

UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL

STATEMENT OF PHYLLIS K. FONG

Inspector General

Before the

COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON RURAL DEVELOPMENT, BIOTECHNOLOGY,
SPECIALTY CROPS, AND FOREIGN AGRICULTURE

U.S. HOUSE OF REPRESENTATIVES

June 10, 2009



Good morning, Chairman McIntyre, Ranking Member Conaway, and Members of the Subcommittee. Thank you for inviting me to testify about our work at the U.S. Department of Agriculture (USDA) Office of Inspector General (OIG) regarding oversight of the American Recovery and Reinvestment Act of 2009 (Recovery Act)¹ funds provided to USDA's Rural Development programs. USDA OIG is directly responsible for continuous oversight of USDA's vast programs and operations; in fiscal year 2008, the Department had expenditures of approximately \$95 billion and approximately 90,000 employees. USDA alone received \$28 billion in Recovery Act funding for a broad array of Department programs and operations, ranging from rural development programs, nutrition assistance, and watershed activities, to wildfire management and broadband activities. Nine separate USDA programs or accounts received at least \$300 million in supplemental funding.

I will begin my testimony with an overview of our plan to conduct oversight of USDA Recovery Act activities and report our results. I will then summarize the results of several specific audits we have completed relating to Rural Development's Recovery Act programs as well as work that is in process and planned.

I. USDA OIG's Oversight Plan for USDA's Recovery Act Activities

We have developed a number of actions to enable OIG to provide timely and effective oversight of USDA's Recovery Act expenditures. In addition to the efforts described below, we conducted immediate outreach to the Department—including meetings with the top officials of the relevant USDA agencies—to advise them of OIG's plans and to solicit their input on where our efforts would be most effective. We are providing them with information on oversight "best practices" as they come to our attention. For example, we provided USDA agencies with a recently issued guide to grant oversight and best practices for combating grant fraud and with information related to a fraud scheme pertaining to Recovery Act funds.

¹ H.R. 1, Public Law 111-5, February 17, 2009.

Summarized below are the major elements of our oversight plan, organized by audit and investigative activity.

A. Recovery Act Oversight at USDA: Audits

We are focusing on key elements such as whether USDA agency officials have established proper internal control procedures and compliance operations, as well as reviewing whether participants in Recovery Act-related programs meet eligibility requirements. OIG's audit work will be conducted in multiple phases based on USDA's Recovery Act activities and expenditures.

Phase 1:

- 1) In recent years, OIG has made audit recommendations on virtually every USDA program that will receive Recovery Act funding. We assessed the extent to which USDA agencies implemented our recommendations to determine whether program weaknesses have been corrected. In cases where OIG's recommendations were not fully implemented, we worked with agency officials to identify the corrective action necessary to ensure effective controls on USDA's Recovery Act expenditures. (The results of this work for Rural Development are described in subsequent sections of this testimony.)
- 2) We expanded the scope of audits that were already in process or planned for USDA programs receiving Recovery Act funds. Among them are reviews of the Farm Service Agency's oversight of farm loans; Rural Development programs for single family housing, business and industry loans, and water and waste disposal programs; the Forest Service's wildland firefighting program; and the Food and Nutrition Service's Supplemental Nutrition Assistance Program (SNAP).
- 3) We are expediting the completion and release of several audits related to Recovery Act-funded programs, including Rural Development's broadband

program and the rehabilitation of flood control dams by the Natural Resource Conservation Service. (The results of our work for broadband are described in subsequent sections of this testimony.)

Phase 2:

- 1) We are designing new audits to specifically review various aspects of the programs receiving Recovery Act funding.
- 2) We are reviewing each USDA agency's Recovery Program Plan and then will develop targeted oversight initiatives.
- 3) Our newly formed Data Analysis and Data Mining group will begin its Recovery Act-related oversight by analyzing data pertaining to Rural Development's Single Family Housing Direct Loan Program.

Phase 3:

We will evaluate the determinations USDA agencies make about the effectiveness of their Recovery Act activities by analyzing their performance measures with respect to outcomes.

B. Recovery Act Oversight at USDA: Investigations

Our Recovery Act investigative efforts will emphasize preventing and identifying fraud, initiating timely investigations when potential criminal activity occurs, and responding to whistleblower reprisal complaints from non-Federal employees. OIG will work with U.S. Attorneys and States Attorney General Offices to prosecute violators and seek asset forfeiture when appropriate.

