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Midwest Region

Audit Report

Rural Rental Housing Loan Prepayment and Restrictive Use Agreements

Report No. 04601-0012-Ch
April 2006

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250

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REPLY TO
ATTN OF: 04601-0012-Ch

TO: Russell T. Davis
Administrator
Rural Housing Service

THROUGH: John Dunsmuir
Acting Director
Financial Management Division

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

SUBJECT: Rural Housing Service, Rural Rental Housing Program,
Rural Rental Housing Loan Prepayment and Restrictive Use Agreements

This report presents the results of our audit of the Rural Housing Service's (RHS) activities related to the prepayment of Rural Rental Housing (RRH) Program loans. As part of our audit, we examined the policies, procedures, and internal controls associated with offers made to borrowers as incentives to remain in the RRH Program. We also reviewed agency actions involving restrictive-use agreements, including the actions of field staff to verify that borrowers were complying with those agreements.

Our audit did not identify any material issues with the loan prepayment process. We did, however, identify two procedural weaknesses that we want to bring to your attention. The first relates to inputting data into the Prepayment Tracking and Concurrence (Pre-Trac) system. The second relates to the verification of compliance with restrictive-use agreements by former borrowers. Your consideration to strengthen controls in these areas would improve the prepayment process by providing greater assurance that incentive offers to borrowers are proper and accurate, and ensure that former borrowers are complying with restrictive use agreements.

BACKGROUND

RHS provides financing to construct multi-family housing projects in rural areas under the authority of the RRH Program. The loans for these projects are subsidized to make them affordable for rural residents with low to moderate incomes. RHS administers the RRH Program through its national office in Washington, D.C., and through Rural Development's network of 47 State and 800 area and local offices.

In 1988, Congress enacted the Emergency Low Income Housing Preservation Act (ELIHPA). This legislation prohibited borrowers who obtained loans through the RRH Program between 1979 and 1989 from prepaying, even though provisions in loan agreements allowed such action. However, in 2001, in *Kimberly v. United States*, 261 F. 3d 864 (9th Cir. 2001), the Ninth Circuit Court ruled that RHS was obligated to honor its contractual commitments and accept prepayment from RRH Program borrowers, regardless of prepayment restrictions stipulated in the ELIHPA statute. Also, in 2002, the Supreme Court ruled in *Franconia Associates v. United States*, that borrowers were entitled to damages when RHS prohibited prepayment of loans. Based on these rulings, RHS proposed legislative changes that would allow all borrowers to prepay loans. The legislation is pending in Congress.

RHS has taken several actions to ensure that it retains sufficient levels of multi-family housing to protect low-income individuals in rural areas. These include an evaluation of the RRH Program and prepayment activities by an independent consulting firm, the development of procedures that encourage borrowers to remain in the RRH Program, and the drafting of new legislation that will allow borrowers to prepay loans made prior to December 15, 1989, without restrictions. In view of the recent judicial rulings, these actions are appropriate for the circumstances.

In 1998, RHS created the Office of Rural Housing Preservation (ORHP). The role of ORHP is to retain, to the extent possible, all multi-family housing projects needed to support the RRH Program. The ORHP is responsible for reviewing and approving incentive offers made to borrowers to keep them in the program. The incentive offers are established by State and area offices, and forwarded to ORHP through the Pre-Trac system.

If a borrower does not accept the incentive offer and the State or area offices determine there is a need for low-income housing in a specific location, or that there is an adverse impact on minorities in the community, a borrower may prepay subject to a restrictive-use agreement. However, borrowers can also appeal this restriction. If a borrower rejects a restrictive use agreement, they must offer the property for sale to a non-profit organization. If they do not find a buyer, they may prepay without restriction. Restrictive use agreements are intended to protect tenants residing in projects at the time of prepayment by prohibiting borrowers from arbitrarily increasing rent payments and requiring specific maintenance standards to preserve the RRH project.

OBJECTIVES

To evaluate agency activities related to the prepayment of RRH loans, incentive offers made to borrowers to remain in the RRH Program, and borrower compliance with restrictive-use agreements.

