Department of
Veterans Affairs

Office of Inspector General

EVALUATION OF LOAN GUARANTY SERVICE'S QUALITY REVIEW SYSTEM

Veterans Benefits Administration's Loan Guaranty Service needed to improve its quality review system.

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Office of Inspector General
Washington DC 20420

DEPARTMENT OF VETERANS AFFAIRS
Office of Inspector General
Washington DC 20420

Memorandum to the Under Secretary for Benefits (20)

Evaluation of Loan Guaranty Service's Quality Review System

1. The purpose of our evaluation was to determine whether Loan Guaranty Service (LGS) had an effective quality review system. In Fiscal Year (FY) 1998, the Department of Veterans Affairs (VA) reported $70 billion in guarantees outstanding on mortgages with a face value of $203 billion. In addition, VA maintained a direct loan portfolio with an unpaid principal balance valued at $1.9 billion. The Veterans Benefits Administration's (VBA) LGS provides program policy, procedures, and operating guidance for VA's home loan program. This is one of a series of evaluations assessing VBA's quality review systems.

2. We reviewed LGS' Internal Control Review (ICR) and Statistical Quality Control (SQC) Programs as well as the activities of their lender Monitoring Unit (MU) and oversight of the contractor servicing LGS' direct loan portfolio. We identified several quality control conditions that require management attention. These conditions are summarized as follows.

- <u>LGS Management had not Periodically Updated Their Management Control Plan (MCP) or Completed ICRs</u>

  The MCP is a required plan that summarizes results of management's risk assessments and planned ICRs. The ICRs are to be completed to provide reasonable assurance that controls are in place and working. According to LGS management, ICRs are a primary method of identifying waste, fraud, and abuse. However, we found that management had not updated their MCP since 1993 and had not completed an ICR since May 4, 1996. The May 4, 1996 review had identified significant control problems with LGS' loan sales program.

- <u>SQC Reviews had not Identified Many Deficiencies</u>

  LGS implemented a revised SQC program during the 2nd quarter of FY 1999. Our review of a sample of cases previously reviewed by LGS or field stations during the 2nd quarter FY 1999 disclosed 59 deficiencies in 40 (37 percent) of the 109 cases reviewed. These deficiencies concerned compliance with LGS' policy and procedures and were not previously identified by LGS or field station reviews. For example, we found several instances where completed property appraisal forms were missing the signature of the person who had completed the appraisal. We also questioned the accuracy of timeliness calculations in several instances. The high rate of undisclosed deficiencies in the cases reviewed could be attributed in part to the newness of the quality control program and in part to the lack of thoroughness by

LGS reviewers. It is important that SQC reviews be thorough. By identifying and correcting deficiencies, SQC reviews improve the delivery of program benefits as well as support LGS' Performance Measurement Scorecard accuracy scores.

- Timely Reporting Would Improve the MU's Effectiveness

  The MU was established in 1990 to review lenders' compliance with VA underwriting policy. We found that the MU actively reviewed lender underwriting and timely sent draft reports to LGS management, but management had not issued timely final reports to the lenders. During FY 1998, the MU completed 39 lender audits and draft reports, identifying 196 instances of egregious underwriting (e.g., underwriting so bad that if given to another lender, it would not be acceptable or approved). However, as of August 1999, LGS finalized and issued only nine of the reports. For FY 1999, the MU had completed eight audits and draft reports, but as of August 1999, LGS management had not issued any of the reports. The reports are important because they frequently result in improved underwriting and in lenders indemnifying VA for egregious underwriting resulting in foreclosure or VA having to pay the guarantee. Lenders indemnify VA for the guaranteed amount of the loan resulting from egregious underwriting, currently a maximum of $36,000. LGS had timeliness standards for issuing draft reports from the MU to LGS, but no timeliness standards for the final lender audit reports.

- Oversight of Direct Loan Servicing Needed Improvement

  In June 1997, LGS outsourced servicing of its direct loan portfolio. As of September 30, 1999, the portfolio included about 29,000 direct loans with an unpaid principal balance valued at $1.9 billion. About 3,200 of these loans, with an unpaid principal balance valued at $209 million, were in serious default. VA defines seriously defaulted loans as those that are 5 or more months delinquent. The borrowers who are in serious default would need to pay $36 million to clear their outstanding delinquencies.

