United States Department of Agriculture
Office of Inspector General

# Loss Claims Related to Single Family Housing Guaranteed Loans



Audit Report 04703-0003-HY
February 2013

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

DATE: February 25, 2013

AUDIT NUMBER: 04703-0003-HY

TO: Dallas Tonsager
Under Secretary
Rural Development

Tammye Trevino
Administrator
Housing and Community Facilities Programs
Rural Development

ATTN: John Dunsmuir
Acting Director
Financial Management Division

FROM: Gil H. Harden
Assistant Inspector General for Audit

Gil H. Harden

SUBJECT: Loss Claims Related to Single Family Housing Guaranteed Loans

This report presents the results of our audit of Loss Claims Related to Single Family Housing Guaranteed Loans. Written responses to the official draft report were received from Rural Development. Excerpts from those responses and the Office of Inspector General's (OIG) positions are incorporated into the Findings and Recommendations sections of the report, where applicable.

Based on the agency's written responses to the official draft report, we are able to accept Rural Development's management decisions on Recommendations 3, 5, 6, 7, 9, 10, 13, 14, 16, 17, 18, 19, and 20. We can accept management decisions on Recommendations 1, 2, 4, 8, 11, 12, 15, 21, 22, and 23, once we have been provided with the information outlined in the report sections, OIG Position.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days, describing the corrective actions taken or planned, and timeframes for implementing the recommendations for which management decisions have not been reached. Please note that the regulation requires management decision to be reached on all recommendations within 6 months from report issuance, and final action to be taken within 1 year of each management decision to prevent being listed in the Department's annual Agency Financial Report. For agencies other than the Office of the Chief Financial Officer (OCFO), please follow your internal agency procedures in forwarding final action correspondence to OCFO.

We appreciate the courtesies and cooperation extended to us by members of your staff during our audit fieldwork and subsequent discussions.

Attachments

cc: (w/attachments)
Director, Planning and Accountability Division, OCFO

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# Loss Claims Related to Single Family Housing Guaranteed Loans

## Executive Summary

Rural Development's Single Family Housing (SFH) Guaranteed Loan Program provides low and moderate-income people who live in rural areas with an opportunity to own adequate, decent, and safe dwellings. The SFH Guaranteed Loan Program substantially reduces a private lender's risk of loss because the Federal Government will reimburse up to 90 percent of the original loan amount if a borrower defaults on a loan. The program funding, as well as the number of guaranteed loans, foreclosures, and loss claims paid, has increased dramatically in recent years. In fiscal year (FY) 2008, the program paid $103 million in loss claims and had 3,369 foreclosures; in FY 2011, the program paid $295 million in loss claims and had 18,808 foreclosures. We conducted an audit to evaluate Rural Development's internal controls over evaluating and issuing loss claim payments to lenders.

We determined that Rural Development needs to strengthen its reviews of loss claims. Specifically, we found that the agency did not: (1) identify loans with questionable eligibility prior to paying loss claims, (2) reduce loss claims when lenders improperly serviced loans, and (3) pay lenders for only eligible expenses. The agency also did not have sufficient controls to fully justify approvals of pre-foreclosure sales, referred to as "short sales."[1] Given the results of our statistical sample of 102 loss claims, we project that the agency paid about $87 million in loss claims that were at risk of improper payments due to questionable loan eligibility, and paid about $254 million in loss claims for loans that were at risk of improper payments due to questionable lender servicing.[2] We also project that, across the program, Rural Development overpaid $6.28 million[3] related to 6,607[4] claims submitted by lenders for loss reimbursement.

We identified 30 out of 102 loss claims for loans that may not have been eligible for the program. Rural Development did not identify these loans as being questionable, and, therefore, paid the loss claims without having them examined by a review committee that may have reduced the losses paid or disqualified the claims entirely. This occurred because Rural Development's review process did not include steps to effectively identify these loans, and did not use software tools to automatically flag loans with potential eligibility issues. While loss claims have grown substantially, staff levels have not kept pace, and staff that review these loans do not specialize in loan eligibility. As a result, for these 30 loans, Rural Development paid over $1.5 million in losses to lenders. Based on our statistical sample, we project that the agency paid

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[1] A pre-foreclosure sale (also referred to as a "short sale") allows a borrower in default to sell his or her home and use the sale proceeds to satisfy the mortgage debt even if the proceeds are less than the amount owed to the lender.
[2] These results are projected over the audit universe of $377 million in loss claims that the agency paid between March 17, 2009, and February 28, 2011.
[3] We are 95 percent confident that Rural Development overpaid between $3.4 million and $9.1 million, which represents achieved precision of +/- 1 percent of the audit universe of $377 million.
[4] We are 95 percent confident that Rural Development overpaid between 5,680 and 7,533 claims, which represents achieved precision of +/- 11 percent of the audit universe of 8,264 loans.

$87 million[5] in loss claims for 1,829 loans[6] that were at risk of improper payments due to questionable eligibility. Rural Development implemented a new regulation in August 2011 that provides the agency with the additional latitude to recoup losses from originating lenders who improperly originate a loan, should the agency determine this to be the appropriate course of action to maximize recovery. Identifying such loans is critical for minimizing losses to the Federal Government.[7]

Once a loan begins experiencing problems, lenders are required to take certain steps to help remedy the issue by communicating with the borrower and evaluating several mitigation options to assist the borrower in remaining in the home. We found that lenders did not take all required steps to mitigate losses to the Federal Government in 71 loss claims from our statistical sample.[8] The agency did not take steps to verify that lenders had considered all options for assisting the borrower without having to resort to foreclosure, and, instead, chose to rely solely on lenders' assertions that they had done so. In addition, the agency used an automated system that does not track or enforce all deadlines found in program regulations, and does not reduce the interest paid on loss claims when lenders did not meet deadlines. As a result, we estimate that 6,110 loss claims were paid on loans that were not adequately serviced by lenders and that $254 million is at risk because Rural Development cannot be assured that losses were minimized as much as possible.[9]

After taking mitigation steps, as described above, if a loan does default, then the lender submits a loss claim to the agency. Loss claims can include costs of repairs needed to make the property ready for sale and additional interest incurred from long sale periods. However, if the costs result from a lender's own negligence, then they are not eligible for reimbursement. We found that Rural Development improperly reimbursed a portion of the losses on over 75 percent of claims in our sample that resulted from lenders taking actions that violated agency regulations. Rural Development did not detect or reduce overpayments due to: (1) ineffective edit checks in its internal system, and (2) errors in processing loss claims according to program regulations. These weaknesses went uncorrected because—while Rural Development did identify overpayments in a high percentage of its quality control reviews—management reported the results directly to lenders, but did not analyze the results to make program improvements. As a

[5] We are 95 percent confident that between $34.5 million and $139 million is at risk based on that criterion, which represents achieved precision of +/- 14 percent of the audit universe of $377 million.
[6] We are 95 percent confident that between 870 and 2,789 loss claims were paid on such loans, which represents achieved precision of +/- 12 percent of the audit universe of 8,264 claims.
[7] Prior to August 2011, Federal regulations were silent with respect to the originating lender's responsibility to the agency in the event the loan is sold or transferred to an eligible lender. Current regulations allow the agency to hold the purchasing lender responsible for fraud or misrepresentation issues that stem from origination. The agency may now seek indemnification from the originating lender as well, should the agency determine it to be the appropriate course of action.
[8] Proactive loss mitigation is a critical loan servicing function by lenders to help borrowers in default on their mortgages retain their homes while minimizing potential financial losses to the lender and USDA.
[9] We are 95 percent confident that between 5,095 and 7,126 loss claims were paid on such loans, which represents achieved precision of +/- 12 percent of the audit universe of 8,264 loss claims. We are 95 percent confident that between $196.3 million and $311.5 million is at risk based on the same criterion, which represents achieved precision of +/- 15 percent of the audit universe of $377 million.

result, Rural Development overpaid lenders more than $87,000 on 77 claims in our sample.[10] We project that, across the program, Rural Development overpaid $6.28 million related to 6,607 claims.[11]

We also found another related issue involving approvals of short sales. Rural Development did not require lenders to submit sufficient documentation justifying such sales and did not issue guidance as to when exceptions should be granted to unqualified borrowers. Instead, Rural Development relied on lenders to validate that borrowers met short sale requirements. As a result, Rural Development paid lenders over $454,000 in loss claims for 10 borrowers in our sample who did not meet the requirements for a short sale. For these claims, the Federal Government lost its ability to pursue reimbursement for losses incurred from these borrowers defaulting on their guaranteed loans.[12]

## Recommendation Summary

To improve program administration and better ensure losses to the Government are minimized as much as possible, Rural Development should conduct a review of its loss claims process to address loans with questionable eligibility, lenders who improperly service delinquent loans, and loss claims that contain unallowable costs. First, the agency should determine whether the loss claims we identified with questionable eligibility should have been reduced, and develop a data analysis tool to identify loans with questionable eligibility. The agency should also re-evaluate the timeframe set in which the government can seek indemnification from lenders who did not adhere to eligibility requirements when originating the loan. To address mitigation issues, Rural Development should require further documentation from lenders, enforce current deadlines, and implement procedures to reduce loss claims submitted by lenders when they do not timely contact and interview borrowers, as required. For unauthorized costs that lenders claimed, the agency should recover, in accordance with agency policy, over $86,700 that Rural Development overpaid to the lenders. The agency also should perform an evaluation to improve its internal systems' edit checks, and provide personnel with training and guidance on how to perform reviews when the edit checks are triggered. Finally, regarding short sales, Rural Development should require more documentation from lenders to support their approval decisions, as well as issue additional guidance.

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[10] We computed this amount to be more than $87,000 by adding up individual line items included within the 77 filed loss claims. However, overall loss claim payments are subject to limitations that the agency has put in place (i.e., payments cannot exceed 90 percent of the original loan amount). After applying these limitations, this reduced the amount that the agency overpaid to over $86,700 on these 77 loss claims, which is the figure that our statistical projections are based on.

[11] We are 95 percent confident that Rural Development overpaid between $3.4 million and $9.1 million, which represents achieved precision of +/- 1 percent of the audit universe of $377 million. We are 95 percent confident that Rural Development overpaid between 5,680 and 7,533 claims, which represents achieved precision of +/- 11 percent of the audit universe of 8,264 claims.

[12] When a borrower is approved for a short sale, his/her debt is relieved, and the Federal Government no longer has the ability to recoup losses from the borrower.

## Agency Response

Rural Development officials generally agreed with our recommendations and commented that implementing them will further strengthen the agency's improper payment compliance. However, agency officials requested that we reconsider the methodology adopted in our assessment of monetary impact, in favor of an approach that better accords with relevant Office of General Counsel opinion and Office of Management and Budget standards for compliance with the Improper Payments Information Act. We have incorporated portions of Rural Development's written response, along with the Office of Inspector General's (OIG) Position in the Findings and Recommendations section of this report. The agency's written response is included in its entirety at the end of this report.

## OIG Position

The agency's response included proposed corrective actions sufficient to reach management decision for 13 recommendations in this report: 3, 5, 6, 7, 9, 10, 13, 14, 16, 17, 18, 19, and 20. However, we have not reached management decision for the remaining 10 recommendations (1, 2, 4, 8, 11, 12, 15, 21, 22, and 23), about which we are requesting additional information from Rural Development.

In addition, we disagree with Rural Development's statements in the initial sections of the agency's response that questioned our work. For instance, on page 3 of the response, agency officials differ with our assessment that 30 of the loans we reviewed contained eligibility issues. Rural Development officials concluded that just 2 of the loans contained eligibility issues that would make a borrower ineligible for a guaranteed loan, and further stated that our estimate of $87 million in loss claims being at risk of improper payments is significantly overstated. We disagree because our conclusion was not that these loans were ineligible—but rather that these loans had questionable eligibility and were not identified by the agency prior to the payment of the loss claim for further review.

On page 3, officials disagreed with our general conclusion that Rural Development may have paid over $341 million for loss claims for loans with questionable eligibility or questionable loan servicing, saying that the statement is confusing and potentially very misleading. The agency also said that our test results show an annual improper payment rate of 1.66 percent and $3.14 million in improper loss claim payments, and that these results confirmed that the SFH Guaranteed Loan Program is at low risk for erroneous payments.[13] We disagree with these characterizations. First, our conclusion was that the $341 million ($87 million from questionable loan eligibility, Finding 1, and $254 million due to questionable lender servicing, Finding 2) was at *risk* of improper payments, not that they *may* have been overpaid. Second, our audit objectives did not include an examination of the SFH Guaranteed Loan Program's level of risk for erroneous, improper payments. Our objective was to evaluate the agency's controls over issuing loss claim payments to participating lenders. Using our audit results to draw conclusions

[13] Based on Office of Management and Budget standards for compliance with the Improper Payments Information Act.

on the program’s level of risk for issuing improper payments and comparing the results to the standards developed by the Office of Management and Budget is not appropriate**.**

# Background and Objectives

## Background

The United States Department of Agriculture (USDA), through its Rural Development mission area, guarantees single family homes in rural areas. Section 502 of the Housing Act of 1949, as amended, authorizes USDA to guarantee loans made by lenders to eligible borrowers through the Single Family Housing (SFH) Guaranteed Loan Program. The SFH Guaranteed Loan Program is designed to provide low and moderate-income people who live in rural areas with an opportunity to own adequate, decent, and safe dwellings and related facilities for their own use. The SFH Guaranteed Loan Program substantially reduces a private lender's risk of loss because the Federal Government will reimburse up to 90 percent of the original loan amount to the lender if a borrower defaults on a loan.

The Rural Housing Service (RHS), an agency within the Rural Development mission area, is responsible for developing, implementing, and monitoring program policy and procedures, and for approving lenders to participate in the program. Rural Development field staff in 47 State offices are responsible for issuing guarantees on loans made by private lenders, such as rural community banks, national banks with operations in multiple States, and nationwide mortgage lenders.

The Centralized Servicing Center (CSC), a unit of RHS, in St. Louis, Missouri, is responsible for reviewing and approving formal loss mitigation requests submitted by lenders, and for reviewing loss claims submitted by lenders for borrowers who have defaulted on their mortgage obligations. Based on their review, CSC officials can pay the claim in full, reduce the claim, or recommend denial of the claim. If CSC officials recommend denial of a loss claim, they forward the recommendation to the RHS national loss claim committee for review and decision. The office of the Deputy Chief Financial Officer (DCFO), also located in St. Louis, Missouri, is responsible for issuing the payment of loss claims to the lenders.

The program funding, as well as the number of guaranteed loans, foreclosures, and loss claims paid, has increased dramatically from fiscal year 2008 through fiscal year 2011 as depicted by the following chart:

| Fiscal Year | Budget[14] | Guaranteed Loans | Foreclosures | Loss Claims Paid |
|---|---|---|---|---|
| 2008 | $4.8 billion | 244,000 | 3,369 | $103 million |
| 2009 | $4.8 billion | 341,000 | 5,872 | $191 million |
| 2010 | $6.2 billion | 468,000 | 10,536 | $198 million |
| 2011 | $12.0 billion | 565,000 | 18,808 | $295 million |

In addition to regular program funding, Congress passed the American Recovery and Reinvestment Act of 2009 (Recovery Act), which appropriated $10.5 billion in funds to Rural

[14] The budget represents regular program funding only. Rural Development also received $10.5 billion in additional funding through the American Recovery and Reinvestment Act of 2009 (Recovery Act).

Development to guarantee the repayment of loans made by private lenders.[15] On March 17, 2009, Rural Development began distributing the Recovery Act funds through the Section 502 SFH Guaranteed Loan Program. Whether the loans are funded by Recovery Act funds or regular program funds, the program requirements and processes for loan origination, delinquent loan servicing and loss claims are the same. The following sections outline the loan origination, delinquent loan servicing, and loss claim processes.

**Loan Origination**

Lenders submit requests for loan guarantees on Form RD 1980-21, *Request for Single Family Housing Loan Guarantee.* Rural Development requires lenders to submit Form 1980-21 when applications for guarantees are sent either by mail or electronically through the Guaranteed Underwriting System (GUS). GUS is an automated underwriting system, implemented in March 2007, to streamline the process used by the lenders to submit applications for loan guarantees.[16]

Lenders determine a borrower's eligibility either through manual underwriting analysis or by using the electronic analysis performed by GUS. A lender's underwriting analysis includes a verification of income, determination of a borrower's repayment ability and creditworthiness, and an appraisal report for the property. For loan applications processed manually, lenders provide the application and documentation to Rural Development field staff for review and approval. For loan applications processed electronically, GUS provides lenders with a preliminary decision of potential acceptance or rejection before an application is submitted to Rural Development. There is substantially less documentation required to be submitted for GUS-underwritten loans, but the lender is still required to maintain those documents in the loan file.

Rural Development field staff are responsible for reviewing loan applications for completeness and for determining that proposed loan guarantees are made to eligible borrowers. The staff also inputs information, such as lender and borrower names, the loan amount, and other loan specifics, into a database recordkeeping system called the Guaranteed Loan System (GLS). Lenders input the loan status in GLS through an electronic data interchange on a quarterly basis, but if a borrower becomes delinquent on a loan, this is done on a monthly basis.[17]

**Delinquent Loan Servicing**

When borrowers are unable to fulfill their mortgage obligation, the lender is required to begin loss mitigation efforts to assist the borrowers in keeping ownership of their home and to reduce losses in the event that the lender must liquidate the property. A loan default occurs when the borrower fails to perform under any covenant of the mortgage or deed of trust and the failure continues for 30 days. Lenders are required to manage loans in default by pursuing loss

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[15] Public Law 111-5, February 17, 2009.

[16] Mortgage underwriting is the process a lender uses to determine if the risk of offering a mortgage loan to a particular borrower is acceptable under such parameters as creditworthiness and capacity to repay.

[17] Electronic data interchange is a direct computer-to-computer exchange of standardized information between lenders and the agency using secure agency applications on the internet.

mitigation, which are efforts with a borrower to work out the delinquency or resolve the defaulted loan in order to maximize recovery and avoid foreclosure. The servicing of loans shortly after they become delinquent is a crucial lender function because it may help borrowers to retain their homes; can reduce or mitigate the financial losses to the lender and the agency; and increases the potential for long term success. Lenders may begin evaluating delinquent borrowers as early as the first day of delinquency.

Lenders perform informal mitigation within the first 90 days of delinquency in an effort to allow borrowers to become current on their mortgage and remain in their home.[18] Informal mitigation occurs between the lender and borrower, and does not involve Rural Development. While agency approval of lender actions is not required within the first 90 days of delinquency, lenders must conduct an analysis to determine the ability of the borrower to meet his/her mortgage obligation and assess the borrower's willingness to cure the delinquency. Federal regulations state that the lender must perform the following loss mitigation actions by specified times in the delinquency:

- Day 20 - The lender must make a reasonable attempt to contact the borrower if the payment is not received by the 20th day.
- Day 30 - The lender must report delinquent accounts every 30 days until the mortgage loan has a current status or the property is liquidated.
- Day 60 - The lender must make a reasonable attempt to arrange and hold an interview with the borrower for the purpose of resolving the delinquency. Reasonable effort consists of not less than one letter sent to the borrower using certified mail. If the lender is unable to contact the borrower, the lender must determine whether the property has been abandoned and if the value of the security is in jeopardy.
- Day 90 - The lender must make a decision with regard to liquidation of the account (i.e., decision to foreclose or submit a servicing plan to the agency for any option other than foreclosure).

Once the borrower becomes three payments delinquent, formal mitigation begins, which requires the lender to obtain Rural Development approval for any actions taken, other than foreclosure.[19] Whether the lender attempts a curable option (e.g., loan modification), or an incurable option (e.g., pre-foreclosure sale), it is required to submit a servicing plan and supporting documentation to Rural Development for approval. Rural Development will evaluate the loss mitigation option recommended by the lender based on an analysis of the borrower's financial circumstances and the status of the loan. Rural Development has established guidance that requires lenders to consider mitigation options in the following order: (1) special forbearance, (2) loan modification, (3) special loan servicing, (4) pre-foreclosure sale, and (5) deed-in-lieu of foreclosure (DIL). The following paragraphs describe each mitigation option:

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[18] Loss mitigation refers to a lender's efforts to assist a borrower in curing a delinquency, or to resolve a defaulted loan to maximize recovery.
[19] Rural Development, *Loss Mitigation Guide*, pg. 1-5, April 17, 2009.

1. **Special Forbearance** - The loan is brought current by gradually increasing the monthly payments in an amount sufficient to repay the arrearage over time or through resumption of normal payments for three months, followed by a loan modification. A special forbearance plan may be offered to a borrower who: (1) is the owner-occupant of the property securing the loan; (2) has recently experienced a verified loss of income or an increase in living expenses, but who has or will have sufficient monthly income to correct the delinquency within the duration of the plan; and (3) is committed to occupying the property as a primary residence during the term of the plan.

2. **Loan Modification** - There is a permanent change in one or more of the terms of a loan that results in a payment the borrower can afford and allows the loan to be brought current. A loan modification may be appropriate for a borrower who: (1) is an owner-occupant of the property, (2) is committed to occupying the property as a primary residence, (3) has experienced a permanent or long-term reduction in income or an increase in expenses, and (4) has recovered from the cause of the default and now has stable income, which is sufficient to support the monthly payments under the modified rate.

3. **Special Loan Servicing** - Provides a means for the borrower to lower the interest rate to a level below a maximum allowable interest rate and extend the term of the loan up to 40 years from the date of loan modification. In order for borrowers to be eligible for special loan servicing, the borrower must be considered, but found not qualified, for traditional servicing options (special forbearance and loan modification).

4. **Pre-Foreclosure Sale** (referred to as a "short sale") - Allows borrowers in default to sell their home and use the proceeds to satisfy the mortgage debt, even if the proceeds are less than the amount owed. This option can only be extended to a borrower who is in default due to a verified involuntary inability to pay.[20] Agency pre-approval is required for non-occupant borrowers when it is verified that the need to vacate is related to the cause of the default (job loss, transfer, divorce, or death) and the reason for default must be permanent. However, a short sale is not available to borrowers who have abandoned their mortgage obligation, despite their continued ability to pay. A borrower, who successfully sells the property, securing the loan using the short sale option, is relieved of the mortgage obligation. In addition, the borrower shall not be pursued for deficiency judgments by either the lender or the agency.

5. **Deed-in-Lieu of Foreclosure (DIL)** - The borrower voluntarily deeds the collateral property to the lender, in exchange for a release from all obligations under the mortgage. A lender may extend a DIL option to a borrower who occupies the property as a primary residence, and is unable to continue to pay mortgage debt. However, a lender may offer a borrower who does not occupy the property a DIL, with prior approval from the agency, if the need to vacate the property was related to the cause of the default (i.e., job loss,

[20] Involuntary inability to pay means that the cause for the default was unintentional, or outside the borrower's control, such as a job loss, divorce, or death. Agency requirements further state that the short sale is not available to borrowers who have abandoned their mortgage obligation, despite their continued ability to pay.

mandatory job transfer, divorce, or death) and the property was not purchased as a rental investment, or used as a rental for more than 12 months.