Phase 1:

- 1) OIG agents are increasing the fraud awareness briefings they conduct for agency personnel and will be distributing information to program stakeholders

on our investigative capabilities and the avenues available for citizens to report Recovery Act-related fraud.

- 2) Our National Computer Forensic Division will be assisting in fraud identification related to USDA's Recovery Act programs, such as matching our audit data mining results against external data bases.
- 3) We are actively participating on national and regional task forces such as the Contract and Procurement Fraud Task Forces and the Mortgage Fraud Task Forces. These organizations increase OIG's ability to identify fraud and partner with other Federal/State investigators and prosecutors.
- 4) OIG is continuing close liaison with USDA agencies to identify fraudulent activities and coordinate with their compliance and investigations units for joint investigations, as appropriate.
- 5) We will use OIG's Hotline as a source of information on potential criminal activity affecting USDA's recovery activities. Each month, our Hotline staff receives approximately 275 contacts and performs an initial assessment of the complaints and allegations to determine the level of OIG investigative inquiry that is warranted. OIG is separately tracking complaints regarding Recovery Act funding and related whistleblower reprisal complaints.

Phase 2:

- 1) After assessing the results of the initiatives described above (and information revealed by our Recovery Act-related audit work), we will open criminal investigations, as appropriate.
- 2) We will work to ensure that entities involved in criminal or serious misconduct are held accountable via criminal and/or civil prosecution, asset forfeiture, agency fines, and administrative sanctions (suspension/debarments, etc.).

C. Reporting OIG's Recovery Act Activities and Results

We recognize the importance of timely reporting by IGs about Recovery Act-related activities. Fulfilling our reporting obligations under the Recovery Act will assist agency heads and congressional oversight committees in carrying out their responsibilities. We will therefore alert USDA officials to program integrity and efficiency problems as quickly as possible to expedite corrective actions. We will incorporate the Recovery Act's new requirements regarding whistleblower reprisal complaints into our semi-annual reports to Congress. As provided by Office of Management and Budget (OMB) guidance, OIG is separately reporting our use of Recovery Act monies and other funds for Recovery Act-related activities in our reports and "Recovery.gov" submissions.

We have instituted a new process to timely issue audit reports related to Recovery Act funds. As we perform our audits, if we identify an issue that could/should be addressed quickly by program officials to prevent fraud, waste, or mismanagement, we will produce a report recommending immediate action. These quick turn-around reports can then be rolled up into consolidated reports. (Examples of these reports are detailed in subsequent sections of this testimony.)

II. Recovery Act-Related Audit and Investigative Work for Rural Development

Rural Development has significant responsibilities related to the Recovery Act. The agency has been charged with administering \$4.36 billion in recovery funds, that when implemented will deliver more than \$20 billion in loans and grants to improve economic opportunity and the quality of life in rural America. Loans and grants will be awarded to build high-speed broadband infrastructure; construct or improve rural water and waste disposal systems; finance homes for rural families; build critical community facilities, such as rural hospitals, community centers, and public safety facilities; and fund new rural business ventures.

A. **Broadband**

In March 2009, we released our report² on the broadband loan and loan guarantee program. This work was initiated at the request of Congress to determine if the Rural Utilities Service (RUS) had made sufficient corrective actions in response to our September 2005 report³ and to answer specific questions posed by the House and Senate Committees on Appropriations.

We found that RUS had not fully implemented corrective action in response to our September 2005 audit report. RUS had written a proposed change to the regulation which would have addressed some of our recommendations; however, they did not implement the rule, choosing to wait for passage of the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill) to ensure that their proposed rule met the new requirements. During the period prior to enactment of the 2008 Farm Bill, RUS continued to make loans to providers in areas with preexisting service, sometimes in close proximity to large urban areas.

In its response to our report, the agency agreed to take corrective actions. However, we remain concerned with the current direction of the broadband program, particularly as it receives greater funding under the Recovery Act. As structured, RUS' broadband program may not meet the Recovery Act's objective of awarding funds to projects that provide service to the greatest number of rural residents who do not have access to broadband service.

Given our concerns, we are coordinating with both the Government Accountability Office (GAO) and the Department of Commerce (DOC) OIG. In March and April 2009, GAO initiated two audits on RUS' broadband program. DOC-OIG is currently conducting audit work to oversee the \$4.7 billion that the National

² Rural Utilities Service's Broadband Loan and Loan Guarantee Program, Audit Report No. 09601-8-Te, issued March 31, 2009.

³ Rural Utilities Service's Broadband Grant and Loan Programs, Audit Report No. 09601-4-Te, issued September 30, 2005.

