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SUBJECT: Report on *Equity Injection in the SBA 7(a) Loan Guaranty Program*

We are pleased to submit the enclosed report, *Equity Injection in the SBA 7(a) Loan Guaranty Program*. This report details findings of the Office of Inspector General inspection regarding equity injection in 7(a) loans.

Past audits and investigations have identified equity injection as a prominent problem in 7(a) loans. The purpose of this study was to synthesize past OIG work in order to look for patterns of problems that might lead to suggestions for solutions to these issues. This inspection reveals that SBA guidance regarding equity injection is unclear. To remedy this inadequacy, SOP 50(10) 4, "Processing;" the Loan Authorization; and loan application forms need to be revised. These revisions should cover the amount(s) of injection the Agency requires, documentation the lender should provide to prove that the injection took place, as well as what the Agency will accept as evidence that the borrower's injection is not encumbered. In addition, standardized training for all Agency and lender employees as well as an Application Checklist should be developed.

We received comments from the Agency and these are addressed in the attached Report.

We would like to express appreciation for the excellent cooperation of Agency headquarters and field personnel as well as lender representatives.

**EQUITY INJECTION  
IN THE SBA 7(A) LOAN  
GUARANTY PROGRAM**

**March, 2003**

**Report No. 3-21**

**Office Of Inspector General  
Inspection & Evaluation Division  
United States Small Business Administration**

**INSPECTION OF  
EQUITY INJECTION**

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## **Executive Summary**

### **Background**

In past audits and investigations, equity injection has been identified as a prominent problem in SBA loans. Equity injection is a practice whereby borrowers are required to invest some of their own assets in their businesses so that they have some of their own money at risk. This practice enables agencies like the SBA to provide loans to borrowers who would not otherwise be eligible for business loans. A private sector lender relies primarily on collateral and cash flow to determine whether or not a potential borrower qualifies for a loan. SBA guaranteed loans, on the other hand, rely on projected cash flow and have less stringent collateral requirements. Because an SBA borrower may not have all the collateral or proven cash flow required by the private sector, the Agency requires its borrowers to inject their own assets (including but not limited to cash) into the project.

### **Methodology**

Because of the frequency of equity injection related audits and investigations, we conducted this study which includes a synthesis of existing OIG work. Data sources include: previously completed investigations cases, audits, and inspections; SBA Standard Operating Procedures and Policy Notices; loan application forms; legislative histories of relevant bills. In addition, interviews and site visits were conducted with SBA administrators; district office officials; lenders and representatives from other federal agencies which have similar guaranteed loan programs. Data from these interviews, site visits and documents were then analyzed to look for patterns that might clarify the increasing role of equity injection problems in OIG cases.

### **Findings**

The central finding is that current SBA guidance regarding the required minimum amounts of equity injection and verification documentation is unclear. These instructions contribute to the increasing occurrence of problems in investigations and audits. Sources of information and instructions for SBA lenders and borrowers such as SOPs, Loan Authorization boilerplates, and forms contain inadequate directions and information. In addition, more training and standardized application checklists are needed.

### **Conclusion**

Because SBA loans are more complex than conventional private sector business loans, the Agency needs to explicitly communicate its standards and requirements regarding equity injection. While Congress has instructed the Agency to delegate much of its loan making function and authority to its lenders, the mandate also indicates the expectation of Federal oversight and monitoring. Because of this dual expectation, lenders must have explicit information regarding areas against which they will be monitored. OMB Circular A-129 specifies standards for federal credit programs. The SBA should follow this guidance to define, standardize, and convey Agency requirements to all participants in its Section 7(a) guaranteed loan program.

## **Recommendations**

Recommendation 1 of 5: The SBA should revise Standard Operating Procedure (SOP) 50 10(4), “Processing,” to clarify minimum amounts and/or percentages of equity that applicants must inject into a given project; what verification the Agency will accept as proof that the applicant’s injection has occurred; and what the Agency will accept as proof that the applicant’s injection is not encumbered.

Recommendation 2 of 5: The National 7(a) Authorization Boilerplate and specialized boilerplates should be amended to more specifically address the issue of equity injection. This document should include detailed information regarding required minimum amounts, the form, the source, and what documentation is acceptable to verify that the injection has occurred. In addition, the “Optional” heading should be removed.

