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INTERNAL CONTROLS

VA Lacked Accountability Over Its Direct Loan and Loan Sale Activities

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The Honorable Jack Quinn
Chairman
The Honorable Bob Filner
Ranking Minority Member
Subcommittee on Benefits
Committee on Veterans' Affairs
House of Representatives

As part of our responsibility to audit the consolidated financial statements of the U.S. Government for fiscal years 1997 and 1998, we participated in the Department of Veterans Affairs (VA) Office of Inspector General (OIG) audit of the VA's Housing Credit Assistance (HCA) program. In its report on VA's fiscal year 1997 financial statements, the VA OIG described several deficiencies that contributed to the VA receiving a qualified opinion on those statements. Among the areas of concern was the level of control and accountability over HCA's direct loan and loan sale activities. Specifically, the OIG

- was unable to conclude that the $3 billion loans receivable account balance of the direct loan portfolio was fairly stated because of inadequate controls and incomplete records and
- identified a number of errors in recording loan sale transactions, including inaccurate and untimely recording of loan sales and improper accounting of loan guarantees.

VA is working to address the internal control weaknesses identified in the audit of its fiscal year 1997 financial statements, but many of the internal control weaknesses that prompted the qualified opinion have not yet been satisfactorily resolved.

As you requested, this report describes weaknesses in the level of VA's accountability and control over HCA's direct loan and loan sale activities and recommends actions needed to improve VA's internal control environment and financial and budgetary reporting for these activities.

Results in Brief

VA did not have appropriate management and operational controls in place to maintain accountability over its direct loan and loan sale activities. VA provided little oversight of contractors that were managing billions of dollars of assets on its behalf and did not ensure that revenues and

expenses were accurate or that cash receipts were deposited promptly in Treasury accounts.

When VA outsourced the servicing of its direct loan portfolio to a contractor in fiscal year 1997, it did not adequately plan or manage the transfer. It concurrently shut down its automated direct loan system and surrendered almost all hard copy loan records to the contractor without retaining basic information needed to confirm or reconcile the number and value of loans serviced by the contractor. As a result, VA was unable to appropriately manage its loan portfolio, including knowing the composition and value of its loan portfolio, reconciling cash flows, or properly monitoring the contractor's work.

Further, the data transferred to the contract servicer, which up to that point had been maintained by more than 40 VA regional offices, was incomplete and inconsistent. This immediately created loan servicing problems. There were delays in allocating payments to borrowers' accounts and in paying property taxes on behalf of borrowers as well as property taxes on VA-owned houses. Also, some borrowers did not receive year-end statements showing interest paid that would be needed for filing tax returns.

VA lacked assurance that receipts from loans were properly collected and allocated to borrowers' accounts, and did not determine the propriety of property tax expenses associated with VA-owned property and, accordingly, could not be confident that appropriate amounts were transmitted to the government. For example, VA reimbursed the contractor for property tax expenses without verifying that such expenses were appropriate and at the correct amount. In addition, VA lacked a basis for properly reconciling the financial activity reported by the contractor to the data recorded in VA's general ledger.

VA's relationship with its contractor had cash management implications. VA had allowed the contractor to open an interest bearing account and retain interest earned on government funds held by the contractor. VA also authorized the contractor to retain receipts until payments could be allocated. In addition, provisions of the servicing agreement called for the contractor to transfer loan payment collections to Treasury on a monthly rather than a daily basis, substantially delaying submission of such collections to the federal government. Both the servicing agreement and VA's subsequent authorizations to the contractor resulted in a violation of

federal law and the Treasury Financial Manual concerning timely deposits of collections.

Regarding VA's loan sale activity—in which VA packages some of its direct loans into a trust and sells shares in the trust to investors with a guarantee of full payment of principal and interest—we found that VA's failure to timely monitor the contractors that service the loans, representing roughly $9 billion since 1992, allowed servicing inefficiencies and improper actions by two servicers to cause financial losses to VA. For example, delayed reporting of loan liquidations by two servicers resulted in excessive payments to investors. Another servicer was charging unauthorized sales management and referral fees to realtors who listed foreclosed properties for sale. VA officials estimated that these two problems had cost VA more than $6 million.

We found that VA's financing and accounting for the guarantees associated with loan sales in effect masked both the existence of the estimated liability for defaulted loans as well as the sources of funds being used to finance those liabilities. Until 1997, VA had not reported or disclosed the loan sales in its financial statements or budget reports or requested funding to cover the cost of these guarantees. For example, VA funded initial cash reserves maintained by its trustee with loan sale proceeds and did not record this transaction in its financial records. VA also improperly directed its trustee to use the unreported investment income from some of the earlier trusts to replenish the reserves to finance the guarantee costs associated with more recent trusts. When that income became insufficient to cover the growing guarantee costs, VA used appropriated funds for such purposes, but lacked the information to accurately tie those costs to the fiscal year when the loans were sold (guarantees issued). Thus, it could not properly reflect costs consistent with the underlying principles of credit reform.[1]

VA has started efforts to address these deficiencies. For example, it has developed an action plan and recently contracted with a consulting firm to bring its financial and budgetary reporting into compliance with credit reform.

[1]We use the term "credit reform" to encompass the (1) Federal Credit Reform Act of 1990, which generally requires that agencies calculate and record the net present value of loans and loan guarantees in its credit programs and include the net cost to the government in the budget, (2) Statement of Federal Financial Accounting Standards No. 2, Accounting for Direct Loans and Loan Guarantees, and (3) OMB Circulars A-11 and A-34, which provide guidance to agencies for budget formulation and execution. For additional information on credit reform implementation, see GAO/AIMD-99-31, Credit Reform: Key Credit Agencies Had Difficulty Making Reasonable Loan Program Cost Estimates, January 29, 1999.

Background

VA reported in its fiscal year 1997 Accountability Report that the HCA program, managed by the Veterans Benefits Administration (VBA) under the direction of the Under Secretary for Benefits, had over $69 billion in guarantees outstanding on mortgages with a face value of $198 billion. The primary objectives of the HCA program 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 as efficiently as possible.

The loan guaranty activity is the primary activity within the HCA program. VA partially guarantees the loans in lieu of veterans making substantial down payments and meeting other conditions generally applicable to conventional mortgage transactions. VA reports that it guarantees approximately 200,000 loans per year to veterans, certain reservists, and active duty personnel.

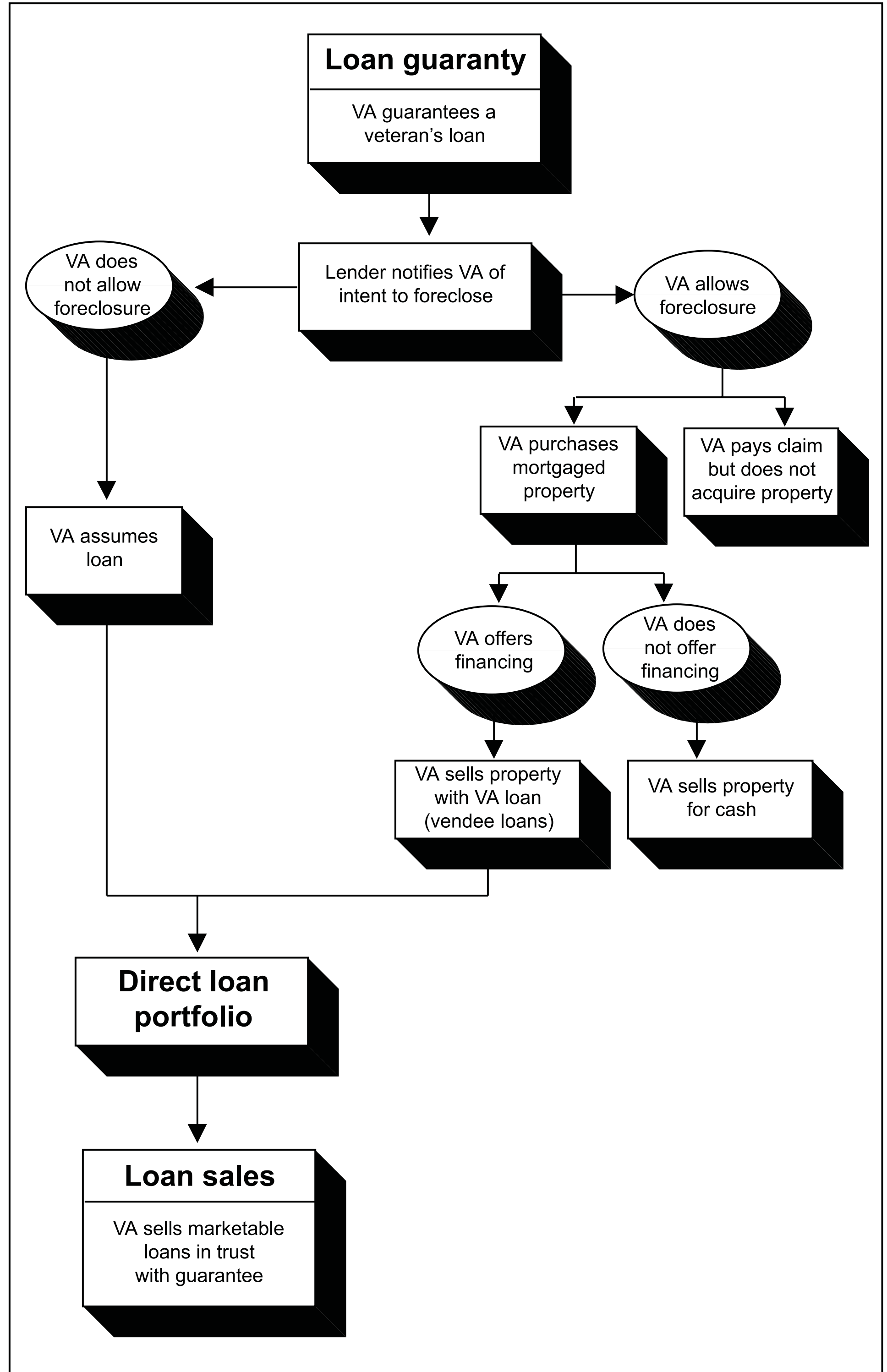
VA, through the HCA program, has responsibility for two secondary activities described in detail in this report. These activities, intended to mitigate HCA program losses, are (1) a direct loan activity with a portfolio valued at over a reported $3 billion as of September 30, 1997, and (2) a loan sale activity where a reported $1 billion of loans from the direct loan portfolio are packaged into trusts and sold to investors each year. (See figure 1.) When a financial institution notifies VA that a veteran's loan is in danger of foreclosure, VA may provide assistance to the veteran by assuming the loan and modifying the terms. The veteran then has a direct loan payable to VA rather than to the financial institution. This loan becomes part of VA's direct loan portfolio. VA estimated that it assumes 2,700 to 3,000 such loans per year.

