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Midwest Region

Audit Report

Controls Over Lender Activities in the SFH Guaranteed Loan Program

Report No. 04601-0017-Ch
July 2009

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

DATE: July 2, 2009

REPLY TO
ATTN OF: 04601-0017-Ch

TO: Tammye H. Trevino
Administrator
Rural Housing Service

THROUGH: John Purcell
Director
Financial Management Division

FROM: Robert W. Young /s/
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for Audit

SUBJECT: Controls Over Lender Activities in the Single Family Housing Guaranteed Loan Program

This report presents the results of our audit of the controls over lending activities in the Single Family Housing Guaranteed Loan Program. Our audit evaluated the systems and processes to ensure that lenders (1) submit accurate and legitimate borrower eligibility data and (2) set interest rates on loans within agency guidelines.

The agency's response to the draft report, dated June 12, 2009, is included as exhibit A, with excerpts and the Office of Inspector General's position incorporated into the relevant sections of the report. Based on the response, we have reached management decision on all recommendations in the report. Please follow your agency's internal procedures in forwarding documentation for final action to the Office of the Chief Financial Officer.

The American Recovery and Reinvestment Act of 2009 (Recovery Act) included almost $10.5 billion in funds to guarantee single-family housing loans in rural areas. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of the funds. Since the issues in this report will directly impact funds disbursed as part of the Recovery Act, we recommend the agency strive to implement the corrective actions as agreed to in the report.

We appreciate the courtesies and cooperation extended to us by your staff during the audit.

Executive Summary

Results in Brief

This report presents the results of our audit of Rural Development's Single Family Housing (SFH) Guaranteed Loan Program. As of October 31, 2008, the agency's portfolio consisted of more than 246,000 guaranteed loans totaling nearly $22 billion. We initiated this audit, in part, because of a recent Office of Inspector General investigation of a lender in Michigan who submitted false documents to obtain loan guarantees from Rural Development. This investigation disclosed that the agency paid fraudulent loss claims of at least $1.75 million on 33 loans. The numbers and total losses could be higher than reported because not all loans guaranteed by Rural Development for the lender were included in the investigation. Another reason for performing our audit was that the U.S. Department of Justice has expressed concern that some lenders were not setting the correct interest rate on loans guaranteed by the Government.

Our primary objective was to determine if the agency had adequate internal controls to prevent or detect such activities. In particular, our objective was to ascertain if the Rural Housing Service (RHS), which develops policy for the program, had adequate controls to ensure that lenders submit accurate and legitimate borrower eligibility data and that lenders set interest rates on loans within agency guidelines. Our audit found that lenders could submit false borrower eligibility documents with little risk of detection and some lenders had set interest rates too high on loans.

Lenders Were Able to Submit False Eligibility Data With Borrower Applications

Overall, our tests of 68 judgmentally selected guaranteed loans submitted to Rural Development by 6 lenders in Michigan (not including the one lender under investigation) did not identify any falsified borrower data. However, we did determine that lenders could submit false documents with little risk of detection by agency staff. This condition exists because the agency does not verify information with an independent source, such as borrower income with employers. Instead, it relies on lenders' internal quality control (QC) reviews to ensure the accuracy and legitimacy of information submitted with loan guarantee applications. Our audit disclosed that lenders' QC reviews were deficient because their plans, which describe in detail the actions to be taken, were generally either inadequate or not fully adhered to by lenders.

The agency's reliance on lenders' internal QC reviews presents a serious concern in that lenders are reviewing themselves. The risk in this self-evaluation process is that lenders will not detect and report identified problems. Furthermore, lenders perform the QC reviews after the agency provides its guarantee on loans. According to agency officials, it may be

difficult to rescind the guarantee if a lender later reports a problem with the loan. This is especially difficult if the lender has sold the loan to another financial institution, which is a common practice in the mortgage industry. This practice involves the sale of loans from originating lenders to other financial institutions that will service the loans. Presumably, those lenders purchase the loans without any knowledge of problems perpetrated by originating lenders.

We questioned RHS officials about requiring agency field staff to verify information submitted by lenders for accuracy and legitimacy. They stated that it would be difficult, if not impossible, for the agency's roughly 1,000 employees, some who only work part-time in this program and others who do not process guaranteed loans at all, to process the approximately 30,000 loan guarantees issued each year and verify the data submitted with those applications. They added that neither the Departments of Housing and Urban Development (HUD) nor Veterans Affairs (VA), both of which also guarantee residential housing loans, verify borrower eligibility data. Thus, despite its limitations, the lender QC review is the more viable control measure available to the agency.

RHS officials can improve the adequacy of lender QC reviews by developing specific minimum requirements to include in lender QC plans. For instance, lender plans did not always include provisions to review a specific number of agency guaranteed loans during the QC review process. Our review of regulations and discussion with officials at HUD and VA disclosed that they required this provision. In fact, HUD and VA procedures required that a minimum of 10 percent of agency guaranteed loans be examined during lender QC reviews.[1] In our audit, we examined the QC plans for eight lenders and discussed the details of those plans with lender officials. We found that only two lenders had reviewed more than 10 percent of the loans guaranteed by the agency.

Both HUD and VA also require lenders' QC plans to review all branch offices, including every loan processor, officer, and underwriter involved in the processing of agency loans. For instance, VA requirements state that the sample must include loans processed by all officers and underwriters and a random selection that includes loans from all branch offices and authorizing agents. None of the eight lenders' QC plans we examined met this requirement.

Our audit disclosed that some lenders had also not adhered to provisions in their QC plans. For instance, one lender had a loan officer perform the QC review even though its plan stated that "the QC process would be independent of the loan origination process." Agency officials did not detect

[1] Statistical sampling is allowed by both agencies when the volume of loans reaches set thresholds.

this type of noncompliance because the agency's Lender Compliance Review (LCR) process did not evaluate lenders' adherence to their QC plans. The agency uses the LCR process to monitor lender compliance with the agency guidelines.

RHS officials agreed to develop specific lender requirements such as including 10 percent of all agency guaranteed loans in the QC review process. In addition, they plan to revise field staff lender monitoring procedures to verify that lenders perform QC reviews in accordance with agency guidelines.

Improper Interest Rates

Our audit also disclosed that some lenders had set interest rates on loans that were greater than the maximum allowed by the agency. In our audit, 4 of 6 lenders reviewed in this area had set interest rates between 0.125 percent and 0.5 percent too high on loans for 11 of 123 judgmentally selected borrowers. The improper rates could cost the 11 borrowers more than $77,000 in excessive interest over the course of their 30-year guaranteed loans. This is significant since the loans were made to low- to moderate-income individuals, many of whom had defaulted on their loans.

RHS had not established policies and procedures that required field staff to verify interest rates set by lenders were within required limits. In addition, RHS did not require lenders to submit the actual date borrowers locked in their interest rate with lenders. Field staff needs this date to determine if the interest rate set by lenders complies with agency guidelines. Based on our discussions, agency officials have begun corrective actions to resolve the interest rate issues identified during our audit.

Recommendations In Brief

We recommend that RHS require lenders to include specific provisions in their QC plans such as the review of (1) at least 10 percent of agency guaranteed loans and (2) all branch offices, including every loan processor, officer, and underwriter involved in the processing of agency guaranteed loans. We recommend that RHS develop procedures to monitor lenders compliance with the QC requirements. RHS should also require lenders to submit evidence of the date borrowers' interest rates were set, and require field staff to verify that rates set by lenders are within agency guidelines.

Agency Response In their response, dated June 12, 2009, agency officials agreed with the findings and recommendations in the report. We have incorporated applicable portions of the response, along with our position, in the Findings and Recommendations section of this report. The agency's response is included in its entirety as exhibit A of the report.

OIG Position We agree with the corrective actions the agency plans to take and have reached management decision on all recommendations in the report.

