



U.S. Department of Agriculture



Office of Inspector General
Great Plains Region

Audit Report

Rural Development's Single-Family Housing Force Placed Insurance Program

Report No. 04099-139-KC
September 2007



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



REPLY TO

ATTN OF: 04099-139-KC

TO: Russell T. Davis
Administrator
Rural Housing Service

THROUGH: John Purcell
Director
Financial Management Division

FROM: Robert W. Young
Assistant Inspector General
for Audit

SUBJECT: Rural Development's Single-Family Housing Force Placed Insurance Program

Summary

Rural Development, a Department of Agriculture agency, provides home ownership opportunities for low-income rural Americans through the single-family housing (SFH) program. It has an \$86 billion portfolio of loans of which \$13.3 billion are for SFH direct loans. To protect its interests, Rural Development force places insurance on security properties if borrowers are unable or unwilling to provide adequate and acceptable insurance coverage. Since September 1998, Rural Development has contracted with Proctor Financial, Inc. (PFI), an insurance broker, to provide force placed insurance for the SFH Direct Loan Program. PFI's insurance policies were issued on a surplus lines basis.¹ A surplus lines tax is imposed on insurance premiums by applicable State law when coverage is placed with an insurer not licensed to transact business in the State where the property is located.

In 2003 and 2004, the Office of Inspector General (OIG) received two separate hotline complaints. The complainants alleged primarily that PFI was collecting surplus lines insurance taxes from SFH borrowers even though PFI had previously obtained a tax exemption from the State of Missouri.

¹ Surplus lines insurance is coverage that is not available from insurers licensed in the State.

Based on the complaints, we began an audit to evaluate the allegations and to determine whether (1) Rural Development officials were properly following Federal regulations and Rural Development procedures, and (2) PFI was properly billing and collecting insurance premiums from SFH borrowers.

Our audit substantiated that PFI requested and obtained a surplus lines tax exemption from the State of Missouri. However, we did not substantiate that PFI was collecting surplus lines taxes from SFH borrowers.² Therefore, we are making no recommendations regarding the complaints. During our review, we found that PFI had not consulted with Rural Development officials, including agency counsel, before requesting the exemption. To prevent similar tax-related questions from arising in the future, we suggest that Rural Development officials, in consultation with the Office of the General Counsel, add a provision in requests for proposals (RFP)³ and procurement contracts for insurance services. The provision should stipulate the contractor's and Rural Development's authorities and responsibilities regarding State tax obligations and exemptions, including the contractor's need to consult with agency officials on tax-related questions.

During our review of the hotline complaints, we identified other areas where we are recommending improvements to the force placed hazard insurance program. We found Rural Development officials force placed insurance coverage above the unpaid loan balance, which exceeded permissible amounts established in the Federal regulations. We recommend that Rural Development officials ensure the *Code of Federal Regulations* (CFR) and Rural Development procedures related to the amount of coverage to force place are consistent and implement and enforce these procedures. In addition, we were unable to determine if Rural Development borrowers met threshold requirements for force placing insurance because Rural Development's procedures were inconsistent and unclear. We recommend Rural Development officials establish and implement consistent procedures and establish controls to ensure compliance with thresholds for force placing insurance coverage. Rural Development officials concurred with the recommendations (see exhibit B for the agency's response in its entirety).

In addition, we found PFI officials incorrectly calculated borrower premiums on force placed hazard and flood insurance resulting in overcharges of almost \$32,000 (see exhibit A). As a result of our audit, PFI officials reimbursed Rural Development for the overcharges, and Rural Development officials implemented new controls to increase the monitoring of contract charges. Since PFI and Rural Development took appropriate actions during the audit, we are not making any recommendations in this area.

Background

Rural Development's mission is to increase economic opportunity and improve the quality of life for all rural Americans. Rural Development's force placed insurance program is a beneficial program that protects the Government's interest in security properties located in all 50 States, Puerto Rico, and the Virgin Islands. As of January 2007, almost \$48 million in uninsured losses have been avoided due to Rural Development's force placed insurance program. About 29,000 of 230,000

² Neither the premium rate in PFI's contract with Rural Development nor PFI's invoices identified taxes were being collected from SFH borrowers. Additionally, our review disclosed that PFI made no remittances to State taxing authorities resulting from the surplus lines tax exemption obtained from the State of Missouri.

³ RFPs are used in negotiated acquisitions to communicate Government requirements to prospective contractors and to solicit proposals.

loans requiring insurance (13 percent) had insurance coverage force placed under this program as of December 2006. The Government funds Rural Development's SFH direct loans. These loans are available for low-income borrowers who wish to obtain home ownership and are commonly referred to as Section 502 Direct Loans. Similarly, the Government directly funds Rural Housing Repair and Rehabilitation Loans (Section 504). However, they differ from Section 502 loans in that they are intended for low-income rural residents who already own and occupy a home that is in need of repairs.

