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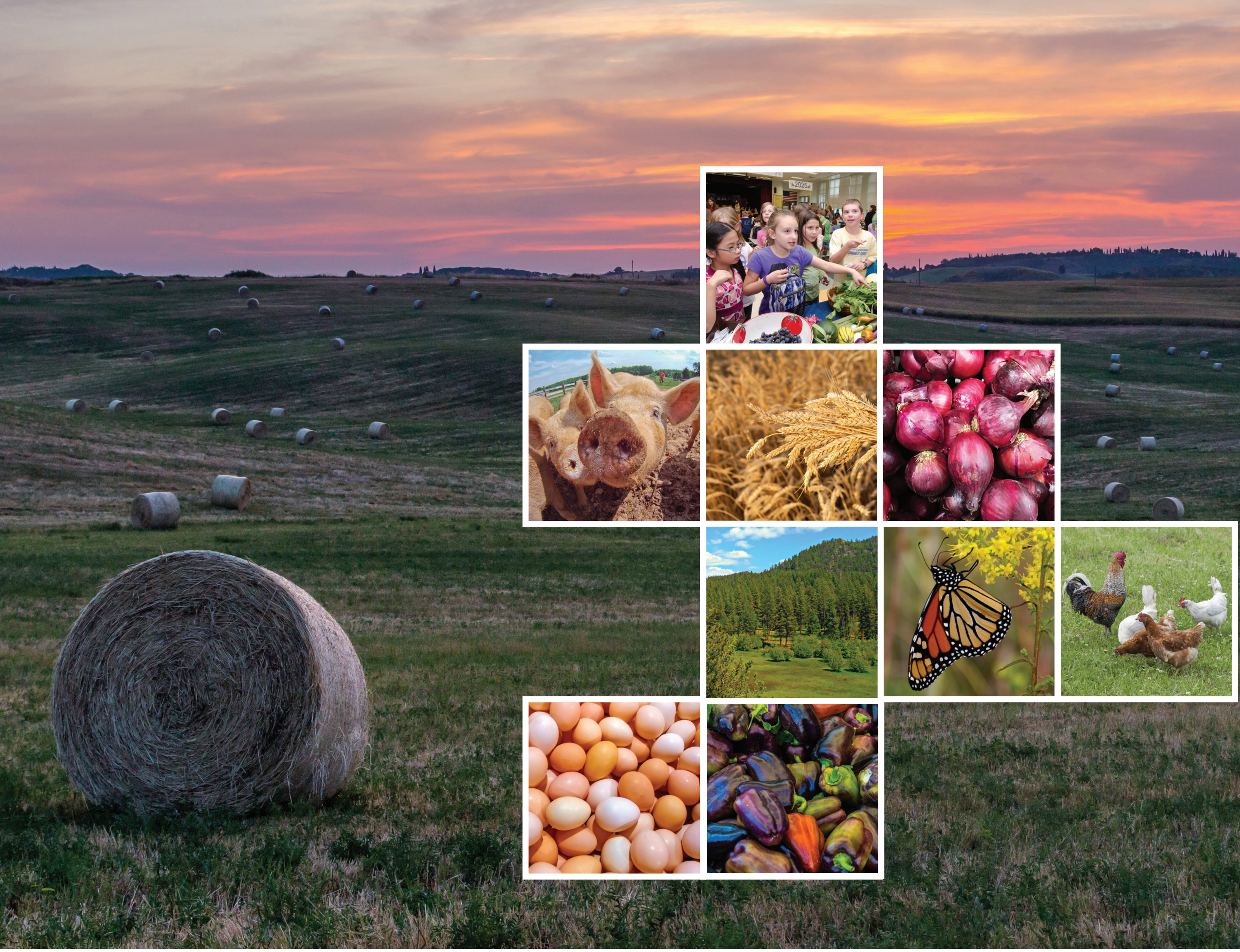
Rural Housing Service's Controls over Originating and Closing Single Family Housing Direct Loans



Audit Report 04601-0001-22

December 2017

OFFICE OF INSPECTOR GENERAL

IMPORTANT NOTICE

This audit report contains sensitive information that has been redacted for public release, due to privacy concerns.

Rural Housing Service's Controls over Originating and Closing Single Family Housing Direct Loans

Audit Report 04601-0001-22

We reviewed RHS controls over SFH direct loans to determine if they are adequately designed and effectively operating.

OBJECTIVE

To determine whether RHS' controls over originating and closing SFH direct loans and the construction of new homes are adequately designed and effectively operating to ensure that SFH direct loans were made only for eligible properties to eligible borrowers.

RECOMMENDS

We recommend reviewing past and current SFH loans, amending loan closing instructions, and providing guidance and training for loan officials.

REVIEWED

We reviewed relevant laws and regulations, evaluated internal controls, analyzed data for SFH loans, and interviewed RHS national office officials and Rural Development State and local (field) officials.

WHAT OIG FOUND

Rural Development, through the Rural Housing Service (RHS), administers the Section 502 Direct Loan Program, also known as the Single Family Housing (SFH) Direct Loan Program. This program provides direct loans to assist both low and very low-income individuals in obtaining decent, safe, and sanitary housing in eligible rural areas. For this audit, we reviewed RHS' controls over SFH direct loans in Arkansas, Florida, Kentucky, and Texas.

We found that for 12 borrowers in Kentucky, Rural Development officials either did not secure primary lien position or have adequate legal documentation to determine if it was the primary lien holder for its mortgages, as required in the USDA Rural Development's Direct Single Family Housing Loans and Grants Field Office Handbook because officials believed parties who filed their mortgages first had first lien position. We also found internal control weaknesses in all four States. For 55 of the 71 reviewed loans, Rural Development field officials did not always follow underwriting standards and procedures. Specifically, officials did not calculate borrowers' income using all feasible methods, did not review and document analyses of borrowers with adverse credit, and did not re-verify borrowers' employment prior to closing. Last, borrowers' loan files did not always contain required documentation such as loan closeout documents that ensure protections for borrowers or guide letters for assistance in repairing home structural defects.

RHS generally agreed with our findings and we accepted management decision for all nine recommendations.

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

DATE: December 18, 2017

AUDIT NUMBER: 04601-0001-22

TO: Rich Davis
Acting Administrator
Rural Housing Service

ATTN: Jacqueline Ponti-Lazaruk
Chief Risk Officer
Rural Development

FROM: Gil H. Harden
Assistant Inspector General for Audit

SUBJECT: Rural Housing Service's Controls over Originating and Closing Single Family Housing Direct Loans

This report presents the results of the subject review. Your written response to the official draft report, dated November 17, 2017, is included in its entirety at the end of the report. Excerpts from your supplemental response, dated December 5, 2017, and the Office of Inspector General's position are incorporated into the relevant sections of the report. Based on your written response, we accept management decision for all nine recommendations in the report and no further response to us is necessary.

Please note that Departmental Regulation 1720-1 requires final action to be taken within 1 year of each management decision to prevent being listed in the Department's annual Agency Financial Report. Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

We appreciate the courtesies and cooperation extended to us by members of your staff during our audit fieldwork and subsequent discussions. This report contains publicly available information and will be posted to our website (http://www.usda.gov/oig) in the near future. Due to privacy concerns, portions of the public report have been redacted.

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Background and Objectives

Background

The Department of Agriculture's (USDA) Rural Development mission is to increase economic opportunity and improve the quality of life for all rural Americans. Rural Development, through the Rural Housing Service (RHS), administers a variety of programs intended to improve housing in rural areas. One of these programs is the Section 502 Direct Loan Program, also known as the Single Family Housing (SFH) Direct Loan Program.[1]

The RHS National Office, located in Washington, D.C., administers the program through 47 Rural Development State offices and a nationwide network of field offices. The Rural Development Centralized Servicing Center, located in St. Louis, Missouri, provides support to local servicing efforts for all RHS SFH direct loans. RHS approved 7,112 SFH direct loans totaling $827,164,630 during fiscal year (FY) 2013; 6,560 SFH direct loans totaling $808,100,709 during FY 2014; and 7,060 SFH direct loans totaling $899,339,107 during FY 2015.