The lender is required to use a loss mitigation option or initiate foreclosure no later than 180 days after the borrower becomes delinquent. Lenders must document the reasons for selecting the loss mitigation option offered to the borrower. The lender must also maintain documentation of all loss mitigation efforts in its servicing or collection notes for a period of seven years.

**Loss Claim Process**

When loss mitigation efforts are not successful, the borrower's loan is terminated before it is paid in full. Whether terminated by foreclosure, a DIL, or a short sale, these loans usually result in the submission of a loss claim to Rural Development by the servicing lender. The servicing lender also submits a claim if the marketing period for a real estate-owned property expires without a sale.[21] Such claims are based upon a liquidation-appraised value.[22] Additionally, the servicing lender is reimbursed for certain expenses associated with the termination action.

When a USDA guaranteed loan is terminated through a liquidation action, such as a foreclosure, short sale, or DIL, the lender must submit a request for a loss claim to the agency within 30 days of the date of the loan liquidation. The lenders submit requests for loss claims on Form RD 1980-20, *Rural Housing Guarantee Report of Loss.*

In 2003, Rural Development implemented an automated loss claim system to expedite the process by allowing agency approved lenders to submit loss claims electronically into the GLS loss claim module.[23] The lenders approved to use this method are not required to submit supporting documents for the claim, unless the agency requires them to do so, because the automated system should identify potentially inaccurate information. However, lenders manually submitting loss claims must submit Form RD 1980-20 and all supporting documents by regular or express mail. RHS officials at CSC process all loss claims and are responsible for reviewing the claims for accuracy and authorizing payments to lenders.

Rural Development designed a set of controls over the automated loss claim system to ensure that claims are paid correctly. One of the most critical controls is a system of edit checks that are designed to automatically identify specific expenses or information that need to be validated by agency officials before the loss claim is paid. Rural Development officials perform a pre-payment review of all claimed expenses prior to payment of a claim for all manual and conditionally approved lenders.[24] For fully approved lenders, they only review the supporting

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[21] The lender is allowed up to six months from the date the property is acquired to sell the property (i.e. marketing period). If the lender does not sell the property within six months, the loss claim is paid according to the liquidation appraisal value.
[22] The liquidation-appraised value differs from the market value appraisal in that it is based on a seller that is under extreme compulsion to sell in a limited marketing period.
[23] In the universe of 8,264 loss claims, 6,499 loss claims were submitted electronically by fully approved automated lenders, and the remaining 1,765 loss claims were submitted by manual or conditionally approved lenders.
[24] Conditionally approved lenders are approved to submit loss claims into the GLS loss claim module, but they must submit all supporting documents with the claim.

documentation for those specific expenses that are triggered by the edit codes. The review is limited to documentation supporting the category that triggered the edit code. Rural Development officials also conduct Post Quarterly Reviews (PQRs) of paid loss claims to the fully approved lenders. A non-random, risk-based sample of loss claim files is selected from each lender for review. For each claim selected, agency officials validate that each specific line item that made up the overall loss amount was paid correctly. If the agency determines that it overpaid or underpaid any loss claims, it notifies the lender and either requires them to refund any overpayment or issues an additional loss claim payment to the lender.

The agency is required to seek indemnification for the loss if fraud or misrepresentation was committed in connection with the origination of the loan and the originating lender had actual knowledge of fraud or misrepresentation. New regulations effective for loans originated on or after August 1, 2011, allow Rural Development to be indemnified for losses paid within 24 months of the origination of a loan, if it determines the originating lender: (1) used unsupported data or omitted material information when submitting the request for a conditional commitment, (2) failed to properly verify and analyze the applicant's income and employment history, (3) failed to address property deficiencies identified in the appraisal inspection report that affect the health and safety of the occupants or the structural integrity of the property, or (4) used an appraiser that was not properly licensed or certified to make residential real estate appraisals. In addition, RHS may seek indemnification at any time, regardless of how long ago the loan closed, if it is determined that there was fraud or misrepresentation in connection with the origination of the loan.

Loss claims may also be reduced or denied if the lender does not service the loan in a reasonable and prudent manner or is negligent in servicing the loan, commits fraud, claims unauthorized items, violates usury laws, fails to obtain the required security position, uses loan funds for unauthorized purposes, or delays in filing the loss claim.

When processing a loss claim, if the CSC processor identifies that the loan did not meet eligibility requirements, he/she is required to recommend the loss claim for denial through CSC management to the RHS national office for review by a loss claim committee. The loss claim committee makes the final decision whether to deny, reduce, or pay the loss claim. If the loss claim is paid, then interest is paid to the lender up to the date the payment is made, as long as the lender submitted the loss claim timely and included all required documents.

**Previous OIG Audits**

OIG recently completed two audits related to eligibility determinations in the SFH Guaranteed Loan Program.[25] The first audit (Phase I) reported internal control weaknesses over the eligibility determinations of guaranteed loans. The second audit (Phase II) tested compliance with eligibility requirements during the loan origination process. The Phase II audit report estimated that over 30,000 loans (almost 37 percent of the portfolio) were ineligible to

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[25] *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Recovery Act Funds (Phase I)* (04703-01-Ch, September 2009), and *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Recovery Act Funds (Phase II)* (04703-02-Ch, September 2011).

participate in the program.[26] Three of the findings in that report involved ineligible borrowers who received loans even though they: (1) did not demonstrate the ability to repay the loan, (2) possessed incomes that exceeded program limits, or (3) already owned adequate housing in their local commuting areas.

## Objectives

The objective of the audit was to evaluate Rural Development's internal controls over issuing loss claim payments to lenders participating in the SFH Guaranteed Loan Program. In addition, the audit assessed whether Rural Development properly determined why the loans failed and whether the agency denied, reduced, or recovered loss claims from lenders who violated program requirements.

[26] In its response to the Phase II audit report the agency disputed the results.

## Section 1: Loss Claim Reviews

### Finding 1: Rural Development Did Not Identify and Review Loss Claims from Loans with Questionable Eligibility Prior to Payment

We identified that 30 out of 102 loss claims from our statistical sample were from guaranteed loans that had questionable eligibility, and that Rural Development did not identify these claims before payment. Because Rural Development did not properly identify these loans, it paid the loss claims without having them examined by a review committee that may have reduced the losses paid or disqualified the claims entirely. This occurred because Rural Development's loss claim review process did not include steps to effectively identify these loans. Agency procedures only required eligibility reviews for loans that defaulted within the first 6 months of origination. According to agency officials, these loans were at a higher risk of having eligibility problems. However, agency officials could not provide any documentation to support why 6 months was chosen over another time frame (e.g., 12 months from default) and one official stated that 6 months was probably too short. In addition, even when Rural Development officials did review loan eligibility, they did not properly analyze the origination data. While loss claims have grown substantially, staff levels have not kept pace, and the specialists reviewing these loans do not specialize in loan eligibility. Also, Rural Development does not have software tools that will automatically identify loans with eligibility problems for further review. As a result, for these 30 loans, Rural Development paid over $1.5 million in losses to lenders. Based on our statistical sample, we project that the agency paid $87 million[27] in loss claims for 1,829 loans[28] that were at risk of improper payments due to questionable loan eligibility. Rural Development implemented a new regulation in August 2011 that provides the agency with the additional latitude to recoup losses from originating lenders who improperly originate a loan, should the agency determine this to be the appropriate course of action to maximize recovery. Identifying such loans is critical for minimizing losses to the Federal Government.[29]

According to regulations, Rural Development is required to review loans in their entirety to determine why they failed and whether any reason exists for reducing or denying the loss claim.[30] In addition, Rural Development may contest the loan note guarantee if fraud or misrepresentation was committed in connection with the origination of the loan and the originating lender had actual knowledge of the fraud or misrepresentation.[31] Finally, in response to an OIG audit recommendation addressing loan origination deficiencies, RHS implemented new regulations, effective for loans obligated on or after August 1, 2011, that allow the agency to

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[27] We are 95 percent confident that between $34.5 million and $139 million is at risk based on that criterion, which represents achieved precision of +/- 14 percent of the audit universe of $377 million.

[28] We are 95 percent confident that between 870 and 2,789 loss claims were paid on such loans, which represents achieved precision of +/- 12 percent of the audit universe of 8,264 claims.

[29] Prior to August 2011, Federal regulations were silent with respect to the originating lender's responsibility to the agency in the event the loan is sold or transferred to an eligible lender. Current regulations allow the agency to hold the purchasing lender responsible for fraud or misrepresentation issues that stem from origination. The agency may now seek indemnification from the originating lender as well, should the agency determine it to be the appropriate course of action.

[30] 7 CFR 1980.376(a) (3), May 22, 1995.

[31] 7 CFR 1980.308, May 22, 1995.

require lenders to indemnify losses paid within 24 months of loan closing if it determines that lenders did not comply with agency regulations when originating guaranteed loans.[32]

We selected a statistical sample of 102 loss claims paid to lenders between March 17, 2009, and February 28, 2011, from defaulted guaranteed loans.[33] We stratified our selection into 3 strata.[34] (A detailed explanation of our statistical sample design and results is presented in exhibit B at the end of this report.) We reviewed each of these defaulted loans to determine whether Rural Development properly evaluated whether lenders originated the loans to eligible borrowers, and whether there was any reason for reducing or denying the loss claim. We also reviewed Rural Development's procedures for reviewing these loans as part of the loss claim review process.

Loss claim specialists at CSC perform an origination review for loans that defaulted within 6 months of origination.[35] The purpose of this review is to ensure that the loans were originated in accordance with agency regulations. The agency developed a checklist for completing these reviews.[36] If a specialist and his/her supervisor determine that the lender deviated from agency regulations or that there were major deficiencies with the borrower and/or property, they then refer the case to the loss claim committee. This committee was founded in May 2009 and is composed of RHS national office officials, who review the documentation and determine whether there is any reason to deny or reduce the loss claim.[37] Between May 2009 and March 2011, 50 loss claims were referred to the committee, of which 7 were denied.[38] Over this same time period, Rural Development paid over 8,400 loss claims.

In total, we identified 30 cases where borrowers did not meet one or more eligibility requirements, including 8 borrowers that had multiple indicators of high risk. During its loss claim review process, RHS officials at CSC did not identify these eligibility concerns, and, therefore, did not refer the claims to the loss claim committee, which would have determined whether the claims should have been denied or reduced. While Rural Development had varied reasons for not subjecting these claims to further review, we believe that an effective data analysis tool that could flag potential eligibility problems would have identified all 30 claims. Most of these loans had problems that could have been easily identified during a data scan, such as low credit scores, high debt ratios, or short employment histories. The issues involved with the 30 cases are detailed in the sections below.

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[32] *Controls Over Lender Activities in the SFH Guaranteed Loan Program* (04601-17-Ch, July 2009).
[33] See Scope and Methodology section for sample selection.
[34] The first stratum contained Recovery Act guaranteed loans that were obligated between March 17, 2009, and September 30, 2010, and the second stratum contained non-Recovery Act guaranteed loans obligated during the same time period. The third stratum contained loans obligated prior to March 17, 2009. See exhibit B of this report.
[35] During the loss claim review, the origination review may be performed for loans that defaulted up to 12 months after origination if the loss claim specialist identifies major concerns.
[36] *Guaranteed Loan Desk Procedure*, November 30, 2010, pg. 80.
[37] For any loans originated prior to August 1, 2011, the agency could only deny a loss claim if fraud or misrepresentation was found.
[38] In addition, eight more were paid, but were subject to a legal settlement in a case with a fraudulent lender. Four were still under review and two were withdrawn. All others were paid for various reasons.

## Loans Not Reviewed

Of the 30 loans with origination issues, Rural Development did not conduct a loan eligibility review on 13 loans. For 3 loans that defaulted within 6 months of approval, officials did not perform the required review.[39] For the other 10 loans, Rural Development did not perform reviews because the loans did not default within 6 months of approval. While origination reviews are required for defaults within the 6-month timeframe, Rural Development procedures state that reviews may be extended to include loans that defaulted up to 12 months after origination if the loss claim specialist identifies major concerns. In addition, regulations state that Rural Development officials are to review loans in their entirety to determine whether any reason exists for reducing or denying the loss claim.[40] However, during their claim processing, processors did not detect issues with these loans and, therefore, did not subject them to further review by the loss claims committee.

We found several origination issues in the 13 loans, including high debt ratios,[41] insufficient incomes, low credit scores,[42] and other factors that should have prevented the loan from being made. For example, the borrower for one loan that defaulted after more than 6 months had financial ratios that exceeded agency requirements. Both ratios were 47 percent, exceeding the agency requirements of 29 percent for the principal, interest, taxes, plus insurance (PITI) ratio and 41 percent for the total debt (TD) ratio.[43] This borrower also had a credit score of 576, which was well below the credit score of 620.[44] In accordance with agency policy, the loss claim specialist did not perform an eligibility review on this loan because it defaulted approximately 36 months after origination. We discussed our origination concerns with Rural Development officials, who agreed that this loan should not have been originated. The Government paid $108,000 on this loss claim without subjecting it to further review.

Another loan was made to a primary borrower with a credit score of 611. According to agency procedures, credit scores of 619 or below require additional verification; however, we were unable to locate this verification in the files that the lender provided.[45] In addition, one of the borrowers on the loan had a bankruptcy less than 36 months before applying. Again, the lender was unable to provide documentation from the borrowers to support that this unacceptable credit

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[39] According to agency officials, one of these loans was not reviewed due to staff error, whereas for the other two loans we were unable to obtain a reason why they were not reviewed.
[40] 7 CFR 1980.376(a) (3), May 22, 1995.
[41] Agency regulations permit loans to borrowers with high debt ratios if the agency concurs with the lender that there are sufficient mitigating circumstances.
[42] Agency regulations do not contain credit score requirements and do not provide for declining a loan because of a low credit score. However, Rural Development issued guidance through Administrative Notices, AN-4346, March 28, 2008, and AN-4441, May 7, 2009, which state that borrowers with a credit score below 620 have a statistically higher likelihood of default, and that underwriters should be especially cautious of additional risk factors with these borrowers. The guidance further states that borrowers with a credit score below 580 are a very high risk.
[43] The PITI ratio is the ratio of the borrower's monthly principal, interest, taxes, plus insurance to monthly gross income. The TD ratio is the ratio of the borrower's monthly total debts (PITI plus all monthly payments, such as car payments, monthly credit card payments) to monthly gross income.
[44] The risk of default is statistically very high for applicants with credit scores below 620.
[45] When a guaranteed loan applicant has a credit score of 619 or below, the agency requires the applicant to submit a verification of rent as evidence that the borrower has the ability to meet his/her monthly obligations. The agency's guaranteed housing specialist is required to review this document when processing the guaranteed loan application.

history was temporary in nature or beyond the borrowers' control. The lender is required to mitigate these circumstances and establish the borrowers' intent for good credit.[46] Rural Development paid $55,000 for this loss claim without subjecting it to further review.

When we discussed the origination review requirements with agency officials, they stated that loans that default within 6 months represent an elevated risk of having origination problems. However, these officials could not provide any documentation to support that 6 months was a better measure of risk, as opposed to another time frame (e.g., 12 months or 24 months from origination). In fact, one official stated that 6 months was probably too short and that Rural Development should consider reviewing loans that defaulted up to 12 months after origination, which, according to the official, is the industry standard. We noted that of the 30 loans with questionable eligibility, 11 defaulted more than 6 months after origination.

**Insufficient Reviews**

For the 17 claims that Rural Development did review, loss claim specialists did not identify eligibility concerns or refer the loans for further review by the loss claim committee. Specialists use a checklist to review the loans, and record such factors as TD ratios, credit scores, and the reason for the default. However, the checklist does not require the specialist to document his/her conclusion regarding eligibility. Also, we note that the loss claim specialists' area of expertise is loss claims and not origination. Therefore, we question whether the loss claim specialists have received sufficient training to properly review loan origination. According to agency officials, each certified loss claim specialist received training courses on how to perform reviews and on fraud detection and deterrence, but the training did not address origination in-depth. The specialists were required to complete a training program before processing loss claims. This program instructed each specialist to complete the checklist for loans that defaulted within 6 months of origination. Each specialist also received an MBA-level class in fraud detection and deterrence.

For one loan, we found multiple eligibility concerns. The borrower's TD ratio was 44 percent and the PITI ratio was 30 percent, which exceeded the agency's requirements of 41 percent and 29 percent, respectively. In addition, the lender omitted over $81,000 in borrower liabilities from the loan application, which would have made the TD ratio much higher. The lender omitted these liabilities from its computation of the TD ratio, noting that the borrower no longer possessed these properties. However, we found that at the time of the application, the credit report still listed these liabilities as derogatory items with outstanding balances owed by the borrower. Although the borrower's credit score of 654 was acceptable, the credit report contained several derogatory items, such as 2 properties that were repossessed by lenders within the previous 6 years for lack of payment. This borrower made only one payment on the loan before defaulting, stating that she did not have enough income to make the loan payments. We also identified several major inconsistencies with the property appraisals used to determine the value of the property at origination and liquidation. The appraised values ranged from $85,000 at origination in March 2009 to $30,000 at liquidation 8 months later. The two appraisals also exhibited other conflicting information related to the condition and the layout of the property. For example, the origination appraisal stated that the subject property conformed to

[46] 7 CFR 1980.345(d), May 22, 1995.

the minimum standards from the Department of Housing and Urban Development (HUD). However, the foreclosure appraisal indicated that the property did not have an adequate heat source, the electrical wiring was a fire hazard, and the functional layout of the property was inadequate. We asked RHS' National Certified Appraiser to review these appraisals. He concluded that both appraisals were unacceptable. We concluded that this loan should have been referred to the RHS national loss claim committee for further review. The Federal Government paid $64,000 for this loss claim.

For another loan that was refinanced as an SFH guaranteed loan, Rural Development did not review the refinanced loan documentation, but instead mistakenly reviewed the origination documents for the original loan. In fact, the documents for refinancing were not included in the loan file at all. A Rural Development official said that this was an error on the specialist's part. Since the specialist did not view the refinancing documents, he/she was unable to identify that the lender had miscalculated the borrower's TD ratio for the refinanced loan. If correctly calculated, the borrower's TD ratio would have been 58 percent, which is well above the agency's requirement of 41 percent or below. An RHS official said that he was not aware of approving a loan to a borrower with a debt ratio as high as 58 percent. After refinancing, this borrower only made two payments before defaulting. The Federal Government paid $153,000 on this loss claim.

An effective automated data analysis tool to detect when certain key requirements exceed threshold levels could have detected most, if not all, of the loans we identified. Such automation is especially important now, with program staffing levels not keeping pace with the SFH programs' high level of growth. We note that at the beginning of fiscal year 2012, the CSC had a backlog of over 3,000 loss claims waiting to be processed. In the current environment, a data analysis tool could save staff time by automatically flagging loans with eligibility problems (e.g., low credit scores, high PITI and TD ratios, etc.) for further review, regardless of when the default occurred. RHS national officials agreed that it would be useful to develop this tool.

**New Rule Should Help to Minimize Government Losses**

As previously mentioned, RHS implemented new regulations, effective August 1, 2011, that allow the agency to revoke the originating lender's eligibility determination and to require the lender to repay the loss claim if RHS determines that a lender did not originate a loan in accordance with the regulatory requirements.[47] In order to recoup the payments, the loss claim must be paid within 24 months of loan closing, and must meet specific conditions regarding the inaccurate or unsupported information. We refer to this new rule as the "indemnification rule."[48]

Since the indemnification rule only applies to loss claims that are paid within 24 months after origination, it would not have applied to 12 of the 30 loans we identified with eligibility issues. For example, for one loan in our sample, the borrower defaulted after making just one payment, yet the loss claim was not paid until 26 months after origination. We analyzed the origination

[47] 7 CFR 1980.308(a) and (b), May 31, 2011.
[48] If RHS determines that there was fraud or misrepresentation, regardless of how long ago the loan was originated, RHS may seek indemnification if the lender had knowledge of the fraud or misrepresentation in connection with the origination of the loan.

documents and found that this borrower had multiple risks, including a low credit score, multiple collections outstanding, no reserve funds, etc. We also noted that the lender itself did not provide timely loan servicing. Therefore, even if Rural Development officials had identified this loan as having eligibility problems, the Federal Government would not be able to recoup its losses under the time lines of the new rule. When we discussed this with RHS officials, they could not provide a basis for why they chose to restrict their reviews to loss claims paid within 24 months of origination.

To compare Rural Development's timeframe with those used by another agency, we found that HUD also implemented an indemnification rule in February 2012. HUD regulations state that if there is a serious violation of origination requirements, HUD can recoup loss claims paid within 5 years of the mortgage insurance endorsement (i.e., loan guarantee).[49] We believe that Rural Development's 24-month timeframe may be too restrictive. Agency officials disagreed with our position because they stated that Rural Development is not limited by the 24-month timeframe when the lender has committed fraud or misrepresentation. However, we found that HUD regulations also waive the timeframe when fraud or misrepresentation is found.

While the timeframe itself is too restrictive, we also found issues with the method used to calculate the timeframe. Based on our analysis, we believe that measuring the time from the origination date to the default date—as opposed to measuring the time from the origination date to the date that loss claims are paid—may be more indicative of loans with higher risk of origination problems. This would give a more consistent manner to measure how quickly a borrower defaulted on a loan, and would mitigate the risk of a lender circumventing the rule by untimely servicing.

As of May 2012, Rural Development officials said that they have not yet established a process to effectively employ the indemnification rule, nor have they established a timeframe for doing so. To make best use of the new rule, the agency must establish standard procedures for reviewing eligibility during the loss claim process. This should include evaluating key areas during the review, such as credit reports, re-calculation of income, debt ratios, and employment history. Due to the limited resources available to perform these reviews and the heavy volume of loss claims, the agency needs to determine the most efficient and effective way to perform eligibility reviews and obtain indemnification, if appropriate.[50] The agency also needs to provide relevant training to all personnel involved. Agency officials agreed that they need to strengthen procedures, but have not yet done so.

In conclusion, Rural Development processed and paid all 102 loss claims in our sample, but did not identify any origination problems or forward any concerns to the RHS national loss claim committee for further review. Based on our sample, we projected that the agency paid $87 million in loss claims for 1,829 loans that were at risk for improper payments due to questionable loan eligibility. Our previous audit of SFH loans guaranteed with Recovery Act

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[49] 24 CFR 203.255(g), January 25, 2012.

[50] Through discussions with agency officials and our analysis of agency reports, we concluded that the staffing level of specialists processing the claims had remained relatively constant (increasing from 14 to 18 from March 2009 to October 2011), whereas the volume of loss claims had increased at a faster pace (from $191 million in loss claims paid in 2009 to $295 million in 2011). In addition, the agency's backlog of loss claims grew from 366 to over 3,000 from March 2009 to October 2011.

funds also found significant issues with borrower eligibility.[51] In light of our previous results, as well as the unidentified origination problems we discuss in this audit, we believe that Rural Development should enhance its efforts to review loan origination during loss claim processing. This includes strengthening existing procedures and creating a data analysis tool for automatically identifying eligibility issues.