  Our review of a sample of 21 seriously defaulted direct loans revealed a number of contractor performance deficiencies. In 67 percent of the cases tested (14 loans), the contractor had not actively serviced the loans. Industry standards consider active servicing, such as telephone contact with the borrower, an important tool in bringing loans current. Active servicing is also required under the contract. In addition, in 33 percent of the cases (7 loans), the contractor had not timely referred seriously defaulted loans for foreclosure. Timely foreclosures assure that delinquent borrowers who continue to occupy their properties are not subsidized for extended periods of time. Finally, in 24 percent of the cases (5 loans), the contractor had not routinely monitored bankruptcy cases. When a borrower files for bankruptcy protection, they are required to make payments under a court-ordered bankruptcy plan. So long as payments are made, VA can not foreclose. However, if three consecutive payments are missed, VA can request that the bankruptcy stay be lifted. Once a stay is lifted, VA can foreclose.

  The 3,200 seriously defaulted direct loans in the portfolio included about 1,700, with an unpaid principal balance valued at $110 million, where the borrower had filed for bankruptcy protection. Foreclosure action had not yet been initiated on the remaining 1,500 seriously defaulted loans, with an unpaid principal balance valued at $99 million. On the seven loans in our sample where the contractor had not made a timely foreclosure referral, the average delinquency was 11 months, with an average unpaid principal balance of $66,900. The average amount necessary to clear the delinquencies on these loans was $6,400. For the five loans where the bankruptcy was not routinely monitored, the average delinquency was 47 months, with an average unpaid balance of $72,400. The average amount necessary to clear the delinquencies on these loans was $27,000.

In June 1997, at the time loan servicing was outsourced, LGS had established a Portfolio Loan Oversight Unit (PLOU) to monitor the contractor's performance. We found that the PLOU currently relies on the contractor's self-generated reports to evaluate its performance. However, the contractor's reports contained data that the PLOU can not validate. The PLOU also planned quarterly site visits to the contractor's headquarters, but due to limited travel resources only two visits were made during FY 1999. We also found that LGS did not monitor the servicing of potential foreclosure and bankruptcy cases to ensure appropriate and timely action was taken to prevent unnecessary loss of government funds.

3. We concluded that Loan Guaranty Service needed to improve its quality review system. As LGS reorganizes and in some instances outsources its activities, it is essential that they maintain program integrity through close oversight of not only their own operations, but those of contractors and program participants as well. During our evaluation LGS management took steps, such as clarifying SQC requirements and resuming field station surveys, that should improve their quality review system. We made a series of recommendations to further strengthen quality controls over the loan guaranty program.

4. You concurred with the findings and provided acceptable implementation plans for the recommendations. We consider the issues resolved, however, we will continue to follow up on planned corrective actions until they are completed.

For the Assistant Inspector General for Auditing,

(Original signed by:)

THOMAS L. CARGILL, JR.
Director, Bedford Audit Operations Division

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RESULTS AND RECOMMENDATIONS

Loan Guaranty Service Needed to Improve Its Quality Review System

Loan Guaranty Service (LGS) needed to strengthen quality controls over the loan guaranty program. Our review revealed several quality control weaknesses that required management attention. LGS management had not updated their Management Control Plan (MCP) in over 5 years nor had they completed required Internal Control Reviews (ICR) in over 3 years. LGS' recently revised Statistical Quality Control (SQC) program had not identified a significant number of deficiencies concerning compliance with LGS' policy and procedures. The lender Monitoring Unit (MU) had not issued timely reports identifying loan underwriting deficiencies. Finally, oversight of the contractor servicing VA's direct loans had not ensured that loans were actively serviced, foreclosed when appropriate, or routinely monitored when in a bankruptcy status. Management needed an effective quality review system to assure that program integrity is maintained over a program having a $70 billion contingent liability.

An Effective Quality Review System Can Ensure Program Integrity and Accountability

An effective quality review system should identify program deficiencies and their causes, recommend corrective action, and follow up to ensure corrective action is taken. An effective quality review system would also support the Veterans Benefits Administration's (VBA) Performance Measurement Scorecard for LGS by evaluating program activities and validating the accuracy data on which the performance measurement is based. We reviewed LGS' ICR and SQC Programs as well as the activities of their lender MU and oversight of the contractor servicing LGS' direct loan portfolio. We identified several quality control conditions that require management attention.

LGS Management had not Periodically Updated Their MCP or Completed ICRs

The MCP is a required plan that summarizes the results of management's risk assessments and planned ICRs. VBA policy states that the MCP must be developed every 5 years, and reviewed annually. We found that LGS management had not updated their MCP since 1993, which covered Fiscal Years (FYs) 1993 through 1997.