The SFH Direct Loan Program provides direct loans to assist both low and very low-income individuals in obtaining decent, safe, and sanitary housing in eligible rural areas.[2] Under the program, individuals can either construct a dwelling, or purchase a newly constructed or existing dwelling. USDA Rural Development's *Direct Single Family Housing Loans and Grants Field Office Handbook* (HB-1-3550) describes loan processing policies and establishes procedures for originating direct loans. Per HB-1-3550, to qualify for the program, applicants must:

- have an adjusted income at or below the applicable low-income limit in the area they wish to buy a house,
- be unable to obtain a loan from other sources due to terms and conditions such as income and credit requirements,
- agree to occupy the purchased property as a primary residence,
- have the legal capacity to incur a loan obligation, and
- demonstrate a willingness and ability to repay debt.

Properties financed with direct loan funds must be modest in size, design, and cost. They also must not have market value in excess of the applicable area loan limit, and certain features are prohibited.[3]

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[1] *The Housing Act of 1949, Pub. L. No. 81-171, Section 502; 7 C.F.R. Part 3550; and USDA Rural Development, Direct Single Family Housing Loans and Grants Field Office Handbook, HB-1-3550, Revised (Jan. 23, 2003) Special PN* govern SFH direct loans.

[2] Generally, rural areas with a population of less than 35,000 are eligible. 7 C.F.R. Section 3550.10.

[3] For example, in-ground swimming pools and properties designed for income producing activities are prohibited. Rural Development's definition of "modest housing" ranges from 1,800 square feet in the Midwest, South, and West regions to 2,000 square feet in the Northeast region. USDA Rural Development, *Modest Housing Determinations*,

Once an applicant is prequalified for a direct loan, the loan originator is required to determine the applicant's eligibility.[4] Determining applicant eligibility involves verifying household income, checking credit history, and reviewing all other eligibility requirements. Once the applicant is verified as eligible, the loan originator uses the verified income information to determine the amount of payment subsidy to which the household is entitled and the maximum loan amount the applicant can receive.[5]

In some cases, the loan amount the agency provides to help an applicant obtain housing can be lowered through a leveraged loan. A leveraged loan is an agency loan supplemented by an affordable housing loan or grant from another funding source—such as a private lender—provided at the same time the agency loan is closed.[6] The loan originator should provide information about other subsidized loans or grants to applicants. Applicants should be referred to entities offering affordable housing products such as grants, forgivable loans, deferred interest loans, and below-market interest rate loans.[7]

Lien priority establishes the order in which multiple lenders are paid, should foreclosure become necessary. The primary lien holder is paid first from all foreclosure proceeds. Remaining lenders are paid from any leftover funds in order of priority. Generally, the primary lien holder is established by the order in which all the mortgages are filed in the county's property records. However, Memorandums of Understanding (MOU) between the lenders or subrogation clauses in the secondary mortgages designate the primary lien holder regardless of when mortgage documents are recorded in county real property records.

Prior Audits

In June 2012, the Office of Inspector General (OIG) issued an audit report that reviewed Rural Development's compliance with its internal control procedures at loan origination and closing to ensure homes and program participants who received Recovery Act funds met eligibility

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Unnumbered Letter (Jan. 7, 2013); USDA Rural Development, *Modest Housing Determinations*, Unnumbered Letter (Feb. 4, 2014); and USDA RHS, *Modest Housing Determinations* (Mar. 3, 2015).

[4] The loan originator is a Rural Development agency employee who works with the loan applicant, conducts the basic underwriting analysis, and makes the loan approval or credit denial recommendation to the loan approval official. USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Glossary Page 6 of 13, Revised (Apr. 1, 2008) Special PN. Underwriting involves the evaluation of the property as outlined in the appraisal report and of the borrower's ability and willingness to repay the loan. USDA Rural Development, HB-1-3555, *Glossary*, Page 49 of 52, Revised (Mar. 9, 2016) Special PN.

[5] "Payment subsidy" is a general term for subsidies that reduce the borrower's scheduled payment. It refers to either payment assistance method 1 or 2, or interest credit per Rural Development's handbook. The agency uses payment subsidies to enhance an applicant's repayment ability for Section 502 loans. USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraph 6.11 and Glossary, Page 9 of 13, Revised (Apr. 1, 2008) Special PN.

[6] USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraph 10.1, Revised (Apr. 1, 2008) Special PN.

[7] USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraph 10.6, Revised (Apr. 26, 2006) PN 397.

guidelines.[8] OIG found that Rural Development field officials had not always fully complied with one or more of the agency's established internal control procedures. Specifically, OIG reported that approved borrowers: (1) had no history of stable and dependable income; (2) had a credit history that did not indicate the ability and willingness to repay a loan; or (3) did not meet repayment ability guidelines. Thus, OIG recommended that Rural Development: (1) provide continuing and targeted training to field personnel; (2) review HB-1-3550 and determine if it should be revised to provide further clarity to field personnel carrying out the policies and procedures; (3) ensure that the document checklist and underwriting compliance tool specifically address the borrower-related issues described in the report; and (4) ensure new regulations, policies, and procedures are effectively communicated and implemented at field office locations. Rural Development agreed with all findings and recommendations in the audit report.

Additionally, in September 2010, OIG issued an audit report that tested the effectiveness of the key controls over the Recovery Act-funded Section 502 SFH Direct Loan Program.[9] OIG identified specific weaknesses in the key controls for: (1) detecting, reducing, and preventing improper payments; (2) preventing previously identified weaknesses from recurring; and (3) segregating key duties. OIG concluded that controls needed strengthening to improve documentation for eligibility determinations and secondary reviews before loan approval in order to detect, reduce, and prevent improper loan payments to SFH direct loan applicants. OIG recommended that Rural Development: (1) strengthen controls to ensure borrower eligibility is updated and re-verified as part of loan closing based on the current information available; (2) revise procedures to require Loan Approval Officials to document the scope and timing of their second party review of eligibility determinations; (3) develop and implement a plan to correct the data integrity and system design issues; (4) develop and implement an automated review process to identify any SFH Direct Loan Program data irregularities for follow-up; (5) develop and implement effective controls to ensure that actions are taken to correct weaknesses identified by State Internal Reviews (SIR) and prevent issues from recurring; and (6) develop procedures and controls, using existing capabilities, to monitor loan approval, obligation, and disbursement activities of users with multiple access authorities. Rural Development generally agreed with the audit report's findings and recommendations.

In conjunction with this audit, and in response to a hotline complaint, OIG issued an interim audit report to the RHS national office.[10] In this interim report, OIG assessed whether RHS followed established policies and procedures when originating and closing a particular SFH direct loan and managing new home construction (See Exhibit C). The agency agreed with one of OIG's two recommendations. However, based on the agency's proposed actions, OIG was able to accept management decision for both recommendations.

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[8] USDA OIG Audit Report 04703-0003-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Compliance Review* (June 13, 2012).

[9] USDA OIG Audit Report 04703-2-KC, *Single-Family Housing Direct Loans Recovery Act Controls–Phase II*, (Sept. 24, 2010).

[10] USDA OIG Audit Report 04601-0001-22(1), *Rural Housing Service's Controls over Originating and Closing Single Family Housing Direct Loans–Interim Report* (Dec. 22, 2016).

Objectives

The audit objective was to determine whether RHS' controls over originating and closing SFH direct loans, and the construction of new homes, are adequately designed and effectively operating to ensure that SFH direct loans were made only for eligible properties to eligible borrowers.

Section 1: Lien Priority in Leveraged Lending Arrangements

Finding 1: Closing Instructions Need Revisions to Ensure RHS Has Correct Lien Position

While reviewing SFH direct loans in Kentucky, we found that field officials did not secure primary lien position or have adequate legal documentation for 12 of 18 borrowers with leveraged loans to confirm the agency was the primary lien holder for the mortgages.[11,12] Due to Kentucky statutes governing real property lien priorities, officials believed that parties who filed their mortgages first had first lien position. Furthermore, an [redacted] was unaware that staff was not obtaining all necessary documentation for other lenders' loans. As a result, RHS placed almost $1 million in loan funds at risk because it did not take necessary steps to ensure its interests are protected. Therefore, we questioned total costs of approximately $1 million for the 12 loans leveraged with other lenders because Rural Development either did not secure primary lien position, or did not have adequate legal documentation to ensure the agency was the primary lien holder for the mortgages (See Exhibit A).[13]

HB-1-3550 (the handbook) requires the agency to hold first lien position when leveraged lending arrangements involve forgivable and deferred payment loans.[14] To obtain the correct lien position, the handbook requires field officials to inform closing agents of the lien position RHS will take. Either the title insurance policy's declaration page or mortgagee clause must state the priority order of all mortgages. After loan closing, loan approval officials are to certify that they examined all loan closing documents and that the loan is properly closed according to agency instructions. In addition to this closing review, each SFH direct loan must have a completed direct loan checklist showing the date loan processing and closing requirements were met.[15] In the post-closing section of this checklist, loan approval officials are required to review closing documents to verify that RHS has received the proper lien priority. Furthermore, the handbook encourages State Directors to enter into MOUs with their lending partners to establish RHS' leveraged lending policies.