Recommendation 3 of 5: Loan application forms need to be revised. While lender form 4-L includes some information regarding equity injection, guaranty application form 4-I, as well as borrower form 4 and short form 4 contain no such information. All forms should be amended to reflect the equity injection amount requirements as well as what the Agency considers adequate verification documentation.

Recommendation 4 of 5: Adequate, standardized training should be provided to all lender and SBA employees involved with loan origination.

Recommendation 5 of 5: the SBA should develop a master Application checklist.

## **Agency Comments and OIG Response**

The Office of Financial Assistance disagreed with the recommendation regarding a minimum equity injection level. We agree that flexibility is important and will work with SBA during the normal follow up process to resolve all recommendations. For full discussion, see page 21.

## Background

SBA-OIG has identified equity injection as a major and recurring problem in investigations and audits of the Section 7(a) program. Audits of loan processing and defaulted loans as well as investigations often uncovered equity injection that is claimed but actually never existed; cases where inadequate amounts of cash or assets were contributed by the borrower; as well as instances of inadequate or fraudulent documentation. Based on the ubiquitous nature of inadequate equity injection and/or documentation, this is an area especially vulnerable to fraud, waste, and abuse.

### The Section 7(a) Loan Guaranty Program

The Section 7(a) Loan Guaranty Program is one of SBA's primary lending programs. Operating (for the most part) through private sector lenders, it guarantees loans to small businesses which are unable to secure financing on reasonable terms through conventional lending channels. A number of specialized Section 7(a) Loan Guaranty Programs exist which focus on issues such as streamlining the loan process, short-term loans, international trade, as well as veterans', women, and minorities' special needs.<sup>1</sup> As of February 26, 2003, the maximum Section 7(a) loan amount is \$2 million.<sup>2</sup>

Today the SBA makes almost no direct business loans, but rather guarantees loans made by the private sector. To simplify the process, many private sector lenders are delegated partial or full authority to approve loans with an SBA guaranteed percentage of the total. Such programs as the Preferred Lender and Certified Lender administer these delegated lending authorities.<sup>3</sup> For the most part, regardless of the specialized status of the lender, small Section 7(a) loans (with a gross loan amount of \$150,000 or less) carry a maximum guaranty of 85 percent. For loans greater than \$150,000, the maximum guaranty is 75 percent.<sup>4</sup>

However, there are exceptions to this general rule. Some special Section 7(a) loan guaranty programs such as *SBAExpress*<sup>5</sup> and *Community Express*<sup>6</sup> loans allow a 50 percent Agency guaranty. The *SBAExpress* program is designed to encourage lenders to increase the number of small loans. The *Community Express* program encourages development in untapped rural and inner-city, pre-designated geographic areas. *Export Express* lenders receive an 85 percent guaranty with a maximum loan amount of \$150,000.<sup>7</sup> Each of the Express programs uses streamlined and expedited loan review and approval procedures to process SBA guaranteed loans. Lenders use their own loan analyses, loan procedures and loan documentation. Export Working Capital loans

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<sup>1</sup> For a synopsis of Section 7(a) special loans, <http://www.sba.gov/financing/synopses.html> (no page). For greater detail on each, see <http://www.sba.gov/financing/indexloans.html> (no page).

<sup>2</sup> SBA Policy Notice Control No. 5000-853, effective 02-26-2003. Available on-line at <http://yes.sba.gov/notices/policy/>.

<sup>3</sup> For additional information about special lender programs, see: <http://www.sba.gov/financing/lender.html> (no page).

<sup>4</sup> <http://www.sba.gov/financing/fr7aloan.html#amounts>; click on "Loan Amounts" (no page).