The ICRs are detailed examinations, which should be completed annually to provide reasonable assurance that controls are in place and working, applicable laws and regulations are complied with, and accountability is maintained over VA's assets. The primary reason for conducting internal control reviews is to examine high-risk areas and enable management to improve their internal controls. According to LGS management, ICRs are a primary method of identifying waste, fraud, and abuse. We noted that LGS stopped performing the annual ICRs with their June 1992 ICR. Subsequent ICRs were planned for a 2-year review cycle. However, management had not completed an ICR since May 4, 1996. The May 4, 1996 review had identified significant control problems with LGS' loan sales program. It is noteworthy that in August 1997, LGS' quality control staff requested an ICR of Loan Processing. LGS management deferred this request because of the restructuring of loan processing from 46 VA Regional Offices (VARO) to the 9 Regional Loan Centers (RLC). No subsequent ICRs of Loan Processing or any other Loan Guaranty function were requested. During our evaluation, LGS management agreed that they had not timely updated their MCP or completed ICRs. LGS management stated they planned to address this issue.

SQC Reviews had not Identified Many Deficiencies

LGS implemented a revised SQC program during the 2nd quarter of FY 1999. The SQC program includes two review levels, a first level performed by the RLC or VARO that completed the work and a second level performed by either the RLC, if a VARO completed the work, or LGS, if a RLC completed the work. The revised SQC was implemented to provide a yearly accuracy rating of each VARO and RLC Loan Guaranty Division, and to reduce quality review workload. The accuracy rating directly supports VBA's Performance Measurement Scorecard for LGS. We identified 335 loan cases, 103 cases for a RLC and 232 cases for LGS that were previously quality reviewed during the 2nd quarter ended March 30, 1999. We sampled 109 of these previously reviewed cases, 50 cases from a RLC and 59 cases from LGS. We identified a total of 59 deficiencies in 40 (37 percent) of the 109 cases reviewed. Of the 59 deficiencies identified, 24 deficiencies, or 41 percent, were attributed to the first level SQC review and 35 deficiencies, or 59 percent, were attributed to the second level SQC review. These deficiencies concerned compliance with LGS' policy and procedures and were not previously identified by LGS or field station reviews. *(See Appendix III on page 13 for a description of our sampling plan.)* The types and numbers of deficiencies are shown in the following table:

SQC Deficiency Type Noted	Total Deficiencies
Inadequate field station compliance with LGS policy and procedures	24
Accuracy of performance measurement scores	19
Accuracy of SQC recorded results	9
Inadequate lender compliance with LGS policy and procedures and Federal law	4
Lack of internal controls or system checks	2
Lack of supporting documentation	1
Total Number of SQC Deficiencies Noted	**59**

The high rate of undisclosed deficiencies in the cases reviewed could be attributed in part to the newness of the quality control program and in part to the lack of thoroughness by LGS and field station reviewers. It is important that SQC reviews be thorough. By identifying and correcting deficiencies, SQC reviews improve the delivery of program benefits as well as support LGS' Performance Measurement Scorecard accuracy scores. Some examples of the deficiencies follow:

In 24 instances, we noted that the field stations were not compliant with LGS' policy and procedures, e.g. Special Adaptive Housing (SAH) escrow agreement amendments policy and procedures. The escrow agreement is the legal document that identifies the grant amount and the disbursement information. All four sampled SAH cases had escrow agreement deficiencies for incorrect grant amounts or disbursement modifications. In October 1998, the grant amount was legislatively increased; LGS management proactively notified the field stations and issued specific procedures on amending the escrow agreements. LGS' SAH unit management concurred with the exceptions, and stated that they would correct the escrow agreement deficiencies. We also noted a lack of documentation regarding SAH mortgage life insurance approval notifications. However, we took no exception because LGS' SAH unit management had taken corrective action by instituting a notification process with the VA Insurance Center. Other exceptions noted were missing signatures and dates on completed property appraisal forms, information discrepancies on VA forms, use of outdated VA forms, and incomplete or missing field station SQC results that serve as the basis for LGS' (second level) SQC reviews.

In 19 instances, we questioned the accuracy of performance measurement or elapsed timeliness scores. Through the SQC review, LGS evaluates eight elapsed timeliness scores on various LGS processes. These elapsed timeliness scores are not associated with the Performance Measurement Scorecard. LGS management stated that the elapsed timeliness scores are a management tool for field station management to assess the efficiency of their operations. We noted 11 exceptions in the first level field station review. We found that timeliness scores were inaccurate because field station staff calculated timeliness on calendar days versus actual working days. LGS management concurred with these exceptions and took corrective action by clarifying the SQC requirements with the field stations. Also, we noted eight exceptions on the second level LGS review. We found that the second level reviews performed by LGS had not verified the accuracy of the timeliness scores. LGS management stated that because of their timeliness standards, generally a 2-day standard processing time, it was unnecessary to verify the field station's timeliness calculations. However, we noted on these exceptions that 2-day timeliness standards were not being met, and in two instances the processing times were over 40 days. LGS clarified the elapsed timeliness reporting standards with the field stations. LGS needed to ensure that the second level SQC reviews verified the accuracy of the timeliness reporting scores and identified whether LGS' elapsed timeliness standards were being met.