VA also has the option of allowing foreclosure and paying the claim resulting from VA's guarantee. In cases where VA pays the claim, VA's involvement ends at this point. However, in approximately 80 percent of such cases, VA purchases the mortgaged property, having determined that it can recover part of its costs by reselling the property. At the end of fiscal year 1997, VA reported more than 16,000 such properties in foreclosure proceedings.

When these properties are resold, VA uses the proceeds to reduce the cost of the loan guaranty activity. A VA property may be sold for cash or offered with a 30-year, fixed rate mortgage. These mortgages are referred to as

vendee loans. VA reported that it sells approximately 80 percent of its properties with vendee loans and estimates that it will generate approximately 18,000 of such loans per year. Although veterans have preference in the bidding process for these properties, vendee loan financing is available to all qualified borrowers. The assumed loans and vendee loans together constitute the majority of VA's direct loan portfolio.

Figure 1: Processes Supporting VA Guaranteed Loans in the Housing Credit Assistance Program



Three times a year, VA selects marketable loans from its direct loan portfolio. The loans are packaged into a trust, and shares in the trust are sold to private investors through private sector underwriters with a guarantee of prompt payment of principal and interest owed. VA backs the guarantee with the full faith and credit of the U.S. Government. With each sale, a new trust is created, and each trust is to have a cash reserve based on the size of the portfolio sold and the terms of the sales agreement. VA reported that since 1992 it has sold approximately $9 billion of loans in this manner. Before 1992, VA sold loans under a different financing structure wherein VA retained a percentage of the ownership in the trusts. As a result of these pre-1992 loan sales, VA reports that it holds an investment valued at $318 million.

In response to a growing recognition of federal financial management problems, the Congress enacted a series of laws designed to improve financial management and the quality and use of cost data in decision-making. To address the deficiencies in recognizing the cost of credit programs, the Federal Credit Reform Act of 1990 (Credit Reform Act) was enacted as part of the Omnibus Budget Reconciliation Act of 1990. The Credit Reform Act was intended to ensure that the full cost of credit programs would be reflected in the budget so that the executive agencies and the Congress could consider these costs when making budget decisions.

Objectives, Scope, and Methodology

Our objectives were to assess the level of control and accountability over VA's HCA direct loan and loan sale activities. To address our objectives, we reviewed the VA OIG's audit documentation on the loans receivable and liability for loan guarantee line items, and interviewed VA officials from the HCA program, accounting, and budget offices. We discussed the processes for managing credit activities and recording related financial information. We compared VA's accounting practices to federal accounting standards and industry standards. We interviewed staff at the nation's largest portfolio manager of residential housing loans to obtain information on management and monitoring processes.

We analyzed VA's internal memoranda regarding planning for the transfer of the direct loan portfolio to an outside servicer, and interviewed VA staff at headquarters and regional offices as well as contractor staff. We assessed VA's monitoring of contractors' work in the direct loan and loan sale activities and reviewed VA's monitoring reports. We also reviewed a

1996 report on internal controls over loan sales, for which VA contracted with a consulting firm.

We briefed VA's management on the deficiencies in the HCA program uncovered in the audit of the fiscal year 1997 financial statements, for which the OIG issued a qualified opinion. We also obtained and reviewed information from VA about the current status of corrective actions on the reported issues.

We conducted our work from September 1997 through January 1999 in accordance with generally accepted government auditing standards.

We requested written comments on a draft of this report from the Secretary or his designee. The Secretary of Veterans Affairs provided us with written comments, which are discussed in the "Agency Comments" section and are reprinted in appendix I.

VA Lacked Accountability and Control Over Its Direct Loan Portfolio

VA did not effectively plan or carry out the transfer of its direct loan portfolio to an outside contractor for servicing in fiscal year 1997. Although outsourcing loan servicing is common, VBA officials did not sufficiently consider the control implications of transferring such a significant asset to an outside contractor.

An effective internal control structure is as important, if not more important, under outsourced loan servicing arrangements than when loan servicing is performed in house. While the authority for daily operations has been shifted to a private sector entity, cognizant agency officials remain responsible for the efficient, effective, and economical management of the outsourced activity. In this case, VA was responsible for determining the adequacy of the servicer's internal control environment, as well as establishing and maintaining its own data or data sources for comparison purposes to allow it to be confident that the activity is being managed in the best interest of the federal government. As of September 1998, about 15 months after the transfer, VA was unable to fully account for the number, value and status of direct loans in its inventory, and had been receiving payments through the servicer for several hundred loans that could not be matched to either servicer or VA loan account records. VA had not yet established adequate controls over cash collected or disbursed on its behalf by the contractor and was unable to properly reconcile the cash flows reported by the contractor to those

recorded in VA's general ledger. In addition, there were serious delays in depositing receipts to VA's account at Treasury.

Furthermore, VA had transferred incomplete and inconsistent loan data to the contractor. This situation contributed to the contractor's problems in servicing the loans and resulted in inconveniences to some borrowers. For example, there were delays in allocating payments to some borrowers' accounts and in paying property taxes on their behalf as well as paying property taxes on VA-owned houses.

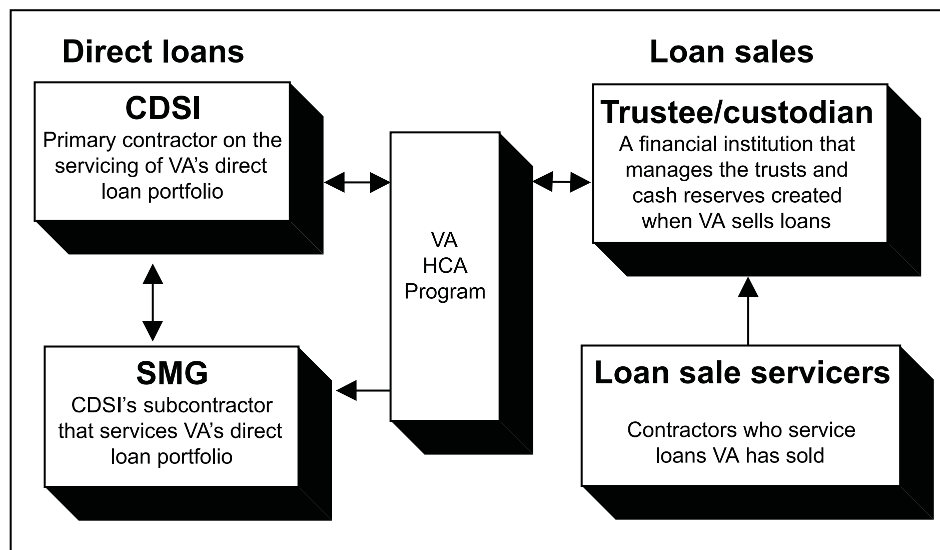
Inadequate Planning for Outsourcing

VA officials stated that in outsourcing the servicing of the direct loans in June 1997, they saw an opportunity to replace outdated systems[2] and concurrently to reduce staff. Rather than managing the loan portfolio out of more than 40 independent regional offices, the direct loan portfolio would be serviced by a private-sector contractor, in cooperation with VA's regional office in Indianapolis. The outsourcing was also seen as a way to better meet the cost data requirements for federal credit programs, since the contractor's systems offered the ability to code all loans and associated expenses and revenues by the loan origination year, necessary information for satisfying the Credit Reform Act. Because the same data are required for financial reporting, the outsourcing was also seen as a way of enabling compliance with federal accounting standards.

