percent down was no longer an assurance that credit would be granted in the conventional loan market. Seasoned payment reserve requirements of 2 to 6 months were necessary in addition to the 20 percent down-payment. If gift funds were utilized the applicant had to include a minimum of 5 percent of their own funds that met seasoning requirements. Minimum credit score thresholds could range from 680 - 740 depending upon the investor. A minimum of three trade lines with a 24 month history was required to obtain a valid credit score. Prior adverse credit such as bankruptcies less than 4 years past the discharge date and foreclosures less than 7 years past the discharge date would render applicants ineligible. Declining real estate market areas required higher credit scores, lower loan-to-value (LTV), and many property types were not eligible for financing, including rural properties, condominiums, duplexes, planned unit developments (PUD's), and manufactured housing.

The OIG obtained a statement from a lender that applicants were given a choice of several loan programs including conventional credit as an alternative to a guaranteed loan. Regulations implementing the Real Estate Settlement Procedure Act (RESPA) were published in the Federal Register on November 17, 2008 with an effective date of January 1, 2010. RESPA requires lenders to disclose information to loan applicants that would allow them to "shop around" for a better mortgage product. The lender indicated that Federal law prohibits "steering" applicants to any loan product and requires giving applicants choices.

The other loan choices applicants might have been offered included riskier loan products like Adjustable Rate Mortgages (ARM). ARMs are riskier because the mortgage payments will eventually increase, making them less affordable. ARM loans in rural areas increase the risk that the economic well-being of rural areas might be affected by borrowers who can no longer afford their mortgage payments and be forced out of their homes. The SFHGLP, on the other hand, guarantees loans only if they feature the safety of a 30-year fixed rate loan term.

Since the RHS regulations were written in 1995, well before RESPA, the Agency proposes to address this finding by eliminating the term “conventional credit” and replacing it with “need for guarantee.” The lender will be required to conduct a preliminary determination regarding the applicant’s ability to obtain traditional credit by addressing the following questions: (1) Does the applicant have personal non-retirement funds of at least 20% of the purchase price that can be used as a down payment; (2) Does the applicant have the ability to pay all closing costs associated with the loan; (3) Can the applicant meet qualifying ratios of no more than 28% PITI and 36% TD; and (4) Does the applicant have an acceptable credit history? This determination will be made on a preliminary basis by the lender prior to any underwriting, based on information provided by the applicant.

OIG Preliminary Finding 4: Borrowers with Structurally Sound and Functionally Adequate Existing Homes Received Loan Guarantees.

The preliminary report indicates 4 borrowers in the statistical sample already owned homes in the local commuting area and no evidence was provided to show the existing homes were inadequate.

Agency Response:

In all cases cited by the OIG, the borrowers had disposed of their existing property (via sale) prior to the Agency’s issuance of a loan guarantee. Because the applicants sold their prior homes before closing the SFHGLP loan, the applicant no longer owned a home and therefore made them eligible for a loan guarantee. The final HUD-1 Settlement Statement evidencing the sale served as verification that the home was sold prior to closing on the SFHGLP loan.

The OIG indicates that when a household already owns a dwelling it should be excluded from consideration for a loan guarantee. 7 CFR 1980-D, section 1980.346 states that: “An applicant must be a person who does not own a dwelling in the local commuting area or owns a dwelling which is not structurally sound, functionally adequate.”

Further, the SFHGLP has a refinance component which allows an existing borrower, who already owns a home, to refinance their loan. The Single Family Housing Direct Loan (SFHDLP) Program requires borrowers to refinance their loan when the borrower’s financial situation has improved, such that the borrower no longer qualifies for payment subsidy. The graduation requirement prompts many SFHDLP borrowers to sell their home and purchase a new property utilizing the SFHGLP program.

The OIG interpretation of the regulation would result in prohibiting refinance transactions or permitting direct loan borrowers from “graduating” to private sector loans and would create subjective decisions by lenders and the Agency regarding the home in question. To limit the SFHGLP to first-time homebuyers under the OIG’s regulatory interpretation could have unintended consequences for the Agency’s direct loan borrowers, and would prohibit borrowers from improving their financial condition by refinancing their existing homes.

To address this finding the Agency proposes to make a technical correction to the regulation that would require the applicant to sell their existing home prior to receiving a loan under the guaranteed loan program.

OIG Preliminary Finding 5: Borrowers Received Loan Guarantees to Purchase Homes with Swimming Pools

The OIG indicates that, contrary to the explicit language of the Recovery Act, three loans were issued Agency guarantees, with Recovery Act funds, that contained an above-ground swimming pool.