<sup>5</sup> <http://www.sba.gov/financing/frfastrak.html>

<sup>6</sup> <http://www.sba.gov/financing/frcomexp.html>

<sup>7</sup> <http://www.sba.gov/financing/frexportexpress.html>

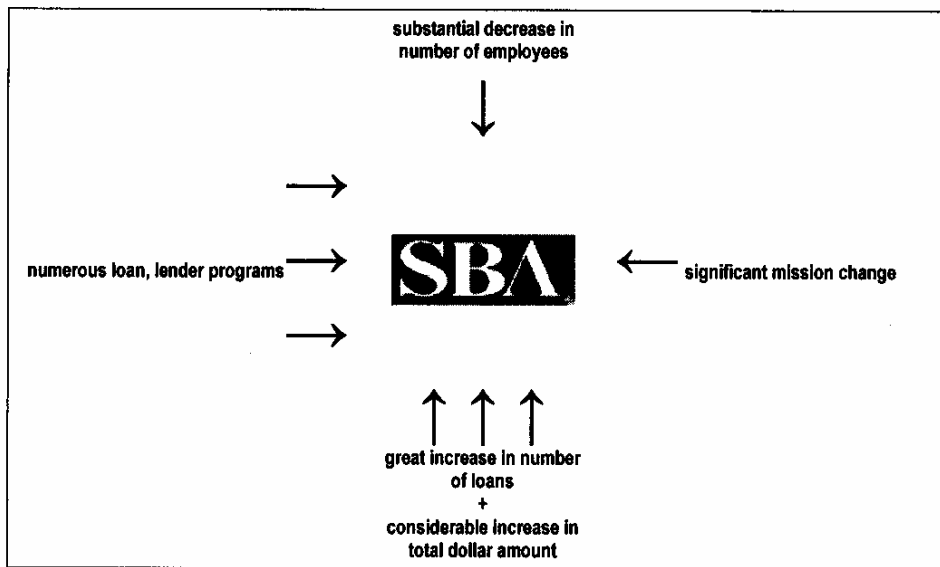
receive as much as a 90 percent guaranty.<sup>8</sup> Likewise, the export working capital portion of International Trade loans also receives a maximum 90 percent guaranty.<sup>9</sup> Thus, the Section 7(a) Loan Guaranty program consists of a mix of various specialized loan, and lender programs.

### Notable Changes in Mission and Procedures

Current policies represent a significant change in mission and procedures in at least four ways as shown in Illustration 1, below. First, in its earliest days, the SBA itself, through its local offices, processed, serviced, and liquidated all loans. However, like much of government, in recent years the Agency has been directed to turn its major functions over to the private sector. This policy is predicated on the premise that government should privatize or outsource functions that can be performed by the private sector, which is assumed, due to the profit motive, to be more cost-efficient. Under this model, government's role shifts to that of oversight of the private sector – government should “steer, not row.”<sup>10</sup> In the SBA's case, this means that (for the most part), the Agency no longer makes direct business loans, but rather guarantees loans made by private lenders.

### Notable Changes

Illustration 1



<sup>8</sup> <http://www.sba.gov/financing/frexporthtml>

<sup>9</sup> <http://www.sba.gov/financing/frinternational.html>

<sup>10</sup> Osborne, David, and Ted Gaebler. (1992) *Reinventing Government: How the Entrepreneurial Spirit Is Transforming the Public Sector*. Reading, MA: Addison-Wesley Publishing Company, Inc.

Next, concurrent with the substantive change in mission, the number of loans and amount of monies being loaned have dramatically increased. From FY 1991-2000, SBA loans totaled \$94.6 billion, more than in the entire history of the Agency prior to 1991.<sup>11</sup> Thus, in a mere ten years, the SBA exponentially surpassed the total dollar amount of loans for which it was responsible than it had in the previous forty years. Third, compounding the significant changes in mission and amount of money to oversee, the Agency has experienced a substantial decrease in the number of employees; from 1990 – 2000, the Agency experienced an overall employment reduction of more than 32 percent.<sup>12</sup>

Finally, the SBA has responded to legislative mandates by adding numerous specialized lender and loan programs. The confluence of mission change to privatization, added loan and lender programs, more loans and fewer personnel has all occurred within a relatively short period of time. Such rapid changes often increase the opportunity for waste, fraud and abuse. These specific widespread, integral changes, illustrated in the previous graphic, may have interacted in ways that help explain the increasing equity injection problems noted by the OIG.