When we discussed the issue of training with agency officials, they replied that they purchased a new training package covering various aspects of loan origination that will be included in loss claim specialists' continuing education plans. We view this as a positive development. However, given the backlogs of loss claims, we question if it is feasible for loss claim specialists to do the research necessary to effectively evaluate loan origination for a large number of loans. We also question whether these specialists, whose primary focus and training is ensuring that loss claims are paid accurately, are the appropriate personnel to also be responsible for identifying claims from loans with questionable eligibility. Therefore, in conjunction with executing the planned loan origination training, the agency needs to assess whether the current process for origination reviews is appropriate. Specifically, the agency should determine, at a minimum, who is best equipped to perform the origination reviews, how they should be conducted, and how the results should be documented.

While the new indemnification rule is a positive step for strengthening the program, it is important that Rural Development strengthen its procedures in order to maximize opportunities for recovery. We also believe that the loss claim time line may be too restrictive and recommend that Rural Development re-evaluate this timeframe, and pursue any necessary regulatory changes.

## Recommendation 1

Review the 30 loans that we determined had questionable eligibility. Determine whether these loans failed because lenders did not properly originate the loans and whether the loss claims filed for these loans should have been reduced. Pursue appropriate action, including recovering funds, from related lenders.

## Agency Response

In the agency's response, dated January 18, 2013, Rural Development officials stated that they will consult and obtain legal written opinion(s) from the Office of General Counsel on the feasibility of which loans (if any) the agency can pursue recovery of funds for based on the loan origination criteria and standards as established in regulations. In addition, Rural Development will audit using the legal opinions all 30 accounts and identify any loans that the agency can pursue collections on, and pursue recovery of funds from each lender for loans that have been determined to have been paid in error.

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[51] *Controls Over Eligibility Determinations for Single Family Housing Guaranteed Recovery Act Funds (Phase II)* (04703-02-Ch, September 2011).

## OIG Position

While we agree with Rural Development's corrective actions in response to this recommendation, in order to reach management decision, the agency needs to also provide a copy of the bill for collections used to pursue recovery of funds from each lender for the loans that the agency determined to have been paid in error.

## Recommendation 2

Develop a data analysis tool to automatically identify loss claims, based on eligibility factors (e.g., low credit scores, high PITI and TD ratios, etc.), that should be further reviewed for loan origination problems.

## Agency Response

Rural Development officials stated that origination reviews on loss claims will be expanded to all accounts that defaulted within 12 months or less and that these reviews will be modified to include verification of property eligibility and GUS approval. The agency also stated that the uploading of the GUS Finding/Decision Page to imaging is included in a Request for Automation that has not been funded yet. Finally, the agency requested a Request for Automation to identify loans which defaulted between 13 and 24 months of origination and/or received servicing in the first 24 months, regardless of the due date of last payment. This will allow the agency to expand origination reviews to selectively identify and review high risk accounts.

## OIG Position

While we agree with Rural Development's corrective actions in response to this recommendation, in order to reach management decision, the agency needs to include identifying loans with eligibility risk factors—such as low credit scores, high ratios, etc.—in order to identify loans that should be further reviewed for origination problems.

## Recommendation 3

Ensure that all loss claim specialists that have been assigned to perform origination reviews have completed the training package that was purchased in fiscal year 2012.[52]

[52] This training package included the following 7 classes: (1) Essentials of Mortgage Lending, (2) Processing Income and Assets, (3) Processing and Underwriting Credit, (4) Gathering Facts on Mortgage Fraud, (5) Ethical Practices in Mortgage Lending, (6) Exploring Guaranteed Rural Housing, and (7) Underwriting and Processing Guaranteed Rural Housing Loans.

## Agency Response

Rural Development officials stated that they will ensure that all specialists complete the training package purchased in fiscal year 2012. In addition, the agency will develop a training program that will focus on the eligibility factors involved with the origination of a loan note guarantee and require all personnel involved in loss claims processing to complete this eligibility training program by September 30, 2013.

## OIG Position

We accept Rural Development's management decision.

## Recommendation 4

Evaluate the loss claim review process to determine whether the current process for origination reviews is sufficient. This should include determining which staff are best equipped to perform these reviews and how they should be conducted.

## Agency Response

Rural Development officials proposed to develop procedures to isolate origination reviews from the loss claim process and to select a number of experienced specialists that will focus on completing origination reviews.

## OIG Position

While we agree with Rural Development's corrective actions in response to this recommendation, in order to reach management decision, the agency needs to state that they will evaluate the loss claim review process and determine whether the current process is sufficient.

## Recommendation 5

Develop procedures to document and evaluate the results of the origination reviews that are completed during the loss claim process and periodically determine whether program improvements are needed.

## Agency Response

Rural Development officials stated that they will: (1) develop a database to track the results of the origination reviews, including information regarding a loan's eligibility for indemnification, property eligibility, income eligibility, data verification, and property standards, and (2) evaluate origination review results semi-annually and provide data statistics and a summary of findings broken down by lender and State. Results will be analyzed to determine whether procedural changes or additional staff training is warranted based on the semi-annual results.

## OIG Position

We accept Rural Development's management decision.

## Recommendation 6

Develop procedures to implement the new regulations issued in August 2011 that allow Rural Development to require lenders to indemnify losses if the lenders did not properly originate a loan.

## Agency Response

Rural Development officials stated that the agency will develop a process to track loans that are indemnified and develop procedures for processing loss claims which qualify under the indemnification rule. The tracking will be included in the database developed in response to Recommendation 5. This database will be used to track loans that are eligible for indemnification, the loss claim payments made to the servicing/holding lender, and the requests and receipt of funds from the originating lender.

## OIG Position

We accept Rural Development's management decision.

## Recommendation 7

Re-evaluate the timeframe set in which the government can seek indemnification from lenders who did not adhere to eligibility requirements when originating the loan. In addition, determine whether the default date or the loss claim payment date is more appropriate. Based on these analyses, pursue any changes that are necessary to the new regulations issued in August 2011.

## Agency Response

Rural Development officials stated that the agency will re-evaluate the current timeframe utilized by the agency to seek indemnification from lenders who did not adhere to eligibility requirements when originating the loan. The evaluation will also consider changes to the timeframe definition. If the re-evaluation concludes a necessary change in timeframes, the agency will begin the process of amending current regulations.

## OIG Position

We accept Rural Development's management decision.

## Finding 2: Rural Development Needs Stronger Oversight and Enforcement of Lenders' Efforts to Mitigate Loan Losses

Lenders did not take all required steps to mitigate the loss to the Federal Government from 71 of 102 loans from our statistical random sample of loss claims.[53] This occurred because Rural Development did not adequately oversee and enforce mitigation actions by lenders for delinquent USDA guaranteed loans. Specifically, the agency did not take steps to verify that lenders had considered all options for assisting the borrower without having to resort to foreclosure, and, instead, chose to rely solely on lenders' assertions that they had done so. In addition, agency officials did not reduce the interest they paid on loss claims by the number of days that lenders exceeded the requirements for servicing and liquidating loans. This included when lenders did not timely contact and interview borrowers when they first became delinquent, or timely decide to liquidate properties and initiate foreclosure actions. Rural Development officials used an automated system that does not track or enforce all deadlines found in program regulations, and made a policy decision not to use their authority to enforce individual regulatory deadlines—deadlines which were established to make lenders take proactive measures and minimize losses to the government. We estimate that 6,110[54] loss claims were paid on loans that were not adequately serviced by lenders and that $254 million[55] is at risk because Rural Development cannot be assured that losses from these loans were minimized as much as possible to the USDA.

According to Federal regulations, lenders are primarily responsible for servicing, and, where necessary, liquidating USDA guaranteed loans and disposing of properties in a manner consistent with maximizing the Federal Government's interests.[56] Lenders are to approach Federal loan servicing as a prudent lender would perform servicing for its own portfolio of loans that are not guaranteed by the USDA.[57] Lenders are also required to provide borrowers with every available loss mitigation opportunity.[58] Finally, Rural Development must verify that lenders comply with agency regulations and guidelines,[59] and should reduce loss claims when the agency determines that lenders were not in compliance.[60]

When a borrower is late making a mortgage payment, early intervention is crucial because it may help borrowers in default[61] to retain their homes, which can reduce or mitigate the financial losses to the lender and USDA. If a borrower does not make three payments, formal mitigation begins. Whether the lender attempts to maintain the loan (e.g., loan modification), or end the loan and begin recovery (e.g., short sale), the lender must submit a servicing plan and supporting documentation to Rural Development for approval. Rural Development evaluates the loss

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[53] Proactive loss mitigation is a critical loan servicing function by lenders to help borrowers in default on their mortgages retain their homes while minimizing potential financial losses to the lender and the USDA.
[54] We are 95 percent confident that between 5,095 and 7,126 loss claims were paid on such loans, which represents achieved precision of +/- 12 percent of the audit universe of 8,264 loss claims.
[55] We are 95 percent confident that between $196.3 million and $311.5 million is at risk based on the same criterion, which represents achieved precision of +/- 15 percent of the audit universe of $377 million.
[56] 7 CFR §1980.302(d) and 1980.309(f), May 22, 1995.
[57] 7 CFR §1980.370, May 22, 1995.
[58] Rural Development Administrative Notice (AN) No. 4607, Exhibit A-*Loss Mitigation Guide*, August 2011.
[59] Lender Participation Agreement in Single Family Housing Guaranteed Loan Program, June 2006.
[60] 7 CFR §1980.376(b), May 22, 1995.
[61] Default occurs when a borrower fails to perform under the mortgage terms and failure continues for 30 days.

mitigation option recommended by the lender, based on an analysis of the borrower's financial circumstances and the status of the loan. Rural Development guidance requires lenders to consider mitigation options in the following order.

1. **Special Forbearance** – A gradual increase in the monthly payments in an amount sufficient to repay the amount past due over time or through resumption of normal payments for three months followed by a loan modification.
2. **Loan Modification** – Permanently changes one or more of the terms of a loan that results in a payment the borrower can afford and allows the loan to be brought current.[62]
3. **Special Loan Servicing** – Provides a means for the borrower to lower the interest rate and extend the term of the loan up to 40 years from the date of modification. In order to be eligible, the borrower must have been considered—but ultimately not qualified—for a special forbearance and loan modification.
4. **Short Sale** – Allows the borrower in default to sell his/her home and use the proceeds to satisfy the mortgage debt even if the proceeds are less than the amount owed. This option can only be extended to a borrower who is in default due to a circumstance outside of the borrower's control.
5. **Deed-in-Lieu of Foreclosure (DIL)** – The borrower voluntarily deeds the collateral property to the lender in exchange for a release from all obligations under the mortgage. A lender may offer a DIL to a borrower who occupies the property as a primary residence, and is unable to continue to pay mortgage debt, and may offer DIL to other types of borrowers with prior approval from Rural Development.

The lender is required to use one of the above options or initiate foreclosure no later than 180 days after the borrower becomes delinquent. Lenders must document the reasons for selecting the loss mitigation option offered to the borrower. The lender must also maintain documentation of all loss mitigation efforts for a period of seven years.

To determine if lenders followed the rules for mitigation, we selected a statistical sample of 102 loss claims that Rural Development paid to lenders from defaulted USDA guaranteed loans.[63] We reviewed these claims to determine if lenders adequately followed the loss mitigation procedures in an effort to minimize the financial loss to USDA. Finally, we verified that Rural Development reduced loss claims submitted by lenders who had not mitigated and/or liquidated loans in accordance with applicable regulations. Overall, we found that lenders had not provided enough evidence to support that they considered all mitigation options, and that Rural Development did not always reduce loss claims submitted by lenders when they did not

[62] Only borrowers in specific circumstances are eligible for options one and two. A special forbearance plan may be offered to a borrower who: (1) is the owner-occupant; (2) has recently experienced a verified loss of income or an increase in living expenses, but will have sufficient income to correct the delinquency within the duration of the plan; and (3) is committed to occupying the property as a primary residence during the term of the plan. A loan modification may be appropriate for a borrower who: (1) is an owner-occupant; (2) is committed to occupying the property as a primary residence; (3) has experienced a permanent or long-term reduction in income or an increase in expenses; and (4) has recovered from the cause of the default and now has stable income sufficient to support the monthly payments under the modified rate.

[63] Refer to exhibit B, Statistical Plan, for a description of our statistical sample.

properly conduct loss mitigation procedures. The following sections illustrate the control weaknesses we found during our audit.

**Lenders Had Insufficient Evidence to Demonstrate Their Mitigation Efforts**

We found that lenders could not provide evidence that they considered all options to maintain the loan, such as special forbearances and loan modifications, prior to proceeding to foreclosure for 13 of the 102 loss claims in our statistical sample.[64] Further, although lenders are required to maintain this documentation,[65] Rural Development did not require that any such evidence be submitted along with a loss claim. Instead, Rural Development procedures only require lenders to submit supporting documentation when officials specifically request it after reviewing the loss claim submission. In the cases where lenders are asked to provide additional support, we found that Rural Development does not have a method for them to certify that they have considered all available options for assisting borrowers in maintaining their loan, such as a checklist for lenders to complete.

For example, in one of the claims we reviewed, we found that the lender initiated foreclosure approximately 5 months after the last payment was made on the related loan. We reviewed the documents that a lender submitted with the loss claim and found no indication that the lender attempted to work with the borrower on any curable loss mitigation options after the loan became delinquent (e.g., special forbearance or loan modification). We requested that the lenders provide additional documentation; however, lender personnel stated that they did not have any additional documentation and did not recall whether they had considered any curable options.

In another loss claim, a borrower was approved for the related loan in May 2006. In January 2007, less than 8 months after the loan was approved, the borrower became delinquent on the loan. Subsequently, the borrower was able to recover and bring the loan current during the next month. However, the borrower eventually defaulted on the loan. Despite the borrower's past attempts to cure the delinquency and to stay in the property, we found no evidence that the lender considered any curable loss mitigation options, such as a special forbearance or a loan modification, prior to the borrower defaulting on the loan. Rather, when we reviewed the documents that the lender provided for the loss claim, we found notes that showed that the borrower was attempting to arrange payments. However, these notes did not support whether the lender evaluated borrower qualifications for the various mitigation options. A Rural Development official stated that if the agency had a requirement for lenders to provide supporting documentation (e.g., lender notes, collection history, etc.) during the loss mitigation process, the agency may have been able to identify that this lender did not properly mitigate this loan.

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[64] For the other 89 claims we were able to locate some evidence in the lender documentation to support that they did attempt loss mitigation options.

[65] Rural Development's *Loss Mitigation Guide*, pages 1-7 and 3-A-4, April 17, 2009, required that lenders maintain evidence of compliance with loss mitigation guidelines, and documentation that they have evaluated borrowers for curable mitigation options.

Overall, we found that Rural Development did not require lenders to submit information supporting that they considered all options for maintaining a loan before resorting to foreclosure. Without any information regarding their attempts, Rural Development cannot ensure that lenders are following regulations designed to both support homeowners and minimize losses to the government. Furthermore, Rural Development officials need to establish a process for penalizing lenders by reducing their loss claims when they find that lenders did not properly mitigate loans as required.

**The Agency Used an Automated System that Did Not Reduce Loss Claims When Regulatory Deadlines Were Missed**

Rural Development uses the Guaranteed Loan System (GLS) to centralize, track, and automate loss claims. We found that the parameters set in GLS to identify untimely serviced loans do not reflect individual deadlines specified in program regulations, which were established to ensure that a lender proactively works to cure a loan in default, and, if warranted, expeditiously liquidate it. If a lender takes timely action in these areas, it can minimize losses to the government. However, because GLS does not reflect the individual deadlines, Rural Development decided not take steps to enforce the deadlines by reducing loss claims.

When GLS was developed between 2003 and 2006,[66] Rural Development used a single timeliness measure to automatically reduce a loss claim if a lender does not initiate foreclosure within 210 days from the borrower's last payment. The 210-day deadline includes two different individual deadlines found in the program regulations. Lenders must decide to: (1) liquidate guaranteed loans within three months of the day a borrower becomes delinquent (i.e., the day on which the first payment was missed, or about 90 days),[67] and (2) initiate foreclosure within 90 days from the date of the decision to liquidate, unless the foreclosure has been delayed by law.[68] Adding in the 30 days between the last on-time payment and the first delinquent payment, Rural Development arrived at the total of 210 days—a deadline that does not appear in program regulations. After the 210-day deadline, GLS automatically reduces loss claims by the amount of accrued interest for the number of days past 210. It does not, however, automatically reduce the claims of vendors that did not meet its regulatory deadlines.[69]

We determined that lenders missed either one or both of the regulatory liquidation deadlines for 60 of the 102 loss claims in our sample. For 57 of these claims, lenders did not make timely decisions to liquidate. For example, in one claim we reviewed, a borrower was over 8 months delinquent before the lender made a decision to foreclose on the property. This was 5 months later than required by regulations.

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[66] *Loss Claim Administration Review Manual*, Chapter 1, June 13, 2008.
[67] 7 CFR 1980.371, May 22, 1995.
[68] 7 CFR 1980.374, May 22, 1995.
[69] 7 CFR 1980.376(b) (6). Negligent servicing includes the failure to contact borrowers and agency officials within required timeframes, secure the property from damage during the liquidation phase, and pay real estate taxes or hazard insurance.

For 7 claims, lenders did not timely initiate foreclosure after making the decision to liquidate.[70] For example, one lender made a timely decision to liquidate, but did not initiate foreclosure at all. Then, after 189 days, the lender submitted a servicing plan for a liquidation method other than foreclosure. We calculated that Rural Development overpaid more than $1,500 in accrued interest to this lender because it did not timely initiate foreclosure and did not reduce the claim. In total, we found that the agency overpaid lenders more than $44,000 in additional interest for the 60 loss claims.

Rural Development reviewers noted that these individual deadlines had been missed during their post-payment quality reviews, and even issued written notices to lenders in order to gain their compliance.[71] Yet, Rural Development never took any actions to reduce a claim as a consequence. When we spoke with them, Rural Development officials confirmed that the GLS system was set up to use only the 210-day deadline. Since it has been nine years since GLS was first developed, Rural Development officials could not recall who made that decision. The officials further stated that they made the policy decision not to impose monetary penalties for violations of the other timeframes, and did not provide further explanation. We disagree with this position, because the regulations clearly allow the agency to reduce the loss claims when lenders do not meet servicing deadlines.

Lenders are also subject to two other, separate deadlines in the program regulations. These are (1) that lenders must make a reasonable attempt to contact borrowers if lenders do not receive mortgage payments by the 20th day after they are due,[72] and (2) the lenders must attempt to arrange and hold interviews with borrowers before their loans are 60 days delinquent.[73] These deadlines involve interactions between the lender and borrower to cure the defaulted loan, and are not recorded in GLS, as the regulatory liquidation deadlines are. Instead, their performance is usually recorded in general documentation that lenders keep in the loan files. Although these deadlines are required in the regulations, Rural Development does not require lenders to submit documentation to support their actions, and in the period of our sample, never took an action against a lender for not adhering to the deadlines.

We determined that lenders involved in 71 of the 102 loss claims in our sample did not timely contact borrowers. For 33 claims, we found no evidence that lenders initially contacted borrowers when their mortgage payments were 20 days late. For 21 claims, we concluded that lenders did not make a reasonable attempt to arrange and hold interviews with borrowers before

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[70] Note: The cumulative number of claims where the lender was late in deciding to liquidate and initiating foreclosure is greater than 60 because 4 loans fell in both categories.
[71] Rural Development officials conduct post-payment quality reviews by examining the entire loss claims file after the claim payment has been made. Officials select approximately 10 percent of loss claims for review to determine if the agency paid the correct amount to lenders. If the agency overpaid a loss claim to a lender, the lender is required to return those funds.
[72] 7 CFR 1980.371(a), May 22, 1995.
[73] 7 CFR 1980.371(b), May 22, 1995.

their loans were 60 days delinquent.[74] Both the 20-day and 60-day requirements are meant to resolve the loan delinquency and minimize losses to the government.[75]

Since regulations do require that each timeframe be met separately—and allow for reductions in claims if a lender fails to act in a timely manner[76]—we believe that Rural Development needs to remove the 210-day limit in GLS and redesign the system to reduce loss claims when individual timeframes are not met. This will help ensure that losses to the government are minimized, and that lenders take a proactive approach to servicing loans.

To conclude, we believe that Rural Development needs stronger oversight and enforcement of lenders' efforts to mitigate losses from USDA guaranteed loans. The agency needs to develop a consistent method for lenders to demonstrate that they considered all possible mitigation options with borrowers prior to foreclosure. The agency also needs to improve its process for reducing loss claims when lenders failed to comply with servicing and liquidating requirements.

## Recommendation 8

Develop and implement a document for lenders to complete and submit with their loss claim that demonstrates that they have attempted all possible loss mitigation options with borrowers before the loan defaults. Require lenders to submit this document with their loss claims.

## Agency Response

In the agency's response, dated January 18, 2013, Rural Development officials agreed to, in lieu of a specific document, require lenders to supply evidence that they worked with cooperative borrowers to extend all qualifying loss mitigation options before the loan defaults, in accordance with the agency's existing loss claim guidelines. This evidence will consist of a complete set of the lender's servicing/collection notes and any other documents the agency determines are necessary to verify the lender's loss mitigation efforts on behalf of the borrower.

## OIG Position

While we agree with the proposed corrective actions, those actions do not provide a consistent, uniform method for lenders to validate that they have considered all possible mitigation options with borrowers prior to foreclosure. Therefore, in order to reach management decision, Rural Development needs to develop and implement a document for lenders to complete and submit with their loss claim that demonstrates that they have attempted all possible loss mitigation options with borrowers before the loan defaults. This document should be required by lenders when they submit their loss claims.

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[74] 7 CFR 1980.371(b), May 22, 1995.
[75] We did not calculate a monetary penalty for this aspect of the timeliness requirements because Rural Development did not ever reduce a lender's claim for missing these deadlines and also did not have procedures for determining this calculation.
[76] 7 CFR 1980.376(b) (6), May 22, 1995.

### Recommendation 9

Develop procedures to reduce loss claims submitted by lenders if the agency determines that the lender did not properly mitigate loans prior to foreclosure.

### Agency Response

Rural Development officials agreed to enhance and strengthen their procedures to reduce loss claims if the agency determines that the lender did not properly mitigate loans prior to foreclosure. Any reductions taken will be based on the agency's regulatory authority.

### OIG Position

We accept Rural Development's management decision.

### Recommendation 10

Implement procedures to reduce lender loss claims when lenders do not timely contact and interview borrowers, as required, during the loss mitigation process.

### Agency Response

Rural Development officials agreed to modify procedures to identify situations when loss claim adjustments will be pursued when lenders fail to contact and interview the borrower(s) timely and their actions resulted in an increase in the loss claim being submitted.

### OIG Position

We accept Rural Development's management decision.