Abbreviations Used in This Report

Fannie Mae	Federal National Mortgage Association
FY	Fiscal Year
HUD	U.S. Department of Housing and Urban Development
LCR	Lender Compliance Review
OIG	Office of Inspector General
QC	Quality Control
RHS	Rural Housing Service
RD	Rural Development
SFH	Single Family Housing
SIR	State Internal Review
USDA	U.S. Department of Agriculture
VA	U.S. Department of Veterans Affairs

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Background and Objective

Background

The U.S. Department of Agriculture, through the Rural Development mission area and the Single Family Housing Guaranteed Loan Program, guarantees the repayment of loans made by private lenders to low- and moderate-income borrowers for the purchase of residential housing in rural areas. A loan guarantee substantially reduces the lender's risk of loss because Rural Development will reimburse up to 100 percent of the outstanding loan principal and interest if a borrower were to default. To qualify for a guarantee, lenders must ensure that each borrower has the ability to repay the loan.

The Rural Development mission area administers the Single Family Housing Guaranteed Loan Program through the Rural Housing Service (RHS) national office in Washington, D.C., and its network of State, area and local offices. The RHS national office is responsible for establishing policy, procedures, and internal controls for the program. RHS officials provide guidance on program activity through RD Instruction 1980-D and perform compliance reviews of all mortgage lenders approved by the national office.

We initiated this audit because of a recent investigation by the Office of Inspector General (OIG) into a lender who submitted false documents to Rural Development to obtain loan guarantees. According to the Federal Bureau of Investigation, 80 percent of all reported losses attributable to housing fraud involved collaboration or collusion with industry insiders.[2] Further, a recent study of mortgage and global banking institutions concluded that the most serious mortgage fraud risk is broker-facilitated fraud.[3] The U.S. Department of the Treasury recently reported that mortgage fraud increased by 1,411 percent between 1997 and 2005.[4] The U.S. Department of Justice recently expressed concern to OIG that some lenders were setting interest rates on guaranteed loans that were excessive and not in compliance with agency guidelines.

Rural Development field offices are responsible for reviewing applications to verify that proposed loan guarantees are made to eligible applicants.[5] Those offices also input information such as lender and borrower names, the amount loaned to the borrower, and the interest rate on the loan, into a database recordkeeping system. The database is the Guaranteed Loan System.

The RHS national office is responsible for approving lenders to participate in the program on a nationwide basis. The agency's field staff can approve

[2] U.S. Department of Justice, Federal Bureau of Investigation: Financial Crimes Report to the Public May 2005.
[3] BasePoint Analytics White Paper, Broker-Facilitated Fraud – The Impact on Mortgage Lenders, 2006.
[4] FinCen Mortgage Loan Fraud: An Industry Assessment based upon Suspicious Activity Report Analysis, November 2006.
[5] RD Instruction 1980.354, dated June 21, 1995.

lenders not authorized by the national office. These lenders generally have smaller operations and only operate in specific States. The agency's field staff must review the activities of State-approved lenders to ensure compliance with agency regulations. The agency performs both State and national office Lender Compliance Reviews on 2 or 5-year cycles depending on the volume of loans originated by a lender.[6]

Lenders use Form RD 1980-21, "Request for SFH Loan Guarantee," to obtain a guarantee on a single-family housing loan. Along with this form, RHS requires lenders to submit documentation that supports the applicant's eligibility to obtain a loan guarantee. These requirements include the lender's underwriting analysis of the applicant's repayment ability, a credit report for the applicant, an appraisal report for the property, and a verification of the applicant's income.[7] RHS requires lenders to certify on Form RD 1980-21 that the loan was made in compliance with program regulations.

As of October 31, 2008, Rural Development's portfolio consisted of more than 246,000 single-family housing guaranteed loans totaling nearly $22 billion. At that time, over 31,000 of those loans, totaling more than $2.6 billion, were in a delinquent status. In fiscal year 2008, the agency paid over $103 million in claims to financial institutions for losses attributed to borrowers who had defaulted on guaranteed loans.

Objective

To evaluate RHS' internal controls over the loan guarantee process. Specifically, to determine if the agency had adequate internal controls to ensure that it did not guarantee loans based on false eligibility documents submitted by the lender, and that interest rates on loans were set within agency guidelines.

[6] RD Instruction 1980.309(g), dated June 21, 1995.
[7] RD Instruction 1980.353(c), dated June 21, 1995.

Findings and Recommendations

Section 1: Loan Origination Abuse

Finding 1 — Lender Quality Control Reviews and Agency Monitoring Efforts Need Strengthening To Prevent Loan Origination Abuse

Mortgage lenders that participate in Rural Development's Single Family Housing Guaranteed Loan Program could submit false borrower eligibility documents without detection by agency officials. Although the Office of Inspector General (OIG) recently investigated a lender that committed such an act, we were unable to identify additional instances through our review of 68 delinquent loans at 6 other lenders in the same State. However, Rural Development remains vulnerable to lenders submitting false documents because of weaknesses in lenders' internal quality control (QC) reviews, the agency's lender compliance review (LCR) process, and the agency's State Internal Review (SIR) process. These weaknesses create an environment in which Rural Development's portfolio could include loans made to ineligible borrowers. For example, the OIG investigation uncovered that Rural Development's portfolio included 46 guaranteed loans made to ineligible borrowers. Out of those loans, 33 have already defaulted, resulting in avoidable loss claim payouts of more than $1.75 million.

The Rural Housing Service (RHS) requires lenders to submit Form RD 1980-21, "Request for Single Family Housing Loan Guarantee," along with documentation supporting applicants' eligibility, to obtain a loan guarantee.[8] To ensure that the information submitted with Form RD 1980-21 is accurate and legitimate, RHS requires lenders to develop and implement internal QC procedures and provide a QC plan to the agency prior to becoming an approved lender.[9] However, RHS does not require lenders to perform specific procedures during the reviews or include specific provisions in QC plans. We concluded that the lenders' QC reviews are the agency's key control to prevent the submission of false borrower eligibility information. To ensure lenders comply with agency regulations, the agency reviews the activities of all lenders on 2 or 5-year cycles depending on the volume of loans originated by a lender.[10]

We are concerned that Rural Development's Single Family Housing Guaranteed Loan Program is vulnerable to abuse. Our concerns are based on internal control weaknesses in three areas. The first weakness involves the lender QC review process, which the agency relies on as its primary control to prevent lenders from submitting false documents with applications for loan guarantees. The second weakness involves the agency's oversight of lender

[8] RD Instruction 1980.353(c), dated June 21, 1995.
[9] RD Instruction 1980.309(b)(1)(v), dated June 21, 1995.
[10] RD Instruction 1980.309(g), dated June 21, 1995.

activities through periodic LCRs. Our last concern relates to the agency's monitoring of field staff through the SIR process. The following sections describe our concerns in each area.

Lender Quality Control Reviews

To verify the legitimacy of borrower eligibility information, agency officials rely on lenders' internal QC reviews. The agency's reliance on these reviews presents some serious concerns. First, lenders perform the reviews after the agency has issued the loan guarantee. According to RHS officials, it may be difficult to rescind a guarantee if an originating lender has sold the loan to another (secondary) financial institution, which is a common practice in the mortgage industry. Presumably, the secondary lenders purchase the loan without any knowledge of problems perpetrated by originating lenders. Rural Development regulations require agency officials to honor the loan guarantee, and pay the loss claim, unless they can prove the secondary lender knew of the fraud or misrepresentation at the time the loan was purchased from the originating lender.[11]

Secondly, lenders perform QC reviews on loans they originate. Since the agency's recourse would need to be against the lender that originated the loan with false documents, that lender has less incentive to conduct a thorough QC review and report any problems to the agency. In our view, agency field staff verifications of information on Form RD 1980-21 would be a better internal control to prevent abuse by lenders.

We questioned national officials about requiring agency field staff to verify information submitted by lenders for accuracy and legitimacy. They stated that the agency has insufficient staff to both process and verify information on the more than 30,000 loan guarantees issued each year. Rural Development has approximately 1,000 employees; however, some of those employees only work part-time in this program while others do not process guaranteed loans at all. We recognize and acknowledge the limitations this situation presents to agency managers. They added that neither the Departments of Housing and Urban Development (HUD) nor Veterans Affairs (VA), both of which also guarantee residential housing loans, verify borrower eligibility data. Thus, lender QC reviews appear to be the more viable internal control option available to the agency.