In four instances, we noted inadequate lender compliance with LGS' policy and procedures, and Federal law. These exceptions related to lenders' untimely submission of required documents, or inaction in correcting loan documents. Two of the loan exceptions pertained to one lender who submitted the required closing documents 5 months after the allowable 60-day period. LGS management stated that Federal regulations only specify that the lender must certify the loan is current when submitting the documents. While the lender had requested an extension and certified the loan was current, we believe that the amount of time the lender took to submit required documents was unacceptable. LGS should closely monitor lender reporting to ensure that if patterns of late reporting do exist, they are identified and corrected.

Also, we noted that in general the prior SQC results were not filed in the loan folder, making it difficult to perform a second level SQC review. We believe that filing the SQC results in the loan folder is important because without the prior review sheets LGS cannot verify the accuracy and timeliness of the prior SQC results. LGS management agreed that it is a quality control issue to maintain the SQC results in the loan folder.

At the beginning of our evaluation, we noted that LGS had not performed field surveys in many years and management did not plan to resume those surveys. The purpose of the field surveys had been to determine the effectiveness and efficiency of management practices and identify areas needing improvement. Subsequent to our initial discussions, LGS resumed the field surveys on July 13, 1999. LGS management agreed that the field surveys are a good opportunity to validate the field stations' Performance Measurement Scorecard data, and follow up on deficiencies identified in prior SQC reviews. LGS management planned to address these areas during future field surveys.

Timely Reporting Would Improve the MU's Effectiveness

The MU was established in 1990 to review lenders' compliance with VA underwriting policy. We found that the MU actively reviewed lender underwriting and timely sent report drafts to LGS management, but LGS management had not issued timely final reports to the lenders.

During FY 1998, the MU completed 39 lender audits and draft reports, identifying 196 instances of egregious underwriting (e.g., underwriting so bad that if given to another lender, it would not be acceptable or approved). However, as of August 1999, LGS finalized and issued only nine of the reports. We noted the remaining 30 lender draft reports identified 185 of the 196 instances of egregious underwriting. Two lenders had a significant number of egregious loans, one lender had 21 loans and the other lender had 43 loans. For FY 1999, the MU had completed eight audits and draft reports, but as of August 1999, LGS management had not issued any of the reports.

LGS had no timeliness standards for issuing final lender audits reports as shown in the following examples from the nine final reports issued for FY 1998.

LGS management issued a final report 317 days after receipt of the MU draft report and 447 days after the initial MU audit work was completed. The MU on-site audit work was completed during October 27-31, 1997. The MU issued a preliminary draft report to the lender on January 23, 1998, identifying two instances of egregious underwriting to be indemnified. On February 24, 1998, the lender concurred with the MU's findings. The MU submitted the draft report to LGS management on March 10, 1998. LGS management issued the final report January 21, 1999 requesting that the lender indemnify the VA for only one of the two egregious loans. LGS management removed the second egregious loan without addressing the lender's concurrence. LGS management had issued the final report about 10 months after the draft was sent from MU and about 15 months after the audit work was completed.

LGS management issued another final report 273 days after receipt of the MU draft report and 447 days after the initial MU audit work was completed. The MU on-site audit work was completed during October 27-31, 1997. The MU issued a preliminary draft report to the lender, identifying three egregious loans to be indemnified. After receiving the lender's response, the MU eliminated one of the egregious loans from consideration for indemnification. The MU submitted the draft report to LGS management on April 23, 1998. LGS management concurred with the MU and issued the final report on January 21, 1999 requesting that the lender indemnify the VA for the remaining two egregious loans. LGS management had issued the final report about 9 months after the draft was sent from MU and about 15 months after the audit work was completed.

LGS management issued another final report 169 days after receipt of the MU draft report and 243 days after the initial MU audit work was completed. The MU on-site audit work was completed during March 30-April 3, 1998. The MU issued a preliminary draft report to the lender with no recommendations for indemnification. The MU submitted the draft report to LGS management on June 16, 1998. LGS management concurred with the MU and issued the final report with no recommendations for indemnification on December 2, 1998. LGS management had issued the final report about 6 months after the draft was sent from MU and about 8 months after the audit work was completed.

Issuing timely final lender reports is important because these reports frequently result in improved underwriting and in lenders indemnifying VA for egregious underwriting resulting in foreclosure or VA having to pay the guarantee. Lenders indemnify VA for the guaranteed amount of the loan resulting from egregious underwriting, currently a maximum of $36,000. We found that LGS had timeliness standards for issuing draft reports from the MU to LGS, but no timeliness standards for the final lender audit reports.

