PROJECT NO. 14801

DATE: June 16, 2014

TO: Steven G. Smith
Director, Office of Disaster Planning and Enterprise Risk Management

From: Robert A. Westbrooks /s/
Deputy Inspector General

SUBJECT: Increase in Maximum Allowable Fixed Debt Percentages in Disaster Loans

This memorandum is to bring to your attention concerns we identified during the survey phase of OIG Project 14801 – *Targeted Review of Hurricane Sandy Loans* regarding two amendments to the agency's standard operating procedure 50 30 7, *Disaster Assistance,* that changed the maximum allowable fixed debt (MAFD) for loan eligibility. These amendments did not undergo the standard clearance process outlined in SOP 00 23 6, *Directives Management Program*, due to a provision in SOP 50 30 7, *Disaster Assistance*, that allows ODA to change policies and guidelines without advance notice. While we are not making any formal recommendations at this time, we are concerned about this provision and believe that from an enterprise risk management perspective it represents a significant internal control weakness and the Agency should implement internal controls to ensure that analyses supporting program changes are reviewed by appropriate parties and risks are identified and mitigated.

Background

In underwriting disaster loans, ODA follows guidelines specified by SOP 50 30 7 which implement the fixed debt method (FDM) lending concept used by the mortgage banking industry for determining borrower repayment ability. The FDM assumes that there is a maximum allowable fixed debt (MAFD) level that borrowers can afford, and if this level is not exceeded, the balance of gross annual income (GAI) will be sufficient to pay taxes and living expenses. When MAFD is exceeded, the borrower is unlikely to be able to pay additional debt and loan default is more likely to occur. The Agency's SOP 50 30 7 set the standard MAFD (expressed as a percentage of GAI) at 36 percent for GAI of $25,000 or less, and 40 percent for GAI greater than $25,000.

Observed Condition

ODA changed the MAFD requirements of SOP 50 30 7 through internal Memos 12-43 and 13-03. These memos did not undergo the standard clearance process outlined in SOP 00 23 6*, Directives Management Program* due to a provision in SOP 50 30 7 that allows ODA to change policies and guidelines without advance notice. Memo 12-43, issued in November 2012, increased the MAFD standard percentages, eliminated the requirement for certain increase justifications, and reduced the authorizations needed for MAFD increases. This memorandum created two new MAFD tiers based on borrower income; 45 percent for GAI of at least $45,000 but less than $60,000, and 50 percent for GAI over $60,000. Based on interviews and documentation provided by ODA, this amendment was intended to increase the volume and timeliness of disaster loan approvals. In January 2013, ODA issued Memo 13-03, which reestablished the original standard MAFD percentages in SOP 50 30 7 and authorized MAFD increases to 45 and 50 percent based on GAI levels and without any further justification of repayment ability. The memorandum, however, did not establish an upper limit on MAFD percentages. Memo 13-03 was implemented as a result of ODA's concerns that higher standard MAFD percentages, as proposed in Memo 12-43, would result in higher monthly payments for borrowers and could result in fewer borrowers eligible for preferential interest rates.

Prior to releasing these memoranda, ODA performed data analysis and prepared a business case for increasing MAFD percentages. The data analysis included portfolio analysis that demonstrated that loans made to borrowers with high credit scores have low default rates. ODA also reviewed private sector mortgage loan quality ranking data that uses credit score, debt to income percentage, loan-to-value ratio, and payment history as loan grading factors. Private sector studies indicate that a 50 percent MAFD and a credit score of 620 correlates to a "B" ranked mortgage loan. Subsequently, ODA used this correlation between debt ratio and credit score to justify the decision to increase MAFD up to 50 percent. We believe that the SOP amendments were not fully justified by this reasoning because the MAFD increases were based on income rather than credit scores. As defined in the amendments, there is not a minimum credit score requirement for a MAFD increase.

Additionally, ODA's analysis did not estimate the potential impact of the proposed MAFD changes on the disaster loan portfolio prior to the amendments. MAFD increases the risk of loan default; therefore, we believe that it would have been beneficial to the Disaster Program to perform analysis to estimate whether the MAFD increase would result in more defaults, and if so, by how much.

Furthermore, we noted the following characteristics that may present risks to the Hurricane Sandy Disaster loan portfolio:

- As of March 2014, 26 percent of Hurricane Sandy charged off loans contained MAFD increases above the original SOP 50 30 7 standards;
- There is no upper limit established for MAFD. A random sample of 135 Hurricane Sandy disaster home loans found that as of March 2014, 27 loans (20 percent) had MAFD percentages greater than 50 percent. The highest MAFD percentages were 84, 71, and 68 percent.

Conclusion

We conclude that the policies implemented to increase the MAFD percentages for the Disaster loan program may increase Agency risk by increasing the likelihood of default for Hurricane Sandy disaster loans and for any future loans made under this policy. We are also concerned that the use of the SOP change provision represents an internal control weakness and believe from an enterprise risk management perspective the agency should implement internal controls to ensure that analyses supporting program changes are reviewed by appropriate parties and risks are identified and mitigated..

If you have any questions concerning this memorandum, please call Andrea Rambow, Acting Director, Credit Programs group at (202) 205-4428.