Telecommunications and Information Administration has been awarded to deploy broadband using Recovery Act funds.

B. Prior Audit Recommendations

In April 2009, we reported on our initial Recovery Act oversight project, which was to review audit recommendations that could impact internal controls over Recovery Act activities for each agency.⁴ We identified recommendations where Rural Development had not implemented the agreed-upon corrective actions within the mandatory one-year timeframe. We then determined which of these recommendations, if left unresolved or not mitigated, would introduce a significant risk of inefficient or improper use of Recovery Act funding. For Rural Development, we identified 17 audit recommendations that met these criteria involving approximately \$10 billion of Recovery Act funds.

In response to our report, Rural Development itemized the actions it was taking to address the risks associated with the unimplemented recommendations related to the business and industry guaranteed loan program, the single family housing direct loan program, and the broadband grant and loan program. For example, the agency explained that corrective action for 8 of the 11 recommendations related to the business and industry guaranteed loan program is affected by the publication of the new guaranteed loan regulation. The agency also responded that, until the new regulation is published, it has taken the steps necessary to minimize the risk of loss to the program, including annual training to State offices and lenders, monitoring to ensure compliance, and periodic notices to provide instruction and clarification.

For the five recommendations related to the broadband grant and loan programs, Rural Development states that it is implementing the evaluations, oversight, and monitoring systems and procedures required for Recovery Act programs under OMB

⁴ Existing Risk to Rural Development's Economic Recovery Program, Audit Report No. 85703-1-HQ, issued April 3, 2009.

guidance. Rural Development has said it plans to have these systems and procedures in place before Recovery Act funds are obligated.

C. Single Family Housing Guaranteed Loan Program

The Rural Housing Service is responsible for distributing Recovery Act funds through the Single Family Housing Guaranteed Loan Program. As of June 3, 2009, Rural Development had obligated over \$4.3 billion to guarantee over 36,000 loans. Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure funds are expended in a manner that minimizes the risk of improper use. As of May 22, 2009, we have issued four reports related to our oversight activities of rural housing. These reports address: (1) internal control weaknesses related to the agency's Guaranteed Underwriting System (GUS); (2) waivers of the agency's debt ratio policy for borrowers participating in the program; (3) lenders' use of independent mortgage brokers ("brokers") to originate loans that are guaranteed by Rural Development; and (4) procedures used by agency field staff when reviewing and approving applications for loan guarantees. These issues will be compiled into a final report at the conclusion of our audit. During this initial phase, we did not perform testing to verify lender compliance with agency policies and procedures. As a result, we have no conclusions on the overall extent of abuse that is, or may be, occurring in the program. Our concern is that substandard loan applications could be submitted to and approved by Rural Development.

1) GUS Internal Control Weakness

In January 2007, Rural Development implemented GUS, an automated underwriting system, to streamline the process used by lenders to submit loan guarantee applications. According to agency national officials, approximately 40 percent of all applications for loan guarantees involving Recovery Act funds have been processed through GUS, compared to a historical average of 25 percent. The internal control weakness we

identified relates to the documentation requirements for lenders who submit loan guarantee applications through GUS. We found lenders do not submit documentation that supports the eligibility of borrowers for applications accepted by GUS. For example, while lenders are required to maintain supporting documents, they do not provide evidence such as employer earning statements that supports borrower income to agency officials. This type of evidence is provided when applications are manually processed by agency officials. Thus, lenders are able to enter inaccurate borrower information into GUS with minimal risk of detection by agency officials prior to approving a loan guarantee.

In response to our recommendations, Rural Development implemented additional controls for processing single family guaranteed housing loans with Recovery Act funds. For example, effective May 18, 2009, Rural Development suspended the use of Recovery Act loan funds for new conditional commitment requests so it could revise GUS quality control processes currently in place. The agency developed additional quality control standards by incorporating a pre-loan closing review of 5 percent of GUS submissions for each GUS-approved lender. The agency also plans to increase compliance testing conducted after loan closing with a focus on GUS loan origination quality. Reviews will concentrate on the participating lenders that originate a high volume of GUS loans or that may have certain GUS loan performance metrics.

2) **Waiver of Debt Ratios**

During our review, we noted that agency policy regarding the waiver of debt ratio requirements was unclear and not being administered by field staff as expected by national officials. Agency policy states that lenders are to submit a request for waivers to debt ratio requirements in writing to Rural Development and include documentation of the appropriate

compensating factors for support of sound underwriting judgment. Based on this policy, agency national officials expected field staff to obtain evidence of the compensating factors, such as bank statements for instances where the compensating factor was a large savings account. However, in the field, we observed that Rural Development staff approved lender request for waivers based only on the request and a description of the compensating factor. For example, the agency's guidelines state that the ratio of total debt to income should not exceed 41 percent; however, we identified a case where this ratio was over 60 percent. Our concern is that lenders may create or exaggerate compensating factors to justify approving a loan for a substandard borrower.