Agency Response:

The Agency issued guidance to field staff that properties with swimming pools were not permitted to receive loan guarantees utilizing Recovery Act funds. An Administrative Notice (AN) was published which officially superseded any informal bulletin board postings. The AN served as official notice to both the Field and to lenders which clearly indicated that no Recovery Act funds should be used for properties with swimming pools.

As a result of this finding, the Agency has de-obligated and re-obligated the identified loans with non-Recovery Act funds, through which above-ground swimming pools are permitted.

OIG RECOMMENDATIONS AND AGENCY RESPONSES:

OIG Recommendation 1:

Take appropriate actions and measures concerning the ineligible loans.

Agency Response:

In accordance with 7 CFR 1980-D, section 1980.308, the loan note guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation of which the lender has actual knowledge at the time it became such lender or which the lender participates in or condones. Unless the Agency or the OIG determines the presence of fraud or misrepresentation, the loan note guarantee remains valid.

The Agency has already taken the necessary steps to de-obligate the loans where the property contained a swimming pool. The loans were re-obligated with non- Recovery Act funds.

To hold originating lenders accountable for the loans they deficiently originate in the future, the Agency is in the final rulemaking stages of implementing indemnification requirements for originating lenders. A proposed rule was published in the Federal Register on May 19, 2010, and the final rule should be published no later than March 1, 2011.

Additional appropriate actions and measures are described with each of the responses following below.

OIG Recommendation 2:

Notify field staff and lenders about the regulatory issues included in this report and emphasize the need for compliance with those regulations.

Agency Response:

The importance of proper use of Recovery Act funds was relayed to lenders and field staff on many occasions during fiscal years 2009 and 2010. To resolve this finding, the national office will share the Fast Report with field staff and lenders and will re-emphasize the need for compliance with applicable regulations.

OIG Recommendation 3:

Review and revise, as necessary, the agency's policies regarding income eligibility, qualifying income, and borrower ability to obtain conventional credit without loan guarantees. In addition, strengthen the oversight procedures used by field staff to verify compliance with those regulatory requirements.

Agency Response:

The Agency continues to review and revise policies as necessary to ensure appropriate use of loan funds, and welcomes any suggestions OIG may have to strengthen such policies and procedures. Acknowledging that RD Instruction 1980-D is outdated, the Agency is in the process of re-writing the entire regulation. The 1980-D Instruction will eventually be replaced with RD Instruction 3555, which will be accompanied by a technical handbook that will provide detailed guidance to staff and Lenders regarding Agency policies and procedures.

Until publication of a new regulation, the Agency will continue to issue Administrative Notices and Unnumbered Letters to clarify policy. Recognizing the necessity to combine the supplemental guidance into one document, and in anticipation of the publication of this Fast Report, Administrative Notice (AN) 4543 dated October 14, 2010 was published to clarify underwriting and loan closing requirements. This publication combined 19 previously issued notices on various subjects. The Agency submits the publication of AN 4543 as a resolution to this finding.

OIG Recommendation 4:

Require lenders to maintain documentation that borrowers existing homes were either inadequate or structurally unsound.

Agency Response:

Lenders are currently required to maintain documentation supporting the applicant's eligibility for the SFHGLP. As part of that documentation for those applicants who disposed of their home prior to loan closing, adequate documentation would typically be a copy of the HUD-1 "Settlement Statement." When a borrower does not sell an existing home which is within the local commuting area, the lender is required to document the retained home is either functionally inadequate or structurally unsound.

To resolve this finding and clarify the Agency's intent, RHS proposes to amend the regulations to clarify that the program allows an applicant to sell a dwelling in the local commuting area before purchasing a new home with SFHGLP assistance.

OIG Recommendation 5:

Develop policy and procedures to ensure that field staff verifies the existence and adequacy of documentation related to instances where borrowers had existing homes prior to obtaining a loan guarantee from Rural Development.

Agency Response:

Field staff currently obtain documentation from the lender that the applicant's existing home was sold prior to loan closing. Acceptable documentation is a copy of the HUD-1. To resolve this finding, the Agency proposes to make a technical correction to the regulation, aligning the regulation with the intent of the program by revising the regulation to allow for an "applicant" to apply with the understanding that no loan note guarantee can be issued until the house is sold and the closing must occur concurrently or prior to closing of the new loan request.

We look forward to continue working with OIG towards developing policies and procedures that minimize risk in the guaranteed loan program. If you have any questions, please contact the Single Family Housing Guaranteed Loan Division at (202)720-1452.