Oversight of Direct Loan Servicing Needed Improvement

In June 1997, LGS outsourced servicing of its direct loan portfolio. As of September 30, 1999, the portfolio included about 29,000 direct loans with an unpaid principal balance valued at $1.9 billion. About 3,200 of these loans, with an unpaid principal balance valued at $209 million, were in serious default. VA defines seriously defaulted loans as those that are 5 or more months delinquent. The borrowers who are in serious default would need to pay $36 million to clear their outstanding delinquencies.

Our review of a sample of 21 seriously defaulted direct loans revealed a number of contractor performance deficiencies. In 67 percent of the cases tested (14 loans), the contractor had not actively serviced the loans. Industry standards consider active servicing, such as telephone contact with the borrower, an important tool in bringing loans current. Active servicing is also required under the contract. The following illustrates cases where the contractor did not actively service a loan.

> A loan, with an unpaid principal balance of $1,084, was transferred to the contractor on June 27, 1997. As of September 1, 1999, the contractor's records showed this loan, with a remaining unpaid principal balance of $239, was 7 months delinquent. The contractor had sent the borrower a payoff letter on December 7, 1998 quoting $315 as the balance due on the loan. This letter also revealed the borrower had an escrow balance of $1,073. The borrower made a regular monthly payment of $242 on December 14, 1998. Although the contractor received no additional payments on this loan, they made no attempt to notify the borrower that they believed he owed additional money on this loan. In fact, the contractor continued to assess monthly late fees and even disbursed a total of $2,469 to pay real estate taxes, thus increasing the borrower's delinquency to $1,797. After reviewing this loan record, we questioned the apparent inadequate servicing performed by the contractor on this loan. We were informed that after the contractor received the December 14, 1998 payment, they should have discontinued payment of real estate taxes, applied the payment of $242, applied escrow funds to the $73 remaining due, and refunded the remainder of the escrow balance. Additionally, telephonic and written contact should have been made with the borrower.

In 33 percent of the cases reviewed (7 loans), the contractor had not timely referred seriously defaulted loans for foreclosure. Timely foreclosures assure that delinquent borrowers who continue to occupy their properties are not subsidized for extended periods of time. The following illustrates cases where the contractor had not timely referred a loan for foreclosure.

> A newly established $91,322 loan, with monthly payments of $500, was transferred to the contractor on December 22, 1998. Payments were never received on this loan and it should have been referred for foreclosure by May 1999. However, the loan was not referred for foreclosure until August 6, 1999. We also noted that the contractor had not actively serviced the loan, either by telephone or other means. It would require over $3,600 (7 monthly payments plus late fees) to clear the outstanding delinquency and bring this loan current.

Finally, in 24 percent of the cases reviewed (5 loans), the contractor had not routinely monitored bankruptcy cases. When a borrower files for bankruptcy protection, they are required to make payments under a court-ordered bankruptcy plan. So long as payments are made, VA can not foreclose. However, if three consecutive payments are missed, VA can request that the bankruptcy stay be lifted. Once a stay is lifted, VA can foreclose. The following illustrates cases where the contractor had not monitored and timely foreclosed a bankruptcy case.

A $45,468 loan, with monthly payments of $412, was transferred to the contractor on June 27, 1997. The borrower was in Chapter 13 bankruptcy status at the time the loan was transferred. No payments were received under the bankruptcy plan subsequent to October 17, 1997, yet the contractor did not request the bankruptcy stay be lifted until June 29, 1998. As of September 1, 1999, the contractor had neither received any additional payments nor taken any follow up action to determine the status of their request that the bankruptcy stay be lifted. It would require over $20,000 to clear the outstanding delinquency and bring this loan current.

The 3,200 seriously defaulted direct loans in the portfolio included about 1,700, with an unpaid principal balance valued at $110 million, where the borrower had filed for bankruptcy protection. Foreclosure action had not yet been initiated on the remaining 1,500 seriously defaulted loans, with an unpaid principal balance valued at $99 million. On the seven loans in our sample where the contractor had not made a timely foreclosure referral, the average delinquency was 11 months, with an average unpaid principal balance of $66,900. The average amount necessary to clear the delinquencies on these loans was $6,400. For the five loans where the bankruptcy was not routinely monitored, the average delinquency was 47 months, with an average unpaid balance of $72,400. The average amount necessary to clear the delinquencies on these loans was $27,000.