One positive point about the lenders' QC review process is that borrowers and their employers would be more likely to cooperate with lender officials during verification efforts because of prior interactions during the loan origination process. Rural Development officials do not have this history with borrowers and their employers because the agency is not the actual lender.

[11] RD Instruction 1980.308, dated June 21, 1995.

We encountered this problem when we attempted to confirm eligibility documentation with borrowers and employers for 68 loans. Many employers were concerned about privacy laws and, therefore, were reluctant to release personal information to us without a release from a borrower. Since the borrower had generally moved or relocated without providing contact information, we did not pursue obtaining releases from them. In the end, we verified the legitimacy of eligibility documentation for 37 of the 68 loans.

There are some measures RHS could take to mitigate the risks involved with lender QC reviews. For instance, to prevent additional losses to the agency, RHS could require lenders to immediately notify agency officials of any false documents or other serious violations found during QC reviews. Currently, RHS rules are silent regarding lenders' actions when QC reviews identify false documents or other serious violations. Further, RHS needs to determine the appropriate action to take if the QC reviews identify false documents. These actions could include rescinding the loan guarantee or attempting recovery from the originating lender to compensate for any paid loss claims.

Given the importance of the lenders' QC process in protecting the Government's interests, we analyzed the adequacy of QC plans for 10 lenders. In addition, we reviewed the operations of eight lenders to verify compliance with agency-approved QC plans and examined the effectiveness of agency oversight of lenders and field staff. Although we were unable to speak with two of the ten lenders because they had gone out of business, we were able to review their QC plans on file with the agency.

Our audit disclosed that RHS' guidelines did not include several requirements for lenders to follow that were critical to ensuring the integrity of information submitted to the agency. One requirement missing from RHS' guidelines was that lender QC plans needed to include a sufficient number of agency guaranteed loans in the review process. Only two of eight lenders in our audit had reviewed more than 10 percent of the loans guaranteed by the agency (Table 1 provides details of our analysis). We reviewed HUD, VA, and the Federal National Mortgage Association (Fannie Mae) lender requirements for guaranteed residential housing loans. We found that all three agencies required lenders to review 10 percent of all guaranteed loans. Thus, we used the 10 percent threshold in our analysis.

Table 1

Lender	No. selected for QC	No. originated	% selected for QC
Lender 1	54	851	**6.42%**
Lender 2	40	484	**8.26%**
Lender 3	6	973	**6.78%**
Lender 4	61	248	**24.60%**
Lender 5	228	1552	**14.69%**
Lender 6[12]	0	142	**0%**
Lender 7	0	9	**0%**
Lender 8	3	58	**5.17%**

Another requirement missing from RHS' guidelines was that lender QC plans must include a review of all branch offices and every loan processor, officer, and underwriter involved in processing agency guaranteed loans. In our audit, none of the eight lenders required this for agency guaranteed loans. HUD, VA, and Fannie Mae require lenders to include such reviews in QC plans for their respective agency guaranteed loans. For instance, VA requirements state that the sample must include loans processed by all officers and underwriters, as well as a random selection that includes loans from all branch offices and authorizing agents. Thus, to verify the integrity of data submitted by lenders, RHS should require lenders to review a sufficient number of agency guaranteed loans selected from all offices and employees that process them.

We also found two lenders who violated provisions that, while not required by RHS, were in their QC plans. For example, Lender 4 had a loan officer perform the QC review even though its plan stated the review would be conducted independent of the loan process. Two lenders' QC plans also stated that borrower eligibility documents for the entire QC sample would be verified with independent third parties. Lender 4 only verified suspicious information while the Lender 3 only verified a percentage of the sample of loans selected for QC review.

We had two concerns regarding this matter. First, RHS did not require lenders to include these provisions in QC reviews of agency guaranteed loans (the lenders had included these only because of HUD, VA, and Fannie Mae,

[12] Lender only provided information from July to September 2007.

with whom the lenders also conduct business, requirements that lenders' QC plans contain these provisions). Second, agency oversight efforts had not detected the lenders' lack of compliance with the QC review procedures. We discussed these issues with an RHS official who agreed that the agency's guidelines should require that lender QC reviews be performed by individuals independent of the loan operation process and that lenders should confirm the entire sample of loans selected with third parties.

Lender Compliance Review Process

Mortgage lenders could submit false borrower eligibility information undetected not only because of weaknesses in their own QC reviews but also because of weaknesses in RHS' lender compliance review (LCR) process. For example, agency officials did not detect lenders' noncompliance with their QC plans because the LCR guide lacked procedures to verify lenders complied with their plans.

To detect future instances of noncompliance, RHS should amend its LCR procedures to verify lenders complied with their QC plans. The LCR should also contain procedures to verify lenders are complying with all QC review requirements recommended in this audit report. This would include verifying that lenders are reviewing a sufficient number of agency guaranteed loans selected from all offices and employees that process them, the reviews are independent of the loan process, and lenders are confirming the entire sample of loans selected with third parties.

Another factor that contributed to the lack of detection was that field staff had not conducted all required LCRs or reviewed lenders' QC process. We examined the actions of the two field offices responsible for LCRs in the State included in our audit. Our examination disclosed that neither office had reviewed all originating lenders when performing LCRs.

One field office had not reviewed any originating lenders. The Area Director for the office stated that originating lenders were not subject to the LCR process prior to fiscal year 2007. Our review of agency guidance dating back to 1999 disclosed that this procedure was required, which a national official confirmed.

The other field office only reviewed lenders with delinquent loans that totaled more than 10 percent of all loan volume. When we were unable to find this provision in the agency's guidelines, the Area Director for that office stated that was how she interpreted the guidelines. A national official stated that agency guidelines do not contain a provision to exclude lenders based on low delinquency rates. The official added that while lenders with higher delinquency rankings should be reviewed more frequently, all active lenders are subject to review. Also, this field office only reviewed loan files and did

not review anything related to lenders' QC process, despite the LCR guide containing procedures related to the QC plan. When questioned, the Area Director for that office stated they complied with their interpretation of the guidelines.

State Internal Review Process

Rural Development requires its field staff to perform periodic reviews of State operations. These State Internal Reviews (SIR) are designed to verify agency officials' compliance with guidelines and regulations. The SIR process did not detect the deficiencies with the LCR process because the SIR guide only included procedures for determining if LCRs had been conducted within the past two years. For example, the guide did not include procedures to determine if field staff subjected all originating lenders to review and if they reviewed lenders' QC plans.

Our work in Michigan found that neither of the two field offices responsible for Single Family Housing Guaranteed Loan Program activities properly conducted the lender monitoring portions of the most recent SIRs. For instance, the SIR guide instructed field staff to randomly select the lesser of 10 percent or 5 State-approved lenders and include a corresponding chart to show the results of the review. The SIR reports we examined indicated that field staff at each office had selected only one lender for review, rather than the higher number required by agency guidelines. We determined that five lenders should have been reviewed by field staff at each office.

When we contacted the field officials who conducted the SIRs, they were unable to recall any details of the reviews. (The reviews were conducted in 2005 and 2006.) State officials were also unable to provide any additional supporting documentation for the lender monitoring portion of the reviews. Therefore, we could not determine why field staff had not followed the SIR guide and reviewed the lesser of 10 percent or five State-approved lenders.

RHS officials stated that in August 2007, they implemented additional procedures to LCR's due to concerns that field staff was not adequately monitoring lender activities. These procedures included a requirement for States to annually submit a schedule listing the LCRs of each type (originating, servicing, and combined) that will take place during an upcoming year. The schedule shows the lenders and dates of anticipated review. At the conclusion of each year, beginning with fiscal year (FY) 2008, field staff is to submit to the national office a report that lists the scheduled and completed LCRs. As of October 2, 2008, field offices had not submitted any FY 2008 reports. In our view, these additional procedures are compensating controls for weaknesses in the SIR process and should assist RHS officials in identifying States that omit originating lenders from the LCR process and should be followed.