The outsourcing plan called for VA to transfer its direct loan portfolio to a contractor that would provide computer facilities and programs for servicing. The contractor also received records related to property still owned by VA and awaiting sale. The winning bidder, Computer Data Systems, Incorporated. (CDSI) (hereafter referred to as the contractor), had a commercial system, called the Loan Servicing Automated Management System (LSAMS), to process, service and account for mortgage loans. CDSI subcontracted with Seasons Mortgage Group (SMG) (hereafter referred to as the servicer) to service the loan portfolio, a function consisting of collecting and allocating mortgage payments from borrowers, pursuing delinquent accounts, maintaining custody of escrow accounts, paying property taxes and hazard insurance for borrowers, and transferring revenue to Treasury for crediting to VA accounts. In addition, the servicer was to pay property taxes related to VA-owned property. (See figure 2.)

[2]Starting in fiscal year 1986, the inadequacy of VA's portfolio loan system, implemented in 1964, was reported as a material weakness in VA's Federal Managers' Financial Integrity Act (FMFIA) reports.

Figure 2: Contractors Involved in VA's Direct Loan and Loan Sale Activities



In preparation for the transfer, VA supplied CDSI with a list of the data fields in VA's Portfolio Loan System (PLS), including those containing borrower names and addresses, amounts for principal, escrow and outstanding balance, and status of payments of property taxes and hazard insurance. CDSI then mapped[3] those fields onto the fields in LSAMS in preparation for the initial transfer of loan records. VA created a tape of the information in PLS and sent the tape to CDSI to be loaded onto LSAMS. VA also created a tape of information from its Property Management System (PMS) to provide CDSI with information on VA-owned properties for which it would be paying property taxes.

VA Did Not Retain Records to Account for the Number and Status of Loans

As discussed later, even though the loan data originally submitted to the contractor were not adequate for servicing purposes, VA was able to reconcile contractor and agency records on the 24,000 loans with an outstanding balance of $1.2 billion[4] that were initially transferred. However, its ability to reconcile and to provide assurance regarding the accuracy of contractor data in LSAMS deteriorated almost immediately. Right after the data transfer, VA shut PLS down, eliminating its most

[3]Mapping involves matching the fields (e.g., loan number) from one database to the fields in another database.

[4]The $1.2 billion represents only the outstanding balances on loans transferred to CDSI. For financial statement reporting, the $3 billion loans receivable account balance includes the outstanding balance for loans, VA-owned property, and accrued interest.

comprehensive source of automated information on its direct loan portfolio. Concurrently, VA management instructed staff at the regional offices to send all hard-copy loan files to the servicer, except the originals of property deeds and deeds of trust that document the loans. The intent was to aid in SMG's loan servicing. According to VA officials, although the regional offices included an inventory of loan information with the files they sent, regional staff were not advised to retain a copy of the inventory, nor did they do so. Three months after the transfer, the regional offices we visited had retained only a few files, aside from the original mortgage and title documents, regarding the loans originated in their offices.

Data Quality Problems

There were immediate problems with SMG's ability to service borrowers' accounts because of inconsistencies in how name and address information had been recorded by regional offices. The data transferred had not been critically reviewed to determine whether it would meet the contractor's data requirements, nor had the data been cleaned up prior to transfer to LSAMS. As a result, what would typically have been a straightforward procedure for developing a mailing list to send loan coupons to borrowers led to serious problems. Loan coupons were sometimes misaddressed because of name problems (e.g., "Mr. Smith John" instead of "Mr. John Smith") or address problems (e.g., the mortgaged property addresses instead of where borrowers actually lived). In some cases, insufficient information resulted in SMG not being able to contact borrowers at all. All of these factors contributed to delays in payments being made, increasing VA's financial risk. Meanwhile, borrowers were not getting information they needed. VA officials informed us that they were not able to send IRS Form 1098, the 1997 Mortgage Interest Statement tax form, to some borrowers by January 31, 1998.

A major reason for the extent of the inaccurate and incomplete data was the presumption that VA regional offices had consistently and completely entered the data into PLS. Although the regional offices had administered the direct loan portfolio for more than 30 years, we found that VA did not adequately involve them in planning for the transfer or adequately advise them of procedures to be followed after the transfer. Prior to outsourcing, VA's regional offices entered loan information in PLS according to their own preferences, because VA had not established standardized procedures. For example, some regional offices used PLS for certain loan information while maintaining other loan-related data elsewhere. Among the data that were not consistently entered in PLS were real estate tax data. This was because each regional office worked with a limited number of taxing jurisdictions

and some regional offices may have it found more convenient to maintain the data elsewhere.

SMG staff soon realized that in many cases they lacked basic information about amounts and deadlines for taxes due on VA-financed properties. Within a few months of the transfer, SMG staff notified VA that they could not ensure that property taxes would be paid on time and in full on every property. Although the contract clearly stated that late payment penalties were the servicer's responsibility, VA acknowledged that it had contributed to the delays and VA agreed to pay all penalties for late taxes. According to VA officials, during fiscal year 1998, these penalties amounted to $26,000 to $27,000 per month. VA told us that, prior to outsourcing, it had paid approximately $6,000 per month for penalties for late taxes. As of January 1999, VA and SMG were discussing available options for reducing late-payment penalties.

Concurrently, in the months immediately following the outsourcing, VA was experiencing difficulties in accounting for the loans in the direct loan portfolio. As regional staff continued to foreclose on VA-financed properties, take back foreclosed properties, resell properties with new mortgages, and assume veterans' loans, there were serious timeliness and accuracy problems in getting the necessary information to CDSI/SMG. As a result, LSAMS started presenting an incomplete picture of the loans in VA's portfolio. The major breakdown was the delay in VA providing data to SMG on loans that VA assumed when borrowers defaulted. As of September 30, 1998, LSAMS data showed that the assumed loans represented approximately 53 percent of the value of VA's direct loan portfolio. VA data showed that assumed loans often went unrecorded for extended periods because it frequently took months and even years for VA staff to receive final documents from financial institutions. In addition,VA did not thoroughly review the data for accuracy.

The process under which VA assumes a guaranteed loan has proven to be an extended task. It includes purchasing the loan from the financial institution that holds it and then typically modifying the loan terms, such as interest rates or repayment periods. Prior to the outsourcing arrangement, VA regional staff serviced assumed loans, collected the initial payments, and entered these loans in PLS.

SMG would not accept assumed loans in its system unless and until the loans were fully established.[5] After the transfer, assumed loans were not being recorded in any automated system until they were fully established. Since regional offices maintained paper files for assumptions in progress, there was no overall central reporting mechanism to establish visibility, and therefore accountability, over these loans.

VA has developed procedures for loan assumptions that VA officials believe will shorten the time it takes for it to assume VA defaulted guaranteed loans. These procedures include required settlement dates for all assumed loans within 60 days after VA approves the loan assumption request. By refusing to pay supplemental claims after 60 days, VA believed that it would increase the incentive for lenders to transfer all necessary documentation promptly.

Over the period of our fieldwork, data on assumed loans was recorded by VA's regional staff on a multipage form, which was reviewed by the Portfolio Loan Oversight Unit (PLOU) staff in Indianapolis before being entered into LSAMS. We found that PLOU's review was not an in-depth assessment, since PLOU staff maintained no loan files and were, therefore, unable to check the accuracy of important items such as payment amount, outstanding principal, amortization and escrow amount. PLOU staff informed us that they checked that all fields on the sheets were filled in and that the correct fiscal year was entered for the assumption. If errors in this basic information were found on the data sheets, PLOU staff returned the sheets to the regional offices for correction. As of September 1998, PLOU staff told us that they were having an error rate of up to 40 percent for these data sheets. This error rate further delayed loans and their associated cash payments from being recorded in LSAMS records and VA's general ledger, and understated the loans receivable balance. As discussed in a later section of this report dealing with cash management problems, such errors also resulted in delays in cash receipts for the federal government.

In July 1998, VA issued instructions to the regional offices to have the multipage form reviewed by their respective finance departments, since they have access to the vital information, before the form is sent via electronic mail to PLOU. As of December 1998, a PLOU official told us that the error rate had dropped substantially but was still about 5 to 6 percent.

[5]A loan is established when VA has a modification agreement with the veteran and has received all necessary documents pertaining to the loan.

VA also experienced problems in transmitting to LSAMS reliable data on properties previously owned by VA which had been recently sold with VA direct financing, referred to as vendee loans. Previously, there had been an electronic link between VA's Property Management System (PMS)[6] and PLS, so that as VA-owned properties were resold with VA direct financing, that information would update PLS. After the shut-down of PLS, VA created a temporary arrangement whereby a staff member would download vendee loan information monthly from PMS and transmit it to LSAMS for entry. Under this system problems such as duplicate loan numbers, which delay servicing of the loans, were not detected until the monthly transfer. As of October 1998, VA was developing an automated file transfer system with CDSI, which is intended to give VA the means to transfer this information to LSAMS automatically each month.