### **The Case for Privatization**

Perhaps the most significant change the SBA has experienced is the privatization of many of its functions. While privatization or contracting out is advocated as an effective means to make government resources go further, the reality is that often government functions do not readily transition to the private sector environment. Certain government activities and requirements may not have an exact comparable format in the private sector. For instance, the private sector, market based motive is to make a profit. That is, the function and goal of profit making lie at the heart of all private lenders' decisions. The profit motive is, in fact, one of the main reasons that many assume the private sector operates more cost efficiently. Government, however, must protect and get the best value for the taxpayers' money. Making a profit and getting the best value for the taxpayers are not equivalent functions. Furthermore, government agencies often must accommodate multiple and sometimes competing purposes.

Ever aware of protecting and getting the best value for the taxpayer, agencies also must juggle additional and numerous considerations. The SBA must assist existing or potential entrepreneurs who are unable to obtain conventional financing on the open market; an undertaking that is unparalleled in and antithetical to conventional private sector lending practices. An SBA guaranteed loan is not the same as a conventional private sector loan. The Agency is mandated to work with these marginal borrowers and find ways to enable them to finance their business ventures – the same borrowers that the private sector generally would not back. These differences in function and motive illustrate the difficulty inherent in much of privatization.

Recent experience with privatization of many government functions shows that to be fully successful, government must provide very specific instructions and guidelines;

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<sup>11</sup> <http://www.sba.gov/aboutsba/sbahistory.html> (no page).

<sup>12</sup> FY2002 Budget Request and Performance Plan, page 17. Available on-line at <http://yes.sba.gov/offices/cfo/fy2002budgetrequest%26performanceplan.pdf>.



sanctions must be in place; and all standards and expectations must be stated very precisely.<sup>13</sup> Government has repeatedly found that contracts, regulations, and all pertinent instructions must be stated very clearly and specifically. The profit motive may lead to greater efficiency. However, the motive to make the greatest possible profit may result in fraud or abuse, as has been recently illustrated by such cases as the Enron Corporation, Tyco International, and Imclone. A noted academic has determined that the greatest opportunity for abuse lies at the intersection of public and private functions.<sup>14</sup>

Explicit directions to the private sector regarding federally supported activities are absolutely vital for preventing the confusion that can lead to such abuses. In a situation where traditional government functions are privatized, the opportunity for reward to the private entity must be balanced with direct, straightforward requirements as well as sanctions for failure to comply. Some private lenders might make mistakes; others might purposefully take advantage of an uncertain environment. In a market environment, when a private entity is unaware or uncertain of requirements, the predictable outcome is for that organization to “go along” with what might be perceived as most efficient and therefore most profitable. In the absence of clear information, it is unlikely that a conventional private sector lender will expend the resources necessary to ferret out exactly what is required. A profit making organization cannot effortlessly take over the all-encompassing governmental SBA lending functions without detailed, specific guidance and oversight.

### **SBA Guaranteed Business Loans are Unique**

Congress’ intent, when establishing the Section 7(a) program, was to provide access to capital for small businesses that are unable to obtain conventional commercial financing. The plan was for entrepreneurs and small businesses which did not qualify for loans (under traditional lenders’ standards) to be given an opportunity to enter the market and compete for their own benefit. As a consequence, jobs would be created, new products and ideas would enter the market, and other economic development would occur. These marginal businesses then would have an opportunity to participate in and benefit the economy that they otherwise might not have.

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<sup>13</sup> See: Frumkin, Peter (2001) “Managing for Outcomes,” in Mark A. Abramson and John M. Kamensky (eds), **Managing for Results 2002**, Lanham MD: Rowman & Littlefield Publishers; Johnston, Jocelyn M., and Barbara S. Romzek (2000) **Implementing State Contracts for Social Services**, Arlington, VA: The PriceWaterhouseCoopers Endowment for the Business of Government, available on-line at [http://endowment.pwcglobal.com/pdfs/Johnston\\_Report.pdf](http://endowment.pwcglobal.com/pdfs/Johnston_Report.pdf); Kahn, Alfred and Sheila Kamerman (1989) **Privatization and the Welfare State**, Princeton NJ: Princeton University Press; Kamerman, Sheila B., and Alfred J. Kahn (June 1998) “Privatization, Contracting, and Reform of Child and Family Social Services.” Prepared for The Finance Project, available on-line at <http://www.financeproject.org/private.htm>; Moe, Ronald C. (Nov/Dec 1987) “Exploring the Limits of Privatization.” *Public Administration Review*, vol. 47, no. 6, pp. 453-460; and Nightingale, Demetra Smith and Nancy Pindus. (Oct 15 1997) “Privatization of Public Social Services,” Washington DC: The Urban Institute, available on-line at <http://www.urban.org/pubman/privitiz.html>.