In June 1997, at the time loan servicing was outsourced, LGS had established a Portfolio Loan Oversight Unit (PLOU) to monitor the contractor’s performance. We found that the PLOU currently relies on the contractor’s self-generated reports to evaluate its performance. However, the contractor’s reports contained data that the PLOU can not validate. The PLOU also planned quarterly site visits to the contractor’s headquarters, but due to limited travel resources only two visits were made during FY 1999. We also found that LGS did not monitor the servicing of potential foreclosure and bankruptcy cases to ensure appropriate and timely action was taken to prevent unnecessary loss of government funds. VA’s Financial and Systems Quality Assurance Service recently completed a review that revealed each foreclosure costs VBA approximately $26,000. Loan servicing deficiencies were identified as the main cause of these losses. Effective oversight is as important, if not more so, under an outsourced loan servicing arrangement. While responsibility for day-to-day operations has been shifted to an outside contractor, LGS officials remain responsible for the efficient, effective and economical management of the loan servicing activity.

Conclusion

Loan Guaranty Service needed to improve its quality review system. As LGS reorganizes and in some instances outsources its activities, it is essential that they maintain program integrity through close oversight of not only their own operations, but those of contractors and program participants as well. During our evaluation LGS management took steps, such as clarifying SQC requirements and resuming field station surveys, that should improve their quality review system.

Recommendations

We recommend that the Under Secretary for Benefits strengthen quality controls over the loan guaranty program by ensuring that LGS management:

a. Develop and maintain a current Management Control Plan to identify vulnerable LGS functions that need to be addressed.

b. Schedule and complete Internal Control Reviews of vulnerable functions.

c. Emphasize to field station and LGS staff the need to more fully comply with the requirements of Statistical Quality Control reviews.

d. Develop and implement timeliness standards for the Monitoring Unit's lender final audit reports.

e. Increase oversight of direct loan portfolio servicing to assure that the loans of delinquent borrowers are actively serviced and foreclosed when appropriate and bankruptcy cases are also monitored to allow timely foreclosure action.

Under Secretary for Benefit's Comments

The Under Secretary for Benefits concurred with the findings and recommendations.

Implementation Plan

The Under Secretary provided an implementation plan that included targeted implementation dates. *(See Appendix IV on pages 14-16 for the full text of the Deputy Under Secretary for Management's comments.)*

Office of Inspector General's Comments

The Under Secretary's implementation plan is acceptable and we consider all issues resolved. However, we will follow up on the implementation of planned corrective actions.

BACKGROUND

In Fiscal Year (FY) 1998, the Department of Veterans Affairs (VA) reported $70 billion in guarantees outstanding on mortgages with a face value of $203 billion. VA reports that it guarantees approximately 300,000 mortgage loans per year. In addition, VA maintains a direct loan portfolio that includes about 29,000 loans with an unpaid principal balance valued at $1.9 billion. VA also packages into trusts and sells shares in some of its most marketable direct loan portfolio properties. This is known as the Vinnie Mac program. The loans are sold with a guarantee that in the event of default, VA will pay the loss plus foreclosure expenses to the note holder. Since 1992, VA's loan sales activities have totaled about $9 billion.

Veterans Benefits Administration's (VBA) Loan Guaranty Service (LGS) provides program policy, procedures, and operating guidance for VA's home loan program. The primary objectives of Loan Guaranty Service are to:

- Assist veterans, certain reservists and active duty personnel in obtaining home mortgage loans from private lenders;
- Assist veterans in avoiding foreclosures; and
- Deliver loan guarantee benefits in the most efficient manner possible.

At the VA Central Office level, LGS is divided into four program groups: Construction and Valuation (C&V), Loan Policy, Loan Management, and Property Management. C&V oversees appraisals, new construction and specially adapted housing, and provides oversight to field C&V activities. Loan Policy oversees underwriting, legal issues, loan origination and approval of lenders, and provides oversight to field Loan Processing activities. Loan Management oversees loan servicing and claims issues, and provides oversight to field Loan Servicing and Claims (LS&C) activities. Property Management develops property management policies and procedures, and provides oversight to field Property Management activities.

Loan Guaranty field operations are generally organized by functions: (1) C&V reviews appraisals of property values, (2) Loan Processing determines veteran eligibility, reviews lender underwriting and loan approvals, and issues VA guarantees, (3) LS&C manages and services delinquent loans, and reviews loan holders' claims against VA guarantees, and (4) Property Management manages and sells VA acquired properties.

As of May 1999, LGS had nearly completed a workload consolidation begun in 1995. Loan Processing and LS&C functions have been consolidated from 46 VA Regional Offices (VARO) to nine Regional Loan Centers (RLC). Each of VBA's nine Service Delivery Networks includes a RLC. They are located at VAROs in Manchester, NH; Cleveland, OH; Roanoke, VA; Atlanta, GA; St. Petersburg, FL; St. Paul, MN; Houston, TX; Denver, CO; and Phoenix, AZ. C&V and Property Management functions generally remain at the VAROs. However, LGS is currently considering outsourcing the Property

Management function. Loan Guaranty also implemented a new Statistical Quality Control (SQC) system in January 1999. The SQC system is designed to promote and maintain a high level of quality and consistency to allow management to assess the accuracy of work performed. The SQC accuracy score supports LGS' Performance Measurement Scorecard. LGS management is responsible for validating the accuracy and integrity of the Scorecard.