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[11] Leveraged loans are defined as loans whereby the applicant has obtained a portion of the needed funds from outside sources (that is, conventional lenders, housing authorities, etc.). Leveraged loans receive processing priority. USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Attachment 3-D, Revised (Nov. 18, 2010) PN 443.

[12] Our non-statistical sample selection of loans for Arkansas and Florida did not include any borrowers with leveraged loans, nor did our selection criteria include leveraged loans as a consideration for selection. In Texas, 1 of 20 loans reviewed was leveraged with another lender.

[13] Included in questioned costs are two loans, with a total value of $187,218, for which Rural Development officials did not secure the primary lien position, as secondary mortgages were recorded prior to RHS' mortgage.

[14] Regulations at 7 C.F.R. Section 3550.59 (a) (2) also require adequate security for SFH loans and that RHS loans generally have first priority.

[15] USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Attachment 3-G, Revised (May 14, 2015) PN 476.

In Kentucky, the leveraged lending arrangements we reviewed involved forgivable and deferred payment loans.[16] For a forgivable mortgage, the balance is eliminated after specific terms are met by the borrower. The mortgages we reviewed will forgive a percentage of the loan for each year the borrower lives in the home or after staying in the home for a set period, usually 10–20 years. Deferred mortgages delay payments for a specified period, typically 10–20 years, or in some cases, until the first mortgage is paid in full. For both types of mortgages, if the borrower moves or sells the property before loan terms are fulfilled, the mortgage amount becomes immediately payable at the stated interest rate and payment schedule.

Of the 20 borrowers OIG reviewed in Kentucky, 18 had a leveraged loan. We analyzed these 18 borrowers' title insurance policy documents, mortgages, and written instructions to closing agents and could not confirm RHS was the primary lien holder for all 18 loans. Recorded copies of the borrowers' second and third mortgages with other lenders were not on file in the field offices we visited, and we were unable to review their recordation dates. Since we could not ascertain whether RHS had the primary lien position, we obtained recorded copies of the borrowers' mortgages with the other lenders. We noted that none of the borrowers' recorded mortgages had a subrogation agreement filed along with the mortgage. After reviewing the recorded mortgage documents, we found that six had a subrogation clause in the recorded second or third mortgages stating that RHS had first lien position. Thus, RHS' interest as first lien holder was protected. For the remaining 12 borrowers, we found that neither the second nor third mortgages had a subrogation clause subordinating their lien position to RHS.

Furthermore, of the 12 mortgages without subrogation clauses, we found 2 instances in which the borrower's second mortgage with the leveraged lender was recorded in the county records before RHS' mortgage. In these two instances, we concluded that Kentucky Rural Development field officials did not secure the primary lien position. Because RHS did not secure first lien position for these two loans totaling $187,218, these funds were at risk should the borrowers default on the terms of their loan agreements.

Rural Development field officials must obtain a title insurance binder from a title company or closing agent to ensure a clear title can be obtained in preparation for closing.[17] The loan originator is responsible for completing a Rural Development Transmittal of Title Information[18] form and providing it to the borrower's closing agent. This form includes a section to list all leveraged lenders and the amount of their loans, but it does not have an area to indicate the lien priority among these lenders. For the 18 leveraged loans reviewed, we found that the instruction

[16] Forgivable loans provide funds that require repayment only if the home buyer fails to comply with program requirements or restrictions. Deferred payment loans may be used to provide funds to be repaid only upon transfer of the property or as a balloon payment at the end of a specified period.

[17] A title insurance binder is a promise from the title company to issue a title insurance policy for the property after closing and contains the same terms, conditions, and exclusions that will be in the actual [title] insurance policy. The terms "commitment" and "binder" are used interchangeably. Title insurance is required for most loans unless the State Director determines that the use of title insurance is not possible, is not economically feasible for the type of loan involved, or in the area of the State where the loan will be made. In these cases, an attorney's opinion can be accepted. Title insurance is not required if the total outstanding balance of any combination of any unsecured Section 502 and 504 loans is less than $7,500.

[18] Form Rural Development 1927-4, Transmittal of Title Information.

form for one borrower did not indicate that leveraged lending occurred. Essentially, the borrower's closing agent was not informed of other mortgagors in the loan transaction. For the 17 forms that did indicate leveraged lending occurred, the loan originator did not indicate on the form that RHS must have first lien position. Since Rural Development's form for obtaining title commitments does not specify what lien position the agency will hold in leveraged lending situations, it is left up to the closing agent to either designate lien priority, or follow up with field officials. Rather than relying on the closing agents, field officials should provide instructions clarifying that RHS is required to have primary lien position.

Once a title insurance binder is obtained and field officials determine that the borrower's selected property will have a clear title, a loan closing date can be set. Before closing, the loan originator must provide the borrower's closing agent with Rural Development form, Loan Closing Instructions and Loan Closing Statement.[19] We reviewed the 18 borrowers' closing instructions and found that none of the instructions clearly requested that RHS obtain first lien position. The written instructions to the closing agent have a section to identify the amount of funds from a leveraged lender; however, there is no place for loan approval officials to indicate that RHS must hold the first lien position. Without notifying the borrower's closing agent of all participating lenders and stipulating that RHS must hold first lien position, the closing agent cannot correctly prepare the title insurance policy as required by HB-1-3550. Additionally, closing agents file mortgage documents in county records where the mortgaged property is located; therefore, Rural Development needs to notify closing agents of the correct order of lien position.

We also observed that Rural Development's Loan Closing Instructions and Loan Closing Statement does not instruct field officials to obtain a recorded copy of second and third mortgages unless RHS is subordinating its lien position to another lender. By not obtaining recorded copies of all mortgage documents associated with a leveraged loan, the loan approval official does not have sufficient documentation to conduct the full post-closing review required by the SFH direct loan checklist. The post-closing review is performed to ensure the loan was closed according to RHS' written instructions. Along with a review of the borrower's title policy, loan approval officials need to compare the recording stamps on all mortgages to verify that RHS holds first lien position. Recorded copies of mortgages should be obtained in all leveraged lending situations so loan approval officials can ensure RHS loans are closed in accordance with agency policies and procedures.

Last, loan approval officials did not always conduct a complete post-closing review. To conduct a full review, the loan approval official must sign the Loan Closing Instructions and Loan Closing Statement to certify the loan closed properly and complete the post-closing section of the SFH direct loan checklist. The post-closing section requires the loan approval official to verify RHS held the proper lien position and obtained the final title policy from the closing agent. We checked the 18 borrowers' loan closing instructions and noted that 16 of the 18 forms were signed by the loan approval official to certify the loan was closed properly. Furthermore, of 18 loans, 9 had one or more problems with the SFH direct loan checklist; the checklist was either not completed or partially completed. Additionally, there was no evidence within the post-closing section of the SFH checklist that the loan approval officials verified the correct lien

[19] Form Rural Development 3550-25, Loan Closing Instructions and Loan Closing Statement.

position for 10 of the 18 borrowers. For the other eight borrowers where the loan approval official checked that RHS had the correct lien position, we question how loan approval officials can verify the agency has the proper lien position without reviewing recorded copies of all mortgage documents.

When we discussed this issue with Rural Development Kentucky State and field officials, they agreed RHS should have the first lien position when an SFH direct loan is leveraged with a forgivable loan. A Kentucky [redacted] told us title documents should list RHS in first lien position and questioned whether RHS was obtaining a complete product from its title insurance companies. Kentucky's [redacted] told us that some type of language needed to be in the title policy to protect RHS' interest. The [redacted] also told us Kentucky's State office does not have any MOUs with its primary lending partners to outline RHS' leveraged lending requirements.