### Recommendation 11

Enforce each 90-day timeframe when lenders do not make timely decisions to liquidate an account or initiate foreclosures for delinquent borrowers. This should include updating GLS to automatically reduce loss claims when lenders do not meet each requirement. This reduction should be the amount of additional interest paid past each of the 90-day time limits.

### Agency Response

Rural Development officials agreed to modify desk procedures to identify situations when loss claim adjustments will be pursued when lenders fail to contact and interview the borrower(s) timely, and their actions resulted in an increase in the loss claim being submitted.

## OIG Position

While we agree with the corrective actions proposed, in order to reach management decision, Rural Development also needs to update GLS to account for each timeframe separately (decision to liquidate and initiation of foreclosure). This GLS update should automatically reduce loss claims when either of these timeframes is exceeded.

## Finding 3: Rural Development Overpaid Lenders for Loss Claims

Rural Development officials improperly reimbursed lenders for losses on over 75 percent of the claims in our statistical random sample. The lenders claimed amounts that they were not entitled to from actions that violated agency regulations. Rural Development did not detect or reduce overpayments due to (1) ineffective edit checks in the agency's GLS and (2) errors in processing loss claims according to program regulations. These deficiencies went uncorrected because—while Rural Development did identify overpayments in a high percentage of its quality control reviews—management did not analyze the review results to make program improvements. Agency officials did not consider the amount of overpayments to be significant enough to be analyzed for program improvements. As a result, Rural Development overpaid lenders more than $87,000[77] on 77 of the 102 claims we reviewed. We project that, across the program, Rural Development overpaid $6.28 million,[78] related to 6,607[79] claims submitted by lenders for loss reimbursement.

The SFH Guaranteed Loan Program allows lenders to submit claims for losses incurred on liquidated guaranteed loans. Federal regulations and agency instructions state that claims must include only the actual expenses and losses incurred by the lender in liquidating a guaranteed loan.[80] Rural Development is required to pay losses on liquidated loans, unless agency officials find a reason to reduce the loss amount.[81] A loss claim may be denied or reduced for reasons such as if the lender committed fraud, submitted unauthorized claim items, or was negligent in servicing the loan. Negligent servicing includes the failure to contact borrowers and agency officials within required timeframes, secure the property from damage during the liquidation phase, and pay real estate taxes or hazard insurance.[82]

We evaluated the process for ensuring the accuracy of loss claims by reviewing two separate samples. First, we randomly selected 102 loss claims from the more than 8,200 loss claims paid to lenders from March 2009 through February 2011. We then examined a selection of paid loss

[77] We computed this amount to be more than $87,000 by adding up individual line items included within the 77 filed loss claims. However, overall loss claim payments are subject to limitations that the agency has put in place (i.e., payments cannot exceed 90 percent of the original loan amount). After applying these limitations, this reduced the amount that the agency overpaid to over $86,700 of the $4.4 million on 77 of the 102 loss claims, which is the figure that our statistical projections are based on.
[78] We are 95 percent confident that Rural Development overpaid between $3.4 million and $9.1 million, which represents achieved precision of +/- 1 percent of the audit universe of $377 million.
[79] We are 95 percent confident that Rural Development overpaid between 5,680 and 7,533 claims, which represents achieved precision of +/- 11 percent of the audit universe of 8,264 loss claims.
[80] 7 CFR 1980.376(b) (2), May 22, 1995, and RD Instruction 1980-D Section 309 (i) (3), March 21, 2007.
[81] 7 CFR 1980.376(a) (2), May 22, 1995.
[82] 7 CFR 1980.376(b), May 22, 1995.

claims that Rural Development had already reviewed as part of its Post Quarterly Reviews (PQRs), in order to assess the PQR process. Our analysis of the two samples—as well as Rural Development's own PQRs—came to the same conclusion: Rural Development in some instances overpaid loss claims to lenders participating in the SFH Guaranteed Loan Program.

**Overpayments Due to Lender Negligence and Claims for Unallowable Expenses**

Rural Development overpaid lenders more than $87,000[83] on 77 of the 102 claims in our sample.[84] Over $54,000 of these overpayments are addressed in Finding 2 and Finding 4 of this report, involving claims for untimely serviced loans and questionable short sales.[85] This finding analyzes the remaining $33,000 in overpayments, which includes: (1) over $20,000 related to damages and excessive interest because lenders did not protect or timely market liquidated properties, and (2) almost $13,000 for miscellaneous unallowable expenses (i.e. duplicate expenses, etc.). These overpayment amounts ranged from $3 to over $6,700. While many of these payments involve low dollar amounts, the high frequency is a concern to the OIG.[86]

For six loss claims, the agency overpaid lenders almost $19,000 because lenders did not properly secure properties during the liquidation phase. For example, one lender listed plumbing repair costs of $500 and damage costs of $4,700 on a loss claim. The property was not properly winterized after the lender took possession, and because of that water pipes burst and damaged the floors. The lender was responsible for protecting the property after foreclosure, and, therefore, was responsible for any damage caused. We considered these costs unallowable, and concluded that Rural Development should have reduced the claim by $5,200. We noted that the agency's edit check did not identify this cost as a potential overpayment, as the edit check is only triggered when the property value drops 20 percent or more from origination to foreclosure. Since $5,200 did not make up 20 percent of the property value, officials were not alerted to review the appraisals to determine the reason for the decrease in property value. This would have allowed the specialist to identify that the property damage was caused by lender negligence. Agency officials agreed that, because the GLS edit check was set at 20 percent, GLS did not alert the specialist to review the appraisals. In addition, we found that the agency did not detect or reduce another six claims by $1,700 for excessive interest when lenders did not list or close properties for sale within 30 days, as required.[87] The agency has not developed an edit check to identify when lenders did not list the properties for sale or close on short sales within 30 days.

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[83] We computed this amount by adding up individual line items included within the 77 filed loss claims. However, overall loss claim payments are subject to limitations that the agency has put in place (i.e., payments cannot exceed 90 percent of the original loan amount). After applying these limitations, we computed that the agency overpaid over $86,700 on these 77 loss claims, which is the figure that our statistical projections are based on.
[84] The 102 claims paid totaled $4.4 million.
[85] Over $44,000 of this amount was accrued interest paid to lenders who violated regulatory timeframes by making untimely decisions to liquidate and initiate foreclosure (see Finding 2). Incentives totaling $10,000 were overpaid to lenders for pre-foreclosure sales that did not meet agency requirements (see Finding 4).
[86] Agency officials stated that they track overpayments to the lenders using the dollar amount instead of the number of occurrences, and thus the smaller dollar amounts are not as significant as the higher ones. They added that it is not beneficial for the agency to expend resources to recover the lower overpayment amounts. They said that during their PQR reviews they use $20 as a threshold amount for determining the amount to be recovered.
[87] Rural Development requires lenders to list the property for sale within 30 days of acquiring the property. The agency also requires lenders to close on a pre-foreclosure sale within 30 days of agency approval.

Agency officials said that it is their policy to reduce loss claims when the lenders exceed these 30-day requirements. In these six instances, the agency had not reduced the claims or made errors in reducing the claims because the agency had not established an edit check to trigger a review of this requirement, nor had it established any specific instruction for the specialist to determine whether the lenders listed the properties for sale or closed on short sales within 30 days.

Overall, the agency overpaid lenders more than $20,000 ($19,000 and $1,700) for damages and excessive interest because these lenders did not protect or timely market liquidated properties. We determined that the agency needs to improve its review process to prevent overpaying lenders in these cases. To identify whether damages were caused by lender negligence, the agency should establish an edit check in GLS to compare the "as is" appraised value to the "as repaired" appraised value. If there is a variance between these two amounts, the agency should require specialists to review the appraisals, property inspection reports, and any other pertinent documents. To identify the untimely marketing of liquidated properties by lenders, the agency needs to establish an edit check in GLS to identify when lenders do not list properties for sale or close on short sales within 30 days. In both cases, the agency needs to reduce the loss claims for the appropriate amount if lender negligence is found.[88]

The remaining $13,000 in overpayments came from 30 loss claims for various unallowable expenses, including unsupported expenses, duplicate expenses, and expenses that were incurred after the marketing period expired.[89] These overpayments were relatively small dollar amounts for many different types of expenses. However, we found that they generally occurred because agency officials did not detect them because of ineffective edit checks or errors made by the specialists processing these loss claims.

For example, we found that a lender claimed a $1,300 management fee as a closing cost, even though the agency purchase approval stated, "All management fees… are not reimbursable in the loss claim." The edit check did not trigger because the total closing costs did not exceed the established threshold—comprising more than 11 percent of the total sales price. However, in this instance, the threshold level was ineffective because it did not alert the loss claim specialist that management fees were not reimbursable.

When edit checks did work properly, sometimes claim specialists made an error and did not catch the discrepancies in supporting documentation. For example, one lender listed $1,750 in property preservation costs on the claim form, but had no documentation to support the charge. The edit check triggered, but the specialist made an error and allowed the payment to go through. The specialist should have disallowed the $1,750. In another example, on one loss claim the agency overpaid the lender $165 for property maintenance (such as lawn mowing) because the specialist allowed duplicate expenses. In this case the edit check triggered a review of supporting documentation, but the specialist did not identify that the lender included five invoices for mowing the lawn over a two week span.

[88] These changes to GLS would also prevent overpayments for loss claims that are manually processed. Manually processed claims are also entered into GLS and are subject to edit codes in the system.
[89] The marketing period is the time period between the date the lender acquires the property and the actual closing date of the sale, not to exceed 180 days.

Rural Development provided all loss claims specialists a training program consisting of on-the-job and classroom training that includes loss mitigation and processing loss claims. After completing the training program, each specialist has 10 percent of his/her work reviewed through an internal quality review to ensure that they are processing the claims accurately. However, since we found that erroneous claims were due, in part, to errors made by the loss claim specialists, we concluded that the agency needs to provided additional training to its loss claim specialists on how to properly evaluate loss claim information when edit checks require additional review. This should include a description of the appropriate actions to take when lenders do not comply with program requirements.

We concluded that the agency needs to review its edit check system, including assessing whether the threshold amounts that trigger an edit check need to be adjusted. According to agency officials, the last time they evaluated the edit check system, they evaluated data from 2006. Agency officials said that they evaluate specific individual edit check thresholds annually and adjust, as necessary; however, a review of the entire edit check system would take funding away from other needed services. The agency's procedure manual calls for a review every two years.[90] In addition, the agency needs to provide guidance and training to its specialists to minimize errors.

**Management Did Not Use Internal Review Results to Improve Program Performance**

Rural Development conducts quarterly PQRs of a non-random, risk-based sample of loss claims. For claims selected, agency officials review all documentation to validate each line item. If the agency determines that it overpaid any loss claims, it notifies the lenders and requires repayment. Our analysis of the PQR results showed that lenders were overpaid in 292 of 633 loss claim reviews (approximately 46 percent) from March 1, 2009, through February 28, 2011. Rural Development recovered over $767,000 in funds incorrectly paid to lenders.[91]

Although Rural Development officials identified these overpayments and recovered the funds from each specific lender, they did not consider the cumulative amount or evaluate the causes of the overpayments. Officials stated that they only identified the overpayments on a lender-by-lender basis, and not from an overall perspective. In addition, they did not perform periodic trend analyses to identify common errors made by lenders when submitting claims, or to determine why their internal controls did not detect or prevent the overpayments. For instance, for 36 of the 633 loss claims they reviewed, Rural Development did not initially detect that lenders did not promptly acquire and secure the property during the liquidation process (an issue described in the previous section). During the PQR, officials discovered these overpayments and required lenders to return over $271,000. However, the officials did not use these results to initiate a review of the loss claims process to determine why and how the lender's negligence in securing the properties was not initially detected.

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[90] *Loss Claim Administration Review Manual*, Chapter 7, June 13, 2008, states that since GLS plays such a vital role in risk management strategy, the system of edit checks will be reviewed every two years.
[91] Rural Development paid a total of over $34.6 million for these 633 loss claims.

Agency officials generally agreed with our concerns and recognized the need to implement corrective actions. The agency has already begun a preliminary analysis to evaluate the internal controls over the automated loss claim system, including edit checks. These officials stated that they did not consider the $767,000 that they overpaid lenders to be significant and that they were confident that the system was working as intended. Therefore, agency officials did not implement any corrective actions based on these results.

Considering that a PQR is a key review process for minimizing losses to the Federal Government, we also believe that Rural Development should expand its PQR sample, if resources permit. *The Loss Claim Administration Review Manual* calls for initially sampling 25 percent of a lender's claims paid in the prior quarter.[92] The manual states that the sample size should be decreased for good performance, with no less than 10 percent being sampled. However, it also states that the sample size should be increased for mediocre performance. We found that Rural Development samples the minimum amount: 10 percent of paid claims. The primary factor used in selecting claims for PQR is whether a claim is paid for more than 50 percent of the original loan amount.[93] Even though almost 4,400 claims met this criterion for the period we reviewed, only 548 loss claims were selected for PQRs.[94]

Further, if PQRs find that a lender has performed poorly on his/her loss claim submissions, Rural Development may lower a lender's status from fully automated to conditional, meaning that they would require a lender to submit all supporting documentation with their claims.[95] However, according to an agency official, no lender has ever been penalized with a conditionally approved or manual processing status due to poor performance. This official said that they had considered lowering a lender's status on a few occasions, but the agency had resolved the problems with the lenders before their status was lowered. Rural Development needs to use PQRs to identify lenders who repeatedly receive overpayments because they did not comply with agency requirements. The agency should also develop a system of penalties that begins with the collection of overpayments and progresses to possible removal from the Guaranteed Loan Program. This system should include such penalties as requiring lenders to submit claims for manual processing, reducing and/or eliminating interest payments while CSC processes the claim, and reducing the overall amount of the loss claim.

**Other Issues**

During our review, we questioned the accuracy of property appraisals performed at origination and liquidation for 9 of the loss claims in our sample.[96] We forwarded these appraisals to a

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[92] *Loss Claim Administration Review Manual*, Chapter 7, June 13, 2008.

[93] Other criteria used in selecting claims for PQRs include: (1) claims for each different type of liquidation method (i.e. short sale, foreclosure, DIL), (2) loans that defaulted shortly after origination, (3) claims where lenders were significantly late in initiating foreclosure, and (4) claims where lenders were significantly late in completing the foreclosure process.

[94] These 548 loss claims were out of the overall total of 633 that were selected for a PQR.

[95] *The Loss Claim Administration Review Manual*, Chapter 5, June 13, 2008, states that if the lender's performance is unacceptable at any time, the agency will suspend or revoke the lender's fully automated status. It further states that if the lender does not submit acceptable claim data into GLS and maintain accurate and complete supporting documentation, the lender's approval for automated processing is revoked.

[96] Lenders conduct several property appraisals related to a guaranteed loan before a loss claim is filed.

Rural Development certified appraiser, who deemed at least one appraisal for each of the 9 claims as unacceptable for several reasons, including that the "value conclusion is not credible or supported" and "site adjustments are not reasonable." In one case, the origination appraisal was $85,000, and the property appraiser wrote that there were no apparent adverse factors in the home. After the borrower defaulted after making just one payment, the property was appraised again during liquidation 8 months later. At that time, the appraisal noted that the heat was inadequate and that the floor plan of the house was functionally inadequate. The house was appraised at only $30,000. The Rural Development national certified appraiser stated that "comments made on the origination review appeared deceptive." This significant decrease in the property value contributed to a loss of more than $64,000 to the Federal Government, which paid the claim based on the original appraisal amount.

Appraisals obtained by lenders during loan origination and liquidation significantly affect the loss claim that Rural Development pays to the lenders if a borrower defaults on the loan. If the origination appraisal was overstated, then the borrower may have paid too much for the property. If the liquidation appraisal is understated, then the proceeds that the lender receives from the sale may be too low. Both of these scenarios increase losses to the Federal Government. Rural Development officials stated that they assume appraisals received from lenders are accurate since they are performed by certified appraisers. We concluded that the agency needs to establish procedures for loss claim specialists to identify questionable appraisals and refer them to the agency's certified appraisers for further analysis. These procedures should also include reducing loss claims, penalizing lenders, and possibly removing appraisers from the Guaranteed Loan Program when unacceptable appraisals are found.

In addition, we found that Rural Development did not process and pay 47 of the 102 loss claims in our sample within 60 days, as required by Federal regulations.[97] This resulted in $16,000 in unnecessary interest costs, as Rural Development is required to pay lenders interest up to the date when the Federal Government actually pays for the loss. As previously mentioned, due to the increasing volumes of loss claims and constant staffing levels, the agency has a backlog. We concluded that the agency needs to perform a cost-benefit analysis to determine whether to make necessary program improvements to enable the timelier processing of claims.

In conclusion, we believe that Rural Development needs to improve its internal controls to identify errors in the loss claims and provide better guidance and training to its staff to better identify errors, as defined in the regulations.

## Recommendation 12

Recover, in accordance with agency policy, the $86,753 that Rural Development overpaid to the lenders from the loss claims that we identified.

## Agency Response

[97] 7 CFR 1980.376(a), May 22, 1995.

In the agency’s response, dated January 18, 2013, Rural Development officials stated that they will review each of the loss claim overpayments identified by OIG, and if they find that the recovery of the overpayment is warranted and cost effective (greater than $124 according to agency policy), and the supporting documentation provided by OIG is adequate, the agency will request refunds of the overpayments after providing the applicable appeal rights.

## OIG Position

In order to reach management decision, Rural Development and OIG need to agree on the dollar amount that the agency will require lenders to repay. The agency also needs to provide OIG with a bill for collections for the agreed upon amount and evidence that an accounts receivable has been established in the agency’s accounting records.

## Recommendation 13

Improve the GLS edit check system to identify property damages that result from lenders not securing properties during liquidation. This should include establishing an edit check in GLS to compare the “as is” appraised value to the “as repaired” appraised value that would prompt the agency to review the appraisals, property inspection reports, and any other pertinent documents when there is a variance between the two values. If lender negligence caused the property damages, loss claims should be reduced.

## Agency Response

Rural Development officials stated that they will submit a Request For Automation to add an edit code to GLS which will be triggered when there is a large variance between the “as is” appraised value and the “as repaired” appraised value (automation is dependent on the availability of funding). They further stated that in the interim, the agency will add verbiage to the existing appraisal or Brokers Price Opinion edit codes requiring the lenders to provide the detailed inspection reports and their servicing notes, along with the entire appraisal and/or Brokers Price Opinion. If the agency’s review of these documents identifies that the damages resulted from lender negligence, the agency will reduce the loss claim.

## OIG Position

We accept Rural Development’s management decision.

## Recommendation 14

Establish edit checks in GLS to identify instances where lenders do not list properties for sale or close on pre-foreclosure sales within 30 days and reduce loss claims when appropriate.

## Agency Response

Rural Development officials agreed to submit a Request For Automation to add edit codes to GLS which will be triggered when lenders do not list a property in a timely manner or do not close on pre-foreclosure sales within the timeframe stipulated by the agency (automation is dependent on the availability of funding). Agency officials stated that, in the interim, the agency will implement procedures to manually reduce accrued interest if a lender does not list a real estate owned property within 30 days of acquiring title or gaining physical possession of the property.

## OIG Position

We accept Rural Development's management decision.

## Recommendation 15

Perform an overall evaluation of the GLS edit check system, including assessing the threshold amounts that trigger edit checks. Based on the results, make any necessary adjustments to improve the system.

## Agency Response

Rural Development officials agreed to complete an analysis during calendar year 2013 to assess the soundness of current edits and to identify the need for any new edits. All automation changes will be pushed into a test environment to allow for user testing prior to implementation. Agency officials stated that edit adjustments will become effective in the production environment by the end of calendar year 2014.

## OIG Position

While we agree with the agency's plan to complete the analysis of the current edit checks and identify the need for any new edit checks during calendar year 2013, we are concerned that permanent corrective actions will not be put in place until the end of calendar year 2014. In order to reach management decision, agency officials need a timelier plan of corrective action (i.e., within 1 year of an accepted management decision).

## Recommendation 16

Provide training and guidance to all personnel involved in processing loss claims to detail how to properly evaluate loss claim information when edit checks require additional review. This should include a description of the appropriate actions to take when lenders do not comply with program requirements.

## Agency Response

Rural Development officials agreed to expand and strengthen formal training on the agency's policies and procedures as they are updated. Agency officials also agreed to hold refresher training on current procedures.

## OIG Position

We accept Rural Development's management decision.

## Recommendation 17

Establish procedures to periodically analyze overpayments identified through the PQRs to determine why existing internal controls did not detect the problems found. Document the results and take steps to revise internal control measures based on these results.

## Agency Response

Rural Development officials stated that they will: (1) develop a worksheet to track PQR monetary findings, the source and cause of the error, and the applicable GLS edit check; (2) identify solutions to prevent overpayments; (3) develop a process for evaluating overpayments identified in future PQRs; and (4) develop automated reports to consolidate database information for trend analysis.

## OIG Position

We accept Rural Development's management decision.

## Recommendation 18

Develop and implement a system with a range of penalties to penalize lenders who repeatedly receive overpayments because they did not comply with agency requirements. These lenders should be identified using the agency's PQRs. Such penalties should include requiring lenders to submit claims for manual processing, reducing and/or eliminating interest payments while CSC processes the claims, reducing the overall amount of the loss claim, and possible lender removal from the Guaranteed Loan Program.

## Agency Response

Rural Development officials agreed to develop a procedural document outlining the steps to take when unacceptable performance is found during PQR reviews. Any penalty taken against a lender will be based on the agency's regulatory authority.

## OIG Position

We accept Rural Development's management decision.

## Recommendation 19

Develop procedures for loss claim specialists to identify questionable appraisals and refer them to the agency's certified appraisers for further analysis. These procedures should also include reducing loss claims, penalizing lenders, and possibly removing appraisers from the Guaranteed Loan Program when unacceptable appraisals are found.

## Agency Response

Rural Development officials stated that they will review the current policies and procedures on reviewing appraisals, and define common criteria and controls under which a specialist will refer an appraisal to a staff appraiser for review. Agency officials stated that any penalties taken against a lender will be based on the agency's regulatory authority.

## OIG Position

We accept Rural Development's management decision.

## Recommendation 20

Perform a cost-benefit analysis to determine whether program improvements can be made to pay loss claims within 60 days, as required by Federal regulations. If so, implement these improvements to prevent the agency from paying excessive interest to lenders.

## Agency Response

Rural Development officials stated that they will analyze staffing, automation efficiencies, and policies and procedures to determine whether program improvements can be made to pay loss claims within 60 days of receiving a loss claim submitted promptly and properly. In doing so, agency officials stated that they will also consider the impact of implementing other OIG recommendations on the 60-day timeframe and the cost effectiveness of making program improvements to pay loss claims within 60 days.

## OIG Position

We accept Rural Development's management decision.

