



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



DATE: June 15, 2010

REPLY TO
ATTN OF: 04703-2-KC (3)

TO: Dallas Tonsager
Under Secretary
Rural Development

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

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

The American Recovery and Reinvestment Act of 2009 (Recovery Act) included \$1 billion for the Rural Housing Service (RHS) to provide single-family housing direct loans to borrowers.¹ Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of funds. The Office of Management and Budget subsequently issued guidance that required Federal agencies to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability objectives of the Recovery Act.²

RHS, an agency within the Rural Development mission area, is responsible for distributing Recovery Act funds through the Section 502 Single-Family Housing (SFH) Direct Loan Program.³ These loans are available for very-low and low income households that cannot qualify for other credit to obtain homeownership. Applicants may obtain 100 percent financing to purchase an existing dwelling, purchase a site and construct a dwelling, or purchase newly constructed dwellings located in rural areas. As of June 1, 2010, RHS had obligated approximately \$952 million in direct loans to about 7,500 very-low and low income borrowers.

Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure agencies expend funds in a manner that minimizes the risk of improper use. During this phase of our audit work, we found that Rural Development's SFH Direct Loan Program information technology system needed enhancements for Rural Development personnel to be able to detect, reduce, and prevent improper payments. These enhancements include (1) establishing system parameters/edit checks for data fields and (2) capturing additional data in the system. This Fast report is the third in a series that will report on our oversight activities regarding SFH direct

¹ The American Recovery and Reinvestment Act, Public Law 111-5, was signed into law on February 17, 2009. The program level increased to about \$1.56 billion due to changes in the subsidy rate for fiscal year 2010.

² *Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, February 18, 2009, and *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009*, April 3, 2009.

³ SFH Direct Loans are authorized by Title V of the Housing Act of 1949 under Section 502. 7 Code of Federal Regulations Part 3550 provides the policies for the SFH Direct Loan Program.

loans. Issues identified in these Fast reports will be compiled into a final report at the conclusion of our audit.

The objective of our audit is to test the effectiveness of the key controls over the Recovery Act-funded Section 502 SFH Direct Loan Program. To accomplish our objective, we tested the effectiveness of Rural Development's use of its automated Dedicated Loan Origination and Servicing (DLOS) system to detect, reduce, and prevent improper payments. We obtained and analyzed Rural Development's database of SFH Direct Recovery Act loans, obligated as of the end of fiscal year 2009. As of September 30, 2009, Rural Development obligated 2,030 SFH Direct Program Recovery Act loans, totaling about \$267 million. We also examined the results of Rural Development's Improper Payments Information Act of 2002 (IPIA) Risk Assessment review, conducted in October 2009. In addition, we interviewed Rural Development national office officials to discuss Rural Development's SFH Direct Loan Program information technology system and its limitations.

We determined that Rural Development could reduce the risk of improper payments by improving the integrity of SFH Direct Loan Program data in DLOS. Rural Development national office oversight is based on a sample of loan file reviews performed by national and State office officials after loan closing to identify and measure the risk of improper loan payments - its annual IPIA Risk Assessment review. We found, and Rural Development national office officials agreed, that data captured in DLOS could be used to identify potentially ineligible applicants before loans are closed, thereby preventing or reducing improper payments. However, the Rural Development national office staff is not using DLOS data for these purposes because of data integrity and system design issues.

In our review, we found data input errors and missing data in critical fields that prevented the effective use of DLOS data for compliance purposes. Rural Development national office officials said that input errors occur because data fields do not have established parameters or edit checks. Rural Development officials agreed that this has been a long-standing problem with the SFH Direct Loan Program data in DLOS. They attributed these conditions to the information technology software being off-the-shelf software that includes industry standard checks and balances, which can be costly to modify to meet SFH program requirements. Rural Development national office officials agreed that system enhancements are needed and overdue, and Rural Development has not made these enhancements a top priority. We believe overcoming these data integrity and system design issues would help Rural Development detect, prevent, and ultimately reduce the occurrence of improper direct SFH program loan payments.

The National Institute of Standards and Technology (NIST) is responsible for developing minimum requirements for Federal information systems. NIST recommends that Federal information systems check information for accuracy, completeness, validity, and authenticity in reviews accomplished as close to the point of origin as possible.⁴ These actions are commonly referred to as edit checks. Rules for checking the valid syntax of information system inputs (e.g., character set, length, numerical range, acceptable values) should be in place to verify that inputs

⁴ NIST's Special Publication 800-53, *Recommended Security Controls for Federal Information Systems*, Revision 2, SI-10, Information Accuracy, Completeness, Validity, and Authenticity, December 2007.

match specified definitions for format and content. These actions are commonly referred to as parameter checks.