Without amending its loan closing instructions and requiring better oversight from loan approval officials, RHS risks losing its primary lien interest in the mortgaged property when participating with lenders offering forgivable and deferred mortgages. Also, Kentucky field officials would benefit from an agreement with their primary lending partners that details RHS' leveraged lending requirements, particularly those related to lien priority. We conclude that all States participating in this type of leveraged lending without ensuring RHS is the primary lien holder are placing RHS funds at risk should the borrowers default on the terms of their mortgage agreements.

Recommendation 1

Secure first lien holder position for the two loans where the secondary mortgage was recorded prior to Rural Housing Service's (RHS) mortgage by obtaining a subrogation agreement with the other lenders.

Agency Response

A subrogation agreement will be pursued for the two loans identified by OIG. RHS estimates a completion date of March 15, 2018.

OIG Position

We accept management decision for this recommendation.

Recommendation 2

Review all leveraged loans not included in OIG's sample in the [redacted] and [redacted] Kentucky field offices for FYs 2013–2017 to determine if RHS has secured the proper lien position. If RHS is not the first lien holder, secure the proper lien position through a subrogation agreement with the other lenders. Develop and implement a plan to review a sample of leveraged loans in the other Kentucky field offices to determine if RHS has secured the proper lien position.

Agency Response

The defined sample in [redacted] and [redacted] Kentucky will be reviewed; and a subrogation agreement will be pursued for any loan where RHS does not have the proper lien position. Also, the Agency will develop and implement a plan to review a reasonable statistical sample of the leveraged loans made in the other Kentucky field offices and take the appropriate action for any loan where RHS does not have the proper lien position. RHS estimates a completion date of November 15, 2018.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Amend loan closing instructions on Form Rural Development 3550-25, Loan Closing Instructions and Loan Closing Statement, to require the loan approval official to fully verify the correct lien position is obtained in all leveraged lending arrangements, regardless of RHS' lien position. The form should include a place for the following information: priority order of leveraged lenders and their lien position, the lien position RHS seeks, and a designated place or checkbox for the loan approval official to verify that correct lien position was obtained and listed in the final title documents.

Agency Response

Form RD 3550-25, Loan Closing Instructions and Loan Closing Statement, will be revised to incorporate the revisions identified by OIG. RHS estimates a completion date of November 15, 2018.

OIG Position

We accept management decision for this recommendation.

Recommendation 4

Require Kentucky Rural Development officials to meet with primary lending partners and discuss requirements for leveraged lending. The discussion should include consideration of entering into Memoranda of Understanding and the use of subrogation clauses to ensure that proper lien positions are established when leveraged lending occurs.

Agency Response

The Kentucky Rural Development officials will be instructed to meet with their primary lending partners to discuss the leveraged lending requirements. RHS estimates a completion date of November 15, 2018.

OIG Position

We accept management decision for this recommendation.

Section 2: Controls for Loan Origination and Closing

Finding 2: Rural Development Field Officials did not Consistently Comply with Policies and Procedures When Making SFH Direct Loans

Despite recent actions RHS has taken to strengthen its controls for making lending decisions and processing SFH direct loans, we identified recurring internal control weaknesses in loan processing similar to those disclosed in prior OIG audit reports.[20] For 55 of 71 SFH loans reviewed valued at approximately $6.5 million, we found that Rural Development field officials did not always follow underwriting standards and procedures in making SFH direct loans. Specifically, field officials in the four States did not: (1) perform income comparisons to project borrowers' income; (2) properly review and document credit history analysis for borrowers with adverse credit; (3) consistently re-verify borrowers' employment prior to loan closing; (4) carry out high-risk loan origination and closing statement responsibilities in accordance with agency guidance; or (5) complete other Federal and administrative requirements necessary for making SFH direct loans. These deficiencies occurred primarily due to misinterpretation of program guidance and loan processing errors by Rural Development field officials. Additionally, some field officials attributed deficiencies to a lack of training and staffing resources for administering the SFH Direct Loan Program. As a result, RHS is at higher risk of making improper payments or providing financing to a borrower who is unable or unwilling to repay the debt. Additionally, the agency may reject an eligible applicant on the basis of inaccurate or incomplete information. Therefore, we questioned total estimated costs of approximately $6.5 million for the 55 SFH direct loans because Rural Development officials did not always follow underwriting standards and procedures in making SFH direct loans (See Exhibit A).[21]

Office of Management and Budget Circular A-123 provides that agency management is responsible for developing and maintaining effective internal control. Effective internal control provides assurance that significant weaknesses in the design or operation of internal control that could adversely affect the agency's ability to meet its objectives would be prevented or detected in a timely manner. RHS' loan processing policies and procedures provide that loan originators are responsible for ensuring that all applicants served are eligible and receive the correct amount of assistance. The loan approval official should review all documents contained in the case file to ensure that they are completed properly and must confirm that the loan originator's underwriting decision is sound.[22]

We examined 71 SFH direct loans made to borrowers in Arkansas, Florida, Kentucky, and Texas during FYs 2013 through 2015. Based on our review, we determined that Rural Development

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[20] USDA OIG Audit Report 04703-0003-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Compliance Review* (June 13, 2012) and Audit Report 04703-2-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Phase II* (Sept. 24, 2010).

[21] Actual amount is $6,549,456.06, and represents the total loan amount of the 55 of 71 loans reviewed that contained 1 or more deficiencies noted in Finding 2.

[22] USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook*, HB-1-3550, Paragraph 4.1, Special PN, Revised (Oct. 25, 2006) PN 403 and Paragraph 8.2, Special PN, Revised (Apr. 10, 2013) PN 461.

field officials in these States did not always follow controls when processing SFH direct loans, as outlined below.

Field Officials did not Compute Borrowers' Income Using All Feasible Calculation Methods

We found that in 37 of 54 loans totaling $4,722,770, field officials did not compute borrowers' income based on all available calculation methods when it was appropriate to do so, nor did they adequately document how the selected income method represented the best projections for those borrowers.[23] This occurred because HB-1-3550 does not clearly prescribe that these calculations should be performed to compare and analyze borrowers' income when this information is readily available in the pay documents applicants provided. Without adequate comparison and analyses of borrowers' projected income, there is less assurance that borrowers' incomes used for underwriting the loans represented the best projections in determining their ability to repay the loans, thereby increasing the agency's risk of over or underestimating income and making improper payments for payment subsidy.

Rural Development field officials must determine the applicant's ability to repay the loan and are required to verify and calculate the applicant's income to project his or her income for the next 12 months.[24] This projection should be based on a comparison and analysis of the figures derived from using all applicable calculation methods.[25] This process should be documented in writing and included in the borrower's case file. After a loan originator determines the suitable methods, the loan originator must determine which figure is most representative of income likely to be received during the next 12 months.

We agree that some income sources, such as fixed monthly or annual salary, will only lend themselves to one calculation method. However, for 37 of the 54 SFH loans we reviewed, Rural Development officials used minimal calculation methods even when other methods of calculation could have been used to determine income. For example, our review of one borrower's loan file in [redacted] revealed that a Rural Development field official projected the borrower's income using the straight-based income calculation. This calculation method resulted in a total income of [redacted]. The official also calculated the borrower's historical income of [redacted] based on the borrower's Federal income tax return. A Rural Development

[23] Of the 71 reviewed borrowers, 54 received income from wages through employment. The remaining 17 borrowers received unearned income, typically from Social Security sources.

[24] When projecting the expected income of a borrower, the loan originator must verify the income source information provided by the borrower. Preferred sources of documentation to verify income outlined in HB-1-3550 include use of a borrower's paystubs, Federal income tax returns, and oral verifications of employment. Other sources could include obtaining written verifications of employment provided by third-party sources or documents prepared by third-party sources when a borrower is unable to provide sufficient recent, reliable, and consistent documentation.