All of these problems negatively affected allocation of payments to the appropriate accounts. During the period of our review, we found that SMG was regularly receiving loan payments, which for the most part referenced a loan number, but SMG could not match the payments to the accounts of any borrowers in LSAMS or VA's records. In some cases, as many as 10 months of unallocated payments were involved. In September 1998, VA continued to receive payments for 289 loans that could not be found in SMG's database. VA officials told us that no records of the loans involved could be found within LSAMS or in paper files at regional offices. At that time, unallocated payments totaled over $541,000 for these 289 loans. Our analysis of these 289 loans showed that VA had received at least two payments for 154 of these loans. VA was unable to explain the nature of these loans or why they had not been recorded. Lengthy delays in getting loan data into LSAMS increased the risk that borrowers may not have been making payments on some loans and that neither the servicer nor VA would be aware of it.

VA officials reported that as of December 4, 1998, they had reduced the unallocated loan payments to approximately $160,000 and were initiating a new procedure to further reduce this total. The new procedures require the servicer to (1) hold, without depositing, loan payments that could not be allocated to a specific borrower's account and (2) return the loan payments to the borrower in cases where two or more payments were unallocated, or part of the loan number was missing, unless either VA had instituted the paperwork for the loan in process or the servicer had received e-mail instructions from one of the regional offices regarding the borrower.

[6]PMS tracks program costs on property owned by VA as a result of foreclosure.

This new procedure, however, does not address the underlying problem of VA's incomplete direct loan portfolio and creates additional cash management problems. By not depositing these checks, the federal government may not be receiving cash that it is owed. Common practice in the mortgage banking industry is to establish a suspense account for unresolved items and to deposit the checks in the bank until the appropriate research is completed and the items are allocated to the proper accounts. Creating suspense accounts heightens the visibility over the extent of the problem and establishes a control mechanism for resolving open items. This technique also would help ensure that loans originating in the regional offices are recorded in VA's loan database.

Inadequate Controls Over Assets and Cash in the Direct Loan Portfolio

Many of the problems that followed outsourcing, including the breakdown in the control environment for loan assets and cash, could have been avoided or mitigated if VA had developed a loan origination database. For example, in the mortgage banking industry such a database is commonly used to manage portfolios of direct loans and loans sold with a guarantee that are serviced by other entities. The database generally contains all loan information needed to amortize a loan, including origination date, original and current loan balance, interest rate, payment date, and term of the loan. Additional information includes the borrower's name, property and borrower's address, borrower's social security number and escrow balance on every direct loan and loan guarantee. Using a similar database as a management control for its direct loan program, VA would be able to forecast expected cash flows, and reconcile cash receipts, disbursements, and loan activity with servicer records. Discrepancies between VA and servicer's data then could be investigated and reconciled promptly.

Furthermore, VA, in the absence of such a database, did not confirm the validity and accuracy of collections and disbursements reported by the contractor by alternative means, such as examining SMG's bank statements, lockbox statements, or tax invoices. Without some kind of verification procedure, based on its own or third party information, VA did not have an independent source of data against which to test and validate the legitimacy of collection and expense amounts reported by SMG. As a result, VA had no way of knowing whether SMG was collecting all payments that were due or whether VA was reimbursing SMG for only valid expenses.

Insufficient Documentation to Perform Reconciliations

In VA's reconciliation at the end of September 1998, reflecting CDSI's entries through June 1998, VA could not reconcile differences between contractor and VA records. For example, there was a difference of almost $4 million

for loan principal outstanding. Since VA does not have either a complete list of loans, or information on adjustments made by CDSI or the regional offices, VA could not determine whether this difference was due to errors, irregularities or merely timing differences.

Cash Management Problems

Under the terms of the servicing agreement, SMG established an interest-bearing bank account in its name for the deposit of all loan payments made by VA's borrowers. As payments were received, SMG attempted to apply payments to the appropriate borrowers' accounts and allocate payments to principal, interest, and escrow amounts. The contract called for SMG to remit by wire to VA on the third business day of each month the total sum of funds collected, including all principal and interest due, with respect to payments received by SMG during the previous month. In addition, VA allowed SMG to defer remittance of any receipts that could not be allocated to loan accounts. VA also allowed SMG to keep all of the interest accrued in this account which, essentially, resulted in additional compensation to SMG. The Contracting Officer's Technical Representative (COTR)[7] told us that since the contract did not specifically require SMG to remit to VA unallocated funds until they were allocated or to remit interest earned on this account, these practices were permissible.

These unallocated funds included funds for which SMG could identify the loan account, but, for a variety of reasons, SMG did not allocate. This pool of unallocated funds remained high throughout the period of our fieldwork. For example, in October 1997, 3 months after SMG began servicing the direct loan portfolio, SMG reported $3.2 million in unallocated funds. When we questioned VA officials about the reasons for this large amount, they attributed it to "the float." They explained that loan payoffs, which required only a few days to be allocated, represented the majority of the unallocated funds, and that because new payoffs were constantly being added, the balances of unallocated amounts in SMG's account remained relatively stable.

While our limited testing did confirm that the majority of these unallocated funds were loan payoffs and the amount of unallocated funds remained relatively high but stable, we also found that loan payoffs did not always clear in a few days. For example in September 1998, we requested from SMG schedules of unallocated funds on deposit as of August 31, 1998, and February 28, 1998. On the February schedule, SMG reported over

[7]A COTR is designated as VA's authorized representative for technical monitoring and other functions of a technical nature not involving a change to the scope, price, terms, or conditions of the contract. The COTR is responsible for certifying as to the satisfactory delivery of service.

$2.5 million in unallocated funds of which loan payoffs represented $1.6 million, or 64 percent of the total. We traced loan payoffs from the February schedule to the payoffs on the unallocated schedule of August 1998. We found that approximately $618,000, or 37 percent of the loan payoff amounts on the February 1998 schedule were still unallocated 6 months later.

Allowing the contractor to deposit these federal collections in its account and the delays in transferring funds to federal accounts violates federal law. An important statute governing federal fiscal management is 31 U.S.C. 3302(b), known as the "miscellaneous receipts" statute. Section 3302(b) requires that government officials and agents of the United States government receiving money on behalf of the government from any source shall deposit the money in the general fund of the Treasury as soon as practicable without deduction for any charge or claim. As a result of section 3302(b), officials and agents of the government may retain and use funds they receive, rather than depositing them in the general fund of the Treasury, only if authorized by another law.

Subsequent legislation, the Credit Reform Act requires that cash flows to the government resulting from direct loan obligations or loan guarantee commitments made prior to October 1, 1991, go to the credit of the program's liquidating account at Treasury, which is a budgetary account. The act also requires that cash flows to the government resulting from direct loan obligations or loan guarantee commitments beginning October 1, 1991, go to the nonbudgetary financing account at Treasury associated with the related credit program. In this regard, VA has not provided us and we have not identified any statute that authorized VA to contractually or otherwise permit SMG to retain the interest earned on these government moneys as a form of compensation, instead of crediting the interest to the appropriate VA account.

Section 3302 also addresses the timing of deposits to the Treasury. Section 3302(c) requires that a person having custody of public money deposit the money in the Treasury, or in a depository designated by the Secretary of the Treasury, not later than the third day after the custodian receives the money. Subsection (c) also authorizes the Secretary of the Treasury to prescribe a greater or lesser period for deposit. The Treasury Financial Manual states that depositors should deposit funds in Federal Reserve Banks unless otherwise authorized, and that deposits should be made daily.[8] VA did not request Treasury to designate a depository before it

[8]See I TFM Sections 4010, 4015.

authorized SMG to establish a bank account and remit funds to VA only once a month. Had SMG, instead, deposited the funds it collected in a Federal Reserve Bank for credit to the liquidating and financing account on a daily basis, no interest would have accrued to SMG on the deposit of payments made on VA loans. To the extent SMG earned interest on the loan payments it received, VA should have had SMG remit the amount of interest to VA for credit to the appropriate liquidating and financing accounts. Because VA permitted SMG to retain interest on loan payments SMG was not entitled to receive under law or contract, these amounts should now be recovered.

In comparison to VA's contractual arrangement with CDSI/SMG, we looked at the practices of Fannie Mae, the nation's largest portfolio manager, which regularly uses private-sector servicers for its direct loans. We found that as a means of maximizing its interest income while controlling cash flow, Fannie Mae requires servicers to remit cash receipts at a minimum on a daily basis, and more frequently if collections exceed $2,500.

Noncash Adjustments Were Made Without Oversight

Noncash adjustments represent changes made to principal loan balances without cash payments or disbursements being made. After transferring loans to SMG for servicing, the regional offices continued to submit noncash adjustments to SMG to change the outstanding loan balances of borrowers' accounts. In ordinary business practice of financial institutions, noncash adjustments are unusual events that require an explanation by the person making the adjustment and the approval of a supervisor. Yet VA regional staff were permitted to forward noncash adjustments regularly, causing principal balances to go up and down, without proper approvals or documentation. For example, during October 1997, SMG recorded approximately $250,000 in noncash adjustments requested by the regional offices. As a result, VA lacked assurance that changes were legitimate and that funds were not being misdirected. When we advised VA management of these activities, it promptly instituted a formal review process for all changes, which required documentation, supervisory approval, and PLOU authorization.