Overall, we concluded that Rural Development will continue to be vulnerable to paying loss claims on false lender-submitted borrower eligibility documentation until it addresses control weaknesses in both lenders' QC processes and agency procedures for monitoring those processes. In FY 2008, Rural Development paid over $103 million in loss claims. By implementing QC requirements, strengthening procedures for monitoring lenders' QC processes, and strengthening supervision over field staff's lender monitoring activities, agency officials will have increased assurance that loans containing false borrower eligibility information would be detected prior to paying a loss claim.

Recommendation 1

Require lenders to notify agency officials of all instances of false documents or other serious violations found during the QC process.

Agency Response

Agency officials revised the existing instruction on February 27, 2009, and issued the "Quality Control Overview, a Reference for Reviewing QC Plans" (QC Overview) which establishes requirements for lenders' QC plans and agency staff's review and approval of these plans. The revised instruction requires that the lender's QC Plan contain provisions from the QC Overview. One provision in the QC Overview requires lenders to have procedures in place to report non-compliance to the highest levels of management and to report suspected misrepresentation to the appropriate authorities. By June 30, 2009, the agency will also amend their procedures to require lenders' QC plans to contain a provision to report serious violations to the State Director and the national office. The provision also states that if necessary, the national office will report suspected fraud to OIG for investigation and final determination.

OIG Position

We accept management decision for this recommendation.

Recommendation 2

Establish procedures to either rescind the loan guarantee or attempt loss claims recovery, in full or in part, when lenders' QC reviews identify false documents caused by lender fraud, misrepresentation or negligence.

Agency Response

Agency officials will establish indemnification procedures for loans originated by eligible lenders. The agency's indemnification procedures will be published in the Federal Register as a proposed rule by May 2010.

OIG Position

We accept management decision for this recommendation.

Recommendation 3

Require lenders to select 10 percent of agency guaranteed loans or apply statistical sampling methodology specifically to agency guaranteed loans during the QC process.

Agency Response

Agency officials revised the existing instruction on February 27, 2009, and issued a QC Overview which establishes requirements for lenders' QC plans and agency review and approval of these plans. The QC Overview states that lenders should review a minimum 10 percent of mortgage loan production quarterly. Sampling procedures should identify a representative sample of all loan products including Rural Development SFH guaranteed loans.

OIG Position

We accept management decision for this recommendation.

Recommendation 4

Require lenders to review all branch offices, including every loan processer, officer, and underwriter who processed Rural Development guaranteed loans during the QC review.

Agency Response

Agency officials revised the existing instruction on February 27, 2009, and issued a QC Overview which establishes requirements for lenders' QC plans. The QC Overview states that the preferred sample methodology shall include production from the following: (1) all branch offices; (2) all loan production sources including authorized agents, loan correspondents (new and existing), and other vendors; and (3) all employees and first payment defaults. Additionally, lenders are to perform special focus reviews to include early payment defaults, loans in foreclosure within six months of origination, and suspect employees.

OIG Position

We accept management decision for this recommendation.

Recommendation 5

Require lenders' QC reviews to be conducted by persons independent of the loan origination process.

Agency Response

Agency officials revised the existing instruction on February 27, 2009, and issued a QC Overview which establishes requirements for lenders' QC plans. The QC Overview requires the lender to have a quality control team that operates independently from loan origination/underwriting and servicing functions and reports directly to the highest level of management. The lender may contract out this function, provided the lender has controls in place to monitor the contractor's performance.

OIG Position

We accept management decision for this recommendation.

Recommendation 6

Require lenders to verify the borrower eligibility documentation for the entire sample of Rural Development guaranteed loans selected for QC review.

Agency Response

Agency officials will revise the QC Overview by June 30, 2009, to require lenders to verify new credit reports, employment, rent, and appraisals for the entire sample of SFHGLP loans selected for QC review.

OIG Position

We accept management decision for this recommendation.

Recommendation 7

Amend the lender compliance review process to monitor lender compliance with their QC plans.

Agency Response

Agency officials will amend the Lender Compliance Review Guide by June 30, 2009, to contain a provision to monitor lender compliance with their quality control plans.

OIG Position

We accept management decision for this recommendation.

Finding 2 Lenders Set Interest Rates That Exceeded Allowable Limits

Our audit disclosed that lenders had set interest rates on loans that were higher than the rate allowed by Rural Development. We determined that 4 of 6 lenders in our sample had set interest rates too high for 11 of the 123 loans we reviewed. We attributed this primarily to the agency's lack of oversight; it had no formal policy or procedures to verify that lenders were complying with agency guidelines. Consequently, some of the 246,000 low- to moderate-income borrowers with loans guaranteed by Rural Development may be paying unnecessary interest to lenders. The interest rates for the 11 borrowers in our sample were set too high by a range of 0.125 to 0.5 percent, and could cost them more than $77,000 in excessive interest over the course of their 30-year loans.

RHS allows lenders to use the interest rates published by VA or Fannie Mae as the basis for the rate charged on loans guaranteed by the agency. It also requires lenders to identify on Form RD 1980-21, "Request for Single Family Housing Loan Guarantee," whether the interest rate on the loan will be based on the VA or Fannie Mae rate, and the date the borrower agreed to set the interest rate (known as the "lock-in" date).

RHS guidelines also state that lenders using the Fannie Mae rate may not set interest rates on loans at more than 0.6 percent rounded-up to the nearest 0.25 percent of that rate on the lock-in date. For example, if a borrower locked in their interest rate on September 1, 2006, the corresponding Fannie Mae rate for that day was 6.34 percent. That rate plus the 0.6 percent, rounded up to the nearest 0.25 percent, arrives at a maximum allowable interest rate of 7 percent for loans where borrowers locked in their interest rate that day.

To determine if lenders complied with RHS' interest rate requirements, we selected 123 loans from 6 lenders for review. Our initial analysis of 68 delinquent loans disclosed that 4 lenders had set rates too high on 5 loans. Because this was a small number of loans, we selected an additional sample of 55 loans from the 4 lenders to determine if our initial results were isolated incidents, and possibly attributable to mistakes, or if they were indicative of a broader problem. Our analysis of the second sample disclosed that three of the lenders set excessive rates for six additional loans. Table 2 summarizes the results of our analyses.

Table 2

Lender	No. of Loans (Initial Analysis)	No. With Rates Too High	No. of Loans (Second Analysis)	No. With Rates Too High	Total No. of Loans	Total No. With Rates Set Too High
Lender A	24	1	24	3	**48**	**4**
Lender B	12	1	17	1	**29**	**2**
Lender C	8	2	10	2	**18**	**4**
Lender D	5	1	4	0	**9**	**1**
Lender E	5	0	0	n/a	**5**	**0**
Lender F	14	0	0	n/a	**14**	**0**
Totals	**68**	**5**	**55**	**6**	**123**	**11**

We uncovered the 11 instances of improper interest rates by first identifying the basis used by the lender for the 123 loans, which was the Fannie Mae rate in all cases, and the lock-in date. We obtained this from the lenders. After obtaining the rate basis and lock-in dates for the 123 loans, we recalculated the maximum allowable interest rate using RHS' guidelines and compared the results to the rates set by the lenders on the loans.

One example that illustrates our analysis involved a borrower who obtained a loan with a 7.5 percent interest rate that should have been set at 7 percent. In this example, the borrower locked in an interest rate on October 15, 2007. The Fannie Mae rate for that date was 6.386 percent. That rate plus the 0.6 percent, rounded up to the nearest 0.25 percent permitted by RHS, arrived at a maximum allowable interest rate of 7 percent on the loan. However, the lender had set the interest rate on the loan at 7.5 percent, 0.5 percent greater than allowed by RHS.

We questioned officials representing the three lenders that had set rates too high in both samples. (We did not approach the fourth lender because no additional instances were uncovered during our second analysis.) Officials from Lender A admitted they had used their own method rather than the agency's method to determine the maximum allowable rate. Officials from Lenders B and C stated they used the VA rate because agency regulations allowed the use of either the VA or the Fannie Mae rate. The officials for those two lenders stated they could use either rate, regardless of what they had marked on Form RD 1980-21. However, this contradicted what they had stated during our preliminary audit work. At that time, those same officials stated they used the Fannie Mae rate exclusively to set interest rates.