From our review of the SFH Direct Loan Program Recovery Act data, we noted the following data integrity and system design challenges:

Establishing System Parameters/Edit Checks to Prevent Data Input Errors

Rural Development needs to establish system parameters/edit checks for data fields in DLOS. We obtained and analyzed Rural Development's database of SFH Direct Recovery Act loans, obligated as of the end of fiscal year 2009. As of September 30, 2009, Rural Development approved and obligated 2,030 SFH Program Direct Recovery Act loans for about \$267 million. Rural Development's SFH Direct Loan Program is designed for individuals who are unable to obtain credit elsewhere, mainly due to limited income and/or assets, but who meet the agency's requirements for repayment ability. In addition, according to *Rural Development Handbook HB-1-3550*, unless an exception is granted, the amount of the loan may not exceed the area loan limit.⁵ Our analysis of DLOS data identified 28 loans where the borrower's eligibility should have been questioned. We found:

- Nine borrowers with net assets (assets minus liabilities) of over \$100,000, which indicates that the borrowers should be able to obtain credit elsewhere and should not have been approved for a SFH loan. Five of these borrowers had net assets that exceeded \$250,000, including two with net assets over \$500,000. For example, one borrower received a \$193,500 loan with \$618,903 in total assets and \$19,999 in total liabilities.
- Five borrowers with net liabilities (liabilities minus assets) of over \$100,000, which indicates that the borrowers do not have repayment ability and should not have been approved for a SFH loan. For example, one borrower received a \$182,500 loan with \$1.52 in total assets, \$178,325 in total liabilities, and an annual income of \$44,520.
- Fourteen loans exceeded the area loan limit by more than \$3,600 (the highest margin was \$22,000 on a \$272,000 loan). (Note: Requests for exceptions may be approved by the State Director if the cost of the property will not exceed \$3,600. Anything above \$3,600 would need Rural Development national office approval.)

Rural Development reviewed the 28 cases we identified above and found that 1 of the 28 borrowers would have been ineligible for the amount of the loan obtained. The borrower received a \$164,540 loan, which exceeded the \$160,000 area loan limit. The Rural Development field office did not properly account for the area loan limit when approving the loan. In the remaining cases, Rural Development found data entry errors occurred or was able to satisfactorily justify the borrower's eligibility. In the case of the borrower with \$618,903 in assets detailed above, Rural Development entered the borrower's bank cash account balance in the system as \$593,885, instead of \$593.88. In the case of the borrower

⁵ Rural Development Handbook HB-1-3550, Direct Single Family Housing Loans and Grants, Field Office Handbook, issued January 23, 2003, and associated Special Procedural Notices. It defines the area loan limit as the maximum market value of a property to be considered modest for the area.

with \$178,325 in total liabilities, Rural Development included the liability from a prior mortgage, but did not include the house as an offsetting asset in the system.

Rural Development National Office officials agreed that establishing system parameters and edit checks at the point of data entry would help ensure that ineligible applicants are not obtaining loans.

Capturing Critical Data to Determine Repayment Ability

Rural Development needs to (1) ensure data are entered into critical fields and captured in DLOS and (2) modify DLOS to include additional data fields needed to determine borrowers' repayment ability before loan closing. A key element in determining eligibility is the borrowers' ability to repay the loan. According to *Rural Development Handbook*

HB-1-3550, the agency bases underwriting decisions on (1) an analysis of the percentage of income the applicant would be required to spend on housing costs and (2) the applicant's total debt if the loan is approved. However, this information is not required to be entered in its loan origination system (LOS).⁶ The principal, interest, taxes, and insurance (PITI) ratio compares the amount the applicant must spend on these housing costs to the applicant's repayment income.⁷ The total debt (TD) ratio compares applicant debt to repayment income.⁸ Borrowers must meet the agency's prescribed limits for both ratios to ensure repayment ability.

Our review of the Rural Development database, as of September 30, 2009, revealed that the PITI and TD ratio fields were blank for 1,221 of 2,030 (60 percent) approved borrowers because these ratios are not required to be entered in the LOS. We found that 4 out of the remaining 809 (2,030 – 1,221) approved borrowers had PITI and/or TD ratios outside Rural Development's prescribed limits.⁹ The credit score field, another indicator of repayment ability, was also blank for 1,875 of the 2,030 (92 percent) approved loans because the information technology system does not automatically populate that data field from the LOS.

In addition, important information for calculating the total housing costs is not currently included in Rural Development's information technology system, such as insurance and real estate taxes. Rural Development national office officials agreed that insurance and real estate tax information are important, since both are components of the repayment ratios, and have initiated actions to modify DLOS to add the insurance and tax fields. Once added to the system, Rural Development needs to ensure that information in the insurance and tax fields is updated at loan closing, as those figures are revised from estimates to actuals as part of closing preparations.

⁶ The LOS, which is part of DLOS, is an information technology application located in each Rural Development field office that is used by loan originators. LOS retains applicant information, calculates maximum loan amounts, and generates loan approval and closing forms.