[25] USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraph 4.3, Special PN, Revised (Sept. 1, 2011) PN 451. These calculation methods include: straight-based, average, year-to-date (YTD), and historical. The straight-based method is calculated by converting the benefit or wage amount to an annual amount, the average method is the income reported on statements or pay stubs for the last 30 days converted to an annual amount, the YTD method is YTD gross earnings divided by a YTD interval and then multiplied by 365, and the historical method is income reported on the previous year's income tax return.

field official subsequently approved the borrower's loan based on consideration of these two numbers.

However, the borrower's pay statement provided adequate information, such as hourly rates and year-to-date income, for applying the average and year-to-date income calculation methods. Our calculations of the year-to-date and average income methods for this borrower resulted in figures of [redacted] and [redacted], respectively. Since income factors into the amount of monthly mortgage payments the borrower can afford and the amount of mortgage assistance, if any, the borrower receives, RHS' income projection selected for loan approval should be based on more than a minimal number of income calculation methods. If field officials had simply selected the lowest figure (such as the historical/income tax figure in the example) for this borrower, the monthly mortgage assistance would possibly be greater than if the higher figure was selected, resulting in potential overpayment of mortgage assistance if the historical income was not the best projection. The Rural Development field official in [redacted] did not perform any other calculations to use for comparison and analysis in making the lending decision, nor adequately document the reason for the income selection from the calculation methods used.

Our review of the remaining 36 borrowers' loan files revealed similar scenarios where Rural Development field officials did not perform income projections when other methods of calculation could have been applied for comparison and analysis of the figures. The files also lacked information explaining the reason why the income method selected was best.

Due to the lack of clarity in describing requirements for income calculation methods contained in HB-1-3550, Rural Development field officials followed their own interpretations of the income calculation requirements and thereby did not consistently apply all income calculation methods when the type of income and available pay information made it feasible to do so. Although some field officials expressed they were not aware that all income calculation methods should be performed or that they were expected to apply all of these methods, HB-1-3550 emphasizes that officials should establish earning trends based on a comparison and analysis of the figures derived from using all applicable calculation methods. Projecting the most accurate income figure for a borrower is crucial, as the income determines the amount of payment assistance a borrower can receive. To better ensure that borrowers are able to repay their loans, the agency needs to take steps to ensure its loan officials compute and analyze borrower's income projections using all feasible methods and adequately document their determinations.

Field Officials did not Fully Review and Document Analyses of Borrowers with Unacceptable Credit Indicators

Our review disclosed that the borrowers for three SFH direct loans valued at $342,504, had indicators of unacceptable credit or a credit score of less than 640, yet there was no documentation in the borrowers' loan files to support that Rural Development field officials conducted a full credit analysis and adequately documented its results. An official at one field office stated the handbook instructions for reviewing applicants with adverse credit and documenting the approval were followed, while an official from another field office attributed the deficiency to an oversight due to working on multiple programs. This practice increases RHS' risk of incurring losses of SFH direct loan funds due to lending to borrowers who may be unable or unwilling to repay the debt.

The loan originator must evaluate the credit history of each proposed party for the loan and investigate indicators of unacceptable credit to determine whether they are accurate.[26] The loan originator must also determine whether there is acceptable justification for any exception. If the applicant's credit score is under 640, the loan originator must use the Credit History Worksheet to summarize the applicant's credit history and determine whether any indicators of unacceptable credit exist.[27] For applicants who do not use traditional credit or have a limited credit history, the loan originator must develop a credit history from at least three nontraditional credit sources such as rental payments, utility payment records, or other means of direct access from the credit provider. If the credit report is more than 6 months old when the underwriting decision is to be made, a new credit report must be ordered. If there were extenuating circumstances,[28] the loan originator may determine that the late payments are not reflective of the applicant's ability to meet financial obligations or manage debts. All extenuating circumstances and any compensating factors must be documented on the Credit History Worksheet.[29]

In one instance for a construction loan made in [redacted] the borrower's (then applicant) credit report disclosed that the borrower had no credit score. Additionally, the borrower had indicators of adverse credit that included [redacted] Yet, field officials did not conduct and document a full credit analysis of the borrower. The loan file contained rent receipts, documentation of insurance payments, and a letter documenting a personal loan the borrower incurred; however, the personal loan was from a [redacted]. The field officials acknowledged that the Credit History Worksheet was not on file for this borrower, but the loan file contained documentation to support that non-traditional credit verifications had been requested. The field official also stated the personal loan was not considered the third reference because it was questionable in

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[26] Indicators of unacceptable credit include payments on any revolving account which were delinquent for more than 30 days on two or more occasions within the last 12 months. Also, outstanding collection accounts with a record of irregular payments with no satisfactory arrangements for repayment, or collection accounts that were paid in full within the last 6 months, unless the applicant had been making regular payments previously. USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraph 4.10, Special PN, Revised (July 8, 2009) PN 430; Paragraph 4.10, Special PN, Revised (Feb 10, 2011) PN 446.

[27] The loan originator should complete Form Rural Development 1944-61, Credit History Worksheet, and include it in the case file to aid the loan approval official in reviewing the applicant's credit history. Derogatory credit may also be the result of extenuating circumstances causing a significant reduction in income and/or increase in financial obligations. USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraphs 4.13 and 4.14, Special PN, Revised (Sept. 1, 2011) PN 451.

[28] "Extenuating circumstances" are events beyond the applicant's control and unlikely to reoccur that may cause a significant reduction in income and/or increase in financial obligations. The applicant must provide a letter to explain the nature of the event that led to the derogatory credit and provide supporting documentation for Rural Development to consider in making its lending decision. USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraph 4.14, Special PN, Revised (Sept. 1, 2011) PN 451.

[29] USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraph 4.12 Special PN, Revised (Sept. 1, 2011) PN 451.

nature. Rural Development field officials requested a third reference, but it was never received from the borrower. OIG concluded that this loan should not have been approved without the third credit reference.

In another instance for a loan made in [redacted] the borrower's [redacted], credit report revealed a credit score of [redacted] and [redacted] accounts with past due balances. Additionally, [redacted] accounts were outstanding collections. There was no support for regular payments or satisfactory arrangements for repayment; this is an indicator of unacceptable credit. The loan file did not contain documentation to support that a full credit analysis had been performed and documented prior to the Rural Development field official's approval in [redacted]. Additionally, field officials did not obtain another credit report on the borrower prior to loan approval, even though the previous credit report was more than 180 days old at loan approval. In [redacted], Rural Development field officials did obtain another credit report that revealed [redacted] and [redacted]. The loan file contained documentation of [redacted] non-traditional credit sources also obtained during [redacted], and the loan was closed [redacted]. The field official acknowledged that performance of a full credit analysis could not be found using the Credit History Worksheet. We believe RHS should not have approved the loan without documenting a full credit analysis and obtaining an updated credit report to assess the borrower's credit worthiness for repaying the SFH direct loan.

Field Officials did not Reverify Employment Prior to Loan Closing

We found that for 34 of 54 borrowers' loans totaling $4,458,107, Rural Development field officials did not reverify their employment or properly document updated reverification of employment within 10 business days prior to the loan closing date. Field officials either attributed these deficiencies to loan processing errors, insufficient training, or difficulty in obtaining oral verifications from employers. As a result, RHS does not have assurance that borrowers' employment statuses have not changed since underwriting the loan, thereby increasing the agency's risk of making improper payments through loans made to persons who no longer meet requirements.