RHS officials informed us they were unaware of any lenders in any State that utilize the VA rate to set interest rates on loans. Since, according to RHS officials, the VA rate is not normally used by lenders, we concluded that it should be eliminated as an option for setting rates. RHS officials agreed with our conclusion and are revising agency policy to remove the VA option for setting interest rates for loans.

Based on discussions with agency officials, we concluded that agency field staff had not detected the improper interest rates because there was no requirement for them to verify lender compliance with agency guidelines. An RHS official we questioned stated that while the agency had no formal policy or procedures, it expected field staff to verify that the interest rate set by lenders was accurate and within established guidelines. However, the field staff we questioned stated that they only perform a cursory review of information submitted on Form RD 1980-21 to determine if interest rates are too high. This cursory review consisted of a visual check of the set rate to ensure that it was not significantly higher than other guaranteed loans.

In our view, RHS needs to establish formal policy to perform such reviews. RHS will need to enforce lender compliance in providing basis information and lock-in dates on Form RD 1980-21 in order for field staff to verify interest rates on loans. We formulated this conclusion because we found lenders only included both the basis and lock-in date for 15 of the 68 loans in our initial analysis. Another issue that could hinder field staff is that borrowers can opt to float the interest rate rather than lock in on a specific date. We identified 47 such instances during our initial analysis of the 68 loans. In each instance, the floating interest rate date provided by the lender on Form RD 1980-21 was not necessarily the date used to establish the interest rate on the loan. RHS will need to clarify this issue for lenders so that the date they provide on Form RD 1980-21 is the actual lock-in date established by borrowers.

We questioned RHS officials about recourse options for the 11 loans we identified with interest rates set too high. One official stated that there were no options to modify the rates because the agency had already issued the guarantees. The official added that field staff needed to identify the improper interest rates prior to issuing the loan guarantees. Once a guarantee is issued it constitutes an obligation supported by the full faith and credit of the Government and is incontestable except for lender fraud or misrepresentation.[13] Since the interest rates for the 11 loans were set too high because of lender mistakes, not fraud or misrepresentation, the agency had no option except to honor the guarantees.

[13] RD Instruction 1980.308, dated June 21, 1995.

Since the agency has no recourse against lenders once it has issued a loan guarantee, the loan closing date is the last opportunity to verify the accuracy of interest rates set by lenders. In our view, loan closing would be an appropriate time to collect the interest rate lock-in date and have the field staff verify that the interest rate on the loan note is within agency guidelines. RHS officials agreed with our conclusion and are revising agency requirements to require lenders to submit lock-in information with closing documents and for field staff to verify lenders set the interest rate in compliance with RHS' guidelines. This would be completed prior to issuing the loan guarantee.

Recommendation 8

Eliminate the VA option for determining the maximum allowable interest rate on loans.

Agency Response

Agency officials will develop a proposed rule for publication in the Federal Register by May 2010, and revise RD Instruction 1980-D, 1980.320 "Interest rate" to eliminate the option of using the VA rate for determining the maximum allowable interest rate on loans.

OIG Position

We accept management decision for this recommendation.

Recommendation 9

Establish requirement for lenders to submit documentation of the lock in date with the loan closing documents.

Agency Response

Agency officials will revise their instruction to require lenders to provide supporting documentation that shows the customers were charged the appropriate interest rate. Agency staff will be required to review the supporting documentation, prior to issuance of the loan note guarantee. The procedures will be implemented via a Procedure Notice by June 30, 2009.

OIG Position

We accept management decision for this recommendation.

Recommendation 10

Establish procedures for field staff to verify that lenders set interest rates in accordance with agency guidelines, prior to issuing the loan note guarantee.

Agency Response

Agency officials will establish procedures to obtain documentation from the lender to support the interest rate charged. Agency staff will be required to verify that the correct rate was charged prior to issuing the loan note guarantee. The procedures will be implemented via a Procedure Notice by June 30, 2009.

OIG Position

We accept management decision for this recommendation.

Scope and Methodology

We conducted our audit of the Single Family Housing Guaranteed Loan Program at the Rural Housing Service's (RHS) national office in Washington, D.C., the Michigan Rural Development State Office, and two area offices in Michigan. We visited the offices of three loan originating financial institutions in Michigan, and interviewed officials at five other institutions telephonically. (We did not visit or contact 2 of the 10 selected lenders because they had gone out of business.) We interviewed four borrowers telephonically to confirm information reported on loan applications. We also contacted 80 employers telephonically to verify income reported for borrowers on 68 loan guarantee applications. (Some of the 68 loans had co-borrowers and some borrowers had multiple employers.)

The period of our audit was from fiscal years (FY) 2005 through 2007. During that period, Rural Development guaranteed over 90,000 loans totaling nearly $9 billion. We selected the State of Michigan, in part, because of a recent Office of Inspector General investigation of a lender in the State that submitted false documents to obtain loan guarantees. The State of Michigan also guaranteed a significant number of loans during the period of our audit (over 13,500 loans) and had a significant number of delinquent loans (over 1,400 delinquent loans) as of March 2008. At that time, Michigan had the second largest number of active and delinquent loans in the country and the largest outstanding unpaid principle, nearly $1.2 billion.

We judgmentally selected 10 lenders (of the 123 originating lenders in the State of Michigan with delinquent loans as of March 2008) to perform our audit. We selected 10 lenders (4 State-approved and 6 nationally-approved) to analyze their quality control processes and verify their compliance with submitted quality control (QC) plans. Of the four State-approved lenders, we selected one because it was the only one with delinquent loans where Rural Development had conducted a lender compliance review in FY 2007, a second because it had the second largest number of loans resulting in loss claims since FY 2005, and a third because it had the second largest percentage of originated loans from FY 2005 through FY 2007 that had defaulted.[14] (We also analyzed the quality control process at the State-approved lender with the largest amount of loss claims and the largest percentage of defaulted loans, but it had gone out of business, so we were unable to verify compliance with its QC plan.)

We selected six nationally-approved lenders, one of which had gone out of business, to also verify they had properly set interest rates on loans. We selected those six because they were among the lenders with the greatest

[14] Defaulted loans are those more than 60 days delinquent.

number of delinquent borrowers in the State. From the six lenders, we judgmentally selected 123 loans to review, totaling over $12 million. We selected 68 of those loans because they were delinquent and the borrowers had either made their last loan payment between January 2007 and January 2008 or had become delinquent within 1 year after the loan was originated. We selected the remaining 55 loans because they had been made during the same time period where some lenders had set interest rates on loans that exceeded agency requirements.

To accomplish our objectives, we performed the following procedures:

- Reviewed RHS' policies related to the setting of interest rates and submission of eligibility documents by lenders;

- Reviewed applicable laws, regulations, and agency procedures to monitor lender activities related to setting interest rates and submitting accurate documentation of borrower eligibility;

- Interviewed agency officials to verify procedures used to monitor lenders as well as the procedures used to monitor agency field staff;

- Analyzed information contained in the agency's Guaranteed Loan System (Note: We did not verify the accuracy of information contained in the system and make no representation of the adequacy of the system or the information generated from it.);

- Reviewed U.S. Department of Housing and Urban Development (HUD), Veterans Administration (VA), and Federal National Mortgage Association (Fannie Mae) loan originator quality controls requirements; and

- Interviewed officials from loan originating financial institutions, officials from HUD, VA, and Fannie Mae, borrowers whose loans were guaranteed by Rural Development, and employers of those borrowers.

We performed our audit fieldwork from April to August 2008. 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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

USDA Rural Development

United States Department of Agriculture
Rural Development

JUN 12 2009

SUBJECT: Housing and Community Facilities Programs Official Draft – Controls Over Lender Activities in the Single Family Housing Guaranteed Loan Program. (Audit No. 04601-017-CH)

TO: Robert W. Young
Assistant Inspector General for Audit
Office of Inspector General

Attached for your review is a response dated April 30, 2009, from Philip H. Stetson, Acting Deputy Administrator, Single Family Housing, concerning the subject audit.