VA Lacked Accountability and Control Over Its Loan Sale Activity

Three times a year, VA selects marketable loans from its direct loan portfolio, packages them, and sells them to investors through an underwriter in order to recoup costs for the HCA program. These loans are sold with a guarantee of payment of principal and interest and are backed by the full faith and credit of the United States. Since fiscal year 1992, the funding for this type of guarantee has been subject to the Credit Reform

Act and OMB's guidance but, until recently, VA had not complied with the requirement to estimate the future liability related to these loan sales and to include the estimated cost of the liability in its annual budget request to the Congress. VA also had not been disclosing and properly accounting for these sales and the associated liability created by the guarantees in its financial statements as required by federal accounting standards. Furthermore, VA had not established an effective control environment for monitoring the servicing on these loans.

Since the mid-1980's, VA has engaged the services of an investment banking firm to sell securities backed by marketable loans in the direct loan portfolio.[9] Each of the sales has a separate trust agreement, which calls for a separate cash reserve associated with each trust based on the size of the portfolio sold and the terms of the sales agreement. Initially, VA funded these cash reserves from a portion of the proceeds VA received from the sale of loans as stipulated in the sales agreement.

Each trust has a loan servicer to collect monthly payments from the borrowers and perform other traditional loan servicing functions, including handling defaults, foreclosures, and routine payoffs. VA has hired the trust department of a major bank[10] to serve as the trustee/custodian for all of these trusts. (See figure 2.) The trustee/custodian manages the trusts, maintains the custody of all funds (including VA's cash reserves), pays the certificate holders, reports to taxing authorities, and provides investors relevant data needed for filing their annual tax returns.

In practice, the servicer deposits receipts from the servicing activities in a depository account managed by the trustee/custodian. The trustee/custodian subsequently transfers these funds to its distribution account to pay investors. When funds in the distribution account are insufficient to pay investors, the trustee/custodian transfers funds from VA's cash reserve account into the distribution account.

Because the loans are sold with guarantees to maximize the sales yield, VA has a contingent liability to the certificate holders as long as these loans remain outstanding. To the extent that loans default and aggregate cash flows are inadequate to pay investors and trust expenses, the guarantee feature comes into play. Because of this guarantee, VA has a responsibility and vested interest in monitoring the servicer and trustee/custodian

[9]Purchasers buy certificates representing a percentage of ownership in the trust. The certificates are collateralized collectively by all of the loans in the portfolio and guaranteed by the U.S. government.

[10]Banker's Trust of California is the trustee/custodian for all of the trusts.

activities to maximize the cash flow from loan servicing operations and to minimize expenses.

Little Oversight Over Loan Servicers and the Trustee/Custodian

Although the sales contract requires VA to replenish cash reserves when needed, in our opinion, an effective control environment requires on-site monitoring of contractors to ensure that the transactions reported are reasonable and appropriate. OMB provides guidance to credit agencies to evaluate and enforce servicers' performance. This guidance states that agencies should undertake biennial on-site reviews of their contractors where possible, but recommends annual on-site reviews for all lenders and servicers with substantial loan volume.[11] The OMB guidance states that agencies are to manage federal credit programs to ensure that federal assets are protected and that losses are minimized in relation to the social benefits provided by credit programs.

VA did not comply with OMB guidance, and the trustee/custodian and the four servicers used by VA operated with little oversight. For example, although VA had been selling loans in a trust structure since the late 1980's, it did not begin monitoring its servicers until 1994. As of October 1998, it had only reviewed three of its four servicers, and no servicer had been reviewed more than once. Further, VA had never reviewed the trustee/custodian.

At one servicer, VA found procedural problems it characterized as not resulting in any significant cost to the government. However, the other two servicers had servicing inefficiencies and had engaged in unauthorized practices. VA's reports on those servicers estimated that the two most serious findings cited had cost VA more than $6 million over the period of the trusts they were servicing. Specifically,

- Servicers were not reporting cash receipts resulting from loan liquidations[12] in a timely manner to the trustee/custodian. As a result, the trustee/custodian was not aware that principal and interest payments to investors were to be correspondingly reduced. Another salient factor is that servicer fees are calculated as a percentage of outstanding loan principal being serviced. Thus, any delays in reporting liquidations would result in both excessive payments to investors as well as servicer fees

[11]OMB Circular A-129 (as revised 1/11/93), Policies for Federal Credit Programs and Non-Tax Receivables.

[12]Loan liquidations are the proceeds of the sale of property from a defaulted mortgage.

unless they were timely detected and appropriate adjustments made to both investor payments and servicer fees.

- One servicer was charging certain sales management and referral fees to realtors who listed foreclosed properties for sale. Such practices were not authorized under the servicing agreement. In its monitoring report, VA stated that the realtors who paid the fee to the servicer had, in effect, agreed to sell the property for a lesser net commission than VA actually paid. The servicer received the increment, which, according to VA's report, ranged from 1 percent to 1.3 percent, thus increasing VA costs and reducing net sale proceeds.

In response to these monitoring efforts, VA officials told us that they are negotiating recovery of estimated losses of federal revenues with the servicers involved. They also told us that while VA had not realigned any of the existing servicing responsibilities, it was channeling all new servicing work to the entity for whom monitoring efforts had not revealed any significant problems.

Inadequate Management Involvement in Relationship With Trustee/Custodian

One trustee handles the custodial arrangements for all 31 of the trusts originated from loan sales dating back to 1988, with reported outstanding balances of approximately $7 billion as of September 1998. Through the conclusion of our fieldwork, VA management had taken little action to oversee the relationship with the trustee/custodian, including management of the cash reserves and the flow and sharing of critical financial and budgetary data associated with trust operations. In essence, the loan sale activity functioned as a stand-alone project, removed from input and oversight by management, accounting, or budget staff. Financial data were not adequately shared with staff who needed to review and record them in VA's accounting and budget records.

One individual at VA was in charge of all operational and administrative phases of the loan sale activity, which included preparing the loan sale documents, calculating the value of the loan portfolio to be sold, authorizing payments to the trustee/custodian for requested amounts when cash reserves fell below contractual levels, and receiving financial reports the contractors generated. In our opinion, such a broad scope of authority without a strong supervisory presence exposes VA to excessive risk that improprieties could occur and not be detected, and that important activities could be neglected. Our 1983 Standards for Internal Controls in the Federal Government, issued pursuant to the Federal Financial Managers' Integrity Act of 1982 to be followed by federal

agencies, outlines key control objectives and explains specific techniques for achieving those objectives. Not achieving the goals for two of these objectives, separation of duties and supervision, contributed to the observed weaknesses in loan sale activities and reporting.

This situation was a factor in VA not detecting or reversing a key decision that authorized the trustee/custodian to report financial data within the trusts on a consolidated basis. The contract with the trustee/custodian required that the reports to VA provide details for each trust that would satisfy data requirements for both credit program administration and financial reporting considerations. A report on the internal controls in the loan sale activity by a consultant cited the trustee/custodian's consolidation of financial reporting for the 12 trusts originated between 1992 and 1996 as a key factor in VA not having the level of detail required to comply with credit reform requirements. Consolidated, rather than trust by trust, reporting masked the performance of individual trusts and eliminated critical data for reasonably estimating program costs under the Credit Reform Act as well as for reliably reporting on financial statements.

VA Did Not Properly Account for Loan Sales and Subsequent Financial Activity

In addition, VA did not have processes in place to ensure that relevant reporting from servicers and the trustee/custodian was channeled to appropriate VA offices. Since all reporting from the trustee/custodian came to one individual, there needed to be a process for the individual to provide the reported information to other VA officials who needed the information for accounting, budgeting, and other purposes. However, we determined that the accounting staff did not have copies of any of the loan sales agreements and that the information they had on the loan sale activity was incomplete because it had either not been forwarded to them or they had not requested it.

This lack of data on loan sales and related transactions was a factor in accounting and financial reporting errors. Our review of the accounting treatment of the loan sale transactions showed that the entries were not in accordance with adopted federal accounting standards and related guidance. Specifically:

- VA incorrectly calculated and classified gains and losses on loan sales,
- VA was not estimating and recording the liability for the guarantee on the loans sold at the time of sale, and
- the reserves held by the trustee/custodian were not recorded in VA's general ledger.

This accounting treatment indicated a lack of familiarity with some elements of proper accounting for credit transactions. Not recording the liability and reserves would suggest that VA had no further responsibility for these loans or a continuing interest in the appropriate servicing of the loans and maintenance of the cash reserves, which is not the case.

After we advised VA that its accounting and budgetary reporting did not accurately reflect the loan sales or the contingent liability, VA, in consultation with OMB, estimated a subsidy and recorded an additional expense as an aggregate adjustment for future losses and related liability for the loan sales not recorded between 1992 and 1997. Because the adjustment was made to the financial statement line item for the direct loan activity and was aggregated with other adjustments related to direct loans, we were unable to determine what portion of this $376 million adjustment was related to the loan sale activity.[13]

In September 1998, VA contracted with a private-sector firm to develop a model for estimating the liability for the loan sales, and to reconstruct all necessary historical information. The firm agreed to research and correct the missing or improperly recorded financial information and produce auditable records supporting the information recorded.