According to HB-1-3550, field officials must obtain an oral verification of employment within 10 business days prior to the loan closing date. A written verification of employment, also dated within 10 business days prior to settlement, may be accepted in lieu of an oral verification of employment. All reverification activity should be documented carefully.[30]

The loan records for these 34 borrowers did not include any documentation supporting that field officials reverified borrowers' employment within 10 business days leading up to their loan closings. For example, one borrower in [redacted] applied for an SFH direct loan on [redacted]. Rural Development obtained a written verification of employment for the borrower on [redacted], and subsequently approved the borrower's loan [redacted]. The borrower's loan closed [redacted]. The borrower's loan file did

[30] USDA Rural Development, *Direct Single Family Housing Loans and Grants Field Office Handbook,* HB-1-3550, Paragraph 8.6 C, Special PN, Revised (Sept. 1, 2011) PN 451.

not contain any documentation to support either an oral or a written reverification of employment within 10 business days prior to the borrower's loan closing date. The field officials agreed there was no oral or written reverification of employment in the borrower's loan records, but had no explanation for why this occurred because [redacted]

When we spoke with other field officials, some attributed these issues to human error for not accomplishing these required processes. An official in one field office commented that, "this process for verifying oral and written employment is not easy because [some] larger employers do not provide verification anymore by phone," and "[y]ears ago it was relatively easy to obtain an oral verification of employment." The field official added that typically, a smaller employer will at least verify the person is still employed; however, larger employers simply refer Rural Development officials to their work number or whatever online source the employer uses. A Rural Development official stated the agency is unable to use the work number because there is a charge for this service and USDA does not provide funds for the payment of this charge.[31] However, the loan files did not contain documentation to support that field officials were unable to obtain either oral or written verifications of employment from employers. Furthermore, review of the loan files disclosed where field officials had obtained either oral or written verifications of employment at earlier stages of loan processing. Reverification of employment is important because it provides the agency with assurance that the borrower's employment status has not changed, thereby reconfirming eligibility for the loan. As a result, we believe the agency should take steps to ensure its field officials understand and follow through with employment reverification requirements.

Loan Origination and Closing Statement Responsibilities Were Not Fulfilled

Our review disclosed that for 41 of 71 SFH direct loans reviewed totaling $5,019,948, Rural Development field officials did not carry out high-risk loan origination and closing statement responsibilities in accordance with agency guidance. Specifically, field officials either did not follow RHS' guidance for achieving separation of duties when processing SFH direct loans, did not fully complete loan closing statements, or left the statements blank. Additionally, field officials did not always certify the loan closing in a timely manner.[32] Field officials attributed these deficiencies primarily to human error and staffing shortages. Also, RHS' guidance does not establish a time standard for completion of the review and certification of loan closing. Lack of separation of duties by field officials in loan processing increases the risk that errors and improper activities may go undetected and lead to improper payments in the SFH Direct Loan Program.

RHS' guidance identifies verification of the applicant's income and credit, obligation of the funds in MortgageServ, and activation of the loan in MortgageServ as high-risk loan origination functions. The name of each staff member who performed each of these high-risk functions should be documented on the Loan Closing Instructions and Loan Closing Statement.

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[31] "Work number" is a source, designated by the employer, for verifying employment.

[32] A staff member other than the loan approval official must verify the applicant's income and credit, obligate the funds in FiServ Loan Servicing Platform (FLSP) (formerly MortgageServ), and activate the loan in FLSP. MortgageServ is a mainframe-based application that is used to service agency loans and monitor loan performance.

A staff member other than the loan approval official must perform the high-risk functions.[33] During the post-closing phase, the loan approval official performs a review and certifies on the Loan Closing Instructions and Loan Closing Statement that the loan was closed in accordance with instructions and the internal control measure of separation of duties was achieved.[34] Timely execution and review of loan closing documentation provides the agency's management with reasonable assurance their controls are operating as designed to timely detect or prevent errors or even fraudulent activity.

When reviewing loan closing statements for these 41 loans, we found that: 1) the loan approval official was also the same person who either verified income and credit or obligated or activated the loan in MortgageServ, or 2) field officials partially completed the loan closing statement where it lacked the loan approval official's signature or left this section of the form completely blank. For 10 loans reviewed in one field office in Kentucky, the loan closing statement disclosed that the official who approved the loan was also the same person who verified income and credit.

Additionally, we found that RHS' guidance does not contain any timeframe for loan approval officials to complete their review and certification of the loan closing statement. In 33 instances, the certifications by loan approval officials occurred at various intervals following loan closings ranging from the same day of loan closing to more than a year after loan closing.[35]

Some field officials explained that human error contributed to the incomplete statements, while others commented that staffing shortages over the past several years have impacted their operations. One field office official stated that she once had two specialists and three technicians preparing loans for her review and approval, but now she shares one technician with two other specialists. Another field official stated that separation of duties was possible years ago, but now not enough employees are available. Field office directors have a variety of responsibilities in their offices, including administering the SFH Direct Loan Program. However, we believe increased assistance from field directors with SFH loan making would help ensure that key duties are divided, especially in field offices with staffing shortages.

We conclude that when the loan approval official also performs other loan processing actions on the same loan, or when there is an incomplete or untimely review and certification of the loan closing statement, the agency's ability to identify errors or possible fraudulent activity

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[33] USDA Rural Development, *Dedicated Loan Origination and Servicing System (DLOS) Training Manual*, Chapter 6 (Apr. 1, 2015).

[34] The loan approval official is responsible for all underwriting exceptions within his/her authority and for determining loan approval. Loan approval officials are specialists in field offices who have loan approval authority. However, field office technicians performed loan processing tasks within the field office. Field office technicians do not have loan approval authority. The loan closing certification is pending the field office's receipt of final title policy from the closing attorney.

[35] The 33 instances comprise of 32 of the 41 loans with loan origination and closing statement deficiencies, plus 1 additional loan file where we questioned the timeliness of the loan closing certification. We were not able to analyze the loan closing certification for 9 of the 41 loans because the loan closing statements were missing the certification dates. The 1 additional loan file was part of our overall sample of the 71 loans reviewed for the audit.

with the loan in a timely manner is diminished. Following loan closing, there is a possibility that a direct loan can be reviewed internally during the agency's SIR that occurs every 5 years. However, because there is no guarantee the loan will be selected as part of the SIR sample, it is essential that field officials properly and timely complete loan closing reviews and certifications.

Borrowers' Loan Files did not Always Contain Required Documentation

RHS did not adequately document or obtain documentation supporting compliance with its loan origination, closing, and construction procedures in its loan files. Specifically, RHS did not ensure there was adequate documentation for construction closeouts and guide letters. This occurred because of field officials' oversight and misinterpretation of agency guidance. The lack of information pertinent to borrowers' SFH direct loans may result in undue hardships if borrowers experience financial issues or defects in materials or construction.

First, we found a lack of construction closeout documents for four loans reviewed, totaling $490,551.[36] A builder's warranty guarantees the quality of the builder's work or materials. RHS' program regulations require field officials to document and maintain one of the two acceptable forms of a builder's warranty in the borrower's loan file.[37] Also, the loan file must contain the Release by Claimants form that the contractor must have each subcontractor sign. The form certifies the contractor has paid each subcontractor and that there are no outstanding claims against the property for the work performed (thereby protecting the U.S. Government's interest in the property). However, we found these essential construction closeout documents were either incomplete or absent from the borrowers' loan files. One Rural Development field official attributed the instances to error while another field official could not explain why this occurred. As a result, the agency cannot provide reasonable assurance that the borrowers were provided protections to which they were entitled.

In 14 instances in Florida and Texas for loans totaling $1,874,777, we found that the guide letter was not issued.[38] RHS is required to send the borrower a guide letter 30 days after the final inspection informing the borrower that RHS can provide financial assistance to help repair major structural defects in new houses it finances. A field official in [redacted] explained that [redacted] was under the impression the guide letter was sent to new borrowers by Rural Development's Centralized Servicing Center. Due to this misunderstanding of agency policy and procedures, field officials did not provide borrowers with essential information about possible compensation for construction defects designed to mitigate risk to the new homebuyer. This lack of information could result in undue financial hardship to borrowers in the event of encountering major structural defects.

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[36] These four loans are comprised of [redacted] relative to builder's warranty totaling [redacted], and [redacted] relative to release of claimants totaling [redacted].

[37] Either Form Rural Development 1924-19, Builder's Warranty (a one-year warranty) or an Insured 10-Year Home Warranty.

[38] Guide Letter 1924-1 of Rural Development Instruction 1924-F.

These internal control weaknesses in the program are similar to prior OIG findings and are of a recurring nature from audits over the past 6 years. In response to a prior OIG recommendation addressing these issues, Rural Development revised HB-1-3550 to strengthen its guidance on borrower-related underwriting factors. The agency also implemented an underwriting and compliance review tool to assist field office personnel in documenting lending decisions.[39] However, although management has taken needed steps to address internal control weaknesses reported, more needs to be done to ensure sound loan decisions that assist low- and very low-income people obtain decent, safe, and sanitary housing in eligible rural areas.

Recommendation 5

Develop a training strategy for field officials that includes the delivery of targeted training to address internal control weaknesses identified in this report. The training strategy should include a survey of field officials for their input on training needs for administering the SFH Direct Loan Program.