This response is being submitted to reach management decision on Recommendations 1-10 in the audit report.

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

JOHN M. PURCELL
Director
Financial Management Division

Attachment

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

Committed to the future of rural communities.

"USDA is an equal opportunity provider, employer and lender."
To file a complaint of discrimination write USDA, Director, Office of Civil Rights, 1400 Independence Avenue, S.W., Washington, DC 20250-9410 or call (800) 795-3272 (voice) or (202) 720-6382 (TDD).

USDA Rural Development

United States Department of Agriculture
Rural Development

APR 30 2009

TO: John Purcell
Director
Financial Management Division
Rural Development

FROM: Philip H. Stetson
Acting Deputy Administrator
Single Family Housing

SUBJECT: Response to OIG Audit No. 04601-~~071~~ 017-CH
Controls over Single Family Housing
Guaranteed Loan Program

Please find attached our responses and supporting documentation regarding the subject audit. If additional items are needed, please contact Joaquin Tremols, Acting Director, Single Family Housing Guarantee Loan Division, at 202-720-1465.

Attachments

1400 Independence Ave, S.W. · Washington DC 20250-0700
Web: http://www.rurdev.usda.gov

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1400 Independence Avenue, S.W., Washington, DC 20250-9410 or call (800) 795-3272 (Voice) or (202) 720-6382 (TDD).

RECEIVED
MAY 06 2009
BY: Martha Price

Audit Number – 04601-0017-CH
Agency Response Date – April 29, 2009

OIG Recommendation 1: Require lenders to notify agency officials of all instances of false documents, or other serious violations, found during the quality control process.

Agency Response: The Agency recently clarified existing procedure which requires lender/servicers to have, and follow, a quality control plan. RD Instruction 1980-D, 1980.309 (b) (1) (v) (A-B) was updated on February 27, 2009, and issued via Procedure Notice Number 427. The revised instruction references the "Quality Control Overview, a Reference for Reviewing QC Plans" (herein called QC Overview), a guide to Agency staff to provide consistency and guidance on reviewing quality control plans.

The QC Overview highlights industry standards, and best practices, and was modeled from existing Government Agencies and Government Sponsored Enterprise (GSE) guidance and training. The QC Overview requires the lender/servicer to have procedures in place to report non-compliance to the highest levels of management and to report suspected misrepresentation to the appropriate regulatory authorities. As part of the lender/servicer compliance review process, under the General Controls work papers, the Agency tests that the lender/servicers have a quality control plan in place and follows that plan.

To fully satisfy this recommendation the Agency has developed a Procedure Notice that is currently in clearance. The revised procedure requires the lender's QC Plan contain a provision to report serious violations to the State Director. The State Director will report to the National Office and, if necessary, the National Office will report suspected fraud to OIG for investigation and final determination.

See attached RD Instruction 1980-D, 1980.309(b) (1)(v)(A-B), Proposed changes to 1980.309 (b)(1)(v) (c) and Quality Control Overview.

Estimated Completion Date for publication of the PN is June 30, 2009. Based on the above information, we request management decision.

OIG Recommendation 2: Establish procedures to either rescind the loan guarantee or attempt loss claims recovery in full, or in part, when lenders' quality control reviews identify false documents caused by lender fraud, misrepresentation or negligence.

Agency Response: The Agency will implement this recommendation by developing and establishing indemnification procedures for loans originated by eligible lenders. The Agency's indemnification procedures will be published in the Federal Register as a proposed rule.

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Estimated Completion Date for publication of the rule is May 2010. Based on the above information, we request management decision.

OIG Recommendation 3: Require lenders to select 10 percent of agency guaranteed loans, or apply statistical sampling methodology specifically to agency guaranteed loans, during the quality control process:

Agency Response: The QC Overview provides guidance to Agency staff on quality control sampling and methodology requirements. Most quality control plans state that the lender should review a minimum 10 percent of mortgage loan production during a particular period of time (usually quarterly). This sampling procedure will identify a representative sample of all loan products, including Single Family Housing Guaranteed Loan Program (SFHGLP) loans. This will provide the Agency with an opportunity to determine if the lender/servicer is in compliance with Agency requirements in loan origination and servicing. In addition, the Agency is required to examine the lenders' completed quality control review as part of the lender compliance review process.

See attached RD Instruction 1980-D, 1980.309(b)(1)(v)(A-B) and Quality Control Overview.

Completion Date was February 27, 2009. Based on the above information, we request management decision and final action on this recommendation.

OIG Recommendation 4: Require lenders to review all branch offices including every loan processer, officer, and underwriter who processed Rural Development guaranteed loans during the quality control review.

Agency Response: The QC Overview describes industry standard of using a targeted sampling methodology. These samples include production from the following: (1) All branch offices; (2) All loan production sources including authorized agents and loan correspondents (new and existing) and other vendors; and, (3) All employees and first payment defaults. Additionally, lenders perform special focus reviews to include early payment defaults, loans in foreclosure within 6 months of origination, and suspect employees.

See attached RD Instruction 1980-D, 1980.309(b)(1)(v)(A-B) and Quality Control Overview.

Completion date was February 27, 2009. Based on the above information, we request management decision and final action.

OIG Recommendation 5: Require lender's quality control reviews to be conducted by person/team independent of the loan origination process.

Agency Response: This recommendation was implemented with the revision to RD Instruction 1980-D, 1980.309 (b) (1) (vi) (B), which requires the lender to have a

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quality control team that operates independently from loan origination/underwriting and servicing functions and reports directly to high levels of management. The lender may contract out this function, provided the lender has controls in place to monitor the contractor's performance.

See attached RD Instruction 1980-D, 1980.309(b)(1)(v)(A-B) and Quality Control Overview.

Completion Date was February 27, 2009. Based on the above information, we request management decision and final action on this recommendation.

OIG Recommendation 6: Require lenders to verify the borrower eligibility documentation for the entire sample of SFHGLP loans selected for quality control review.

Agency Response: This recommendation was partially implemented with the revision to 1980D, 1980.309 (b)(1)(vi)(A), and will be fully implemented by revising the QC overview to require a represented sample of SFHGLP loans to be reviewed. The current revision requires written procedures for document re-verification process, sampling methodology, consistent and timely review process, and document retention. The revised QC Overview will specify that the quality control plan must require re-verification for the sample of SFHGLP loans, through the use of new credit reports, verifications of employment, verification of rent, and appraisals (either desk or field reviews).

The quality control plan must also address other documents that may be subject to review or re-verification, such as mortgage application, title search, sales contracts, occupancy certification, previous shelter cost certifications, promissory notes, deeds of trust or mortgages, hazard and flood policies and the HUD-1.

See attached RD Instruction 1980-D, 1980.309(b)(1)(v)(A-B) and Quality Control Overview.

Estimated Completion Date for revisions to the QC Overview is June 30, 2009. Based on the above information, we request management decision

OIG Recommendation 7: Amend the lender compliance review process to monitor lender compliance with their quality control plans.

Agency Response: The Agency will adopt this recommendation by amending the compliance review guide to contain a provision to monitor lender compliance with their quality control plans. The Agency will continue to monitor lender compliance, with their quality control plans, during the lender/servicer compliance review process in accordance with RD Instruction1980.309 (g) (1). Quality control plans are tested under the General Controls work papers in the Lender/Servicer Compliance Review guide. The Agency has been performing lender/servicer quality control reviews, under the National

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Office compliance review plan, since 2004. Similarly, in 2007, the Agency issued a procedure notice and corresponding compliance review guide to complete reviews of State-based lender/servicers.

See attached RD Instruction 1980-D, 1980.309(b)(1)(v)(A-B) and Quality Control Overview.

Estimated Completion Date to amend the Compliance Review Guide is - June 30, 2009. Based on the above information, we request management decision on this recommendation.