Replenishment of Reserves Not Financed Properly

Periodically, the trustee/custodian asked VA to replenish the cash balances for the individual trusts to designated levels. VA did not follow the Credit Reform Act and related requirements when identifying the sources of the funds to satisfy the underlying federal guarantees. As noted above, VA had been initially funding the reserve for each trust from the proceeds of the loan sale transaction. It had not accounted for the source of the cash used to fund the reserves or estimated and recognized the liability associated with the federal guarantee. Also, VA was not reporting subsequent replenishment of the cash reserves or disclosing the funding source.

Under the Credit Reform Act, in order to fund the guarantees, VA should have estimated its future liability for satisfying guarantees on the loans sold and included it in annual budget requests to the Congress. In addition, VA should have notified both OMB and Treasury to set up program and financing accounts for guarantees made beginning October 1, 1991. These

[13]The subsidy cost related to these trusts was recorded as part of the direct loan program. However, OMB Circular A-11 requires that the related subsidy cost for loans sold with a guarantee be included as part of the loan guarantee program. For fiscal year 1999, VA plans to include the subsidy cost for the loans sold in the appropriate program.

accounts are used to record the appropriation for the net cost to the government for the guarantee, record the sale transactions, and track the subsequent activity for the loans sold. Annually, VA should have reestimated the liability and included any reestimate in its budget and financial statements.

Instead, VA had been financing those replenishments off the books. Specifically, VA did not record the interest income or the replenishments of the reserve in its accounting records. For several precredit reform loan sales, VA reported that it had retained investments valued at $318 million as of September 30, 1997. We found that VA had been improperly using the income from those investments to finance replenishment of the reserves for trust agreements initiated after 1991 (those subject to credit reform requirements). VA officials told us that since the income from all of the trusts flowed to the same trustee/custodian, they had instructed the trustee/custodian to use the investments to finance replenishments for the post-1991 trusts. The Credit Reform Act clearly stipulates that income arising from pre-1992 credit activities must be used only to offset expenses arising from those same activities. Such income is not to be used to offset expenses for post-1991 activities, which is what VA routinely did.

VA exclusively relied on income from the pre-1992 investments to replenish the reserves of post-1991 trusts until fiscal year 1997, when income from that source became insufficient. At that juncture, VA started using funds from the direct loan financing account to replenish the trust reserves in fiscal years 1997 and 1998.

For fiscal year 1997, VA transferred $14 million to the trustee/custodian to augment cash reserves from the 1997 cohort[14] of its direct loan financing account[15] because, as described above, it had not set up the appropriate financing mechanism to finance those losses. In 1998, VA transferred another $40 million from the 1998 cohort in its direct loan financing account to replenish the reserves.

[14]As described in OMB Circular No. A-34, a cohort applies to post-1991 direct loans and loan guarantees committed by a program in the same fiscal year even if disbursements occur in subsequent fiscal years. Accounting and other records must be maintained separately for each cohort within the program's financing account. Any payment for losses from the financing account must be applied to the cohort in which the original loan was disbursed.

[15]Under the Federal Credit Reform Act of 1990, a financing account is the nonbudgetary account or accounts associated with each credit program account, which holds balances, receives the subsidy cost payment from the credit program account, and includes all other cash flows to and from the government resulting from post-1991 direct loans or loan guarantees.

While VA had started to shift to post-credit-reform financing sources for the post-1991 trusts replenishments, it did not have the information that would enable charging the cost of replenishing the related reserves to the proper fiscal years (cohorts). Financing all the losses incurred for any particular year from just one cohort is contrary to the basic concept outlined in OMB's Circular A-11, implementation guidance for the Credit Reform Act, which attempts to accurately account for costs by the fiscal year in which the activity was originated. VA officials are currently in discussion with Treasury officials on establishing the appropriate funding mechanism for the guarantee on loans sold.

Conclusions

The purpose of the loan sale and direct loan activities discussed in this report is to provide opportunities for mitigating losses on defaulted VA-guaranteed loans in the HCA program, where reported guarantees outstanding total $69 billion. VA has not been successful in moving to outsourcing arrangements for these activities. It has not yet instituted adequate safeguards over either the assets or the cash flows managed by private contractors. Until it establishes an adequate evaluation base and more stringent monitoring activities, it will provide little assurance to others that the HCA programs are being run prudently. Instituting the kinds of controls employed by major owners of housing loan portfolios is necessary and would help in forming the basis for good program management and reliable data for reporting financial and budgetary results.

Recommendations

In order to effectively manage loan assets and the cash flows associated with VA's direct loans, we recommend that the Secretary of Veterans Affairs direct the Under Secretary for Benefits to:

- Provide a basis for monitoring and controlling loan and property assets and any related cash flows managed by contractors by establishing a database for direct loans, through the development of a complete inventory of all loans originated. The database should be similar to the information systems in place at major owners of housing loan portfolios. Benchmarking with major owners of housing loan portfolios should offer perspective in the data requirements and capabilities offered by such systems for creating an adequate control environment for overseeing both in-house activities as well as outsourced functions.
- Implement processes to allow immediate improvements in VA's capability to monitor contractor servicing of direct loans and disbursements related

to VA-owned properties. These improvements would include periodically obtaining tax bills for VA-owned properties from independent sources and comparing this information to that in its Property Management System to validate servicer requests for reimbursement of expenses.

- Develop a centralized database to immediately record loans in the process of being assumed by VA in order to establish timely and thorough visibility over those assets and to facilitate transferring such information to the contract servicer expeditiously.
- Reconcile all loan records in the contractor's database to VA's general ledger on a monthly basis, by the end of the following month.
- Continue to develop standardized policies and procedures intended to ensure completeness, consistency, and accuracy of data obtained and recorded concerning individual loans and properties. Implement quality assurance steps to ensure the accuracy of this data.
- Adhere to federal legislation and guidance regarding cash management. Servicers should be instructed to remit all proceeds to VA's Treasury accounts daily upon receipt. Further, VA should recoup the total interest earned on SMG's account balances from the inception of VA's contract with CDSI/SMG.
- Establish suspense accounts, and a control account in VA's general ledger, to record all collections that cannot be allocated to specific loan accounts.

Regarding gaining operational and accounting control over loan sale activities, the Secretary of Veterans Affairs should direct the Under Secretary for Benefits to:

- Complete the reconstruction of the historical data for the loan sales, the resulting trusts, and financing for the required reserve accounts for each trust.
- Establish adequate separation of duties and supervision over VA staff involved in all loan sale operational and administrative activities.
- Develop and implement procedures to ensure that relevant data from servicers and the trustee/custodian are provided promptly to VA offices responsible for managing or recording trust activities and transactions.
- Record loan sale transactions and all subsequent activity associated with the trusts consistent with federal accounting standards and any related guidance. This would include:
  - making appropriate accounting adjustments to accurately reflect the results of prior years' transactions and
  - recording all financial transactions relating to trust activities, including those associated with the original sale, the establishment of the reserves, drawdowns to satisfy the federal guarantee, subsidy

reestimates, and replenishments to satisfy trust agreement provisions as well as revenue from trust investments and assets.

Finally, we recommend that the Secretary of Veterans Affairs direct the Under Secretary for Benefits to:

- Establish and implement adequate monitoring activities of outsourced activities to include both direct loans and VA property servicing as well as activities associated with the loan sales. These efforts should be designed to comply with OMB Circular A-129 and be stringent, given the risks inherent in the existing servicing environment.
- Disclose cash flows related to loan sales and related guarantees in VA's budget records, calculate and report the cost of direct loans and loan guarantees, and budget for the subsidy and administrative cost of the loans and guarantees in accordance with the Credit Reform Act and OMB Circular A-11.

Agency Comments and Our Evaluation

In commenting on a draft of this report, VA concurred with 11 of our 13 recommendations and agreed to implement them as part of its current effort to correct direct loan and loan sale records. Of the remaining two recommendations, VA disagreed with one, and reserved agreement pending a legal opinion on the other.

VA characterized the financial management weaknesses presented in this report as being relatively minor. We disagree. By any measure, the problems we identified are material financial and management control weaknesses. The problems discussed in this report are so pervasive that they resulted in qualified opinions by VA's Office of the Inspector General on VA's financial statements for both fiscal years 1997 and 1998. The $3 billion in loans and VA-owned property and $9 billion in potential liability on loan sales represent guaranteed loans previously serviced by private lenders that went into default and were acquired by VA. VA now bears the primary responsibility for insuring prudent management of these assets, in an effort to recoup losses and to preclude additional losses on the properties for which loans were originally guaranteed.

VA stated that it had initiated a number of corrective actions. In our report, we recognize that VA is taking good first steps to correct these problems, and our recommendations for improvements are intended to assist the agency in attaining the level of accountability and control envisioned in the growing body of financial and program management legislation.

VA did not concur with our recommendation that it test the validity of contractor billings for property taxes paid on VA's behalf. VA stated that its Portfolio Loan Oversight Unit uses the Property Management System to verify these payments. We agree that verifying VA ownership of property in order to determine whether VA had any responsibility for taxes on individual properties is a good first step. However, the thrust of our recommendation is that VA verify that amounts paid for property taxes were accurate. As pointed out in our report, VA could accomplish this by obtaining tax data through readily available means. The verification could be accomplished efficiently by testing selected transactions that provided a statistically valid sample. Verifying the amounts in sample transactions would provide adequate assurance that the billings from the contractor were reasonable.