To improve service and cut taxpayer costs, Rural Development created the Centralized Servicing Center (CSC), which uses an automated system to provide benefits to borrowers nationwide. The CSC, located in St. Louis, Missouri, began providing home loan services to new borrowers beginning on October 1, 1996. The CSC services all Rural Development SFH direct loans, which are both Section 502 and 504 loans. To protect its interests, Rural Development force places insurance for security properties if borrowers are unable or unwilling to provide adequate and acceptable insurance coverage. The force placed insurance remains in effect until borrowers obtain and submit evidence of other acceptable insurance coverage.

Beginning in 1998, PFI was awarded the Rural Development contract for force placed insurance for a total of 5 years, including 4 option years. PFI was again awarded the contract in 2003, and options were granted in 2004, 2005, and 2006. A contract year runs from September 1 to August 31. PFI's insurance policies were issued on a surplus lines basis. Surplus lines insurance is insurance coverage that is not available from insurers licensed in the State. Surplus lines insurance companies are not licensed to write insurance in particular States, but they can do business there if licensed insurers decline to write the insurance. Since they are not licensed, the insurance premiums are subject to a surplus lines tax.

Objective

The overall objective was to evaluate the allegations contained in the hotline complaints to determine whether they could be substantiated. We also determined whether (1) Rural Development officials were properly following Federal regulations and Rural Development procedures and (2) PFI was properly billing and collecting insurance premiums from SFH borrowers.

Scope and Methodology

To assess the validity and accuracy of the allegations contained in two hotline complaints, we performed reviews at CSC in St. Louis, Missouri; PFI in Troy, Michigan; and the Missouri Department of Insurance (MDI) in Jefferson City, Missouri. The review covered contract years 1998-1999 through 2006-2007 for Rural Development's SFH force placed insurance program. From contract year 1998-1999 through the end of contract year 2005-2006, SFH borrowers paid over \$95 million in force placed insurance premiums. Fieldwork was performed from May 16, 2006, through January 29, 2007.

To accomplish our audit objectives, we:

- Interviewed responsible Rural Development officials to inquire about the allegations contained in the hotline complaints and to further our understanding of the Rural Development SFH program.
- Interviewed appropriate PFI officials to inquire about the allegations contained in the hotline complaints and to find out how PFI met its contractual obligations.
- Interviewed the applicable MDI officials to learn about the surplus lines tax exemption granted to PFI.
- Reviewed the amount of insurance coverage force placed for contract year 2005-2006 to ensure Rural Development officials complied with the CFR and Rural Development procedures.
- Reviewed PFI billings and borrower insurance payments from contract years 1998-1999 through 2005-2006, to ensure premium charges met contractual requirements.

We conducted our audit in accordance with *Government Auditing Standards*.

Finding 1:

Rural Development Force Placed Insurance Coverage Which Exceeded Permissible Amounts Established in the Federal Regulations

Rural Development officials force placed insurance coverage above the unpaid loan balance, which exceeded permissible amounts established in the Federal regulations. This occurred because Rural Development officials did not establish or implement procedures consistent with Federal regulations on the amount of coverage to insure. The regulation was revised January 1, 2006, but Rural Development officials did not change their procedures for either the 2005-2006 contract year⁴ or for the 2006-2007 contract year, which began on September 1, 2006. Our testing of the data and of Rural Development's procedures for the 2005-2006 contract year disclosed that the majority of these loans had insurance coverage, and related premiums, well above the limits prescribed in the new regulation. Based on those tests and the fact that Rural Development did not change its procedures when the new regulation came into effect, this would have resulted in borrowers paying millions of dollars in extra insurance premiums when hazard insurance was force placed in amounts above unpaid loan balances for the 2006-2007 contract year.

We found that Rural Development's Dedicated Loan Origination and Servicing System (DLOS) CSC Handbook procedures did not limit the amount of coverage to the unpaid loan balance, which was inconsistent with the CFR provisions. The CFR provisions for the SFH program provide that the *maximum* amount of coverage should not exceed the unpaid loan balance.⁵ In contrast, internal procedures in the DLOS CSC Handbook state that the *minimum* amount of coverage is the unpaid

⁴ September 1, 2005, to August 31, 2006.

⁵ 7 CFR 3550.61(b), dated January 1, 2006, provides that the dwelling and any other essential buildings must be insured in an amount that is the *lesser* of 100 percent of the insurable value (replacement cost) of the property *or* the unpaid loan balance.

loan balance.”⁶ Since the handbook only prescribes a *minimum* amount of coverage, Rural Development routinely force placed coverage in amounts greater than the unpaid loan balance, which does not comply with Federal regulations.