OIG Recommendation 8: Eliminate the VA option for determining the maximum allowable interest rate on loans.

Agency Response: The Agency will adopt this recommendation and are in the process of drafting a work plan to develop a proposed rule for publication in the Federal Register. The rule will revise RD Instruction 1980-D, 1980.320 "Interest rate" to eliminate the Lender's published VA rate for first mortgage loans with no discount points." Additionally, based on initial feedback from OIG, the Agency has taken immediate steps to address the maximum interest rate that customers are charged. On September 9, 2008, a ListServ announcement titled "Maximum Interest Rates for Single Family Housing Guaranteed Loan Program" was provided to Agency staff and all approved lenders. The purpose of the ListServ was to provide guidance for calculation and documentation of eligible interest rate.

See attached ListServ Announcement.

Estimated Completion Date for completion of the rule is May 2010. Based on the above, we request management decision.

OIG Recommendation 9: Establish requirement for lenders to submit documentation of the lock-in date with the loan closing documents.

Agency Response: The Agency will develop a Procedure Notice to expand upon the guidance in RD Instruction 1980-D, 1980.320, which currently requires the lender to document the rate and the date it was determined. The expanded procedures will require the lenders to provide supporting documentation that shows the customers were charged the appropriate interest rate; and, Agency staff will be required to review the supporting documentation, prior to issuance of the Loan Note Guarantee.

Based on initial feedback from OIG, the Agency has taken immediate steps to address the maximum interest rate that customers are charged. On September 9, 2008, a ListServ announcement titled "Maximum Interest Rates for Single Family Housing Guaranteed Loan Program" was provided to Agency staff and all approved lenders. The purpose of the ListServ was to provide guidance to the Agency and approved lenders for the calculation and documentation of eligible interest rate.

See attached ListServ Announcement.

Estimated Completion Date for the Procedure Notice is June 30, 2009. Based on the above, we request management decision.

OIG Recommendation 10: Establish procedures for field staff to verify that lenders set interest rates in accordance with agency guidelines, prior to issuing the loan note guarantee.

Agency Response: The Agency will adopt this recommendation by establishing procedures to be followed by Agency staff, to obtain documentation from the lender, to support the interest rate charged. Agency staff will be required to verify the correct rate was charged prior to issuing the loan note guarantee. The procedures will be implemented via a Procedure Notice.

Additionally, based on initial feedback from OIG, the Agency has taken immediate steps to address the maximum interest rate that customers are charged. On September 9, 2008, a ListServ announcement titled "Maximum Interest Rates for Single Family Housing Guaranteed Loan Program" was provided to Agency staff and all approved lenders. The purpose of the ListServ was to provide guidance to the Agency and approved lenders for the calculation and documentation of eligible interest rate.

See attached ListServ Announcement.

Estimated Completion Date for publication of the Procedure Notice is June 30, 2009. Based on the above, we request management decision.

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Quality Control Overview

A Reference for Reviewing Quality Control Plans

The Single Family Housing Guaranteed Loan Program (SFHGLP)'s RD Instruction 1980-D, section1980.309 (b) (1) (v) requires that a lender/servicer submit a quality control plan as part of the lender/servicer approval process. This Quality Control Overview references resources available to SFHGLP field office staff to review quality control plans.

Resources:

Resources include Quality Control (QC) and fraud prevention training tools and guidance from Freddie Mac, Fannie Mae, Veterans Administration (VA), and Housing and Urban Development (HUD). The following are some valuable links or references available for lenders:

Freddie Mac Discover Gold Through Quality
Quality Control Best Practices

Freddie Mac Discover Gold Through Quality Fraud Prevention Best Practices

Fannie Mae Single Family
2007 Selling Guide
Part I: Lender Relationships
I, Chapter 1: Lender Approval (01/31/06)
(Available on www.allregs.com)

HUD Clips Chapter 7 Quality Control Plan

VA Pamphlet 26-7, Revised Chapter 1: The Lender

Agency Review of Quality Control Plans
The Single Family Housing Guaranteed Loan Division (SFHGLD) issued Procedure Notice 427, dated February 27, 2009, which enhanced guidance for Agency employees when reviewing a lender's eligibility for participating in the Section 502 Guaranteed loan program. The Agency also completes lenders'/servicers' compliance reviews in accordance with RD Instruction 1980-D, section 1980.309(g), and as part of that process, reviews QC plans.

During these reviews the State Directors should be sure that all new and existing lenders in the SFHGLP revise their QC plans to ensure that the plan includes and that the lenders are sampling and reviewing SFHGLP loans. Additionally,

the Agency must ensure that lenders using the SFHGLD's Guaranteed Underwriting System (GUS) have adequate QC and data integrity checks included in its QC process and procedures for automated underwriting systems.

General Requirements for QC Plans:

1. Must be in writing outlining policies and procedures along with any forms and checklists used in the process.
2. Employees must operate independently of loan origination and servicing departments or the lender/servicer may contract out this function. If the function is contracted out, the lender must adequately monitor the performance of the contractor.
3. Have procedures to report non-compliance to the highest levels of management. May be monthly or at the most a quarterly basis.
4. Have procedures to report non-compliance or suspected misrepresentation to the appropriate regulatory authorities.
5. Identify training opportunities for lender/servicer staff.
6. Set timeframes for review and follow-up procedures.
7. Have procedures in place to monitor any third party originators (TPOs).
8. Include a consistent process to sample, select, and review SFHGLP loans.

Policies/Procedures and Checklist Requirements

During the QC process, review of loan origination files should result in a determination that prudent lending practices are used by the lender/servicer.

The QC plan may include checklists to effectively and efficiently review loans. It should include standard reporting on a monthly or quarterly basis.

Lender/servicers must ensure that there are adequate processes in place to protect borrower information from disclosure to unauthorized parties during the quality control process.

Quality Control Methodology and Sampling Requirements

Quality control plans may use any combination of pre-closing and/or post-closing quality control reviews. Typically, a quality control review selection should be made on a monthly basis, so that any corrective actions may be implemented as soon as possible.

The sampling method should at a minimum include 10% of mortgage loan production. Sampling procedures should indentify a representative sample of all

loan products; including SFHGLP loans. For post-closing reviews, loans should be reviewed within 90 days of the promissory note date.

Sampling Methods:

A targeted sample is the preferred method for SFHGLP loan samples, however, lenders may use random sampling (simple, systematic or stratified).

The sample should include:

1. All branch offices and all loan production sources including authorized agents and loan correspondents;
2. All employees;
3. Loans that miss the first payment; and,
4. New correspondent lenders or other vendors.

As a special focus a lenders' quality control plan should include performing Early Payment Default Quality Control Reviews, on early payment default loans that are 60 days past due within 6 months of loan closing, loans in foreclosure and loans with loss claims paid within the past 24 months.

Note: State Directors should be sure that quality control plans include at a minimum the information above. However; detailed information the method of loan selection performed by lender/servicers can be found in the guides mentioned in the resource section of this overview.

Loan Origination Document Re-verification Process

The QC program should include a review for completeness and accuracy and include a re-verification of underwriting and closing documents. Loans run through an automated underwriting system should have a data integrity check which verifies loan documents against the final submission of the loan.

The following documents should be listed in the quality control plan for re-verification:

1. A new credit report
   - May be full credit report or a merged in-file credit report and must be obtained for each borrower whose loan is included in the QC review.
1. Verification of Employment
2. Verification of Income
3. Appraisals
   - The plan should detail the number of desk and field reviews per review period.

Other documents or certifications subject to review and re-verification, if deemed necessary, may include:

1. Mortgage application
2. Title searches
3. Sales contracts
4. Occupancy certifications
5. Previous shelter cost certifications
6. CAVIRS
7. Source of funds (ex. Gift letters)

Loan Closing Documents:

Items which should be reviewed for completeness and accuracy:

1. Promissory Notes
2. Deeds of Trust and mortgages
3. Title binders
4. Hazard and flood policies
5. HUD-1

FAQ's

1. Does the lender/servicer need a quality control plan that mentions the review of Rural Development loans?

   Yes. We have found in lender/servicer compliance reviews that lenders may not sample a representative sample of loan types. This oversight does not allow the lender/servicer to adequately measure risk.

