UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

MAY 1 4 2009

REPLY TO
ATTN OF: 04703-0001-Ch

TO: Cheryl L. Cook
Acting Under Secretary
Rural Development

FROM: Robert W. Young
Assistant Inspector General
for Audit

Robert W. Young

SUBJECT: Controls Over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (2)

The American Recovery and Reinvestment Act of 2009 (the Recovery Act) included almost $10.5 billion in funds to guarantee single-family housing loans in rural areas. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of the 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.[1] On March 20, 2009, Rural Development was authorized to begin distributing Recovery Act funds.

The Rural Housing Service, an agency within the Rural Development mission area, is responsible for distributing Recovery Act funds through the Section 502 Single-Family Housing Guaranteed Loan Program. As of May 6, 2009, Rural Development had obligated over $3.7 billion to guarantee over 31,000 loans. Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure funds are expended in a manner that minimizes the risk of improper use. This memorandum is the second one to report on our oversight activities. This report relates to waivers of the agency's debt ratio policy for borrowers participating in the program. This issue, along with the others identified in these memoranda, will be compiled into a final report at the conclusion of our audit.

To accomplish our objectives, we assessed the program's policies and procedures, as well as its internal controls, and discussed them with the agency's national, State, and area officials.[2] Agency officials followed this guidance to process loan note guarantees obligated under the authority of the Recovery Act. We visited four Rural Development area offices in two States

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[1] On April 3, 2009, OMB issued "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009."
[2] Rural Development Instruction 1980-D, dated June 21, 1995, and associated Administrative Notices.

to examine borrower files and observe the loan note guarantee process. We did not perform testing to verify lender compliance with agency policies and procedures.

During our review, we noted that agency policy regarding the waiver of debt ratio requirements was unclear and not being administered by field staff as expected by national officials. Agency policy states that lenders are to submit a request for waivers to debt ratio requirements in writing to Rural Development and include documentation of the appropriate compensating factors for support of sound underwriting judgment.[3] Based on this policy, agency national officials expected field staff to obtain evidence of the compensating factors, such as bank statements for instances where the compensating factor was a large savings account. However, in the field, we observed that Rural Development staff approved lender requests for waivers based only on the request and a description of the compensating factor.

Rural Development field officials in both States we visited informed us that agency policy did not require lenders to submit documentation other than to describe the compensating factor. In fact, one State's lender handbook supports this interpretation. The handbook states that ratio waivers must be requested to Rural Development in writing and compensating factors must be identified on the transmittal summary. The handbook does not mention the submission of documents to support the compensating factors.

We identified several instances where lenders requested waivers of debt ratios for borrowers even though those ratios significantly exceeded agency guidelines. Rural Development staff approved those waivers based solely on the lenders written request for the waiver. The agency's guidelines state that the borrower ratio of principal, interest, taxes, and insurance to income should not exceed 29 percent. It further states that the ratio of total debt to income should not exceed 41 percent. Our concern is that lenders may create or exaggerate compensating factors to justify approving a loan for a substandard borrower. In the cases we identified, borrower repayment ability ratios ranged up to 42 percent (for principal, interest, taxes, and insurance to income) and over 60 percent (for total debt to income).

In our view, the risk that lenders may take advantage of this weakness is significant enough that agency officials should take action to mitigate the potential for abuse. However, as stated above, we have not yet performed tests to determine if lenders have actually taken advantage of the weakness. As a result, we have no conclusions on the overall extent of abuse that is, or may be, occurring in the program. Our concern is simply that lenders could erroneously waive agency requirements and submit substandard loans to Rural Development.

We discussed this issue in detail with agency national office officials on April 29, 2009. They generally agreed with our conclusion and agreed to implement corrective action. We recommended that the agency clarify its requirements that lenders submit supporting documentation for all waivers on loans submitted to field staff for manual processing. On May 6, 2009, an agency national office official informed us that agency policy is being revised in

[3] Rural Development Administrative Notice No. 4366, dated May 7, 2008.

accordance with our recommendation. Please provide a written response within 5 days that outlines your stated corrective action.

For applications submitted through the Guaranteed Underwriting System, we recommended in a prior memorandum that agency officials perform additional compliance reviews of lender files and require lenders to submit supporting documents for a random sample of loans. (See OIG Memorandum dated May 11, 2009.) This documentation should include the compensating factors.

If you have any questions, please contact me at (202) 720-6945, or have a member of your staff contact Steve Rickrode, Audit Director, Rural Development and Natural Resources Division, at (202) 690-4483.

United States Department of Agriculture
Rural Development

TO: Robert W. Young
Assistant Inspector General for Audit

ATTN: 04703-0001-Ch

FROM: for Dallas Tonsager Cheryl L. Cook
Under Secretary
Rural Development

MAY 21 2009

THRU: James C. Alsop James C. Alsop
Acting Administrator
Housing and Community Facilities Programs

SUBJECT: Controls over Eligibility Determinations for Single Family Housing Guaranteed Loan Recovery Act Funds (2)

We are in receipt of your letter on the subject.

RD Instruction 1980-D, section 1980.345(c)(3) limits debt ratios to 29 percent for Principal, Interest, Taxes, and Insurance (PITI) and 41 percent for total debt (TD). Debt ratios higher than these are permitted by Agency regulations, require Agency concurrence, and must be supported by compensating factors. Your office has expressed concern that Agency staff may be approving debt ratio waivers without always obtaining supporting documentation from lenders, and that in such cases lenders may create or exaggerate compensating factors to justify loan approval. In addressing the concerns articulated in your letter, we propose the following new actions.

We are drafting and will issue additional quality control procedures for our field offices. Manually underwritten loans with debt ratios above certain thresholds will be required to be reviewed by the loan approval official's immediate supervisor. Written supervisory concurrence will be required to be retained and/or imaged. Supporting documentation of the compensating factors will be required and will be retained as part of the permanent record. Note that some supporting documentation is invariably already on record. For example, the Agency's published guidelines state that a credit score of 660 or over is a strong compensating factor for a debt ratio waiver. Because the Agency retains the credit report in every case, there would be no additional documentation for this compensating factor.

As you are aware, the Guaranteed Underwriting System (GUS) accepts loans with debt ratios higher than 29 percent for PITI, and 41 percent for TD. Our response to your letter dated May 11, 2009, describes the additional measures we will take for loans accepted through GUS. We note that loans accepted through GUS continue to perform better than manually underwritten loans, and there are no adverse indications at this time.

We look forward to continue working with you toward exercising the greatest due diligence in obligating funds under the American Recovery and Reinvestment Act of 2009, as well as other appropriations. Should you have any questions about this memorandum, please contact the Single Family Housing Guaranteed Loan Division at (202) 720-1452.