Agency Response

The internal control weaknesses identified in this report will be interwoven into existing training platforms and included in the Agency's training strategy. RHS estimates a completion date of November 15, 2018.

OIG Position

We accept management decision for this recommendation.

Recommendation 6

Provide loan officials with supplemental guidance clarifying procedures to require calculation of all feasible income calculation methods when adequate income information is available for projecting an applicant’s income.

Agency Response

With Procedure Notice 492 dated January 6, 2017, an automated worksheet for computing income was put into place. The worksheet provides a valuable tool to loan application packagers and Rural Development staff. It helps the user to organize, calculate, and report on a customer's income. With the use of the tool, the user is prompted to consider all the applicable considerations related to income (type, source, deductions, calculation methods, etc.). While the use of this tool is required in the program's handbook, its utilization will be stressed as part of the Agency's training strategy. RHS estimates a completion date of November 15, 2018.

[39] USDA OIG Audit Report 04703-0003-KC, *Single-Family Housing Direct Loans Recovery Act Controls – Compliance Review* (June 13, 2012).

OIG Position

We accept management decision for this recommendation.

Recommendation 7

Develop and implement a process to provide additional oversight by requiring State offices to periodically review SFH direct loan files to ensure they are in accordance with the Federal and administrative requirements.

Agency Response

In its initial response, RHS provided that an additional oversight process will be developed and implemented. At the request of OIG, RHS provided additional details about its planned corrective action. Specifically, RHS stated that this will be a State office oversight process. Quality checks on new loans as well as withdrawn and rejected applications will confirm the Loan Originator and Loan Approval Official complied with the underwriting standards and procedures. Attachment 6-B, Loan Underwriting Review, in Handbook 1-3550 will be revised to require that a sample of applications and closed loans be reviewed for each field office. RHS estimates a completion date of November 15, 2018.

OIG Position

We accept management decision for this recommendation.

Recommendation 8

Through revisions to Form Rural Development 3550-25, Loan Closing Instructions and Loan Closing Statement, establish a timeframe for loan approval officials to complete the review and certification of loan closing statements.

Agency Response

Form RD 3550-25, Loan Closing Instructions and Loan Closing Statement, will be revised to incorporate the revisions identified by OIG. RHS estimates a completion date of November 15, 2018.

OIG Position

We accept management decision for this recommendation.

Recommendation 9

Evaluate staffing levels at all field offices responsible for administering the SFH Direct Loan Program. Develop and implement strategies to deliver the SFH Direct Loan Program in offices that encounter staffing shortages.

Agency Response

The overseeing officials will be asked to evaluate the staffing levels in the field offices administering the program, and strategies will be implemented to aid in the delivery of the program, especially for offices that are understaffed. RHS estimates a completion date of November 15, 2018.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

We conducted this audit to determine whether RHS' controls over originating and closing SFH direct loans as well as the construction of new homes are adequately designed and effectively operating to ensure that SFH direct loans were made only for eligible properties to eligible borrowers. Our audit focused on SFH Direct Loan Program activities for FYs 2013 through 2015. RHS obligated $827.2 million for 7,112 SFH direct loans in FY 2013; $808.1 million for 6,560 SFH direct loans in FY 2014; and $899.3 million for 7,060 SFH direct loans for FY 2015. RHS carries out program activities in all 50 States as well as in Puerto Rico, Guam, Marshall Islands, Palau, and the U.S. Virgin Islands.

Initially, we performed survey fieldwork at the RHS national office located in Washington, D.C., Rural Development's Arkansas State office, and two of the State's local (field) offices from December 2015 to February 2016. Although we performed tests of controls in Arkansas, we generally limited our survey fieldwork to developing an understanding of RHS' loan origination, closing, and construction aspects of the SFH Direct Loan Program.

Subsequently, we conducted audit testing at three Rural Development State offices: Florida, Kentucky, and Texas. These States were non-statistically selected based on the following criteria: high number of SFH direct loans closed, high number of loans closed for newly constructed dwellings, and a mid-range or higher rate of payment delinquency:

- **Florida**–selected because it ranked among the highest number of SFH direct loans closed in FYs 2013 through 2015. It was also high in number of construction loans closed during FYs 2013 through 2015 and had a high delinquency rate.

- **Kentucky**–selected because it ranked among the highest number of construction loans during FYs 2013 through 2015. It also had an intermediate number of SFH direct loans closed and a mid-level delinquency rate.

- **Texas**–selected because it ranked among the highest number of SFH direct loans closed in FYs 2013 through 2015. It was also high in number of construction loans closed during FYs 2013 through 2015, had a mid-level delinquency rate, and was geographically diverse.

At each State visited, we conducted fieldwork at two non-statistically selected field offices to further review RHS' controls for originating and closing SFH direct loans as well as the home construction process (see Exhibit B). Field offices were selected based on a high number of SFH direct loans for construction and whether prior SIRs disclosed that the office had a large number of discrepancies. We reviewed a non-statistical sample of 71 SFH direct loan files (11 in Arkansas, 20 in Florida, 20 in Kentucky, and 20 in Texas) totaling $8,188,794, and 4 withdrawn applications. We selected these direct loans based on loan amounts, fiscal year, and loan type. We conducted fieldwork from December 2015 through June 2017.

To accomplish our objectives, we:

- Reviewed laws, regulations, policies, procedures, handbooks, administrative notices, unnumbered letters, and other published guidance;
- Determined the impact of prior OIG investigations and hotline complaints on the scope of our work;
- Documented the national, State, and local offices' organizational structure and their responsibilities for the SFH direct loan program;
- Evaluated Rural Development's performance measures for the SFH direct loan program;
- Reviewed Rural Development's Federal Managers' Financial Integrity Act report, the Agency Financial Report, USDA's Annual Performance Report, and prior OIG reports to determine if any issues impacted the scope of our work;
- Interviewed RHS national office officials and Rural Development State and local officials;
- Reviewed RHS internal control reviews at the national office for overseeing the SFH Direct Loan Program;
- Evaluated internal controls for originating, closing, and constructing SFH direct loans;
- Examined RHS' controls and handling of program complaints at the national, State, and local levels;
- Reviewed SIRs conducted in Arkansas, Florida, Kentucky, and Texas during FYs 2013 through 2015;
- Analyzed nationwide SFH direct loan data for trends and outliers;
- Reviewed a non-statistical sample of 11 direct loans in Arkansas during survey testing by using an electronic template to assess borrower and property eligibility and whether closing and construction procedures were followed;
- Reviewed a non-statistical sample of 10 direct loans at each field office reviewed in Florida, Kentucky, and Texas during audit testing by using an electronic template to assess borrower and property eligibility and whether closing and construction procedures were followed;
- Analyzed selected States' methodology for allocating funds to area offices; and
- Assessed the type of training the agency provided to SFH program staff during FYs 2013 through 2015, and reviewed data on staffing levels from FYs 2013 to 2015.

We did not verify information in any RHS electronic system and we make no representation regarding the adequacy of any agency computer systems. However, we performed comparisons of SFH direct loan data obtained from national, State, and field offices to ensure they were complete. Additionally, for the sample of loans, we compared the automated data to source documents to ensure accuracy.

We conducted this performance audit in accordance with generally accepted government auditing standards. These standards require that we plan and perform our audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence we obtained provides a reasonable basis for our findings based on our audit objectives.

Abbreviations

CFR..Code of Federal Regulations
DLOS.....................................Dedicated Loan Origination and Servicing System
FY ....fiscal year
HB ....handbook
MOU......................................Memorandum of Understanding
OIG ....Office of Inspector General
RHS..Rural Housing Service
SFH ....Single Family Housing
SIR ....State Internal Review
USDA.....................................United States Department of Agriculture
YTD ....year to date

Exhibit A: Summary of Monetary Results

Exhibit A summarizes the monetary results for our audit report by finding number.

Finding	Description	Amount[40]	Category
1	Housing loans closed without documentation of Rural Development's lien position[41]	$998,739.06	**Questioned Costs and Loans, No Recovery**
2	Loan processing weaknesses[42]	$5,550,717	**Questioned Costs and Loans, No Recovery**
Total[43]		$ 6,549,456.06	

[40] The costs in Finding 1 are based on the value of 12 loans. We also noted deficiencies on these 12 loans in Finding 2. To avoid duplication, we did not include their value in the questioned costs for Finding 2.