2. Do we need to review quality controls plans at both lender/servicer approval and lender/servicer compliance reviews?

   Yes. Review the QC Plan Policies and Procedures and the most recently completed QC report during the compliance review.

3. Does the plan need to address training, and, if so, what types?

   Yes. Training should be provided to lender/servicer staff on industry updates to loan processing, underwriting, and servicing updates, and fraud prevention.

4. Who may I call for further assistance?

   Feel free to contact the SFHGLP by calling the Division telephone number (202) 720-1452. Or you may contact: Susanne Wilson, susanne.wilson@wdc.usda.gov; Stuart Walden, stuart.walden@wdc.usda.gov; or, Michelle Corridon, michelle.corridon@wdc.usda.gov.

RD Instruction 1980-D
§1980.309 (a) (Con.)

(3) Any Lender approved as a supervised or nonsupervised mortgagee for the VA;

(4) Any Lender approved by Fannie Mae for participation in one to four family mortgage loans;

(5) Any Lender approved by Freddie Mac for participation in one to four family mortgage loans;

(6) An FCS institution with direct lending authority; and

(7) Any Lender participating in other RHS, Rural Business-Cooperative Service, Rural Utilities Service, and/or Farm Service Agency guaranteed loan programs.

(b) Lender approval. A Lender listed in paragraph (a) of this section must request a determination of eligibility in order to participate as an originating Lender in the program. Requests may be made to the State Office serving the State jurisdiction or to the National Office when multiple State jurisdictions are involved.

(1) The Lender must provide the following information to RHS:

(i) Evidence of approval, as appropriate, for the criteria under paragraph (a) of this section, which the Lender meets.

(ii) The Lender's Tax Identification Number.

(iii) The name of an official of the Lender who will serve as a contact for RHS regarding the Lender's guaranteed loans.

(iv) A list of names, titles, and responsibilities of the Lender's principal officers.

(v) An outline of the Lender's internal loan criteria for issues of credit history and repayment ability and a copy of the Lender's quality control plan for monitoring production and servicing activities. State Directors are responsible for

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(Revision 1)

reviewing the quality control plan to ensure it contains the minimum following items, also referenced in the Quality Control Overview which provides the format and content for the Agency review of lender/servicer quality controls plans: (Revised 02-27-09, PN 427.)

(A) Written procedures for document re-verification process, sampling methodology, consistent and timely review process and document retention, and

(B) Has a quality control team that operates independently from loan origination/underwriting and servicing functions or contract out this function.

(vi) An executed Form AD 1047, "Certification Regarding Debarment, Suspension, and Other Responsibility Matters - Primary Covered Transactions."

RD Instruction 1980-D
§1980.309 (a) (Con.)

(3) Any Lender approved as a supervised or nonsupervised mortgagee for the VA;

(4) Any Lender approved by Fannie Mae for participation in one to four family mortgage loans;

(5) Any Lender approved by Freddie Mac for participation in one to four family mortgage loans;

(6) An FCS institution with direct lending authority; and

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(1) The Lender must provide the following information to RHS:

(i) Evidence of approval, as appropriate, for the criteria under paragraph (a) of this section, which the Lender meets.

(ii) The Lender's Tax Identification Number.

(iii) The name of an official of the Lender who will serve as a contact for RHS regarding the Lender's guaranteed loans.

(iv) A list of names, titles, and responsibilities of the Lender's principal officers.

(v) An outline of the Lender's internal loan criteria for issues of credit history and repayment ability and a copy of the Lender's quality control plan for monitoring production and servicing activities. State Directors are responsible for

10

reviewing the quality control plan. A Quality Control Overview document is available to assist Agency employees on the review of lender/servicer quality control plans. The quality control plan must contain the necessary features as required by the approving organizations listed in 1980.309(a)(1)-(5) of this subpart. These features include but are not limited to the following:
(Revised xx-xx-xx, PN xxx.)

(A) Written procedures for document re-verification process, sampling methodology, consistent and timely review process and document retention.

(B) Has a quality control team that operates independently from loan origination/underwriting and servicing functions or contract out this function.

(C) Written procedures to report violations of laws or regulations, false statements, and program abuses directly to appropriate authorities including the State Director. The State Director will provide this information to the National Office SFHGLP Director.
(Revised xx-xx-xx, PN xxx.)

(D) Ensure adequate quality control and data integrity checks are included for loans processed through automated underwriting systems.
(Revised xx-xx-xx, PN xxx.)

(E) Adequate monitoring of all vendors or contractors involved in the origination process.
(Revised xx-xx-xx, PN xxx.)

§1980.309 (b) (Con.) RD Instruction 1980-D

(2) The Lender must agree to:

(i) Obtain and keep itself informed of all program regulations and guidelines including all amendments and revisions of program requirements and policies.

(ii) Process and service RHCDS guaranteed loans in accordance with Agency regulations.

(iii) Permit RHCDS employees or its designated representatives to examine or audit all records and accounts related to any RHCDS loan guarantee.

(iv) Be responsible for the servicing of the loan, or if the loan is to be sold, sell only to an entity which meets the provisions of paragraph (a) of this section.

(v) Use forms which have been approved by FHA, Fannie Mae, Freddie Mac, or, for FCS Lenders, use the appropriate FCS forms.

(vi) Maintain its approval if qualification as an RHCDS Lender was based on approval by HUD, VA, Fannie Mae, or Freddie Mac including but not limited to maintaining the minimum allowable net capital, acceptable levels of liquidity, and any required fidelity bonding and/or mortgage servicing errors and omissions policies, and properly administering an acceptable quality control plan including a representative sample of all loans types and loan production processes, including Agency RHS loans. As required by HUD, VA, Fannie Mae, or Freddie Mac, as appropriate.
(Revised xx-xx-xx, PN xxx.)

(vii) Operate its facilities in a prudent and business-like manner.

(viii) Assure that its staff is well trained and experienced in loan origination and/or loan servicing functions, as necessary, to assure the capability of performing all of the necessary origination and servicing functions.

RD Instruction 1980-D
§1980.309 (b)(2)(ix) (Con.)

(ix) Notify RHCDS in writing if the Lender:

(A) Ceases to meet any financial requirements of the entity under which the Lender qualified for RHCDS eligibility;

(B) Becomes insolvent;

Rural Development

SFH Origination News

From the National Office in Washington DC

Single Family Housing Guaranteed Loan Programs

September 9, 2008

Maximum Interest Rates for Single Family Housing Guaranteed Loan Program

The Agency and approved participating lenders must adhere to RD Instruction 1980-D, section 1980.320 when calculating the maximum interest rate allowed for Single Family Housing Guaranteed Loan Program (SFHGLP) loans.

Currently, RD Instruction 1980-D, section 1980.320 provides two options for selecting the interest rate. Lenders may select the higher of the two options to establish the *maximum* allowable rate. Only interest rates at or below this maximum threshold may be locked.

1. Current Fannie Mae rate as defined in section 1980.302(a) of RD Instruction 1980-D
2. Lender's published VA rate for first mortgage loans with no discount points

The preferred interest rate cap most widely used is the Fannie Mae ninety day delivery rate plus sixty basis points rounded up to the nearest quarter of one percent. See RD Instruction 1980-D, section 1980.302(a) and Instruction 440.1, Exhibit B, footnote number nine. Fannie Mae historical rates may be found on the internet at: https://www.efanniemae.com/sf/refmaterials/hrny/

VA does not publish a daily interest rate, therefore lenders should refer to published rates offered by their institutions. The correct VA rate to select is the "par" rate with no discount points. If using the VA rate, lenders should document it with their rate sheet on the date the rate was locked.

In all cases, lenders are responsible for documenting the date the interest rate is locked. The lock date is the date on which lenders and borrowers agree to a specific interest rate. **The date the rate is locked will be utilized to calculate the maximum allowable interest rate.** I

Loan Note Guarantees will not be issued for loans closed outside of the acceptable interest rate thresholds.

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