SCOPE AND METHODOLOGY

We performed work at the RHS National office, the Iowa (IA) and Illinois (IL) Rural Development State offices, and at two area offices (one in each State). We also visited five former RRH properties to interview tenants. During fiscal year (FY) 2005, borrowers prepaid 103 loans for RRH projects with outstanding loan balances of over $19 million. The two States we visited had prepayments for 37 RRH projects with loans totaling over $3 million during FY 2005. We judgmentally selected, based on fiscal year and area office, 10 loans that had been prepaid (six in IA and four in IL). These loans totaled almost $1.6 million.

We performed tests of internal controls over the prepayment process, and tested program and accounting records that we considered necessary to meet our objectives. For each loan, we reviewed multi-family housing program and Pre-Trac records to verify that the loans were, in fact, eligible to be prepaid, and that incentive offers were properly and accurately computed by the Pre-Trac system. We also reviewed restrictive-use agreements and interviewed tenants to ensure that former borrowers were in compliance with those agreements.

We conducted fieldwork from August 2005 through February 2006. Our audit was performed in accordance with *Government Auditing Standards.*

THE FOLLOWING OBSERVATIONS WERE MADE DURING OUR REVIEW THAT WE WANT TO BRING TO YOUR ATTENTION:

OBSERVATION 1: Data Input Controls

We examined records for 10 judgmentally selected loans that had been prepaid during FY 2005 in Iowa and Illinois. While our tests did not disclose any errors in the accuracy of data in the Pre-Trac system, we did find that there was no control to ensure that State and area officials accurately input data into the system.

Borrowers apply to prepay RRH loans through Rural Development State and area offices. Officials from those offices obtain financial data from various sources and input it into the Pre-Trac system. This would include data such as the assessed value of the property, based on an appraisal, and the outstanding loan balance from the Automated Multi-family Housing Accounting system. It would also include the date of the loan, which, if made after December 15, 1989, would not be eligible for prepayment. The system uses this and other data to calculate incentive offers. There are no procedures in place to check the accuracy of data which was input into the system.

A State official believed that they would recognize major errors because the resulting incentive offer would be significantly higher or lower than expected, based on past experience. We agree with this statement for egregious errors. However, it would not be the case for smaller errors that would not be clearly evident and likely not be detected by State and area officials, or by ORHP officials at the national office who approve incentive offers.

One control that would, in our view, be easy to implement and cost effective is a second-party review. This control would involve an examination, by a second State or area official, of data input into the system. This procedure would take just a few minutes to complete and, since there are generally only a few prepayments per office each year, should not be a burden.

OBSERVATION 2: Verifying Compliance with Restrictive-Use Agreements

State and area officials had not met with or did not plan to meet with tenants to verify that former RRH borrowers were complying with restrictive-use agreements. RHS guidelines require that State and area officials perform annual visits to former RRH properties with tenants protected by restrictive-use agreements. The guidelines state that the loan servicing official is to verify that the property is properly maintained, investigate any written tenant complaints related to the restrictive-use agreement, and keep owner certifications and records of visits in the project file.

We visited five former RRH apartment complexes in two States and met with 21 tenants protected by restrictive-use agreements. Our visits disclosed no instances where former borrowers had improperly increased tenant rent, or had failed to properly maintain the apartment unit. However, we did find that agency officials from one State had not interviewed any of the tenants (the other State had not performed any annual visits to former RRH properties at the time of our review). Officials from the State that had performed visits informed us that they had not met with tenants because agency guidelines do not require it. They added that they would only meet with a tenant if there was a written complaint, or if the tenant approached them during a visit.

While our visits did not disclose any instances of noncompliance by former borrowers, there is a risk that it could occur and not be uncovered by current procedures. Therefore, we believe that consideration should be given to require interviews with tenants to discuss rent payments and maintenance of their apartment units. Also, our experience with tenant interviews was that it took just a few minutes and, thus, should not be a burden on staff.

We appreciate the cooperation of your staff during the audit and no response to this report is necessary.

Informational copies of this report have been distributed to:

Administrator, Rural Housing Service,	
Through: Director, Financial Management Division Operations and Management	4
Government Accountability Office	1
Office of Management and Budget	1
Office of the Chief Financial Officer	
Director, Planning and Accountability Division	1