[41] Included in questioned costs are two loans, valued at $187,218, where Rural Development officials did not secure the primary lien position, as secondary mortgages were recorded prior to RHS' mortgage.

[42] The amount of questioned costs for Finding 2 represents the dollar value of 55 loans in question less the value of the 12 loans reported in Finding 1. In Finding 2, we noted multiple deficiencies on the 55 loans, and for purposes of this exhibit, we only counted the loan value once.

[43] The total questioned costs represent the value of 55 loans.

Exhibit B: RHS/Rural Development Offices Visited

The table below represents a listing of the RHS and Rural Development offices visited during fieldwork.

Office	Location
RHS National Office	Washington, D.C.
Arkansas State Office	Little Rock, Arkansas
[redacted]	[redacted] Arkansas
[redacted]	[redacted] Arkansas
Florida State Office	Gainesville, Florida
[redacted]	[redacted] Florida
[redacted]	[redacted] Florida
Texas State Office	Temple, Texas
[redacted]	[redacted] Texas
[redacted]	[redacted] Texas
Kentucky State Office	Lexington, Kentucky
[redacted]	[redacted] Kentucky
[redacted]	[redacted] Kentucky

Exhibit C: Interim Report

USDA OIG Audit Report 04601-0001-22(1), *Rural Housing Service's Controls over Originating and Closing Single Family Housing Direct Loans*–Interim Report (Dec. 22, 2016).

RURAL HOUSING SERVICE'S RESPONSE TO AUDIT REPORT

United States Department of Agriculture

Rural Development

Richard A. Davis
Acting Administrator

Rural Housing Service
1400 Independence Ave, SW
Room 5014-S
Washington, D.C. 20250

November 17, 2017

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

THROUGH: Jacqueline Ponti-Lazaruk /s/ JACQUELINE PONTI-LAZARUK
Chief Risk Officer
Rural Development

FROM: Richard A. Davis /s/ RICHARD A. DAVIS
Acting Administrator
Rural Housing Service

SUBJECT: Rural Housing Service's Controls over Originating and Closing Single Family Housing Direct Loans
Audit Number 04601-0001-22

The Rural Housing Service (RHS) is appreciative of the Office of Inspector General's (OIG) recent audit of the single family housing direct loan program. As with past audits, RHS will fully address the recommendations and fully complete the agreed upon actions as part of our continuous efforts to improve program delivery through a variety of means (e.g. process improvement, training, automation, communication, etc.). RHS will complete the actions outlined below by the estimated complete dates (ECD) shown below. Each action will be completed in a judicious and timely manner; actions that can be completed in a shorter period of time will be.

Section 1: Recommendations 1 - 4 related to leveraging arrangements and lien priority.

A leveraging arrangement is where the Agency loan is supplemented by a loan and/or grant from another funding source that meets the criteria outlined in Handbook-1-3550, Chapter 10. Leveraging arrangements represent a small percentage of the program's overall activity; ten percent or less of the obligation activity each fiscal year.

Recommendation 1: Secure first lien holder position for the two loans where the secondary mortgage was recorded prior to RHS's mortgage by obtaining a subrogation agreement with the other lenders.

Agency Response to Recommendation 1: A subrogation agreement will be pursued for the two loans identified by OIG.

ECD: March 15, 2018

Recommendation 2: Review all leveraged loans not included in OIG's sample in the [redacted] and [redacted] Kentucky field offices for fiscal years (FY) 2013 – 2017 to determine if RHS has secured the proper lien position. If RHS is not the first lien holder, secure the proper lien position through a subrogation agreement with the other lenders. Develop and implement a plan to review a sample of leveraged loans in the other Kentucky field offices to determine if RHS has secured the proper lien position.

Agency Response to Recommendation 2: The defined sample in [redacted] and [redacted] Kentucky will be reviewed; and a subrogation agreement will be pursued for any loan where RHS does not have the proper lien position. Also, the Agency will develop and implement a plan to review a reasonable statistical sample of the leveraged loans made in the other Kentucky field offices and take the appropriate action for any loan where RHS does not have the proper lien position.

ECD: November 15, 2018

Recommendation 3: Amend loan closing instructions on Form Rural Development 3550-25, Loan Closing Instructions and Loan Closing Statement, to require the loan approval official to fully verify the correct lien position is obtained in all leveraged lending arrangements, regardless of RHS' lien position. The form should include a place for the following information: priority order of leveraged lenders and their lien position, the lien position RHS seeks, and a designated place or checkbox for the loan approval official to verify that correct lien position was obtained and listed in the final title documents.

Agency Response to Recommendation 3: Form RD 3550-25, Loan Closing Instructions and Loan Closing Statement, will be revised to incorporate the revisions identified by OIG in Recommendations 3 and 8.

ECD: November 15, 2018

Recommendation 4: Require Kentucky Rural Development officials to meet with primary lending partners and discuss requirements for leveraged lending. The discussion should include consideration of entering into Memoranda of Understanding and the use of subrogation clauses to ensure that proper lien positions are established when leveraged lending occurs.

Agency Response to Recommendation 4: The Kentucky Rural Development officials will be instructed to meet with their primary lending partners to discuss the leveraged lending requirements.

ECD: November 15, 2018

Section 2: Recommendations 5 - 9 related to controls for loan origination and closing.

OIG noted that the origination weaknesses were specific to the Agency staff not: 1) calculating the borrower's income using all feasible methods, 2) reviewing and documenting the borrower's adverse credit, and 3) re-verifying the borrower's employment prior to closing.

Item 1 was addressed in January 2017 with the introduction of an automated worksheet for computing income; this worksheet will be discussed further under Recommendation 6. Item 2 is a common training topic. To complement the training, efforts are underway to revise Form RD 1944-61, Credit History Worksheet.

Recommendation 5: Develop a training strategy for field officials that includes the delivery of targeted training to address internal control weaknesses identified in this report. The training strategy should include a survey of field officials for their input on training needs for administering the SFH Direct Loan Program.

Agency Response to Recommendation 5: The internal control weaknesses identified in this report will be interwoven into existing training platforms and included in the Agency's training strategy.

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Recommendation 6: Provide loan officials with supplemental guidance clarifying procedures to require calculation of all feasible income calculation methods when adequate income information is available for projecting an applicant's income.

Agency Response to Recommendation 6: With Procedure Notice 492 dated January 6, 2017, an automated worksheet for computing income was put into place. The worksheet provides a valuable tool to loan application packagers and Rural Development staff. It helps the user to organize, calculate, and report on a customer's income. With the use of the tool, the user is prompted to consider all the applicable considerations related to income (type, source, deductions, calculation methods, etc.). While the use of this tool is required in the program's handbook, its utilization will be stressed as part of the Agency's training strategy.

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Recommendation 7: Develop and implement a process to provide additional oversight by requiring State offices to periodically review SFH direct loan files to ensure they are in accordance with the Federal and administrative requirements.

Agency Response to Recommendation 7: An additional oversight process will be developed and implemented.

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Recommendation 8: Through revisions to Form Rural Development 3550-25, Loan Closing Instructions and Loan Closing Statement, establish a timeframe for loan approval officials to complete the review and certification of loan closing statements.

Agency Response to Recommendation 8: Form RD 3550-25, Loan Closing Instructions and Loan Closing Statement, will be revised to incorporate the revisions identified by OIG in Recommendations 3 and 8.

ECD: November 15, 2018

Recommendation 9: Evaluate staffing levels at all field offices responsible for administering the SFH Direct Loan Program. Develop and implement strategies to deliver the SFH Direct Loan Program in offices that encounter staffing shortages.

Agency Response to Recommendation 9: The overseeing officials will be asked to evaluate the staffing levels in the field offices administering the program; and strategies will be implemented to aid in the delivery of the program – especially for offices that are understaffed.

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Should you have any questions regarding the contents of this memorandum, please contact Barry Ramsey, Director of the Single Family Housing Direct Loan Division (SFHDLD), at (202) 720-5378 or Brooke Baumann, SFHDLD Branch Chief, at (202) 690-4250.

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