In response to our recommendations, Rural Development has stated that it will issue additional quality control procedures for its field offices. For example, manually underwritten loans with debt ratios above certain thresholds will be required to be reviewed by the loan approval official's immediate supervisor. Written supervisory concurrence will be required to be retained and/or imaged. Supporting documentation of the compensating factors will be required to be retained as part of the permanent record.

3) Lenders' Use of Brokers

The agency relies on lenders' underwriting processes to scrutinize loan applications originated by brokers. Rural Development guidance states that a lender may use agents (i.e., brokers) in carrying out its responsibilities. However, lenders are fully responsible for the actions of their agents. We are concerned that some lenders will not adequately evaluate broker-originated loans before submitting them to Rural Development officials. Our concern is based on two factors that, in our view, increase the risk that lenders will submit substandard loans to Rural

Development. The two factors are (1) the compensation method for brokers and (2) the industry practice by which originating lenders typically sell loans to other lenders after loan closing. Brokers are compensated for each originated loan. (Specific compensation depends on the brokers' contracts with the originating lenders and State regulations.) Thus, there is an incentive to submit as many loan applications as possible to originating lenders to increase the brokers' income. The agency relies on lenders to review information on applications during the underwriting process to prevent such abuse. However, those reviews may not always be effective because it is a common industry practice for originating lenders to sell the loans they make to other lenders for servicing. Therefore, some originating lenders may be less willing to dedicate resources to scrutinize loans that will be sold to other lenders. In addition, the agency generally does not deny loss claims made by servicing lenders or seek recourse against originating lenders.

In response to our recommendations, Rural Development has stated that it will increase its compliance testing with a focus on loan origination quality for loans originated by brokers. Reviews will concentrate on participating lenders that originate a high volume of loans initiated by brokers.

4) Procedures for Reviewing and Approving Applications

During our visits to four agency field offices, we observed that agency loan specialists routinely performed all functions in the loan guarantee process with no supervisory review prior to issuance of the guarantee. These functions included the review of loan guarantee applications for completeness and borrower eligibility, the approval of the application for guarantee, and the input of applications into the agency's system of records (GUS) where the obligation of funds will occur. The agency does not require a segregation of duties or supervisory (or second party) review

prior to issuance of the loan guarantee. This creates a situation where agency loan specialists and other field staff could fail to detect lender errors or collude with lending officials to guarantee substandard loans. Of greatest concern to us is that agency field staff may not detect lender errors and mistakes because of the significant loan volume associated with the distribution of Recovery Act funds. In less than two months of distributing Recovery Act funds, the agency has already exceeded the typical number of guarantees in a year. We are aware that some area offices have too few employees to adequately separate duties. For instance, one of the four offices we visited had three employees, only one of which was a loan specialist. It would be difficult to adequately separate duties in that office. However, the other three offices had five employees, four of which were loan specialists. Therefore, it would be more feasible to separate duties in those circumstances.

Rural Development did not agree with our recommendation that the agency implement segregation of duties in offices where it was feasible based on staffing levels to ensure the accuracy of all applications versus just a sample. Instead, the agency proposed additional quality control procedures to ensure a second party review is taking place on a selection of loans approved by Rural Development officials. The agency explained that this review will be performed by designated agency employees and better ensure loans originated were adequately reviewed for eligibility. OIG will continue to assess this issue as we further examine this program.

D. Work in Process and Planned

As of June 2, 2009, OIG had six Rural Development Recovery Act audits in process related to guaranteed and direct single family housing, water and waste disposal loans and grants, community facility loans and grants, business enterprise grants, and business and industry guaranteed loans. We expect to initiate as many as three

additional assignments related to housing before the end of this fiscal year. Our audit plan for fiscal year 2010 will be developed this summer and put in place by October 2009. It is likely that the fiscal year 2010 plan will include audits of Rural Development programs to determine if funding recipients complied with program requirements and to evaluate agency determinations about the effectiveness of Recovery Act activities.

This concludes my testimony. I want to thank Chairman McIntyre, Ranking Member Conaway, and Members of the Subcommittee for the opportunity to present testimony on behalf of OIG. I would be pleased to address your questions.