Finally, VA pledged to modify its processes to adhere to cash management principles established in federal legislation and other guidance. It did not take issue with our view that federal law does not authorize VA to contractually or otherwise permit the contractor to retain interest earned by depositing federal collections in the contractor's account. Regarding the matter of recouping of interest earned by the contractor, VA neither concurred nor disagreed with our recommendation, stating that its General Counsel is reviewing the issue of recoupment.

We are sending copies of this report to Senator Arlen Specter, Senator Ted Stevens, Senator Robert C. Byrd, Senator Fred Thompson, Senator Joseph Lieberman, Senator John D. Rockefeller IV, Representative C. W. Bill Young, Representative Lane Evans, III, Representative Bob Stump, Representative David Obey, Representative Dan Burton, and Representative Henry A. Waxman in their capacities as Chairmen or Ranking Minority Members of Senate and House Committees. We are also sending copies to Togo D. West, Jr., Secretary of Veterans Affairs, the Honorable Jacob J. Lew, Director of the Office of Management and Budget, and the Honorable Joseph Thompson, Under Secretary for Benefits of the Department of Veterans Affairs. Copies will be made available to others upon request. If you have any questions or wish to discuss the issues in this report, please contact me at (202) 512-4476. Major contributors to this report are listed in appendix II.

Gloria L. Jarmon
Director, Health, Education and Human Services,
Accounting and Financial Management Issues

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Abbreviations

CDSI	Computer Data Systems, Incorporated
CDSI/SMG	Computer Data Systems, Incorporated/Seasons Mortgage Group
COTR	Contracting Officer's Technical Representative
FMFIA	Federal Managers' Financial Integrity Act
GAO	General Accounting Office
OIG	Office of Inspector General
OMB	Office of Management and Budget
HCA	Housing Credit Assistance Program
LGY	Loan guaranty activity
LSAMS	Loan Servicing Automated Management System
PLOU	Portfolio Loan Oversight Unit
PLS	Portfolio Loan System
PMS	Property Management System
SFFAS	Statement of Federal Financial Accounting Standards
SMG	Seasons Mortgage Group
USC	United States Code
VA	Department of Veterans Affairs
VBA	Veterans Benefits Administration

Comments From the Department of Veterans Affairs

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF VETERANS AFFAIRS
WASHINGTON DC 20420

FEB 24 1999

Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Management Division
U. S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Dodaro:

We have reviewed your draft report, ***INTERNAL CONTROLS: VA Lacked Accountability Over Its Direct Loan and Loan Sales Activities*** (GAO/AIMD-99-24). In general, the report describes problems related to the outsourcing of portfolio loan servicing and attempts to present those as indicative of a lack of control and accountability over the Department of Veterans Affairs' (VA) Housing Credit Assistance direct loan and loan sale activities. We disagree with this overall assessment. During internal Departmental reviews, VA already identified many of the problems described in this report. We have made and are continuing to make significant efforts to correct the issues GAO discusses. Considering the relatively small size of VA's liability for the direct loan and loan sale activities, when compared to the potential liability of VA's primary program of guaranteeing loans to veterans, we believe that VA's use of limited Government resources has well served the desire of the American public for its Government to do more with less. Some of GAO's recommendations will be helpful in fine tuning a small part of what has been an outstanding program to help veterans purchase homes and retain them during financial difficulties whenever possible.

The enclosure further discusses your recommendations and the Department's plans for implementing them. We appreciate the opportunity to comment on your report.

Sincerely,

Dennis Duffy
Assistant Secretary for
Planning and Analysis

Enclosure

Enclosure

DEPARTMENT OF VETERANS AFFAIRS COMMENTS TO
GAO DRAFT REPORT, ***INTERNAL CONTROLS: VA Lacked Accountability Over Its Direct Loan and Loan Sales Activities***
(GAO/AIMD-99-24)

In order to effectively manage loan assets and the cash flows associated with VA's direct loans, GAO recommends that the Secretary of Veterans Affairs direct the Under Secretary for Benefits to:

- **provide a basis for monitoring and controlling loan and property assets and any related cash flows managed by contractors by establishing a database for direct loans, through the development of a complete inventory of all loans originated, similar to the information systems in place at major owners of housing loan portfolios. Benchmarking with such entities should offer perspective in the data requirements and capabilities offered by such systems for creating an adequate control environment for overseeing both in-house activities as well as outsourced functions.**

Concur - VA was discussing establishment of such a data base before outsourcing its portfolio loan servicing, but limited resources delayed its realization. We have intensified our discussions since GAO issued its draft report and located funds for software to help design such a data base. We anticipate completing a preliminary design before the end of FY 1999.

- **implement processes to allow immediate improvements in VA's capability to monitor contractor servicing of direct loans and disbursements related to VA-owned properties such as obtaining, on a periodic basis, tax billings for VA-owned properties from independent sources and comparing this type of information to that in its Property Management System to validate servicer requests for reimbursement of expenses.**

See comment 1.

Do Not Concur - There is really nothing specific in this recommendation, other than one process, which is similar (but more costly) than an existing one. VA has established a Portfolio Loan Oversight Unit (PLOU) that monitors the contractor's servicing performance, and also audits invoices for services performed and reimbursement of expenses. The PLOU has access to VA's Property Management System to track tax expenses and ensure against overpayment. Obtaining tax billings from independent sources would be costly and possibly confusing to taxing authorities who expect to provide such information only to the entity paying the taxes.

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Enclosure

DEPARTMENT OF VETERANS AFFAIRS COMMENTS TO
GAO DRAFT REPORT, ***INTERNAL CONTROLS: VA Lacked Accountability Over Its Direct Loan and Loan Sales Activities***
(GAO/AIMD-99-24)
(Continued)

- **develop a centralized data base to immediately record loans in the process of being assumed by VA in order to establish timely and thorough visibility over those assets and to facilitate transferring such information to the contract servicer expeditiously.**

Concur - This is a feature of the new Loan Servicing and Claims (LS&C) system, which has been in development for over 10 years. Beta testing of the system is scheduled for April of this year, with installation in July. [For information purposes, "refunded" is the term VA uses to describe a loan acquired from a private holder in order to assist a veteran in retaining home ownership. The term "assumed" is generally used within the mortgage industry to refer to a loan originally made by one party which a second party has agreed to repay as part of the purchase price of the home.]

See comment 2.

- **reconcile all loan records in the contractor's database to VA's general ledger on a monthly basis, by the end of the following month.**

Concur - Reconciliations have been done since conversion - but not by the end of the month. This goal should be assisted by better systems interfaces, so that the more cumbersome manual research and adjustment method can be phased out. GAO recognized that VA was making reconciliations by noting VA had a $4 million "unreconciled balance" (out of $1.3 billion) for loan principal (or about the equivalent value of 80 loans) at the end of FY 1998. The unreconciled balance at the end of December 1998 is in the half million dollar range. VA will continue its reconciliations and corrections of past problems. As increased systems support becomes available and station loan establishment improves, the reconciliation process should be easier and corrections more timely. As stated above, VA will continue to reconcile monthly and make corrections as required. The timeliness of identifying corrective actions needed will be dependent on systems improvements.

See comment 3.

- **continue to develop standardized policies and procedures intended to ensure completeness, consistency, and accuracy of data obtained and recorded concerning individual loans and properties. Implement quality assurance steps to ensure the accuracy of this data.**

Concur - The Department views this as an affirmation of its efforts to develop standard policies and procedures related to the relatively new outsourcing of portfolio loan servicing. Some of the procedures already developed have been geared toward

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See comment 4.

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DEPARTMENT OF VETERANS AFFAIRS COMMENTS TO
GAO DRAFT REPORT, ***INTERNAL CONTROLS: VA Lacked Accountability Over Its Direct Loan and Loan Sales Activities***
(GAO/AIMD-99-24)
(Continued)

identifying inaccurate data, so that it may be corrected. This will be an ongoing process.

- **adhere to Federal legislation and guidance regarding cash management. Servicers should be instructed to remit all proceeds to VA's Treasury accounts daily upon receipt. Further, VA should recoup the total interest earned on SMG's account balances from the inception of VA's contract with CDSI/SMG.**

Concur on part one - concurrence or non-concurrence on part two is pending legal review. In an effort to obtain the best possible price for this contract, VA followed the precedent of many subservicing contracts and allowed the contractor to hold funds and remit collections to Treasury monthly. Our contracting review did not disclose the requirements of 31 U.S.C. 3302, and it was not until a year after first expressing concerns about this practice that GAO finally advised us of this law. However, since that time we have placed a high priority on reviewing the alternatives to bring the contract into compliance with the law, and will implement whatever is in the best interests of the Government. The issue of recoupment is still under legal review and our final position will depend on the General Counsel's opinion. Changes to daily deposits into Treasury accounts should be accomplished before the end of this year, but the speed of conversion to this process will be balanced against the Government's liability for equitable adjustment arising from changes to contract terms.