## Section 2: Pre-Foreclosure Sales

### Finding 4: Rural Development Approved Pre-Foreclosure Sales for Unqualified Borrowers

Rural Development did not require lenders to submit sufficient documentation justifying pre-foreclosure sales, referred as "short sales," for borrowers. It also did not issue guidance as to when exceptions should be approved for allowing these sales for borrowers not meeting sale requirements. Instead, Rural Development relied on lenders to determine whether borrowers met short sale requirements. Agency officials also stated that they did not issue instructions for when exceptions should be granted because it would be difficult to list all of the exceptions that were possible. As a result, Rural Development paid lenders over $454,000 in loss claims for 10 borrowers in our sample who did not meet the requirements for a short sale.[98] Rural Development officials did not document why they granted exceptions and allowed the short sales in these cases, and thus cannot support whether these decisions were in the Federal Government's best interest. The Federal Government lost its ability to pursue reimbursement for the losses incurred from these borrowers defaulting on their guaranteed loans.[99]

According to Federal Regulations, Rural Development may accept lenders' plans to use liquidation methods other than foreclosure (i.e., short sale) as long as the lender fully documents how they will result in a savings to the Federal Government.[100] Agency regulations allow borrowers who are in default on their loans to sell the property through a short sale, but borrowers must demonstrate an involuntary inability to pay their mortgage (due to job loss, job transfer, divorce, or death). Lenders are required to verify the borrower's financial status and that the value of the home has declined to less than the amount owed on the mortgage.[101] Lenders are required to submit a servicing plan and specific supporting documents[102] to obtain approval before proceeding with a short sale, and if they follow program requirements, may receive a $1,000 incentive when they file a loss claim.[103] According to agency guidelines, all lenders that have received prior approval from the agency for a short sale will receive a one-time loss mitigation incentive of $1,000 at the time of filing each loss claim.

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[98] A pre-foreclosure sale (also referred to as a "short sale") allows a borrower in default to sell his or her home and use the sale proceeds to satisfy the mortgage debt even if the proceeds are less than the amount owed to the lender.
[99] Borrowers agree to reimburse the USDA for any loss that they cause the agency when they are approved for a guaranteed loan. The Federal Government may pursue these losses through the Debt Collection Improvement Act of 1996. However, if a borrower is approved for a short sale, his/her debt is relieved, and the Federal Government no longer has the ability to recoup losses from the borrower.
[100] 7 CFR 1980.374(d) (4), May 22, 1995.
[101] *Guaranteed Loans Loss Mitigation Desk Procedures*, pg. 135, October 2010.
[102] Lenders are required to submit the following documents with their servicing plan: hardship letter, current pay stub, property appraisal, sales contract, and a credit report. The servicing plan describes the information about the borrower, property, loan, and the lender's recommended loss mitigation option.
[103] *Loss Claim Administrative Review Manual*, pg. 3-5, June 2008.

**Borrowers Were Ineligible for Short Sales**

Our statistical sample included 24 loss claims that Rural Development approved for short sales. We evaluated these claims to determine whether the short sales met agency requirements by analyzing the servicing plans and the supporting documentation submitted by lenders and used by Rural Development officials to approve the sales. We also requested that lenders provide us with additional information, such as the lenders' servicing notes and documents to validate the borrower's monthly expenditures, which are not required by Rural Development, to enable us to better evaluate whether borrowers met eligibility guidelines for short sales. Based on our analysis, we identified 10 borrowers, with loss claims of more than $454,000, who did not meet agency requirements for a short sale. These 10 borrowers did not meet the requirements for the following reasons:[104]

- 8 borrowers did not have an involuntary inability to pay.[105]
- 3 borrowers did not occupy the property as their primary residence.[106]
- 9 borrowers did not have a permanent reason for defaulting on the loan, such as a job loss, divorce, permanent disability, or death.[107]

Based on our analysis, we found that Rural Development officials: (1) obtained insufficient documentation to properly determine borrower eligibility for short sales and (2) improperly approved exemptions for ineligible borrowers. Rural Development did not require lenders to submit their servicing notes, which contained important information that would have affected the agency's decision whether to approve the short sales. The agency also has not issued guidance on when exceptions to short sale requirements may be granted. The following sections describe in detail our conclusions regarding Rural Development officials' reasons for approving the short sales.

**Insufficient Documentation to Determine Borrower Eligibility for Short Sales**

We identified six loss claims in our sample where notes in lender servicing files indicated that the borrowers were ineligible for a short sale. The lenders had not provided this information to Rural Development officials because the agency did not require them to submit it when seeking Rural Development's approval for the short sale. When we discussed the lender servicing notes with agency officials, they agreed with our position and stated that they would not have approved the six short sales if they had been aware of the information contained in the servicing files.

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[104] The cumulative number of borrowers listed is greater than 10 because some borrowers had not complied with more than one requirement.

[105] Rural Development's *Loss Mitigation Guide*, page 3-C-1-3, April 17, 2009, states that the short sale may be extended to a borrower who is in default due to a verified involuntary inability to pay.

[106] Rural Development's *Loss Mitigation Guide*, pages 3-C-1-3 and 3-C-1-6, April 17, 2009, states that the borrower should occupy the property unless pre-approval is obtained from the agency.

[107] *Guaranteed Loans Loss Mitigation Desk Procedures*, October 2010, state that for a short sale, the reason for default must be permanent.

One lender informed Rural Development that a borrower was in default because the borrower incurred legal fees, had medical and dental bills, and took a personal vacation, and could not pay the loan. Rural Development officials approved the short sale request, based on the involuntary inability to pay regulations, which was supported by information submitted by the lender. The lender submitted all required documents to Rural Development; however, our review of the lender's servicing notes, which were not required for short sale approval, disclosed that the borrower did not meet any of the involuntary inability to pay criteria. Instead, the borrower had decided simply to discontinue payment on the loan. The lender's servicing notes stated that the borrower was offered several options that would have enabled her to make loan payments and remain in her home. Even though the borrower qualified for these options to save the loan, the borrower refused each option. Based on this information, we determined that the borrower was not eligible for a short sale.

Rural Development officials had not identified the issue because they had not obtained the lender's servicing notes when they reviewed and approved the short sale servicing plan. The officials informed us that if they had seen the documentation, they would not have approved the short sale. The agency forfeited the opportunity to recover the over $36,000 loss from the borrower through debt collection, which included a $1,000 incentive paid to the lender for qualifying the borrower for the short sale.[108] We were unable to determine if the lender intentionally withheld information from Rural Development officials. However, in our view, the lender should have been aware that this borrower did not meet the eligibility criteria for a short sale.

In another case, a lender's servicing plan stated that the borrower had lost his job, and had moved to another State to be closer to family and to search for employment. Rural Development officials approved the short sale because the borrower had lost his job. The officials relied on the lender to validate that the borrower met the requirements for a short sale. However, our review of the lender's files, including the lender's servicing notes, disclosed that while the borrower had lost his job, he found another position and continued making mortgage payments for another 18 months before moving to another State. The lender's servicing notes and the hardship letter[109] stated that the borrower voluntarily moved from the residence to be closer to his family. Agency procedures state that a short sale is not available to borrowers who have abandoned their mortgage obligation, despite having a continued ability to pay.[110] Therefore, we concluded that the borrower was not eligible for a short sale. The Rural Development approving official agreed with our position and stated that if he had been provided the lender servicing notes, he would have reconsidered whether to approve the short sale. This official also said that he thought that the borrower was willing to remain in his home; with the lender servicing notes, he would not have approved the short sale. Officials also acknowledged that obtaining lender servicing notes was important to identify instances of noncompliance with short sale requirements. The agency paid over $12,000 in losses to the lender for this claim, which, due to the short sale being approved, could not be recovered by the Federal Government.

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[108] This was the amount that the USDA paid to the lender for the loss claim it submitted.
[109] Hardship letters are provided by borrowers who are in default to describe the reasons why they are unable to pay their mortgage obligations. Lenders are required to submit the hardship letter to Rural Development with their request for approval of the short sale.
[110] Rural Development's *Loss Mitigation Guide*, page 3-C-1-3, April 17, 2009.

We also found that agency officials relied solely on lenders to certify that the financial data provided by borrowers to qualify for short sales met regulatory requirements. In the 10 cases that we found that did not meet the eligibility requirements for a short sale, the lenders provided the servicing plans for approval and Rural Development officials approved them without verifying the borrowers' financial information. When we discussed this issue with agency officials, they stated that they believed that the financial information that lenders provided on the servicing plans was accurate and they did not request supporting documentation to validate these figures. However, our review of the lender servicing notes and other documentation, as well as the borrower's financial circumstances, disclosed that 3 of the 10 borrowers were financially secure and, thus, not eligible for a short sale.

**Rural Development Improperly Granted Exceptions to Borrowers from Short Sale Requirements**

Rural Development officials granted exceptions to four borrowers for short sales in our sample, even though they were aware that the borrowers were ineligible. One Rural Development official stated that the agency considered short sales to be the best option for the Federal Government in these circumstances. However, the official was unable to provide any evidence to support this position. Another Rural Development official said that it was agency policy to grant exceptions on an ad hoc basis, depending on the circumstances of each case. The official added that Rural Development had not established guidance outlining the circumstances for granting an exception or the specific criteria to use when granting exceptions. Agency policy does state that lenders must demonstrate that the short sale is in the best interest of the Federal Government. None of the lenders for the four cases had provided support that they met the requirement, yet agency officials approved the sales.

We analyzed documentation pertaining to the approval of the four short sales. We found three instances where Rural Development officials granted exceptions and approved short sales for borrowers, although they had voluntarily vacated their residences. For the other case, Rural Development granted an exception for a borrower who quit a job, which caused the default. Borrowers who voluntarily vacate their residences or choose to quit their jobs are not eligible for a short sale. In each of the four exceptions granted, agency officials did not document the reasons why they made the exceptions. The agency has not established any guidance to describe specifically when exceptions may be granted.

Rural Development needs to establish guidance describing specific circumstances when an exception for a short sale can be approved. Whenever an exception is granted, this guidance should also require that the reasons are fully documented, that it is in the best interest of the Federal Government to approve this short sale, and that it is approved by a supervisor.

Rural Development approved 10 of the 24 short sales in our statistical sample to borrowers who were not eligible. As a result, the agency paid over $454,000 in loss claims, and released the borrowers from their obligation to repay the Federal Government for any losses that they caused. Agency officials stated that the short sales generally resulted in savings from foreclosure costs. We do not disagree that this could be true, but lenders were not required to provide evidence to support this. Therefore, we are recommending that Rural Development strengthen its procedures to enable them to make consistent and accurate decisions regarding the approval of short sales.

## Recommendation 21

Amend existing procedures to require lenders to submit with their short sale servicing plans their servicing notes and all other applicable documents to substantiate the borrowers' monthly expenses and income, and any other documents deemed pertinent to describe all servicing actions taken, including hardship letters, contacts with borrowers, attempts to save the loan and to keep the borrowers in their home, and verification of borrower occupancy.

## Agency Response

In the agency's response, dated January 18, 2013, Rural Development officials stated that they will review policies, procedures, and guidelines regarding the documentation that lenders are currently required to submit in support of their short sale servicing plan. If a determination is made that additional documentation is required, the agency agrees to amend the existing procedures.

## OIG Position

While we agree with the corrective actions proposed, in order to achieve management decision, the agency needs to amend, and not just review, existing procedures to require lenders to submit, along with their short sale servicing plans, their servicing notes and all other applicable documents to substantiate the borrowers' monthly expenses and income, and any other documents deemed pertinent to describe all servicing actions taken.

## Recommendation 22

Require lenders to submit evidence demonstrating how the short sale will result in a cost savings for the Federal Government.

## Agency Response

Rural Development officials stated that they will continue to monitor established guidelines in an effort to determine the cost effectiveness as industry standards evolve. Should data support the need to amend established guidelines, the agency would agree to consider revisions.

## OIG Position

While we agree with the corrective actions proposed, they do not require lenders to provide support showing that a short sale results in savings to the Federal Government. Therefore, in order to achieve management decision, the agency needs to require lenders to provide evidence of this analysis.

## Recommendation 23

Establish guidance describing specific circumstances when an exception from short sale requirements may be approved. This guidance should require that whenever an exception is granted, the reasons for the exception are fully documented.

## Agency Response

Rural Development officials stated that the agency will review and expand existing guidance regarding the exceptions to the short sale requirements, and that the most common exceptions will be included in the update to the current Loss Mitigation Guide.

## OIG Position

While we agree with the proposed corrective action, in order to reach management decision, Rural Development needs to also require in its guidance that the reasons for granting exceptions to short sale requirements are fully documented.

## Scope and Methodology

We conducted our audit at the RHS national office in Washington, D.C., and at RHS' CSC and DCFO, in St. Louis, Missouri. The objective of our audit was focused on loss claims from loans guaranteed with Recovery Act funds.[111] However, because the internal controls over the SFH Guaranteed Loan Program were the same for loans guaranteed with either the Recovery Act or regular appropriated funds, we expanded our original audit objective to include loans from both funding sources.

We randomly selected 102 loss claims paid between March 17, 2009, and February 28, 2011,[112] using a sample design with 3 strata.[113] The first stratum included 69 loss claims from Recovery Act loans obligated between March 17, 2009, and September 30, 2010. The second stratum included 12 loss claims from loans obligated with regular appropriations between March 17, 2009, and September 30, 2010. The third stratum included 8,183 loss claims from loans obligated with regular appropriations before March 17, 2009. We randomly selected 40 loss claims from the first stratum, all 12 loss claims from the second stratum, and 50 loss claims from the third stratum.

Rural Development paid over $377 million for 8,264 loss claims between March 17, 2009, and February 28, 2011. This included both Recovery Act and regular appropriated funds. Rural Development paid over $4.4 million to lenders for the 102 loss claims in our statistically random sample. We examined supporting documentation for over 99 percent of the expenses listed on the102 loss claims in our random sample.

To accomplish our objective, we performed the following procedures:

- Reviewed applicable laws, regulations, agency policies, procedures, and guidance related to originating loans; servicing, mitigating, and liquidating delinquent loans; and processing loss claims for the SFH Guaranteed Loan Program.
- Reviewed prior GAO and OIG audit reports related to the SFH Guaranteed Loan Program.
- Interviewed RHS, CSC, and DCFO officials to understand the agency's policies and oversight for servicing loans, and conducting loss claim reviews, including the procedures used to validate, process, and pay loss claims. We also obtained an understanding of the agency's GLS and its Imaging Workflow system, both of which were used in the loss claim review process.
- Reviewed all supporting documentation maintained by Rural Development for our statistical random sample of 102 loss claims, including loan origination, loan servicing, and loss claim processing data, to verify compliance with agency policies and procedures, and to verify that the loss claims were paid accurately. We also verified whether there was sufficient evidence that lenders properly mitigated losses from defaulted loans.

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[111] The American Recovery and Reinvestment Act of 2009, Public Law 111-5, February 17, 2009, authorized funds to be used for single family housing loan guarantees.
[112] Rural Development obligated loans using Recovery Act funds during this time period.
[113] The rationale for the sample size is explained in exhibit B of this report.

- Reviewed loan origination documentation to identify any loans with questionable eligibility, and evaluated the effectiveness of Rural Development's review of loan origination during the processing of loss claims.
- Tested the accuracy of GLS loss claim computations and also reviewed the results of DCFO's monthly testing of GLS computations.
- Requested that Rural Development's national certified appraiser review property appraisals for loss claims from our sample.
- Analyzed CSC's PQR results for the 633 loss claims it had selected for review. The 633 loss claims totaled about $34.7 million and were paid between March 1, 2009, and February 28, 2011.[114]

We performed our audit fieldwork from December 2010 through June 2012. We conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. As part of this audit, we tested GLS' application controls; however, we did not review the system's general controls.[115] We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[114] CSC selected the 633 loss claims from over 8,400 loss claims totaling about $381 million.
[115] GLS' general controls were evaluated in *Controls Over Eligibility Determinations for SFH Guaranteed Loan Recovery Act Funds (Phase 2)* (04703-02-Ch, September 2011).

## Abbreviations

Recovery Act .............American Recovery and Reinvestment Act of 2009
CSC.............................Centralized Servicing Center
DCFO..........................Deputy Chief Financial Officer
DIL..............................Deed-In-Lieu of Foreclosure
FY ...............................Fiscal Year
GAO............................Government Accountability Office
GLS.............................Guaranteed Loan System
GUS.............................Guaranteed Underwriting System
HUD............................Department of Housing and Urban Development
OIG .............................Office of Inspector General
PITI .............................Principle, Interest, Taxes, Insurance Ratio
PQR.............................Post Quarterly Reviews
RHS.............................Rural Housing Service
SFH .............................Single Family Housing
TD ...............................Total Debt Ratio
USDA..........................United States Department of Agriculture

## Exhibit A: Summary of Monetary Results

| Finding Number | Description | Amount | Category |
|---|---|---|---|
| 1 | Loss Claims Paid On Loans with Questionable Eligibility | $86,753,760 | Questioned Costs and Loans, No Recovery |
| 2 | Loss Claims Paid On Loans that Lenders Did Not Adequately Service | $253,899,549 | Questioned Costs and Loans, No Recovery |
| 3 | Loss Claims Overpaid to Lenders | $86,753 | Questioned Costs and Loans, Recovery Recommended |
| 3 | Loss Claims Overpaid to Lenders | $6,193,772 | Questioned Costs and Loans, No Recovery |
| **TOTAL** | | $346,933,834 | |

The table above summarizes monetary results by findings and includes a description, dollar amount, and the category of questioned costs. The table illustrates Finding 1 has $86,753,760, Finding 2 has $253,899,549, Finding 3 has $86,753 of questioned costs and loans with recovery recommended, and Finding 3 has $6,193,772 of questioned costs and loans, with no recovery recommended.

For Finding 3, we are recommending that the agency recover the exact amount of the overpayment that we computed on our reviews of 102 loss claims. We also include as questioned costs with no recovery, the statistical projection of the overpayments (less the overpayments from our sample).

# Exhibit B:  Statistical Plan

## Sample Design and Results for Audit Number 04703-0003-Hy
## Loss Claims Related to Single Family Housing Guaranteed Loans

**Objective**

This sample was designed to support the audit of Rural Development's internal controls over issuing loss claim payments to lenders participating in the SFH Guaranteed Loan Program.  This included assessing whether Rural Development properly determined why the loans failed and whether the agency properly denied, reduced, or recovered loss claims from lenders who violated program requirements.  Because the controls over loss claim payments were the same prior to the Recovery Act, the audit scope included loss claims for loan guarantees made outside the Recovery Act time period.  We chose a design stratified on three time periods to estimate control attributes and dollar amounts associated with control exceptions.

**Audit Universe**

Our universe consisted of 8,264 guaranteed loans for which Rural Development paid loss claims between March 17, 2009, and February 28, 2011.  The total value of these loan guarantees was over $377 million.

**Sample Design**

Our audit team was interested in projecting sample results to the entire universe of loss claims. We had no historical information on error rates for the criteria being audited; therefore, we made some assumptions on which to base a sample size calculation.  Overall, we wanted a sample size sufficient to support reasonable precision on projections of attributes even if error rates ranged from 30 to 50 percent.  For a simple random sample, a 95 percent confidence level, and a confidence interval width (absolute precision) of +/- 10 percent, various combinations of these assumptions lead to sample sizes ranging from about 80 to about 95.  Lower error rates would result in tighter precision for the same sample size.  Because we planned to stratify the sample, and we could not predict what effect the stratification would have on overall precision, we elected to use a total of 90 claims for two random strata and all 12 claims in the census stratum. Therefore, we selected 102 loss claims for review in three strata as indicated below:

1) Stratum I - loss claims for Recovery Act loan guarantees obligated during the Recovery Act period, March 17, 2009, to September 30, 2010.  As of February 28, 2011, there were a total of 69 loss claims paid totaling $3,261,344.  In this stratum we selected a simple random sample of 40 loss claims totaling $1,880,988 for review.

2) Stratum II - loss claims for non-Recovery Act loan guarantees obligated during the Recovery Act period, March 17, 2009, to September 30, 2010. As of February 28, 2011, there were 12 loss claims paid totaling $434,330. This was a census stratum: all 12 loss claims were reviewed.

3) Stratum III - loss claims for non-Recovery Act loan guarantees obligated prior to March 17, 2009. As of February 28, 2011, loss claims totaling $374,083,469 were paid on 8,183 loans obligated between May 28, 1992, and March 16, 2009 (i.e., not overlapping with Stratum II). In this stratum we selected a simple random sample of 50 loss claims totaling $2,103,052 for review.

**Results**

We had no historical data about this program, hence our sample design is based only on information we had at the time the audit was initiated. Nevertheless, our sample results achieved and are reported at the targeted precision for attributes of around +/-10 percent at the 95 percent confidence level. We had no way of knowing how much variation between and within strata we would find before audit criteria were tested. To present a full picture of our findings, we report the results for each stratum separately, and then show an overall projection to the entire audit universe from all three strata combined. This, in effect, illustrates the contribution of each stratum to the overall estimates and the variability of each stratum to the precision of the estimates.

**Stratum I Results**:

This stratum was based on Recovery Act loss claims that were obligated during the period of March 17, 2009, to September 30, 2010. This represents a group of loan guarantees for loans with a relatively short history. Given the shorter life span of the loans in this stratum, they could be considered to be potentially more risky than loans that have been in existence for a longer time (which is the case in Stratum III).

We did not know what magnitude of error to expect in any of the strata; however, our results met the targeted precision at the 95 percent confidence level. Our sample universe for this group was 69 loss claims paid. We selected a simple random sample of 40 claims for review. The results of our sample are presented in Table 1.

# Exhibit B: Statistical Plan

Table 1:

| RESULTS FOR STRATUM I ONLY | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | 95% Confidence Interval | | | | |
| **Criteria Tested** | **Estimate** | **Standard Error** | Lower | Upper | **Coefficient of Variation** | **Actual observations found in sample** | **Achieved absolute precision (+/-)*** |
| Loss claims paid on loans with questionable eligibility | 24 | 3.417 | 17 | 31 | .141 | 14 | 10% |
| Dollar amount estimate for loss claims paid on loans with questionable eligibility | $1,436,558.71 | $246,249.91 | $938,471.25 | $1,934,646.18 | .171 | $ 832,787.66 | 15% |
| Loss claims not serviced timely by lenders | 50 | 3.198 | 44 | 56 | .064 | 29 | 9% |
| Dollar amount estimated for loss claims not served timely by lenders | $2,310,273.68 | $211,435.04 | $1,882,605.94 | $2,737,941.42 | .092 | $1,339,289.09 | 13% |
| Overpaid claims | 55 | 2.865 | 49 | 61 | .052 | 32 | 8% |
| Dollar amount estimate for overpaid claims | $65,071.33 | $10,355.38 | $44,125.60 | $86,017.06 | .159 | $1,880,987.64 | 1% |

*Absolute precision = 100 x (1/2) x (upper bound – lower bound) / Universe total. For example: 100 x (0.5) x (31 – 17) / (69) = 10.14 percent, or 10 percent rounded.

**Stratum II Results**:

This stratum represented a census of 12 non-Recovery Act loss claims paid during the period of March 17, 2009, to September 30, 2010. Since this stratum is a census, its results do not project to the universe, but *add* to the overall total projections. Results are presented in the Table 2.