In addition to the above mentioned field functions, Loan Guaranty has also established a Monitoring Unit (MU) at VARO Nashville and a Portfolio Loan Oversight Unit (PLOU) at VARO Indianapolis. The MU performs audits of lender underwriting. The PLOU was established in June 1997 after Loan Guaranty Service outsourced loan servicing of its direct loan portfolio. The PLOU monitors the performance of the contractor responsible for servicing Loan Guaranty's direct loan activity and acts as a liaison between the contractor, VARO Loan Guaranty activities and Regional Counsels, VA's legal entity.

OBJECTIVE, SCOPE AND METHODOLOGY

Objective

The purpose of the evaluation was to determine whether the Veterans Benefits Administration's (VBA) Loan Guaranty Service (LGS) had an effective quality review system. This was one of a series of evaluations of the VBA business lines' quality review systems.

Scope and Methodology

To assess LGS' quality review system, we evaluated its Statistical Quality Control (SQC) program. Our evaluation of the SQC focused on a population of 335 loan cases, 103 loan cases from the Regional Loan Center (RLC), Atlanta, GA and 232 loan cases from LGS that were previously quality reviewed during the quarter ending March 31, 1999. We sampled 109 of the 335 loan cases. Our evaluation focused on the quality measure of accuracy as identified in Loan Guaranty's Performance Measurement Scorecard. We did not address the quality measures of speed, unit cost, customer satisfaction, or employee development. We assessed the quality of work completed as well as the method for selecting sample sizes and sample cases. For each sampled case, we analyzed the loan case file, to determine whether cases were accurately quality reviewed. To determine whether deficiencies had been properly identified, we compared our results to those obtained by LGS. In cases where we questioned LGS' actions, we requested comments from RLC Atlanta and LGS management. This process resulted in adjustments to our preliminary exceptions. All issues were resolved and mutually agreed upon exceptions were used for our analyses.

Also, we reviewed the contractor's servicing of LGS' direct loan portfolio. We focused on a population of 3,079 seriously delinquent direct loan cases as of August 2, 1999. We sampled 21 active or recently terminated portfolio loans to determine whether the contractor was actively servicing the delinquent loans.

In addition to our samples, we also:

- Analyzed the responsibilities and potential vulnerabilities of each of Loan Guaranty's four functional areas, Construction and Valuation, Loan Processing, Loan Servicing and Claims, and Property Management.
- Reviewed VBA Performance Measurement Scorecards.
- Discussed the quality review process with LGS management and staff.
- Conducted site reviews at LGS, RLC Atlanta, Portfolio Loan Oversight Unit at VARO Indianapolis, and Monitoring Unit at VARO Nashville.

- Reviewed LGS' Management Control Plans from 1988 through the present, which includes the Internal Control Review program.

- Reviewed applicable VA policy and procedures for the sampled cases.

- Discussed the review process and potential findings at various stages of the review with VBA program officials.

The evaluation was conducted in accordance with generally accepted government auditing standards for staff qualifications, independence, and due professional care; field work standards for planning, supervision, and evidence; reporting standards for performance audits, and other field work and reporting standards which may apply.

DETAILS OF REVIEW

SAMPLING PLAN AND RESULTS

Review Universe

We surveyed the Loan Guaranty Service's (LGS) Statistical Quality Control (SQC) program at one Department of Veterans Affairs Regional Loan Center (RLC) and LGS. We identified 335 loan cases, 103 cases for the RLC and 232 cases for LGS that were previously quality reviewed during the 2nd quarter ended March 30, 1999.

Sample Design

For survey purposes, we randomly sampled 50 RLC and 59 LGS loan cases. Our sample included cases from the four primary functions of the loan guaranty program: Construction and Valuation (C&V), Loan Policy, Loan Management and Property Management. We compared the prior LGS SQC results to the veterans' loan folder. We performed an independent review of four Special Adaptive Housing loan cases from the C&V program group. We did not independently validate that the LGS universe for the selected RLC and LGS comprised the entire universe of LGS previously quality-reviewed cases. However, nothing came to our attention that would lead us to believe that any sample cases were missing from our review universe.

Sampling Results

We identified a total of 59 deficiencies in 40 (37 percent) of the 109 cases reviewed. Of the 59 deficiencies identified, 24 deficiencies, or 41 percent, were attributed to the first level SQC review and 35 deficiencies, or 59 percent, were attributed to the second level SQC review. The types of deficiencies included: inadequate field station compliance with LGS policy and procedures, accuracy and integrity of performance measurement validation, accuracy and integrity of SQC recorded results, inadequate lender compliance with LGS policy and procedures and Federal law, lack of internal controls or system checks, and lack of supporting documentation. In addition to these deficiencies, we also noted that for the most part the prior SQC results were not documented in the loan folder.

