U.S. Department of Agriculture

Office of Inspector General
Western Region

Audit Report

Rural Housing Service
Guaranteed Rural Rental Housing Program – Bond Financing

Report No. 04099-106-SF
March 2008

UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20250

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REPLY TO
ATTN OF: 04099-106-SF

TO: Russell T. Davis
Administrator
Rural Housing Service

THROUGH: John Purcell
Director
Financial Management Division

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Guaranteed Rural Rental Housing Program – Bond Financing

We initiated an audit of the use of bonds to finance loans under Rural Housing Services' (RHS) Guaranteed Rural Rental Housing Program (GRRHP). Our objective was to identify issues that would affect program integrity. We determined during our review that RHS was in the process of making regulatory changes to enhance program integrity, such as requiring lenders to retain in its own portfoloio 5 percent of all loans that are over $5 million. These actions appear adequate to protect the Government's interest. Accordingly, we are closing the audit with no further action required by the agency.

BACKGROUND

RHS increases the availability of affordable housing and community facilities for low and moderate income rural residents through its GRRHP. Under the program, RHS guarantees up to 90 percent of loans issued by private or State lenders to qualified borrowers. Program regulations require lenders to originate, fund, and service the loan as a prudent lender would for its own portfolio of loans. Before the guarantee becomes effective, lenders must certify that the terms identified in a conditional commitment have been met and must agree to service the loan according to program requirements.

The program allows lenders to use the proceeds from the sale of bonds to outside investors (bond holders) to fund program loans. Thus, lenders can finance investments through external sources but must repay principal and interest to the bond holders, normally through a trustee (a third party responsible for holding and disbursing funds). In accordance with the financing agreement between the lender and the borrower, loan proceeds are placed with the trustee. Both the trustee and the bond issuer enter into a trust indenture agreement, which sets the parameters of the sales transaction and establishes the terms and provisions for using the bond funds.

In May 2005, RHS requested that the Office of Inspector General (OIG) review a guaranteed loan to build 90 multi-family housing units in Mississippi. The lender financed the loan with two bonds totaling nearly $5.4 million and assigned the loan note guarantee to a trustee. Our audit concluded that the lender did not originate and service the loan according to program requirements (Audit 04601-9-SF). The borrower paid over $1.1 million for costs associated with the bond (e.g., interest to bond holders) but paid nothing that contributed to actual housing construction. In total, the borrower received over $2.8 million without building any of the housing units. We also concluded that the lender disbursed bond funds prior to RHS issuing the guarantee, paid developer fees prior to services being rendered, did not use its own money to fund the loan (reducing it's financial incentive to ensure proper servicing of the loan), and assigned the loan note guarantee to a trustee without RHS' prior approval. Finally, RHS had no regulations to provide guidance to lenders regarding the use of bonds to fund the program's projects. Therefore, we initiated a review to determine if RHS had corrected program issues identified in our previous report.

OBJECTIVE

Our objective was to identify issues related to bond financing that would require RHS' action to protect program integrity.

SCOPE

We planned to review program projects that were funded through the use of bond financing during fiscal years 2003 through 2007. In October 2007, we conducted fieldwork at RHS' national office in Washington, D.C. We determined that since the agency had made and is continuing to make program improvements related to bond financing, we are closing the audit. Consequently, our sample was limited to the guaranteed loan reviewed during our previous audit.

METHODOLOGY

To accomplish our objective, we performed the following procedures:

- Interviewed RHS' national office officials about bond financing and their understanding of the requirements necessary for a lender to assign a loan guarantee to a separate entity.

- Analyzed regulations, handbooks, and documentation on new policy and procedures in order to determine if controls were adequate to ensure that lenders use bond financing efficiently and effectively.

- Interviewed officials at the Office of the General Counsel to determine their understanding of the bond financing process and whether they provided any guidance to RHS.

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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

SUMMARY

In our previous audit (04601-9-SF), we had concerns about (1) the lack of regulations to guide lenders in the use of bond financing, including but not limited to, the assignment of the loan note guarantee to a third party, (2) the ability of a third party to present, and have the Government honor, the loan note guarantee, (3), developer fees being paid before services are rendered, and (4) whether lenders have sufficient incentive to properly originate and service the loan when bonds are issued, and the guarantee is assigned to a third party.

Based on our concerns, we initiated a nationwide audit to identify program issues that would require RHS to take immediate action to protect program integrity.

We determined during the course of our review that RHS had begun making the following improvements that would address the areas of concern noted above:

1. New regulations were established in February 2005 which require lenders to submit an “Assignment Guarantee Agreement” form to the agency for review prior to a third party becoming a legal holder of the loan note guarantee.

2. In addition, a work plan was signed by the Office of Program and Budget Analysis in November 2005 to amend GRRHP regulation 7 CFR Part 3565 to establish guidelines for bond financing of loans including adding policy for the use and distribution of developer fees.

3. This work plan will also add a provision that will give lenders additional financial incentive to properly service the loan by requiring lenders to retain in its own portfolio, 5 percent of all loans that are over $5 million.

Since the agency is implementing the above program improvements relating to bond financing, we are closing the audit with no further action required by your agency.

We appreciate the assistance and cooperation of your staff during our audit.