# Exhibit B: Statistical Plan

Table 2:

| RESULTS FOR STRATUM II ONLY | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | 95% Confidence Interval | | | | |
| **Criteria Tested** | **Estimate** | **Standard Error** | Lower | Upper | **Coefficient of Variation** | **Actual observations found in sample** | **Achieved absolute precision (+/-)** |
| Loss claims paid on loans with questionable eligibility | 5 | .000 | 5 | 5 | .000 | 5 | N/A - census |
| Dollar amount estimate for loss claims paid on loans with questionable eligibility | $194,110.64 | $ 0 | $194,110.64 | $194,110.64 | .000 | $194,110.64 | N/A - census |
| Loss claims not serviced timely by lenders | 5 | .000 | 5 | 5 | .000 | 5 | N/A - census |
| Dollar amount estimated for loss claims not served timely by lenders | $200,078.76 | $ 0 | $200,078.76 | $200,078.76 | .000 | $200,078.76 | N/A - census |
| Overpaid claims | 5 | .000 | 5 | 5 | .000 | 5 | N/A - census |
| Dollar amount estimate for overpaid claims | $11,121.09 | $ 0 | $11,121.09 | $11,121.09 | .000 | $11,121.09 | N/A - census |

**Stratum III Results**:

This stratum consisted of loss claims for non-Recovery Act loan guarantees obligated prior to March 17, 2009. Our simple random sample of 50 claims projects to this group of a total of 8,183 claims. This stratum represents loan guarantees with a longer life span, hence they could potentially be less risky than the loan guarantees in Stratum I and II.

We did not know what error magnitude to expect in this stratum; however, our results achieved and are reported with the targeted precision at the 95 percent confidence level. Results are presented in Table 3.

## Exhibit B: Statistical Plan

Table 3:

| RESULTS FOR STRATUM III ONLY | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | **95% Confidence Interval** | | | | |
| **Criteria Tested** | **Estimate** | **Standard Error** | Lower | Upper | **Coefficient of Variation** | **Actual observations found in sample** | **Achieved absolute precision (+/-)** |
| Loss claims paid on loans with questionable eligibility | 1800 | 482.772 | 830 | 2770 | .268 | 11 | 12% |
| Dollar amount estimate for loss claims paid on loans with questionable eligibility | $85,123,091.24 | $26,312,476.80 | $32,246,189.44 | $137,999,993.04 | .309 | $520,121.54 | 62% |
| Loss claims not serviced timely by lenders | 6055 | 511.194 | 5028 | 7083 | .084 | 37 | 13% |
| Dollar amount estimated for loss claims not served timely by lenders | $251,389,196.71 | $29,014,149.22 | $193,083,080.90 | $309,695,312.52 | .115 | $1,536,045.44 | 68% |
| Overpaid claims | 6546 | 466.169 | 5610 | 7483 | .071 | 40 | 11% |
| Dollar amount estimate for overpaid claims | $6,204,332.60 | $1,435,340.32 | $3,319,908.24 | $9,088,756.96 | .231 | $37,909.89 | 3% |

**Overall Projections**:

Overall results are projected to the audit universe of 8,264 claims with a total value of $377,779,143. Achieved precision, relative to the universe of 8,264 claims, is reflected by the confidence interval for a 95 percent confidence level. All projections are made using the normal approximation to the binomial as reflected in standard equations for a stratified sample.[116]

Projections are shown in the Table 4 below. Narrative interpretation of the results is presented below the table.

[116] Scheaffer, Mendenhall, Ott, Elementary Survey Sampling, Fourth Edition (Chapter 5), Duxbury Press, c1990.

# Exhibit B: Statistical Plan

Table 4:

Overall Projections

| Criteria tested | Estimated number (percent of audit universe) | Standard Error | 95% Confidence Interval Bounds | | Coefficient of Variation | Actual observations found in sample | Achieved absolute precision (+/-) |
|---|---|---|---|---|---|---|---|
| | | | Lower | Upper | | | |
| Loss claims paid on loans with questionable eligibility | 1,829 (22%) | 482.784 | 870 | 2,789 | .264 | 30 | 12% |
| Dollar amount estimate for loss claims paid on loans with questionable eligibility | $86.8 million | $26.3 million | $ 34.5 million | $139 million | .303 | $1.5 million | 14% |
| Loss claims not serviced timely by lenders | 6,110 (74%) | 511.204 | 5,095 | 7,126 | .084 | 71 | 12% |
| Dollar amount estimated for loss claims not served timely by lenders | $253.9 million | $29.0 million | $196.3 million | $311.5 million | .114 | $3.1 million | 15% |
| Overpaid claims | 6,607 (80%) | 466.178 | 5,680 | 7,533 | .071 | 77 | 11% |
| Dollar amount estimate for overpaid claims | $6.3 million | $1.4 million | $3.4 million | $9.1 million | .229 | $0.87 million | 1% |

Based on our sample, we estimate that:

- 1,829 loss claims (22 percent of the audit universe) were paid on loans with questionable eligibility. We are 95 percent confident that between 870 and 2,789 loss claims were paid on such loans, which represents achieved precision of +/- 12 percent of the audit universe of 8,264 claims.
- $86.8 million is at risk based on loss claims paid on loans with questionable eligibility. We are 95 percent confident that between $34.5 million and $139 million is at risk based on that criterion, which represents achieved precision of +/- 14 percent of the audit universe of $377,779,143.
- 6,110 loss claims (74 percent of the audit universe) were paid on loans that were not serviced timely by lenders. We are 95 percent confident that between 5,095 and 7,126 loss claims were paid on such loans, which represents achieved precision of +/- 12 percent of the audit universe.

# Exhibit B: Statistical Plan

- $253.9 million is at risk based on loss claims paid on loans that were not serviced timely by the lender. We are 95 percent confident that between $196.3 million and $311.5 million is at risk based on the same criterion, which represents achieved precision of +/- 15 percent of the audit universe.
- Rural Development overpaid on 6,607 claims (80 percent of the audit universe). We are 95 percent confident that RD overpaid between 5,680 and 7,533 claims, which represents achieved precision of +/- 11 percent of the audit universe.
- Rural Development overpaid approximately $6.3 million on loss claims. We are 95 percent confident that RD overpaid between $3.4 million and $9.1 million, which represents achieved precision of +/- 1 percent of the audit universe.

## Exhibit C: Questionable Loans

| Sample Number | Loss Claim Amount | Origination Date | Default Date (first missed payment) | Total Months from Origination to Default |
|---|---|---|---|---|
| **Stratum I** | | | | |
| 1-1 | $49,936 | 7/10/2009 | 9/1/2009 | 1 |
| 1-2 | $26,464 | 2/27/2009 | 5/1/2009 | 2 |
| 1-4 | $54,962 | 2/27/2009 | 5/1/2009 | 2 |
| 1-5 | $26,259 | 7/23/2009 | 10/1/2009 | 2 |
| 1-9 | $55,540 | 4/17/2009 | 7/1/2009 | 2 |
| 1-10 | $56,487 | 3/31/2009 | 10/1/2009 | 6 |
| 1-15 | $60,484 | 9/8/2009 | 3/1/2010 | 5 |
| 1-17 | $86,744 | 4/1/2009 | 3/1/2010 | 11 |
| 1-19 | $29,533 | 3/23/2009 | 6/1/2009 | 2 |
| 1-20 | $64,612 | 3/13/2009 | 6/1/2009 | 2 |
| 1-27 | $93,916 | 3/23/2009 | 12/1/2009 | 8 |
| 1-31 | $41,724 | 5/14/2009 | 12/1/2009 | 6 |
| 1-38 | $32,560 | 2/18/2009 | 8/1/2009 | 5 |
| 1-39 | $153,565 | 4/9/2009 | 8/1/2009 | 3 |
| **Stratum II** | | | | |
| 2-1 | $16,843 | 6/18/2009 | 1/1/2010 | 6 |
| 2-2 | $30,549 | 8/26/2009 | 11/1/2009 | 2 |
| 2-3 | $77,379 | 4/10/2009 | 10/1/2009 | 5 |
| 2-8 | $31,871 | 7/17/2009 | 10/1/2009 | 2 |
| 2-9 | $37,468 | 3/17/2009 | 6/1/2009 | 2 |
| **Stratum III** | | | | |
| 3-1 | $23,818 | 3/19/2004 | 9/1/2007 | 41 |
| 3-3 | $108,519 | 11/23/2004 | 12/1/2007 | 36 |
| 3-4 | $45,585 | 10/19/2006 | 8/1/2007 | 10 |
| 3-12 | $30,917 | 8/31/2007 | 11/1/2007 | 2 |
| 3-18 | $35,230 | 9/5/2007 | 1/1/2009 | 15 |
| 3-20 | $31,885 | 11/29/2006 | 12/1/2007 | 12 |
| 3-22 | $33,994 | 1/20/2006 | 2/1/2008 | 24 |
| 3-34 | $63,503 | 7/17/2007 | 7/1/2008 | 11 |
| 3-35 | $29,438 | 4/13/2005 | 4/1/2008 | 35 |
| 3-42 | $71,579 | 7/2/2007 | 11/1/2007 | 3 |
| 3-44 | $45,654 | 3/15/2007 | 8/1/2008 | 16 |

The table above summarizes the 30 questionable loans into the 3 strata from our statistical sample. There are 14 questionable loans in Stratum I, 5 questionable loans in Stratum II, and 11 questionable loans in Stratum III. The table illustrates the loss claim amount, origination date, default date, and the number of months between origination and default for each of the 30 loans.

# USDA’S
# RURAL DEVELOPMENT'S
# RESPONSE TO AUDIT REPORT

United States Department of Agriculture
Rural Development

January 18, 2013

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

FROM: John Dunsmuir /s/ John Dunsmuir
Acting Director
Financial Management Division

SUBJECT: Official Draft Report # 04703-003-HY: Loss Claims Related to Single Family Housing Guaranteed Loans

Attached, please find Rural Housing Service's response to the subject official draft report.

If you have any questions, please contact Debby Shore of my staff at (202) 692-0191.

Attachments

January 18, 2013

**TO:** Gil H. Harden
Assistance Inspector General for Audit

**THRU:** Tammye Treviño
Administrator
Housing and Community Facilities Programs
Rural Development

John Dunsmuir
Acting Director
Financial Management Division

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

**SUBJECT:** Audit Number 04703-0003-HY
Loss Claims Related to Single Family Housing Guaranteed Loans

Introduction

Thank you for providing the U.S. Department of Agriculture (USDA) Rural Development (RD) and Rural Housing Service (RHS) with the Office of Inspector General (OIG) draft report entitled "Loss Claims Related to Single Family Housing Guaranteed Loans," Audit Number 04703-0003-HY. We appreciate the opportunity to respond to OIG's review of RHS compliance with the payment of loss claims under the Single Family Housing Guaranteed Loan Program (SFHGLP). The agency generally agrees with the recommendations in this report which will further strengthen RD's improper payment compliance. However, we do ask that OIG reconsider the methodology adopted in its assessment of monetary impact, in favor of an approach that better accords with relevant Office of General Counsel opinion and Office of Management and Budget (OMB) standards for compliance with the Improper Payments Information Act (IPIA). For your consideration, USDA offers the following comments and requests that a copy of these comments be included in the final report.

Background

Rural Development's SFHGLP currently has 677,694 loans with a value of $76.4 billion. The program continues to grow by over 100,000 loans each year and the unpaid principal is increasing over $13.7 billion annually. In FY 2012, the program paid $496 million in loss claims, an increase of over $202 million when compared to FY 2011. The program requires the borrower to pay an upfront guarantee fee and an annual fee based on the outstanding loan balance. This program is a **zero subsidy** loan program and requires no budget authority or appropriations to fund the program. Although no appropriated funds were lost or at risk under this program, we are committed to reducing improper payments in order to lower the fees charged to borrowers in order to participate in the program.

Under the requirements of IPIA, USDA agencies must annually perform risk assessments of all programs at the appropriate level. USDA has developed risk assessment guidance that meets IPIA requirements. The methods used to perform risk assessments were developed through consultation with OMB, OIG and the Government Accounting Office. Under the loan guarantee program, an improper payment includes duplicate disbursements, disbursements in an incorrect amount, or any disbursements that are not in compliance with law, program regulations, or agency policy. OMB has defined "significant improper payments" as gross annual improper payments (i.e., the total amount of overpayments plus underpayments) in the program exceeding:

(1) both 2.5 percent of program outlays and $10,000,000 of all program or activity payments made during the year reported **or**
(2) $100,000,000 (regardless of the improper payment percentage of total program outlays).

RD performed a risk assessment on the SFHGLP in FY 2012. This assessment included verification of eligibility as well as the verification of the loss claim payments. The risk assessment concluded that the SFHGLP has a 2.25% error rate with $8.59 million in annual improper (erroneous) payments. The program is considered low risk by OMB's definition.

Finding 1 Comments

During the audit OIG and RD had several discussions related to the payment of loss claims on loans which OIG perceived as having questionable eligibility (Finding 1). We agree with OIG's overall observation and recommendation that RD needs to be more consistent when identifying loans which defaulted due to lender errors at loan origination. However, we differ with OIG's assessment that 30 of the loans reviewed contained eligibility issues which would have allowed RD to forego paying the loss claim in its entirety based on existing regulations. As discussed with OIG, lenders are afforded appeal rights for any adverse decision (loss claim denial) rendered by RD. To ensure that the logic RD used to pay the 30 loans in question was correct and to obtain a basis for RD's defense when denying future claims, we consulted with and obtained two separate Office of General Counsel opinions (See attachments 1 and 2). The first opinion was provided to OIG during the audit. The second opinion was obtained after the draft was received. Based on these opinions and a subsequent detailed re-audit of the 30 accounts in question, the agency subject matter experts concluded that 2 of the 30 accounts identified by OIG contained eligibility issues which did not qualify the borrower for a SFHGL and resulted in the default. Thus, the OIG estimate of $87 million in loss claims being at risk of improper payments is significantly overstated.

Remaining Findings' Comments

In the remaining findings , OIG concluded that RHS improperly reimbursed lenders for losses in 77 of the 102 claims reviewed, resulting in an overpayment of $87,000. These overpayments amounts ranged from $3 to over $6,700. OIG estimated that RHS overpaid lenders $6.28 million over a two year period or $3.14 million annually. We feel that these results are reasonable, accurate and in-line with RD's own IPIA risk assessment conducted in FY 2012. OIG concluded that out of $377 million paid on 8,264 loss claims submitted by lenders over a **two-year period**, RD overpaid $6.28 million, a 1.66% error rate. Essentially, OIG's test results show an annual improper payment rate of 1.66% and $3.14 million in improper loss claims payments. These test results confirmed RD's assessment that the SFHGLP is at low risk for erroneous payments. By focusing its impact analysis on the number of loss claims, OIG inadvertently sidesteps the critical OMB requirement of looking at the actual dollar amount of improper payments when determining risk. The majority of these 77 overpayments were very small amounts that were not cost beneficial to pursue at the time of review or to recover after payment. Instead of focusing on the number of occurrences of improper payments, RD uses the approach, defined by IPIA and OMB, of reporting improper payment rates based on dollar amounts instead of occurrences.

Additionally, we cannot agree with OIG's general conclusion that RHS **may** have paid over $341 million for loss claims for loans with questionable loan eligibility or questionable lender servicing. We believe the OIG statement is confusing and potentially very misleading. OIG found after a two-year review/audit period that the agency overpaid lenders $87,000 (in the audit sample) for an error rate of 1.66% on $377 million in loss claims paid. In other words, the $341 million amount quoted is the estimated total claims paid to lenders, not the estimated improper (erroneous) payment amount actually paid.

Responses to Recommendations

Specific responses to individual recommendations can be found in Attachment 3.

Once again, we appreciate the opportunity to respond to OIG's report on RHS's compliance with the payment of loss claims under the SFHGLP, and we hope that our comments will help in the preparation of the final report.  If you have questions, please contact Mr. John Dunsmuir, Acting Director, RD Financial Management Division, at (202) 692–0082.

Attachments

1. OGC Opinion, dated 06/16/2011
2. OGC Opinion, dated 12/10/2012
3. Recommendation Responses

**Management Response**
**Loss Claims Related to Single Family Housing Guaranteed Loans**
**Audit No.: 04703-003-HY**

**Recommendation No. 1:** Review the 30 loans that we determined had questionable eligibility. Determine whether these loans failed because lenders did not properly originate the loan and whether the loss claims filed for these loans should have been reduced. Pursue appropriate action, including recovering funds, from related lenders.

**Management Response:** We concur with the Office of Inspector General's (OIG) recommendation that the 30 loans in questions should be reviewed after consulting and receiving legal advice and guidance from Rural Development's Office of General Counsel (OGC).

The following action will address this recommendation:

1) Consult and obtain legal written opinion(s) from RD's OGC on the feasibility of which loans (if any) the Agency can pursue recovery of funds based on loan origination criteria and standards as established in RD's regulations. (Completed June 16, 2011 and December 10, 2012)

2) Audit using the OGC opinions all 30 accounts and identify any loans which the Agency can pursue collections. (Completed 12/2012 – The Agency has determined that 2 of the 30 cases identified by OIG contained eligibility issues which did not qualify the borrower for a Single Family Housing Guaranteed Loan and resulted in the default.)

3) Pursue recovery of funds from each lender for loans which have been determined to have been paid in error.

**Date Corrective Action Will be Completed:** June 30, 2013

**Recommendation No. 2:** Develop a data analysis tool to automatically identify loss claims, based on eligibility factors (e.g. low credit scores, high PITI and TD ratios, etc.), that should be further reviewed for loan origination problems.

**Management Response:** We concur with OIG's recommendation to develop procedures to identify loss claims with eligibility factors that should be further reviewed for loan origination problems. Automation is dependent on the availability of funding. Lacking funding, this process will be performed manually in conjunction with the other recommendations (i.e., establishing timeframes for review.)

The following action will address this recommendation**:**

1) Origination reviews on loss claims will be expanded to all accounts that defaulted within 12 months or less. The origination reviews will be modified to include verification of property eligibility and GUS approval.

2) Uploading the GUS Finding/Decision Page to imaging is included in a Request for Automation (RFA) that has not been funded yet.

3) Request an RFA to identify loans which defaulted between 13 and 24 months of origination and or received servicing in the first 24 months regardless of the due date of the last payment (DDLPI). This will allow the agency to expand origination reviews to selectively identify and review high risk accounts. Origination reviews on loss claims will be expanded for loans with a DDLPI equal to or less than 12 months. Implementation of origination reviews beyond 12 months is pending funding and implementation of automation.

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 3:** Ensure that all loss claim specialists that have been assigned to perform origination reviews have completed the training package that was purchased in fiscal year 2012.

**Management Response:** We concur with OIG's recommendation that all specialists performing loss claim origination reviews will complete the AllRegs training package purchased in FY 2012. The AllRegs continuing education training package has also been renewed for FY 2013.

The following action will address this recommendation:

1) All specialists will complete the following AllRegs courses:

   - Exploring Guaranteed Rural Housing
   - Underwriting and Processing GRH Loans
   - Essentials of Mortgage Lending
   - Processing Income and Assets

2) Develop a **WebEx** or **Microsoft Office Live** training program that will focus on the eligibility factors involved with the origination of a loan note guarantee. All personnel involved in loss claims processing will be required to complete the eligibility training by September 30, 2013.

**Date Corrective Action Will be Completed:** September 30, 2013

**Recommendation No. 4:** Evaluate the loss claim review process to determine whether the current process for origination reviews is sufficient. This should include determining what staff is best equipped to perform these reviews and how they should be conducted.

**Management Response:** We concur with OIG's recommendation to evaluate the loss claim review process to determine whether the current process for origination reviews is sufficient.

The following action will address this recommendation:

1) Develop procedures to isolate origination reviews from the loss claim process. A select number of experienced specialists will focus on completing origination reviews. (Completed 3/2011.)

2) All Guaranteed Loan Section employees will complete continuing education courses identified in Recommendation #3 on originating loans before being assigned origination reviews.

3) Develop a **WebEx** or **Microsoft Office Live** training program that will focus on the eligibility factors involved with the origination of a loan note guarantee. All personnel involved in loss claims processing will be required to complete the eligibility training by October 1, 2013.

**Date Corrective Action Will be Completed:** October 1, 2013

**Recommendation No. 5:** Develop procedures to document and evaluate the results of the origination reviews that are completed during the loss claim process and periodically determine whether program improvements are needed.

**Management Response:** We concur with OIG's recommendation to develop procedures to track and evaluate the results of the origination reviews.

The following action will address this recommendation**:**

1) Agency will develop a database to track the results of the origination reviews. Included in the database will be information regarding a loan's eligibility for indemnification, property eligibility, income eligibility, data verification, and property standards.

2) Agency will evaluate origination review results semi-annually and provide data statistics and summary of findings broken down by lender and state. Results will be analyzed to determine whether procedural changes or additional staff training is warranted based on the semiannual results.

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 6:** Develop procedures to implement the new regulations issued in August 2011 that allow Rural Development to require lenders to indemnify losses if the lenders did not properly originate a loan.

**Management Response:** We concur with OIG's recommendation to develop procedures to implement the new regulations requiring lenders to indemnify losses if the lenders did not properly originate a loan.

The following action will address this recommendation:

Agency agrees to develop a process to track loans that are indemnified and develop procedures for processing loss claims which qualify under the indemnification rule. The tracking will be included in the database developed in response to Recommendation #5. This database will be used to track loans that are eligible for indemnification, the loss claim payments made to the servicing/holding lender, and the requests and receipt of funds from the originating lender.

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 7:** Re-evaluate the timeframe set in which the government can seek indemnification from lenders who did not adhere to eligibility requirements when originating the loan. In addition, determine whether the default date or the loss claim payment date is more appropriate. Based on these analyses, pursue any changes that are necessary to the new regulations issued in August 2011.

**Management Response:**

Management agrees with the OIG's recommendation to re-evaluate the current timeframe utilized by the Agency to seek indemnification from lenders who did not adhere to eligibility requirements when originating the loan. The evaluation will also consider changes to the timeframe definition.

The following action will address this recommendation:

If the re-evaluation concludes a necessary change in timeframes the Agency will begin the process of amending current regulation.

**Date Corrective Action Will be Completed:** January 15, 2014

**Recommendation No. 8:** Develop and implement a document for lenders to complete and submit with their loss claim that demonstrates that they have attempted all possible loss mitigation options with borrowers before the loan defaults. Require lenders to submit this document with their loss claims.

**Management Response:** We concur with the intent behind OIG's recommendation to develop and implement a document that demonstrates the lenders attempted all possible loss mitigation options, and require the lenders submit this document with their loss claims.

Administrative Notice (AN) No. 4515 requires lenders to send specific supporting documentation with their loss claim package to the Agency for review and approval. The supporting documents required for all manual and conditionally approved lenders include the lender's consolidated default log detailing all servicing contacts with the borrower. Lenders that have been fully approved to process loss claims are required to provide the documents specified by the edit checks built into the GLS. If the lender exceeds the acceptable liquidation timeframes, the lender's consolidated default log, or system notes, is a required document for the loss claim.