MEMORANDUM FROM THE DEPUTY UNDER SECRETARY FOR MANAGEMENT, DATED FEBRUARY 15, 2000

Department of Veterans Affairs

Memorandum

Date: February 15, 2000

From: Deputy Under Secretary for Management (20)

Subj: Draft Report, Evaluation of Loan Guaranty Service's Quality Control System (Project No. 1999-00159-R1-0157)

To: Assistant Inspector General for Auditing (52)

1. Thank you for the opportunity to review and comment on the Inspector General's draft report on the effectiveness of the Loan Guaranty Service's quality control system.

2. The Veterans Benefits Administration concurs with the five recommendations listed in the draft report. Our comments and implementation plans for each recommendation are included in the attachment to this memorandum.

3. Questions may be referred to Keith Pedigo, Director, Loan Guaranty Service, who can be reached on 202-273-7331.

/s/
Nora E. Egan

Attachment

MEMORANDUM FROM THE DEPUTY UNDER SECRETARY FOR MANAGEMENT (cont.)

Draft Report, Evaluation of Loan Guaranty Service's Quality Control System (Project No. 1999-00159-R1-0157)

Recommendation a: Develop and maintain a current Management Control Plan to identify vulnerable Loan Guaranty Service (LGS) functions that need to be addressed.

Response: A Vulnerability Assessment and Management Control Plan will be completed by March 1, 2000.

Recommendation b: Schedule and complete Internal Control Reviews of vulnerable functions.

Response: Loan Guaranty Service will resume a regular cycle of Internal Control Reviews according to the Management Control Plan to be completed by March 1, 2000. It is anticipated that at least one preliminary Internal Control Review will be conducted annually. It should be noted that this schedule may be impacted by the VBA Program Integrity Review Project.

Recommendation c: Emphasize to field station and LGS staff the need to more fully comply with the requirements of Statistical Quality Control reviews.

Response: A number of the discrepancies noted by the audit were procedural in nature and did not increase vulnerability of the program. Other inconsistencies may be attributed to the newness of the updated Statistical Quality Control (SQC) program and are expected to diminish with experience. We have scheduled an interactive televised training broadcast for Central Office Loan Guaranty Service staff and all field stations on program oversight on February 15, 2000. During that broadcast we will review the requirements for SQC reviews and stress the need for care in conducting them.

Recommendation d: Develop and implement timeliness standards for the Monitoring Unit's lender final audit reports.

Response: Written timeliness standards for the lender final audit reports will be established by March 1, 2000.

MEMORANDUM FROM THE DEPUTY UNDER SECRETARY FOR MANAGEMENT (cont.)

Recommendation e: Increase oversight of direct loan portfolio servicing to assure that the loans of delinquent borrowers are actively serviced and foreclosed when appropriate and bankruptcy cases are also monitored to allow timely foreclosure action.

Response: To ensure that portfolio loans are actively serviced, that seriously defaulted loans are referred for foreclosure timely, and that bankruptcy cases are routinely monitored to ensure timely request for relief from stay, Loan Management (LM) has established an Oversight Review Team (ORT). This team is comprised of LM, Portfolio Loan Oversight Unit (PLOU), VACO Finance, and Financial & Systems Quality Assurance Service (FSQAS) personnel. Input also will be routinely solicited from the Office of the Inspector General and General Accounting Office. The ORT will determine how many specialized onsite reviews and performance audits need to be conducted each year, as well as the scope of and organization responsible for performing each review/audit (i.e., outside contractor, PLOU, FSQAS, LM, etc.). These reviews and audits will enable Loan Guaranty Service to effect corrective change to ensure that the portfolio loan servicing contractor (PLSC) complies with the performance requirements of the contract. By ascertaining the needs and concerns of all parties involved in or charged with audit responsibility and/or oversight of the PLSC, Loan Guaranty Service oversight reviews and audits will be broader, more informative/valuable, and will be less disruptive to contractors because governmental concerns will be addressed in fewer reviews/audits. Currently, a performance audit of the portfolio loan servicing contractor [ACS Government Solutions Group, Inc./Seasons Mortgage Group (ACS/SMG)] has been awarded and is underway. This audit should be completed within the next several months.

On December 6-9, 1999, the PLOU conducted a periodic audit of SMG's servicing activities. Presently, the PLOU is discussing corrective changes with ACS/SMG regarding the issues identified in their audit report and the issues identified by the IG.

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