<sup>14</sup> Kettl, Donald F, (1993). **Sharing Power: Public Governance and Private Markets**, Washington DC: The Brookings Institution.

By design, any SBA borrower is more likely to default than a well capitalized conventional business owner or entrepreneur. The very fact that a given SBA borrower qualifies for an Agency loan means that it is a riskier proposition. To accommodate that higher risk and encourage small business growth, SBA loans are based on projected cash flow – the anticipation of a business generating increased profits over a period of years. This likelihood of increased profits by the business is the key to a small business qualifying for an SBA guaranteed loan.<sup>15</sup> A related, important difference between SBA and private sector lending concerns collateral. Conventional commercial loans, for the most part, are secured with collateral, generally worth 100% or more of the amount borrowed. This traditional private sector requirement makes it difficult, if not impossible, for many small business owners to have access to capital. To ameliorate this risk, the SBA allows borrowers to inject assets (cash or other fixed resources such as equipment; these are equity injections) into the project. While a borrower may not have the collateral needed to qualify for a conventional loan, the potential ability to repay the loan – based on realistic projected growth of the business – coupled with adequate equity injection, may allow an entrepreneur to qualify for an SBA loan.

These injected assets, known as “equity injection,” permit a borrower to make up for the lack of collateral required by private lenders. In addition to making up for less collateral than would be required in a conventional loan, it is thought that a borrower who has injected some of their own assets into a project to be financed will be more likely to stay committed to the business. Thus, SBA secures these loans by the assets available to the borrower.<sup>16</sup> The existence of equity injection reduces the overall risk to the government as well as increasing the likelihood that the borrower will stay involved with the loan and the business. These assets have been loosely defined in order to allow discretion to lenders so that they can work with the borrower to come up with a satisfactory project. This worked relatively well when all loans were made or approved by local SBA offices that understood the entire process and were thoroughly familiar with the concept. However, institutional knowledge does not necessarily seamlessly transfer from government to the private sector. The increase in investigations and audits where equity injection is an issue raises questions as to whether private lenders fully understand the concept and its importance.

As stated earlier, private sector lenders exist for the primary purpose of making a profit; they are not concerned with guarding the taxpayer’s money but rather with their own business interest which is to make loans quickly and profitably. The inherent tension, the fundamental difference between the public and private sector, fully emerges in this example of SBA guaranteed Section 7(a) loans. In order for these sorts of privatized arrangements to work, government must understand this basic purpose of the private sector. Because of the private sector’s basic motivation to make a profit, government has experienced repeatedly that appropriate oversight, specific instructions, and sanctions for failure to comply are vital in ensuring its various, sometimes competing functions which

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<sup>15</sup> SOP 50-10(4), Ch. 4 §1, paragraph (d) (2), p. 84.

<sup>16</sup>13 CFR Ch. 1 § 120.150, paragraph (f) lists “Sufficient invested equity to operate on a sound financial basis” among the SBA’s lending criteria.

include protecting taxpayer dollars, guarding individual rights, and protecting citizens' safety.

### **Equity Injection, a Closer Look**

Because potential SBA borrowers do not meet the full collateral requirements standard for conventional private sector loans, government backed SBA loans are to be based on anticipated cash flow of the business affected by the loan. That is, the crucial issue is a determination as to whether the potential small business borrower can generate adequate cash flow to service the loan. Lending criteria for SBA loans is outlined in 13 CFR Ch. 1 § 120.150. Paragraph (e) of that section lists "Ability to repay the loan with earnings from the business" among the lending criteria. The SBA Standard Operating Procedure (SOP) 50-10(4), however, augments this requirement by stating: **'The ability to repay a loan from the cash flow of the business is the most important consideration in SBA's loan making process.'**<sup>17</sup>