These documentation requirements do not serve as a catch-all for the Agency when reviewing a lender's loss claim. Should the Agency determine additional documents are needed to process the loss claim, the Agency, acting in its own discretion, may require such documentation. Lenders are required to retain the servicing and collection histories for each borrower.

The following action will address this recommendation**:**

In lieu of a specific document, management agrees to require lenders to supply evidence that they worked with cooperative borrowers to extend all qualifying loss mitigation options before the loan defaults, in accordance with the Agency's existing loss claim guidelines. This evidence will consist of a complete set of the lender's servicing/collection notes and any other documents the Agency determines are necessary to verify the lender's loss mitigation efforts on behalf of the borrower.

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 9:** Develop procedures to reduce loss claims submitted by lenders if the Agency determines that the lender did not properly mitigate loans prior to foreclosure.

**Management Response:** Although the Agency already has procedures in place to reduce loss claims if the Agency determines the lender did not properly mitigate a loan, we agree to enhance our current procedures.

Note: RD Instruction 1980-D requires lenders to perform those services which a reasonably prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. It further states the lender is responsible for servicing a loan. If the loan is 90 days delinquent and the lender chooses a method other than foreclosure to resolve the delinquency, the lender must then submit a servicing plan to the Agency for approval. RD Instruction 1980-D does not specify the lender must consider each loss mitigation option in a specific order when servicing the loan. It is at the lender's discretion to continue with the borrower, consider voluntary liquidation or deed-in-lieu of foreclosure, or other methods not outlined in RD's regulations. Although prior approval is not required in all cases, the Agency may reject a plan that does not protect the Government's interest.

RD Instruction 1980-D also states the Agency may reduce a loss claim if the lender: committed fraud; claimed items not authorized under RD regulations; violated usury laws; failed to obtain required security and/or maintain the security position; used loan funds for unauthorized purposes; delayed filing the loss claim; or failed to act, failed to act timely, or acted in a manner contrary to that in which a reasonably prudent lender would act. A connection must be made between the lender's action or failure to act and loss amount on the loan.

The following action will address this recommendation**:**

Management agrees to enhance and strengthen our current procedures on reducing loss claims if the Agency determines the lender did not properly mitigate loans prior to foreclosure. Any reductions taken will be based on the Agency's regulatory authority.

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 10:** Implement procedures to reduce lender loss claims when they do not timely contact and interview borrowers, as required, during the loss mitigation process.

**Management Response:** We concur with OIG's recommendation, provided that evidence exists that the lender's failure to timely contact and interview the borrower(s) resulted in an increase in the loss claim submitted and/or negligent servicing is determined. However, in cases where the labor cost necessary to investigate and obtain documentation to support the loss claim adjustment exceeds the cost of the proposed reduction, an adjustment will not be pursued.

The following action will address this recommendation**:**

Desk procedures will be modified to implement procedures to identify situations when loss claim adjustments will be pursued when lenders fail to contact and interview the borrower(s) timely and their actions resulted in an increase in the loss claim being submitted.

Note: The proposed 7 CFR Part 3555 gives specific penalties for the lender's failure to act. Attachment A provides details on the penalties included in the 3555 Handbook. (Pending implementation.)

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 11:** Enforce each 90-day timeframe when lenders do not make timely decisions to liquidate an account or initiate foreclosures for delinquent borrowers. This should include updating GLS to automatically reduce loss claims when lenders do not meet each requirement. This reduction should be the amount of additional interest paid past each of the 90-day time limits.

**Management Response:** We concur with OIG's recommendation, provided that evidence exists that the lenders failure to make timely decisions to liquidate an account or initiate foreclosure resulted in an increase in the loss claim submitted and/or negligent servicing is determined. However, in cases where the labor cost necessary to investigate and obtain documentation to support the loss claim adjustment exceeds the cost of the proposed reduction, an adjustment will not be pursued.

The following action will address this recommendation:

Desk procedures will be modified to implement procedures to identify situations when loss claim adjustments will be pursued when lenders fail to make timely decisions to liquidate an account or initiate foreclosure, and their actions resulted in an increase in the loss claim being submitted.

Note: The proposed 7 CFR Part 3555 gives specific penalties for the lender's failure to act. Attachment A provides details on the penalties included in the 3555 Handbook. (Pending implementation.)

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 12:** Recover, in accordance with Agency policy, the $86,753 that Rural Development overpaid to the lenders from the loss claims that we identified.

**Management Response:** We concur with OIG's recommendation. The Agency agrees to review the loss claims identified by OIG. If recovery of the overpayment is found to be warranted and cost effective (greater than $124), and the supporting documentation provided by OIG is adequate, the Agency will request refunds of the overpayments after providing the applicable appeal rights. (Note: The average cost to reprocess and provide appeal rights is $124.)

The following action will address this recommendation:

1) Request from OIG the detail and supporting documentation for each overpayment in question.
2) Review and request recovery of all overpayments that are in accordance with Agency policies and procedures and the overpayment is in excess of $124.

**Date Corrective Action Will be Completed:** September 30, 2013

**Recommendation No. 13:** Improve the GLS edit check system to identify property damages that result from lenders not securing properties during liquidation. This should include establishing an edit check in GLS to compare the "as is" appraised value to the "as repaired" appraised value that would prompt the Agency to review the appraisals, property inspection reports and any other pertinent documents when there is a variance between the two values. If lender negligence caused the property damages, loss claims should be reduced.

**Management Response:** We concur with OIG's recommendation to establish edit checks in GLS to identify property damages that result from lenders not securing properties during liquidation.

The following action will address this recommendation:

Management agrees to submit a RFA to add an edit code to GLS which will be triggered when there is a large variance between the “as is” appraised value and the “as repaired” appraised value. Automation is dependent on the availability of funding.

To help reduce risk in the interim, the Agency will add verbiage to the existing appraisal/BPO edit codes requiring the lenders to provide the detailed inspection reports and their servicing notes, along with the entire appraisal and/or BPO. If damages resulting from lender negligence are found during the review of these documents, the Agency will reduce the loss claim. (Completed 5/2/12.)

**Date Corrective Action Will be Completed:** September 30, 2013

**Recommendation No. 14:** Establish edit checks in GLS to identify instances where lenders do not list properties for sale or close on pre-foreclosure sales within 30 days and reduce loss claims when appropriate.

**Management Response:** We concur with OIG’s recommendation to establish edit checks in GLS to identify instances where lenders do not list properties for sale or close on pre-foreclosure sales in accordance with RD guidelines and reduce loss claims when appropriate.

The following action will address this recommendation:

Management agrees to submit a RFA to add edit codes to GLS which will be triggered when lenders do not list a property in a timely manner or do not close on pre-foreclosure sales within the timeframe stipulated by the Agency. Automation is dependent on the availability of funding.

To help reduce risk in the interim, the Agency will implement procedures to manually reduce accrued interest if a lender does not list an REO property within 30 days of acquiring title or gaining physical possession of the property. (Completed 2/9/12.)

**Date Corrective Action Will be Completed:** September 30, 2013

**Recommendation No. 15:** Perform an overall evaluation of the GLS edit check system, including assessing the threshold amounts that trigger edit checks. Based on the results, make any necessary adjustments to improve the system.

**Management Response:**

Management agrees with the OIG’s recommendation to evaluate page edits currently utilized by the GLS Loss Claim Administration System. The current page edits will expire in December of 2014.

The following action will address this recommendation:

An analysis will be completed during calendar year 2013 to assess the soundness of current edits and to identify the need for any new edits. All automation changes will be pushed into a test environment to allow for user testing prior to implementation.

**Date Corrective Action Will be Completed:**

Edit adjustments will become effective in the production environment by the end of calendar year 2014.

**Recommendation No. 16:** Provide training and guidance to all personnel involved in processing loss claims to detail how to properly evaluate loss claim information when edit checks require additional review. This should include a description of the appropriate actions to take when lenders do not comply with program requirements.

**Management Response:**

Although the Agency already has a strong training program in place, we concur to provide additional training and guidance to all personnel.

Currently, the Agency reviews 100% of all new specialists' work during a certification period. The certification process is a lengthy training period, where the specialist undergoes thorough classroom and one-on-one training with a senior specialist and/or supervisor. After certification, 10% of all loss claim payments made each month by the specialists are reviewed by management. All specialists' performance standards are based not only on volume, but also on accuracy.

During post-payment reviews, if a monetary error made by the specialist during the pre-payment review is found, this information is forwarded to management to address with the individual specialist. Additional training and changes in processing procedures are also made as a result of errors found during the post-payment reviews.

Monthly, training is held for specialists to address errors found during both management reviews and the post-payment reviews. The specialists also complete continuing education courses through AllRegs, AgLearn and Mortgage Bankers Association.

The following action will address this recommendation:

Management agrees to expand and strengthen formal training on the Agency's policies and procedures as they are updated. The Agency also agrees to hold refresher training on current procedures by end of FY 2013.

**Date Corrective Action Will be Completed:** September 30, 2013

**Recommendation No. 17:** Establish procedures to periodically analyze overpayments identified through the PQRs to determine why existing internal controls did not detect the problems found. Document the results and take steps to revise internal control measures based on these results.

**Management Response:** We concur with OIG's recommendation to establish procedures to periodically analyze overpayments identified through the Post Quality Reviews (PQRs) to determine why existing internal controls did not detect the errors found.

The Agency is always looking to increase internal controls and reduce improper payments. The overall analysis of the post-payment results, data provided by OIG, quality reviews and any other internal audit/control studies are valuable in achieving this goal.

The following action will address this recommendation:

1) Develop a source/cause list for monetary findings. Link each PQR error code to the applicable GLS edit code(s) where applicable. On the PQR worksheet, add columns to record the applicable GLS edit code(s) for each finding and show if the edit code was triggered in GLS when the lender submitted the claim. Also add column to show if error was a result of lender error, Agency error or Program issue. When development of list is complete, implement coding and columns for new PQR reviews moving forward.

2) Identify solutions to prevent overpayments.

3) Develop a process for evaluating overpayments identified in future post-payment quality reviews. Develop Access database to track the PQR errors identified. Database will list monetary amounts of the errors, GLS edit codes if applicable, source/cause reasons, Agency employee, lender employee, PQR reviewer and any other relevant information identified.

4) Develop automated reports to consolidate database information for trend analysis. Information will be reportable by date range for all fields collected. Develop procedures and timelines for future reviews to include:

   a. Semi-annual reports to monitor overpayment findings. Develop threshold limits to trigger an early detailed review and analysis of overpayments.
   b. An annual review of overpayments and controls.
   c. Based on review results, identify areas where procedures, policy or prepayment controls would reduce or eliminate overpayments in the future.
   d. Implement procedural/operational fixes identified and approved.
   e. Submit policy decision recommendations for approval. Track progress of decision/approval and/or implementation.
   f. Submit system enhancement solution recommendations for approval, prioritization and development. Automation is dependent on the availability of funding.

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 18:** Develop and implement a system to penalize lenders who repeatedly receive overpayments because they did not comply with Agency requirements. These lenders should be identified using the Agency's PQRs. Such penalties should include requiring lenders to submit claims for manual processing, reducing and/or eliminating interest payments while CSC processes the claims, reducing the overall amount of the loss claim, and possible lender removal from the Guaranteed Loan Program.

**Management Response:** We concur that a decision matrix should be developed to specify actions to take to penalize lenders who repeatedly receive overpayments because they do not comply with Agency requirements.

Currently, RD's Loss Claim Administration Review Manual includes options that are available if a lender fully approved to process loss claims develops an unacceptable pattern of findings in post-payment reviews. These options include changing the post-payment review schedule from quarterly to monthly; requiring the lender to complete additional training; and increasing the sample size for PQR reviews. If the lender's performance does not improve, the Agency may withdraw the automated processing approval.

The following action will address this recommendation:

Using the existing penalties, the Agency agrees to develop a procedural document outlining the steps to take when unacceptable performance is found during PQR reviews. Any penalty taken against a lender will be based on the Agency's regulatory authority.

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 19:** Develop procedures for loss claim specialists to identify questionable appraisals and refer them to the Agency's certified appraisers for further analysis. These procedures should also include reducing loss claims, penalizing lenders, and possibly removing appraisers from the Guaranteed Loan Program when unacceptable appraisals are found.

**Management Response:** The Agency agrees to OIG's recommendation to review the current procedures on referring questionable appraisals to a certified appraiser for further analysis.

The following action will address this recommendation:

Although the Agency has procedures in place to refer a questionable appraisal to a senior specialist, supervisor or staff appraiser, management agrees to review the current policies and procedures on reviewing appraisals. Management also agrees to define common criteria and controls under which a specialist will refer an appraisal to a staff appraiser for review. Any penalties taken against a lender will be based on the Agency's regulatory authority.

**Date Corrective Action Will be Completed:** September 30, 2013

**Recommendation No. 20:** Perform a cost-benefit analysis to determine whether program improvements can be made to pay loss claims within the 60 days, as required by Federal regulations. If so, implement these improvements to prevent the Agency from paying excessive interest to lenders.

**Management Response:** Management agrees to OIG's recommendation to perform a cost benefit analysis to determine whether program improvements can be made to pay loss claims within the prescribed 60 days. In addition, management reserves the right to assess the additional cost of implementing OIG's other recommendations included within this report. If the cost to implement any of the recommendations, as specified above, is determined to exceed the cost savings of the recommendation, the agency reserves the right to amend its management response. All amended responses will be supported by cost data documenting the recommendation implement is cost prohibitive or not cost effective.

The following action will address this recommendation:

The Agency will analyze staffing, automation efficiencies, policies and procedures to determine whether program improvements can be made to pay loss claims within 60 days of receiving a loss claim submitted promptly and properly. Management will also address the impact of implementing the other recommendations on the number of days to process a loss claim. Recommendations and outcomes will be subject to funding and implementation restrictions and timeframes. Management reserves the right, based on the results of the analysis, to forgo implementing any of the management responses, will provide this information to OIG, and will amend the proposed management responses if they are not determined to be cost effective.

**Date Corrective Action Will be Completed:** December 31, 2013

**Recommendation No. 21:** Amend existing procedures to require lenders to submit with their short sale servicing plans their servicing notes and all other applicable documents to substantiate the borrowers' monthly expenses and income, and any other documents deemed pertinent to describe all servicing actions taken, including hardship letters, contacts with borrower, attempts to save the loan and to keep the borrower in their home, and verification of borrower occupancy.

**Management Response:** We concur with OIG's intent of validating the circumstances tied to the borrower's current inability to pay. We agree with requiring the lenders provide documentation substantiating the borrowers' monthly expenses and income, and other pertinent information associated with the short sale servicing plan.

The current Administrative Notice (AN) 4607 requires lenders to send specific supporting documentation related to the servicing plan type for Agency review and approval. The core supporting documents required for all servicing plan types, retention and disposition, consist of income documentation, a credit report, detailed budget and hardship letter outlining the borrower's failure to pay. Regardless of the servicing plan type, these documents provide sufficient evidence to determine the borrower's capacity to either cure the default, or support a disposition plan type.

If the lender determines the borrower does not have the capacity to cure the default and recommends a disposition servicing plan type, the lender is required to send an appraisal or broker price opinion, sales contract and, if applicable, a HUD-1 settlement statement.

These documentation requirements, although plan specific, do not serve as a catch-all for the Agency when reviewing a lender's recommendation. In fact, should the Agency determine additional documents are needed to approve the plan, the Agency, acting in its own discretion, may require such documentation. Lenders are required to retain the servicing and collection histories for each borrower, including their financial analysis and supporting documentation.

The following action will address this recommendation:

Management agrees to review policies, procedures and guidelines regarding the documentation lenders are currently required to submit in support of their short sale servicing plan. If a determination is made that additional documentation is required, the Agency agrees to amend the existing procedures.

**Date Corrective Action Will be Completed:** 12/31/13

**Recommendation No. 22:** Require lenders to submit evidence demonstrating how the short sale will result in a cost savings for the Federal Government.

**Management Response:** We concur with OIG's recommendation. Administrative Notice (AN) 4607 requires lenders provide a servicing plan, hardship letter from the borrower, current pay-stub, BPO/appraisal, sales contract, HUD-1 settlement statement and credit report when submitting a short sale for approval. By reviewing these documents, the lender and the Agency determines if the short sale is in the best interest of the Federal Government.

Below is the justification of our response:

The Loss Mitigation Comprehensive Policy Clarification (AN No. 4607) is published by Rural Housing each year. The intended purpose of the AN is to provide guidance on loss mitigation alternatives to approved lenders that service Section 502 Guaranteed Loans.

The responsibility for servicing SFHGLP performing and non-performing loans lies with the approved SFHGLP lenders. Pursuant to 7CFR 1980.374(d); when a method other than foreclosure is to be recommended the servicer must submit a plan to the Agency.

When reviewing a short sale the servicer and the Agency apply established guidelines to determine the borrower's eligibility and financial capacity, coupled with the cost effectiveness of the short sale transaction. For example; the Agency has established a threshold in which the net sales proceeds are at least 82% of the subject properties "As-Is" appraised value.

The approved lender is responsible for demonstrating the short sale results in a cost savings to the Federal Government. Lenders are required to demonstrate the borrower has experienced an involuntary inability to pay that prevents the borrower from meeting their mortgage obligation. Providing the borrower meets established guidelines, the short sale will prevent further risk of loss to the Federal Government by reducing or eliminating the costs associated with foreclosure, property maintenance, overhead and additional interest.

The following action will address this recommendation:

The Agency will continue to monitor established guidelines in an effort to determine the cost effectiveness as industry standards evolve. Should data support the need to amend established guidelines, we would agree to consider revisions.

**Date Corrective Action Will be Completed:** 12/31/13

**Recommendation No. 23:** Establish guidance describing specific circumstances when an exception from short sale requirements may be approved. This guidance should require that whenever an exception is granted, the reasons for the exception are fully documented.

**Management Response:** We agree with OIG's recommendation to establish guidance describing specific circumstances when an exception from short sale requirements may be approved.

In the Pre-Foreclosure Sale Overview Section of AN 4607, Borrower Requirements, the Agency has established 2 examples of exceptions when considering a short sale. The first exception addresses vacancy and the second imminent default. In either case, lenders are required to document the exception in the servicing file.

Although these 2 examples occur often, the Agency gives every exception equal consideration, provided the lender has adequately documented the reason to support an exception.

The following action will address this recommendation:

The Agency will review and expand existing guidance regarding the exceptions to the short sale requirements. The most common exceptions will be included in the update to the current Loss Mitigation Guide.

**Date Corrective Action Will be Completed:** 12/31/13

# APPENDIX 9
# PENALTIES

# APPENDIX 9

# PENALTIES

### *1. Claim for Unallowable Expenses*

The lender's loss claim request should reflect only allowable expenses. If the Agency's review of the lender's claim shows that unallowable expenses have been claimed, the loss claim amount will be reduced by the amount of unallowable expenses to reflect only allowable costs. The Agency will document any costs it disallows and the reasons for its determination. The following are some of the costs the Agency will disallow:

- Additional interest accrued beyond 90 days of acquisition;
- Interest accrued after allowable foreclosure time frame;
- Late fees;
- In-house lender expenses such as employee salaries, in-house legal fees, travel, or REO management fees; and
- Liquidation or disposition costs that is not reasonable and customary for the area or fees that exceed fees as noted in Attachment 18-B of Chapter 18.

### *2. Failure to Adhere to Required Collection Procedures*

The lender is responsible for ensuring that all required collection actions are taken within the prescribed time frames and carefully documented. The Agency will reduce or deny a lender's claim if the lender fails to document that all required collection actions were taken at the appropriate times as noted in Chapter 18. The following are the penalties for failure to fulfill required collection obligations. Penalties take into consideration grace periods offered by the Agency outlined in Section 18.4C of Chapter 18 of this Handbook.

- If the lender fails to make any contact with the borrower within 65 days past due, the claim will be denied.
- If the lender fails to notify the Agency when the account is in default, the claim will be denied.

- If the lender fails to make first contact with the borrower within 25 days past due but makes contact within 65 days past due, accrued interest will be reduced by 50 percent.

- If the lender fails to inspect the property within 65 days past due, but no loss results, the accrued interest will be reduced by 10 percent.

- If the lender fails to inspect and secure an abandoned property, the loss claim will be reduced by 10 percent and the dollar value of the loss attributable to the lender's failure to secure property, as documented in an appraisal. If a loss has not been documented by an appraisal, the claim will be denied.

***3. Failure to Adhere to Required Foreclosure Time Frames***

The lender is responsible for foreclosing on the property within the time frames detailed in Attachment 18-A of Chapter 18. If the lender fails to do so, the Agency will reduce the claim by the amount of any interest accrued beyond the allowable foreclosure time line.

***4. Failure to Ensure That All Applicable Property Standards Were Met***

The lender is responsible for ensuring that the property meets a variety of property standards when the loan guarantee is issued. If a loss claim is filed that indicates that some or all of the loss may be attributable to problems with the property itself, the Agency will investigate the cause of the problem. If the problem is due to the failure of the property to initially meet property standards, the penalty imposed on the lender will depend upon several factors, including whether the lender made a good faith effort to ensure that the property met all required standards, but was provided incorrect information by another party, and whether the property problem actually resulted in any loss of value.

If there is a negative impact on the property's value, and the lender can document that it acted in good faith to ensure that standards were met, the claim must be reduced by the reduction in property value.

If the lender cannot document that it acted in good faith to ensure that property standards were met, the claim must be denied.

### *5. Failure to Maintain the Property*

Lenders are responsible for ensuring that properties securing guaranteed loans are adequately maintained throughout the life of the loan. In particular, lenders are responsible for making protective advances to protect the security property at any point necessary during the life of the loan and if the lender is unable to contact a past-due borrower, determining whether the property may have been abandoned and if so, securing the property. If the Agency determines that failure to maintain the property has resulted in a loss, the Agency will determine the dollar value of the loss attributable to the lender's failure to act and deduct that amount from the loss claim.

### *6. Failure to Dispose of the Property for an Appropriate Amount*

The lender is responsible for ensuring that when property is liquidated, either voluntarily or through foreclosure, it is sold for an amount that is supported by an appraisal and is acceptable to the Agency. Chapter 19 outlines the minimum requirements for meeting the Agency's price expectations in various disposition scenarios. If the lender fails to dispose of a property at an appropriate price, the Agency will reduce the loss claim by the difference between the sale price and the price that should have been obtained.

### *7. Failure to Obtain Required Security*

The lender is responsible for obtaining the needed security for the loan. If the borrower becomes delinquent on the loan and it is shown that the lender failed to obtain all required security, the loss claim may denied in accordance with 7 CFR 3555, Section 108(c).

### *8. Failure to Maintain the Required Security*

If the lender fails to make a needed protective advance, the claim will be reduced by the cost of repairing damage caused by failure to act.