We questioned Rural Development officials about the difference between the CFR and the handbook. The officials agreed that there was a discrepancy between the handbook and the regulation, and Rural Development did not follow the regulation during the 2006-2007 contract year.

Rural Development officials explained that the amount of coverage depended on the last known coverage⁷ at the time of force placement. When the last known coverage was unavailable, Rural Development officials force placed insurance coverage based on the unpaid loan balance at the time of original force placement. However, the last known coverage in most cases exceeded, and often far exceeded, the unpaid loan balance. In response, Rural Development officials claimed that they force placed insurance at the last known coverage (value of the property) on record because it not only protected the Government’s interest, but also protected any borrower equity accumulated over years of ownership.

The officials added that they have started taking action to correct the discrepancy between the regulation and the handbook.

Recommendation 1:

Ensure that the *Code of Federal Regulations* and the DLOS CSC Handbook procedures, related to the amount of coverage to force place on borrowers, are consistent and implement and enforce these procedures.

Agency Response:

Rural Development concurred that the recommended changes to the regulations and handbook will resolve the issues noted in the finding. A direct final rule to amend regulations to resolve the noted findings has been prepared and is in the clearance process for Federal Register publication. Corresponding handbook changes have also been made and will be implemented following the regulation changes. All changes should be implemented by March 31, 2008.

OIG Position:

We accept management decision. For final action, Rural Development needs to provide the Office of the Chief Financial Officer (OCFO) confirmation when the Federal Register publication has been issued in final and when the corresponding handbook changes have been implemented.

⁶ DLOS CSC Handbook, HB-2-3550, Attachment 3-A, May 27, 1998, states that “the *minimum* amount of coverage that is acceptable is an amount at least equal to the balance of the secured debts.”

⁷ If applicable, the last known coverage is the amount of insurance coverage maintained by a borrower’s previous insurance provider on record with the agency.

Finding 2:**Rural Development's Procedures Were Inconsistent and Unclear**

We were unable to determine if Rural Development borrowers met threshold requirements for force placing insurance. This occurred because Rural Development's procedures were inconsistent and unclear regarding when to force place hazard insurance. In addition, Rural Development did not have a system in place to readily identify whether or not borrowers met threshold requirements for force placing insurance. During the 2005-2006 contract year, we identified about 3,000 borrowers with force placed insurance that might not have met threshold requirements.⁸

According to the DLOS CSC Handbook, hazard insurance is not required if the *total outstanding agency debt and any senior liens* against the property are equal to or less than \$7,500 for Section 502 loans, and \$15,000 for Section 504 loans.⁹ However, another procedure contradicts the DLOS CSC Handbook by stating the amount of *unpaid loan balance* can determine whether an account will be added to the force placed cycle. In contrast, that procedure states that Section 502 and 504 loans are excluded when the unpaid loan balance is less than \$7,500.¹⁰ Under the second scenario, the unpaid loan balance could be well below the amount of the total outstanding agency debt and senior liens. As a result, a significant number of borrowers who would meet the threshold requirements under one procedure would not necessarily meet the requirements under the other procedure.

During followup discussions, Rural Development officials said they followed the procedure in the DLOS CSC Handbook for determining if the borrower met threshold requirements. However, the officials stated that Rural Development did not have a system in place to readily identify whether or not borrowers met threshold requirements for force placing insurance. Rural Development officials explained that determining the total outstanding agency debt and any senior liens against the property was a manual process. They make the threshold determination at the time the loan is initially force placed. Subsequent to that, in order to determine if each of the approximate 3,000 borrowers identified by OIG still met the total outstanding agency debt threshold, Rural Development officials would have to manually review each account separately.

In addition, Rural Development officials explained that Rural Development only excludes accounts with balances below the threshold that are *new* to force placed insurance; therefore, they do not reject accounts that are *renewing* force placed insurance. Rural Development officials only compute the threshold determination on balances at the time the account is initially force placed. However, neither procedure clearly specifies that the threshold only applies to borrowers who are new to force placed insurance.

Rural Development officials concurred that the procedures were inconsistent and unclear, and they added that they were in the process of rewriting the procedures.

⁸ Rural Development provided us with the unpaid loan balance for borrowers with force placed insurance. We found 2,832 Section 502 properties with current loan balances below \$7,500 and an additional 138 Section 504 properties with current loan balances below \$15,000.

⁹ DLOS CSC Handbook, HB-2-3550, paragraph 3.3 A 1, revised September 18, 2002.

¹⁰ *Lender Placed Insurance Procedures*, undated.

Recommendation 2:

Establish and implement consistent procedures for force placing insurance and establish controls to ensure compliance with thresholds for force placing insurance coverage.