⁷ Repayment income is based only on the income attributable to parties to the note and is used to determine whether an applicant has the ability to make monthly loan payments. Very low income applicants are considered to have repayment ability if they do not have to pay more than 29 percent of repayment income for PITI expenses. Applicants with incomes above the very low-income limit are considered to have repayment ability if they do not have to pay more than 33 percent of repayment income for PITI expenses.

⁸ Applicants, regardless of income, are considered to have repayment ability when they do not have to spend more than 41 percent of repayment income on total debt.

⁹ Rural Development examined the four cases and found that data input errors occurred in two instances, and Rural Development granted waivers in the other two instances.

Rural Development national office officials agreed that it is important (1) to ensure information is entered into critical fields and captured in DLOS, (2) to include additional data fields in DLOS needed to compute repayment ratios, and (3) that data in DLOS needs to be updated before loan approval and closing to reflect the actual information that field personnel used to make eligibility determinations.

We also believe that Rural Development should augment its oversight policies and procedures to target and review loans before loan closing to ensure that Recovery Act loans are only being approved for eligible applicants. Currently, the Rural Development national office focuses its oversight primarily on manual loan file reviews, which include IPIA Risk Assessments and State Internal Reviews. However, the loan file review process is a time-consuming, labor-intensive process that focuses on closed loans. Rural Development national office officials agreed that improving the information technology system data would allow them to automate the review process to better target and review loan files to detect, reduce, and prevent improper payments before loan closing.

We discussed the issues identified in this report with Rural Development national office officials on January 27 and February 3, 2010. On April 7, 2010, Rural Development provided us with supplemental information for the loans where we questioned the borrower's eligibility for the program. During these and other follow-up discussions, Rural Development officials generally agreed with our findings to correct data integrity and design issues and have already initiated actions to add some key fields to DLOS. They also agreed that identifying data irregularities could help target ineligible applicants before loan closing to ensure that direct SFH program funds are expended on those individuals intended to benefit from the Recovery Act.

We recommend that the Rural Development national office:

- (1.) Develop and implement a plan to correct the data integrity and system design issues involving DLOS. These issues include identifying and establishing critical system parameters and edit checks at the point data is entered or updated; ensuring information is entered into critical data fields and captured in DLOS; modifying DLOS to include additional data fields needed to determine borrower repayment ability; and ensuring that the data in DLOS are always updated with the most current figures before loans can be approved and closed.
- (2.) Develop and implement an automated review process at the National, State, and/or area offices to identify any SFH Direct Loan Program data irregularities for follow up and to target and review loan files before closing to ensure Recovery Act SFH direct loans are only being approved for eligible applicants.

Please provide a written response within 5 days outlining your proposed corrective action for this issue. If you have any questions, please contact me at (202) 720-6945, or have a member of your staff contact Steve Rickrode, Director, Rural Development and Natural Resources Division, at (202) 690-4483.

USDA'S

RURAL DEVELOPMENT

RESPONSE TO AUDIT REPORT



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

June 23, 2010

TO: Gil H. Harden
Assistant Inspector General for Audit

FROM: Dallas Tonsager /s/
Under Secretary
Rural Development

SUBJECT: Single Family Housing Direct Loans Recovery Act Controls – Phase II
04703-2-KC (3)

This is in response to your memorandum dated June 15, 2010, in which you requested a response to your recommendations contained in the subject report. The objective of this audit was to test the effectiveness of the key controls over the Recovery Act funded Section 502 SFH Direct Loan Program.

To accomplish this objective, the OIG tested the effectiveness of Rural Development's use of its automated Dedicated Loan Origination and Servicing (DLOS) system to detect, reduce, and prevent improper payments. The OIG obtained and analyzed Rural Development's database of SFH Direct Recovery Act loans obligated as of the end of fiscal year 2009. As of September 30, 2009, Rural Development had obligated 2,030 SFH Direct Program Recovery Act loans, totaling about \$267 million. The OIG also examined the results of Rural Development's Improper Payments Information Act of 2002 (IPIA) Risk Assessment review, conducted in October 2009. In addition, they interviewed Rural Development National Office officials to discuss Rural Development's SFH Direct Loan Program Information Technology System and its limitations.

We generally agree with the findings and conclusions and agree that there is a need for well placed edits in the (DLOS) system. We also agree that improvement to the data warehouse would help RD to develop and implement better oversight reviews. We would like to point out that the subject report indicates high error rates, and that these are from reports generated by the RD data warehouse. RD loans are processed through the DLOS system and loan decisions are made with the information input into the system. The error rates indicated in the subject report came from information uploaded from DLOS system to the data warehouse. We realize there are some issues getting data to the warehouse; however, the DLOS system does have the required information for loan making decisions.

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Washington, DC 20250-9410 or call (800)795-3272 (voice) or (202) 720-6382 (TDD).

Again, we agree with the findings and conclusions of the subject report and look forward to implementing these recommendations so that we can provide better oversight reviews. We have already been working on some quick fixes and other system edit modifications.

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