If the lender fails to contact the borrower within 65 days past due to determine whether the property has been abandoned and/or fails to secure an abandoned property by 95 days past due and no damage attributable to the lender's failure can be documented, the claim must be reduced by 10 percent.

If damage attributable to the lender's failure can be documented, the claim must be reduced by 10 percent plus the cost of repairing damage caused by the failure to act.

### *8. Provision of Unauthorized Assistance*

The Agency cannot make a loss claim payment in the case of unauthorized assistance. If, at the time the loan note guarantee was approved, a borrower did not qualify for the SFHGLP or evidence is present that the property did not meet all property requirements, the Agency must deny the loss claim.

In very unusual circumstances, it is possible that a borrower might use some portion of the loan funds for an unauthorized purpose without the lender's knowledge (i.e. – cash returned at closing that did not represent cash from personal funds contributed by or on behalf (gift funds) of the borrower) or purchase of furniture. In such a case, the Agency would honor the loss claim, but reduce the loss claim payment by the amount of the funds that were used for the unauthorized purpose.

### *9. Violation of Interest Rate Restrictions*

The lender is responsible for ensuring that any interest rate negotiated with a borrower for a SFHGLP loan falls within the program's guidelines as described in Chapter 7 of this Handbook. If evidence exists the lender violates the program's interest rate restrictions, the Agency will deny the loss claim.

### *10. Commission of, or Failure to, Report Knowledge of Fraud*

Any time a lender commits fraud, or fails to report fraud about which the lender knew, or should have known, the Agency will deny the loss claim.

### *11. Failure to Carry Out Established Monitoring Guidelines for Real Estate tax and Hazard Insurance Premium*

If the lender fails to carry out established monitoring guidelines for real estate tax and hazard insurance premium, the Agency may revoke lender approval.

### *12. Sale of Loan to Non-Approved Lender or Other Party*

If the lender sells the loan to a party not approved to participate in the GRH program, the Agency will terminate the loan note guarantee.

### *13. Failure to Adhere to Underwriting Guidelines*

Although the Agency does not underwrite loans, there are underwriting requirements that lenders must follow. If the Agency determines that the loan was not underwritten in accordance with Agency requirements, the Agency may terminate the loan note guarantee, or the originating lender may be required to indemnify the Agency if a loss claim is paid.

### *14. Incomplete Closing Documentation*

If the Agency determines that closing documentation is incomplete, or that there were minor, correctable errors in the documents, the lender may be granted up to 30 days to correct the situation. If the complete package is not resubmitted within 30 days, and the account is in default, the Conditional Commitment will not be honored.

### *15. Failure to Comply with the Soldiers and Sailors Civil Relief Act*

The Agency will not include interest on a loss claim filed in excess of six percent for the period a veteran was eligible, nor for any period of time the lender failed to establish the note rate after notification by the borrower of non-active military service.

### *16. Unauthorized Sale or Transfer*

The Agency will withdraw the guarantee if the security property is transferred without an assumption of the debt, unless transferred under the Garn-St. Germaine rule.

### *17. Failure to Adhere to Agency Standards for Handling Bankruptcy*

The Agency may reduce or deny any loss claim by 10 percent resulting from an account in bankruptcy that is subsequently foreclosed when accurate and timely actions were not initiated.

### *18. Property with Environmental Issues at Time of Liquidation*

If the property's value at the time of liquidation is affected by environmental issues, the lender must document how the hazard developed and became known. If the lender failed to conduct appropriate due diligence at loan origination, the loss claim will be denied or reduced by the decrease in market value attributable to the environmental hazard.

### *19. Failure to Pursue Deficiency Judgments*

The lender must pursue deficiency judgments if the benefits of collection are expected to outweigh the costs. If the lender chooses not to pursue a deficiency judgment, the lender must justify the decision in writing and submit it along with the loss claim. If the lender fails to pursue collection without adequate justification, the Agency will reduce the loss claim by the amount of the anticipated collect.

June 16, 2011

Our Ref: LEG 5-2-1

MEMORANDUM FOR JOAQUIN TREMOLS
DIRECTOR
SINGLE FAMILY HOUSING
GUARANTEED LOAN DIVISION

FROM: Janet Safian /s/ Janet Safian
Acting Assistant General Counsel
Community Development Division

SUBJECT: Determining Repayment Income for Guaranteed Single Family Housing (GSFH) Loans

You have asked about the proper interpretation of the 7 CFR 1980.345(c) eligibility requirement concerning the guaranteed borrower's repayment ability. In particular, you raise 6 individual cases where the applicant had held their current job for less than 24 months. The lenders found that the applicants met debt ratios based on their current income in the particular circumstances, and RD issued guarantees in 2009 using American Recovery and Reinvestment Act (ARRA) funds.

We understand that these 6 cases may be added to those found ineligible in OIG's December 6, 2010, Audit No. 04703-0002-Ch(1) on the use of ARRA funds in the GSFH program. Beginning on page 5 of that Report, OIG explains errors it found relating to repayment ability that it attributed to lenders using unstable, inconsistent, or only most recent earnings as qualifying income to calculate debt ratios. OIG relied on 7 CFR 1980.345(c)(2)(i) and (3):

> (2) Income, for the purpose of determining the total debt ratio, includes the total qualifying income of the applicant, coapplicant, and any other member of the household who will be a party to the note.
> (i) An applicant's qualifying income may be different than the ``adjusted annual income" which is used to determine program eligibility. **In considering qualifying income, the Lender must determine whether there is a historical basis to conclude that the income is likely to continue. Typically, income of less than 24 months duration should not be included in qualifying income.** If the applicant is obligated to

pay child care costs, the amount of any Federal tax credit for which the applicant is eligible may be added to the applicant's qualifying income.

. . .

(3) The applicant meets RHS requirements for repayment ability when the applicant's total debt ratio is less than or equal to 41 percent and the ratio of the proposed PITI to income does not exceed 29 percent.
(emphasis added)

The Agency believed that the "lenders used appropriate judgment," especially considering other factors that mitigated risk, such as credit scores over 660. Debt ratios may be exceeded based on compensating factors if RD concurs under 7 CFR 1980.345(c)(5). OIG, however, found the borrowers' financial condition so questionable, in its judgment, that the borrowers were ineligible for the guarantees. OIG "used a more conservative approach that included a borrower's 2-year work history." That method, in their view, was "a more prudent method to ensure that qualifying income is adequate and dependable." (OIG Report, p. 6) Where the lender used the borrower's current income (even if earned for less than 24 months), OIG used the average of the borrower's actual earnings during a 2-year period regardless of their current salary. We understand that OIG has taken the same approach to calculating repayment income in the additional 6 cases. The Agency responded to Preliminary Finding 2 that the regulation allows flexibility for using income received for less than 24 months. The lender could show stability and continuity of employment through education and training of students entering employment or through investigation of income and employment documents. RD also pointed out that FHA and the mortgage industry finances applicants with less than 24 months at their current employment when they have very strong credit scores.

Based on the applicable regulations and RD's clarification of the regulations in Administrative Notices, it is our opinion that OIG's requirement of a 2-year averaged income calculation is not legally required and cannot be used to find the borrowers ineligible or otherwise take adverse action against the borrowers. While our analysis may have some bearing on the original 8 cases discussed in the OIG Report, you have only asked our opinion as to the 6 additional cases found ineligible by OIG.

RD regulation 7 CFR 1980.345(c)(2) does not prohibit income of less than 24 months from being included in qualifying income if the lender otherwise determines that there is some historical basis to conclude that it is "likely to continue." While the 24 month duration may be "typical," and a shorter duration "should not" be included, the regulation does allow flexibility. This regulation says nothing about averaging income over a 2-year period to determine qualifying income for calculation of debt ratios under paragraph (c)(3). While such an approach may be prudent or conservative as OIG suggests, it is not required. Based only on the regulation, we believe the appropriate inquiry in these cases is whether the lender reasonably found some historical basis to conclude that income was likely to continue. Only if qualifying income does not result in debt ratios being met, would a lender consider compensating factors and seek a debt ratio waiver under paragraph 7 CFR 1980.345(c)(5).

RD attempted to clarify its very general repayment ability regulation in several Administrative Notices (AN) throughout 2009. In particular, see RD AN No. 4435 (April 30, 2009), RD AN No. 4441 (May 7, 2009), RD AN No. 4470 (August 18, 2009), and RD AN No. 4474 (September 17, 2009). While such internal policy does not create substantive rights and duties on the public, it would apply in any National Appeals Division (NAD) appeal under 7 CFR 11.10(b) as a generally applicable interpretation of the laws and regulations of the agency. Furthermore, the agency's interpretation of its regulations would be subject to deference from a court.[1] In our opinion the Agency has reasonably interpreted its regulations to require the lender's case-by-case analysis and flexibility in underwriting. See RD AN No. 4435, page 2. The lender is responsible for determining that an applicant's income is stable, predictable, and likely to continue. It must use sound underwriting judgment. Many components make up this analysis: the applicant's occupation, employment tenure, opportunities for future advancement, educational background, and occupational training. See RD AN No. 4474, pages 2 and 6. Nowhere in these notices, does RD require a 2-year averaged income to calculate qualifying income. RD AN No. 4435, p. 4, in fact suggests that 2 or more years in a current position is not required in every case, but would be an excellent compensating factor if debt ratios were not met. RD AN No. 4474, p. 2, states that unless there is evidence that the income will no longer be received, the lender may assume that it will continue. There is no minimum length of time an applicant must have held a position to consider employment income dependable.

Based on RD's regulation and policy guidance and the factual information you provided, it is our opinion that the lenders reasonably determined that the applicant's current income was likely to continue under 7 CFR 1980.345(c)(2). Using this qualifying income, we understand that debt ratios were adequately met without the need for waiver. We will address each case you raised in turn:

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[1] It is a well established principle that agencies are given deference in the interpretations of statutes and regulations they administer. When faced with a problem of statutory construction, great deference is given to the interpretation of the agency who is charged with its administration. Auer v. Robbins, 519 U.S. 452, 461 (1997). When Congress does not directly speak to the precise question at issue, the Secretary's approach must be sustained, so long as it is based on a permissible construction of the statute. Chevron U.S.A. Inc., v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-843 (1984). To sustain an agency's application of a statutory term, the agency's construction must not be the only reasonable one. When the construction of an administrative regulation rather than a statute is at issue, deference is more clearly in order. Udall v. Tallman, 380 U.S. 1, 16 (1965). The administrative interpretation has controlling weight unless it is plainly erroneous or inconsistent with the regulation. Bowles v. Seminole Rock Co., 325 U.S. 410, 414 (1945).

1. The applicant was employed for 12 months as a teacher and had a 757 credit score. The applicant had worked as a security guard while studying to obtain a teaching certificate. The co-applicant was a college Administrative Coordinator for 12 months and had worked as a bank teller previously. The co-applicant had a 720 credit score.

   RD AN No. 4435, p. 4, states that underwriters should consider applicants who change positions frequently to better their financial position. They should give more credence to a history of continuous employment. These applicants had been continually employed and held their current positions for 12 months. Position changes were not frequent. Relying on RD AN No. 4474, p. 2, there was no reason to believe that the current income would not continue. There is no indication that either applicant was in a probation period where lenders must use extreme caution under p.3 of this notice. Page 5 of the notice suggests that it could even be appropriate to consider future income for a teacher who will begin a contract with the new school year. Based on page 6 of the notice, this applicant has many components of probable stability and continuance of income based on occupation, tenure, opportunity for future advancement, and education. While it is not necessary in this case, we note that the applicants' high credit scores would be considered compensating factors under RD AN No. 4435, p.3.

2. The applicant was a Licensed Practical Nurse (LPN) before she completed her education to become a Registered Nurse (RN). She worked as an RN for 5 months. She had a credit score of 683. The same analysis applies as under #1.

3. The applicant has worked 16 months as a laborer. Before this the applicant was unemployed for 3 months when their employer went out of business. The applicant has a credit score of 695.

   RD AN No. 4435, p. 4, states that underwriters should give more credence to a history of continuous employment (no gaps due to multiple separations, etc.). This applicant did not change positions frequently. RD AN No. 4470, p.9, states that lenders should document gaps in employment as they relate to the stability of income in the future. Relying on RD AN No. 4474, p. 2, there was no reason to believe that the applicant's current income of 16 months would not continue. Page 3 of this notice cautions that the applicant should not have any gaps in employment more than a month, within the 2 year period, but that allowances may be reasonable in some cases. While a lender could reasonably find the applicant's current income to be stable and likely to continue, we note that the applicant's high credit score would be considered compensating factor in any case under RD AN No. 4435, p.3.

4. Applicant worked at Walmart until they obtained a better job at Kirby Inland Marine where they have been employed 13 months. The applicant has a credit score of 683. RD AN No. 4435, p. 4, states that underwriters should consider applicants who change positions frequently to better their financial position. While this applicant did not change jobs frequently, its one change was to better their financial condition. The analysis under #3 applies here, except there is no apparent gap in employment within the 2 year period. This makes an even stronger case for use of current income as qualifying income to calculate debt ratios.

5. Applicant has worked for 24 months with the same employer, but in different positions. 12 months ago the applicant was promoted from Chef to Executive Chef, with a substantial increase in salary. The applicant has a credit score of 707. The same analysis applies as under #1. The fact that the 2 positions were held under the same employer is not significant. The point is that the salary from the current position can reasonably be expected to continue under the circumstances.

6. The applicant had a 5 year stable job history, and debt ratios were within acceptable limits. The applicant had a credit score of 613, so OIG believed there was insufficient repayment ability.

   Credit scores are not relevant to repayment ability under 7 CFR 1980.345(c) unless debt ratios are not met and compensating factors, such as credit scores, are needed for a waiver. In such case, there is no minimum credit score required for a waiver under RD AN No. 4435. Credit scores are more relevant to credit history requirements under 7 CFR 1980.345(d). As a general underwriting guideline under RD AN No. 4441, lenders should judiciously evaluate and carefully screen credit histories of applicants with credit scores of 619 and under; such applicants are not necessarily poor risks and should not be automatically rejected.

Based on the foregoing, the lenders and RD could reasonably find repayment ability in these cases. The agency regulations and generally applicable interpretations of those regulations do not require applicants to have held their current job for 24 months. They do not require an averaging of income over the 24 months. They only require the lender to consider all the circumstances in each case and find some historical basis to reasonably conclude that income is likely to continue. The agency may choose to revise or expand its general repayment requirements in 7 CFR 1980.345(c) to ensure consistent interpretation and limit lender flexibility. If you have any further questions, feel free to contact me at ph. 202-720-2923.

OGC/CDD:JSafian:pmw:6/16/11:Repayment Income 2011 OIG Audit of GSFH

USDA

United States Department of Agriculture

Office of the General Counsel

Washington, D.C. 20250-1400

Attachment 2

December 10,2012

MEMORANDUM FOR JOAQUIN TREMOLS
DIRECTOR
GUARANTEED SINGLE FAMILY HOUSING LOAN DIVISION

FROM: Mina Kim, Attorney /s/ Mina Kim
Food Assistance, International and Rural Division

SUBJECT: Determining Repayment Ability for Guaranteed Single Family Housing Loans

You have asked the Office of General Counsel (OGC) for an opinion on several issues regarding determination of repayment ability of borrowers in the Rural Development (RD) Guaranteed Single Family Housing (GSFH) program, including calculation of qualifying income, debt ratios, and credit scores. These issues arose from a recent Office of the Inspector General (OIG) draft report on an audit of the GSFH program. Each issue will be discussed in turn below.[1]

Calculation of Repayment Income

The first issue is whether less than 24 months of income can be used to determine an applicant's qualifying income under 7 CFR 1980.345(c)(2)(i), which states:

> (2) Income, for the purpose of determining the total debt ratio, includes the total qualifying income of the applicant, coapplicant, and any other member of the household who will be a party to the note.
>
> (i) An applicant's qualifying income may be different than the "adjusted annual income" which is used to determine program eligibility. In considering qualifying income, the Lender must determine whether there is a historical basis to conclude that the income is likely to continue. Typically, income of less than 24 months duration should not be included in qualifying income. If the applicant is obligated to pay child care costs, the amount of any Federal tax credit for which the applicant is eligible may be added to the applicant's qualifying income.

[1] OGC is responding to general issues that were raised-we are not evaluating and responding on a case-by-case basis to each of loans OIG identified as questionable.

(emphasis added). As stated in our June 16, 2011 OGC memorandum regarding "Determining Repayment Income for Guaranteed Singly Family Housing (GSFH) Loans", it is our opinion that the regulation provides flexibility and does not require that an applicant have 24 months of income, and having less than 24 months of income cannot be used on its own to find an applicant ineligible.

The regulation does not prohibit income of less than 24 months from being included in qualifying income if the lender determines that there is some historical basis to conclude that the income is "likely to continue." While the 24-month duration may be "typical," and a shorter duration "should not" be included, the regulation does not prohibit income of a shorter duration from being included. While including only income of 24 months or more may be prudent or conservative, it is not required. Based only on the regulation, the appropriate inquiry is whether the lender reasonably found some historical basis to conclude that income was likely to continue.

RD attempted to clarify the general repayment ability regulation in several Administrative Notices (AN) covering the time period audited by OIG. In particular, see RD AN No. 4435 (April 30, 2009), RD AN No. 4441 (May 7, 2009), RD AN No. 4470 (August 18, 2009), and RD AN No. 4474 (September 17, 2009). While such internal policy does not create substantive rights and duties on the public, it would apply in any National Appeals Division (NAD) appeal under 7 CFR ll.IO(b) as a generally applicable interpretation ofthe laws and regulations ofthe agency. Furthermore, the agency's interpretation of its regulations would be subject to deference from a court.[2] RD may reasonably interpret its regulations to require the lender's case-by-case analysis and flexibility in underwriting. *See* RD AN No. 4435, page 2. The lender is responsible for determining that an applicant's income is stable, predictable, and likely to continue. It must use sound underwriting judgment. Many components make up this analysis: the applicant's occupation, employment tenure, opportunities for future advancement, educational background, and occupational training. *See* RD AN No. 4474, pages 2 and 6. Unless there is evidence that the income will no longer be received, the lender may assume that it will continue if it uses sound judgment in evaluating the aforementioned factors. *See* RD AN No. 4474, p. 2. Nowhere in these notices does RD require a 24-month averaged income to calculate qualifying income.

[2] It is a well established principle that agencies are given deference in the interpretations of statutes and regulations they administer. When faced with a problem of statutory construction, great deference is given to the interpretation of the agency who is charged with its administration. Auer v. Robbins, 519 U.S. 452,461 (1997). When Congress does not directly speak to the precise question at issue, the Secretary's approach must be sustained, so long as it is based on a permissible construction of the statute. Chevron U.S.A. Inc., v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-843 (1984). To sustain an agency's application of a statutory term, the agency's construction must not be the only reasonable one. When the construction of an administrative regulation rather than a statute is at issue, deference is more clearly in order. Udall v. Tallman, 380 U.S. 1, 16 (1965). The administrative interpretation has controlling weight unless it is plainly erroneous or inconsistent with the regulation. Bowles v. Seminole Rock Co., 325 U.S. 410,414 (1945).

To summarize, there is no minimum length of time an applicant must have held a position to consider employment income dependable.

Debt Ratio Waiver

The next issue concerns debt ratios and whether and when they may be exceeded. The short answer is that debt ratios may be exceeded when appropriate compensating factors are present.

Calculating debt ratios is part of the overall determination of repayment ability. There are two debt ratios: (1) principal, interest, taxes and insurance to income ratio (PITI ratio); and (2) total debt ratio (TD ratio), which takes into account the PITI plus any additional monthly debt obligations. 7 CFR 1980.345(c)(3) states that an "applicant meets [Rural Housing Service] requirements for repayment ability when the applicant's total debt ratio is less than or equal to 41 percent and the ratio of the proposed PITI to income does not exceed 29 percent."

While an applicant meets repayment ability requirements with a 29 percent PITI ratio and 41 percent TD ratio, an applicant with ratios exceeding these percentages is not automatically ineligible. Pursuant to 7 CFR 1980.345(c)(5), the ratios may exceed 29 and 41 percent ifthere are compensating factors and the lender obtains agency concurrence. Acceptable compensating factors supporting a debt ratio waiver include, but are not limited to: applicant having a history over the previous 12 month period of devoting a similar percentage of income to household expense to that of the proposed loan; accumulation of savings; credit score of at least 660; no or minimal increase in proposedhousing expenses; conservative attitude toward the use of credit; previous credit history verifies that applicant is able to devote a greater portion of income to housing expense; employment history (ex. 2 years or more in current position or changes in employment that better applicant's financial position); additional compensation (ex. public benefits, food stamps, bonuses, etc.); cash reserves post-closing; potential for increased earnings and carer advancement; trailing spouse income (home is purchased for relocation of primary wage earner and secondary wage earner has established employment history, is currently seeking work, and has reasonable prospects for securing a job); and a low TD ratio combined with other compensating factors. *See* 7 CFR 1980.345(c); RD AN No. 4435, pp. 3-4.

The agency has informed OGC that if the lender is using the automated Guaranteed Underwriting System (GUS), agency concurrence is built into GUS because that system uses an algorithm which considers appropriate compensating factors consistent with GSFH policies before issuing a recommendation on loan approval. If the GUS algorithm determines that compensating factors justify a debt ratio waiver and all other eligibility requirements are met, an electronic debt ratio waiver is created when GUS issues a recommendation for loan approval. If the lender is manually underwriting the loan, the lender submits a debt ratio waiver request with supporting documentation, and any agency concurrence is given in writing. Whether the lender uses GUS or manually underwrites the loan, the lender's permanent loan file must include documentation of the compensating factors and support the lender's request for a debt ratio waiver. *See* AN 4435, p. 3.

Credit Score

The next issue is whether applicants with credit scores lower than 620 could be approved. The GSFH regulations do not specify a minimum credit score in order for an applicant to be eligible. 7 CFR 1980.345(d) states that an "applicant must have a credit history which indicates a reasonable ability and willingness to meet obligations as they become due." No minimum credit score is required, and the indicators of unacceptable credit history in 7 CFR 1980.345(d)(l) do not include low credit scores. As stated in the June 16, 2011 OGC memorandum, RD AN No. 4441 generally provides that lenders should judiciously evaluate and carefully screen credit histories of applicants with credit scores of 619 and under, however such should not be automatically rejected just because their scores are below 620.

High Debt Ratios and Low Credit Scores

The last issue is whether applicants with high debt ratios and low credit scores could be approved. The GSFH regulations do not specify that an applicant with high debt ratios and a low credit score is automatically ineligible. However, lenders are advised to be especially cautious in cases where the applicant's credit score is below 620 and there is a debt ratio waiver. *See* RD AN No. 4441, p. 4. As explained above, there are a myriad of factors used to determine an applicant's repayment ability. Therefore, while the combination of a high debt ratio with a low credit score indicates a need for heightened diligence in underwriting, the mere presence of such a combination does not necessarily render an applicant ineligible.

If you have any further questions, please contact me at (202) 720-6458.

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