Agency Response:

As a control, CSC internal desk procedures now require twice monthly monitoring of force placed accounts to ensure compliance with the threshold requirements of the revised regulations and handbook. A direct final rule, which will amend regulations to resolve the noted findings, has been prepared and is in the clearance process for Federal Register publication. Corresponding handbook changes have been made and will be implemented following publication of the regulation changes. These changes should be implemented by March 31, 2008.

OIG Position:

We accept management decision. For final action, Rural Development needs to provide the OCFO confirmation when the Federal Register publication has been issued in final and when the corresponding handbook changes have been implemented.

Exhibit A – Summary of Monetary Results

| Description | Amount | Category |
|--------------------------------------|----------|--|
| Charges in Excess of Contracted Rate | \$31,856 | Question Costs – Recovery Recommended |

Exhibit B – Agency Response

Exhibit B – Page 1 of 3



United States Department of Agriculture
Rural Development

SEP 25 2007

SUBJECT: Official Draft - Rural Development's
Single-Family Housing Force Placed Insurance
Program (Audit No. 04099-139-KC)

TO: Robert Young
Assistant Inspector General
for Audit

Attached for your review is Housing Program's response dated September 25, 2007, to the Official Draft for the subject audit.

This response is being submitted for inclusion in the Final Report and your consideration to reach management decision on Recommendations 1 and 2 in the audit.

If you have any questions please contact Arlene Pitter of my staff on (202) 692-0083.

A handwritten signature in black ink, appearing to read "John M. Purcell".

JOHN M. PURCELL
Director
Financial Management Division

Attachment

1400 Independence Ave, SW • Washington, DC 20250-0700
Web: <http://www.rurdev.usda.gov>

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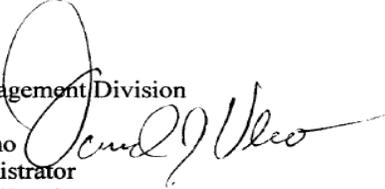
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United States Department of Agriculture
Rural Development

SEP 25 2007

TO: John Purcell
Director
Financial Management Division

FROM: David J. Villano 
Deputy Administrator
Single Family Housing

SUBJECT: Office of the Inspector General (OIG)
Audit Number 04099-139-KC
Rural Development's Single Family Housing
Force Placed Insurance Program

CC: Pat Fiala, Director, Centralized Servicing Center (CSC)

This provides Rural Development's response to the above subject OIG Audit Report dated September 7, 2007. We are asking for a Management Decision for all recommendations within the subject report.

In order to expedite Management Decision at the earliest possible date; we are respectfully requesting the OIG initial assessment of our resolutions within 60 days and a monthly status report thereafter until audit closure is reached.

FINDING 1: Rural Development force placed insurance coverage which exceeded permissible amounts established in the Federal Regulations.

RECOMMENDATION 1

Ensure that the *Code of Federal Regulations* and the DLOS CSC Handbook procedures, related to the amount of coverage to force place on borrowers, are consistent and implement and enforce these procedures.

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Rural Development Response:

We disagree with the language “*millions of dollars in extra*” insurance premiums. Force Placed premiums charged for last known coverage is the ordinary rate or in some states lower than the rate the customer would have paid if obtaining a policy on their own. In many cases borrowers requested CSC to force place coverage because home insurance was not available to them at affordable rates. In hurricane-prone states where insurance rates are generally highest, CSC *avoided millions of dollars* in loss to customers caused by Katrina and other storms, because of our proactive policy of forcing at the last known coverage.

Although we disagree with this language, we believe that the recommended changes to the regulation and handbook will resolve the issues noted in the finding. A direct final rule to amend regulations to resolve the noted findings has been prepared and is in the clearance process for Federal Register publication. Corresponding handbook changes have also been made and will be implemented following the regulation changes. All changes should be implemented by March 31, 2008.

FINDING 2: Rural Development procedures were inconsistent and unclear.

RECOMMENDATION 2

Establish and implement consistent procedures for force placing insurance and establish controls to ensure compliance with thresholds for force placing insurance coverage.

Rural Development Response:

As a control, CSC internal desk procedures now require twice monthly monitoring of force placed accounts to ensure compliance with the threshold requirements of the revised regulations and handbook.

A direct final rule which will amend regulations to resolve the noted findings has been prepared and is in the clearance process for Federal Register publication. Corresponding handbook changes have been made and will be implemented following publication of the regulation changes. These changes should be implemented by March 31, 2008.

Informational copies of this report have been distributed to:

Administrator, Rural Housing Service

Attn: Agency Liaison Officer (4)

Government Accountability Office (1)

Office of Management and Budget (1)

Office of the Chief Financial Officer

Director, Planning and Accountability Division (1)

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bcc:

D. Gannon, RIG

R. Price, ARIG

L. Jenkins, Senior Auditor

Reader File

Wallet File