- **establish suspense accounts, and a control account in VA's general ledger, to record all collections that cannot be allocated to specific loan accounts.**

Concur - This can be done in the general ledger maintained for direct loans at Indianapolis.

Regarding gaining operational and accounting control over loan sale activities, GAO recommended that the Secretary of Veterans Affairs should direct the Under Secretary for Benefits to:

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Enclosure

DEPARTMENT OF VETERANS AFFAIRS COMMENTS TO
GAO DRAFT REPORT, ***INTERNAL CONTROLS: VA Lacked Accountability Over Its Direct Loan and Loan Sales Activities***
(GAO/AIMD-99-24)
(Continued)

- **complete the reconstruction of the historical data for the loan sales, the resulting trusts, and financing for the required reserve accounts for each trust.**

Concur - VA has contracted for services that include this reconstruction.

- **establish adequate separation of duties and supervision over VA staff involved in all loan sale operational and administrative activities.**

Concur - Limited resources have affected both separation of duties and the level of supervision over this staff. Recently another employee was detailed to learn the program to allow for some separation, but that employee transferred to another office. VBA is developing a solicitation for a full-time employee in this area. As for supervision, the direct supervisory position has been vacant for over a year, but finally has been announced as open for candidates.

- **develop and implement procedures to ensure that relevant data from servicers and the trustee is provided timely to VA offices responsible for managing or recording trust activities and transactions.**

Concur - This will be completed as part of our loan sale accounting contractor's development of procedures to use the data in accounting for VA liabilities.

- **record loan sale transactions and all subsequent activity associated with the trusts consistent with federal accounting standards and any related guidance. This would include:**
    - **making appropriate accounting adjustments to accurately reflect the results of prior years' transactions.**
    - **recording all financial transactions relating to trust activities including those associated with the original sale, the establishment of the reserves, drawdowns to satisfy the federal guarantee, subsidy reestimates, replenishments to satisfy trust agreement provisions, as well as revenue from trust investments and assets.**

4

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DEPARTMENT OF VETERANS AFFAIRS COMMENTS TO
GAO DRAFT REPORT, ***INTERNAL CONTROLS: VA Lacked Accountability Over Its Direct Loan and Loan Sales Activities***
(GAO/AIMD-99-24)
(Continued)

Concur - A VA contractor is designing a system for recording loan sales transactions and all subsequent activity. The contractor is also reconstructing past sold loan activity. In FY 1999, VA will also test and, if successful, implement electronic fund transfer (EFT) as the reimbursement method to the trust for guarantee obligations under the loan sales agreement.

- **establish and implement adequate monitoring activities of outsourced activities to include both direct loans and VA property servicing as well as activities associated with the loan sales. These efforts should be designed to comply with OMB Circular A-129 and be stringent given the risks inherent in the existing servicing environment.**

Concur - VA has already established the PLOU to monitor servicing of direct loans and tax payments for VA-owned properties. As for loan sales, our Lender Monitoring Unit has audited three of the four servicers of sold vendee loans, and should complete the audit of the fourth by the end of this year. At that time we will be in a better position to accomplish the biennial on-site reviews indicated by OMB guidance. The addition of another staff person to the loan sales unit should enable better ongoing review of all other aspects of loan sales.

- **disclose cash flows related to loan sales and related guarantees in VA's budget records, calculate and report the cost of direct loans and loan guarantees, and budget for the subsidy and administrative cost of the loans and guarantees in accordance with the Federal Credit Reform Act of 1990 and OMB Circular A-11.**

Concur - As noted above, a VA contractor is designing a system for recording loan sales transactions and all subsequent activity.

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The following are GAO's comments on the Department of Veterans Affairs' letter dated February 24, 1999.

GAO Comments

1. See "Agency Comments and Our Evaluation" section.

2. When VA uses the term "refunded" loans, it is describing a transaction more commonly known as "assumed" loans. We chose to use the term most understandable to readers outside of VA.

3. Reconciliations are a basic control for financial management and accountability. The failure of VA to achieve timely and complete reconciliations of its direct loan records with the contractor's indicates a systemic problem with the flow of accounting information. The dollar amount involved is less significant than the fact that the reconciliations cannot be performed successfully. VA has the responsibility to its borrowers to ensure that their loan balances are accurate.

4. VA is responsible for ensuring the propriety and legality of services it contracts for, and the practices to be employed.

Major Contributors to This Report

Accounting and Information Management Division, Washington, D.C.

Alana Stanfield, Assistant Director
Elizabeth Kreitzman, Audit Manager
Mel Mench, Senior Assistant Director
Maria Zacharias, Communications Analyst
Christina Quattrociocchi, Senior Auditor
Suzanne Lightman, Auditor

Office of General Counsel

Jeffrey A. Jacobson, Assistant General Counsel

Glossary

Assumed loans - Loans which were originally guaranteed by VA and held by private lenders. After the lenders notified VA of intent to foreclose, VA took over the loans from the lender and became the creditor to the veterans involved. VA may modify the terms of the loan with the veteran during the assumption.

Cash reserve fund - The fund created during a loan sale and financed by VA. VA retains ownership of cash in the fund. The fund is used to pay VA's guarantee of principal and interest as well as other expenses.

Cohort - As described in OMB Circular No. A-34, a cohort includes all loans obligated or loan guarantees committed by the program in the same fiscal year, even if disbursements occur in subsequent fiscal years. Cohort accounting applies to post-1991 direct loans and loan guarantees. Accounting and other records must be maintained separately for each fiscal year within the program's financing account. Any payment for losses from the financing account must be applied to the fiscal year in which the original loan was disbursed.

Computer Data Systems, Incorporated (CDSI) - The primary contractor that services VA's direct loan portfolio. It provides computer facilities and the servicing programs.

Credit reform - Refers to the collective requirements as set forth in (1) the Federal Credit Reform Act of 1990, which generally requires that agencies calculate and record the net present value for credit programs and include the cost to the government in the budget, (2) Statement of Federal Financial Accounting Standard No. 2, Accounting for Direct Loans and Loan Guarantees, and (3) OMB Circulars A-11 and A-34.

Direct loan activity - Actions relating to the creation, recording, and servicing of VA's direct loan portfolio. The majority of direct loans are classified as either assumed or vendee loans. (See these terms for further explanation.)

Established loan - An assumed loan for which VA has a modification agreement with the veteran and has received all necessary documents pertaining to the loan.

Financing account - The nonbudget account or accounts associated with a credit program account, which holds balances, receives the subsidy cost payment from the credit program account, and includes all other cash

flows to and from the government resulting from post-1991 direct loans or loan guarantees.

Housing credit assistance program - A function of VA concerned with housing credit activities. Its objectives are to assist veterans, certain reservists, and active duty personnel in obtaining mortgage loans; assist in avoiding foreclosures; and deliver the loan guarantee benefit as efficiently as possible.

Loan guaranty activity - Actions related to providing a partial guaranty of loans made by private lenders to veterans and service members to purchase and retain homes, including claim payments, loan assumptions, and property acquisition and management.

Loan sale activity - Actions related to the sale by VA of loans from its direct loan portfolio. The loans are packaged into a trust and sold with a guarantee of repayment of principal and interest.

Loan Servicing Automated Management System (LSAMS) - Loan servicing program provided by CDSI that processes and accounts for mortgage loans for VA's direct loan portfolio.

Pre-1992 loan sale investments - Investments VA holds from loan sales prior to 1992 which continue to generate income.

Outsourcing - The process of contracting for performance of a function previously performed in-house, such as direct loan servicing.

Portfolio Loan Oversight Unit (PLOU) - A VA entity that oversees the direct loan portfolio servicer's functions and reconciles the general ledger accounts related to the direct loan portfolio.

Qualified opinion - A opinion which states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.

Seasons Mortgage Group - A subcontractor to CDSI that services VA's direct loan portfolio.

Servicer - A private sector entity that performs servicing functions for VA's loan sale and direct loan activities. For the direct loans, the servicer collects and allocates mortgage payments from borrowers, pursues delinquent borrowers, maintains custody of escrow accounts, and pays taxes on VA-owned properties. The servicers for the loan sale activity are responsible for managing the loan portfolio of sold loans, accounting for individual loans in the portfolio, collecting mortgage payments, maintaining escrow accounts, foreclosing on delinquent borrowers, maintaining and selling foreclosed property, and reporting financial results of these activities to the trustee/custodian.

Subsidy cost - The government's estimated net costs, in present value terms, of direct or guaranteed loans over the entire period the loans are outstanding. For direct or guaranteed loans disbursed during a fiscal year, a subsidy expense is recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows.

Trust - A structure in which investors are issued certificates that represent shares in the cash flows from loans sold by VA. The trust is administered by a trustee/custodian.

Trustee/custodian - A financial institution VA contracts with in connection with the loan sale activity. The trustee/custodian manages the trusts created by the sale and is responsible for maintaining the custody of all funds (including VA's cash reserves), paying certificate holders, and filing with taxing authorities. The trustee/custodian is also responsible for reporting to VA financial activity within the trusts and other information as requested by VA.

Vendee loan - A mortgage loan made by VA for the purchase of VA-owned property.

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