To reduce the added risk resulting from the more lenient collateral requirements, SBA borrowers may contribute, or "inject" cash and/or other assets into the project. This is stated in the CFR, just after the projected cash flow requirement: "Sufficient invested equity to operate on a sound financial basis."<sup>18</sup> In addition to reducing government's risk, the concept of equity injection allows a borrower to personally invest in the project. Other criteria include that the borrower demonstrate character determination, managerial experience, and collateral guidelines.<sup>19</sup> Ideally, then, once a small business owner demonstrates potential ability to repay the loan based on projected cash flow of the business and satisfies other named criteria, including adequate equity injection, that individual is eligible for government-backed SBA financing.

While the concept of equity injection is carefully designed, and understood by the SBA (and some other agencies that administer various types of government backed loans), this is a good illustration of the difficulties encountered during a transition to the private sector. A private lender, motivated by profit, seeks and loans to the most qualified potential borrower. This customer must have adequate collateral that can be sold to offset the lender's potential loss should the borrower not be able to repay the loan. The main focus of a private sector loan officer is to ensure that the cash flow comes from a reliable source and that adequate collateral secures the loan. This private sector routine is a reasonably straightforward process. Because SBA loans are different, it is important for the Agency to provide concise directions and strict monitoring. Without extremely precise, detailed instructions, lenders may see the equity injection requirements as unimportant and unnecessary "red tape." The private sector may substitute the SBA guaranty for their collateral requirements and ignore the equity injection requirements.

The differences may be somewhat muted, but full realization of these fundamentally dissimilar institutions is essential when privatizing. These somewhat subtle distinctions

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<sup>17</sup> SOP 50-10(4), Ch. 4 §1, paragraph (e) (1), p. 84. (Bold, underlined text from SOP.)

<sup>18</sup> 13 CFR Ch. 1 § 120.150 paragraph (f).

<sup>19</sup> For an exhaustive list of SBA lending criteria, see 13 CFR Ch. 1 § 120.150. Note that inadequate collateral "will not be the sole reason for denial of a loan request" (paragraph h).

explain why government agencies must be very specific, have very detailed instructions including meaningful sanctions for failure, and adequate, appropriate resources to oversee the private entities that assume governmental functions. SBA loans were created to reach a part of the citizenry that the private sector could not profitably serve. To do this correctly, private lenders need extensive training and detailed guidance. A private lender trained to focus on collateral requirements to secure a loan may not view the concept of equity injection as significant to their normal business practices. While the SBA SOPs attempt to give direction and guidance to the lenders, more specificity is needed.

### **Website Information**

The SBA public website information regarding equity injection is very limited, is not clear, nor is it easily accessible to users. For instance, in the section addressed to potential borrowers, “owner’s equity contribution” is named among other criteria to obtain a guaranteed Section 7(a) loan.<sup>20</sup> However, no specific information that defines or describes what this means is included. The “Lender’s and Equity Investor’s Guide”<sup>21</sup> includes a statement that the SBA looks for “reasonable personal contribution and/or business equity” and “adequate equity or investment in the business” with no further instructions regarding what minimum amount or percentage would be considered adequate. Finally, “The U.S. Small Business Administration’s Small Business Startup Kit”<sup>22</sup> does ask a potential borrower: “Have you invested savings or personal equity in your business totaling at least 25 percent to 50 percent of the loan you are requesting?”

Importantly, none of these documents are readily visible from the website.<sup>23</sup> In addition, the documents are lengthy, and equity injection is mentioned, as cited above, in only a very cryptic fashion. Neither lenders nor borrowers are informed as to the appropriate percentage of equity injection for a given loan. Nowhere in this information is there any guidance or suggestion that this injection needs to be verified. Nor is there a description of the sort of documentation that is necessary to demonstrate these requirements have been met.

### **Other Federal Agencies’ Practices**

Some Federal government lending agencies other than the SBA provide very specific directions to lenders and borrowers. Freddie Mac, which essentially accepts only cash as an injection, has a nine item list in its Single-Family Seller/Servicer Guide and accompanying bulletin describing exactly what is considered cash; four items specify what is not cash. There are a few items that indicate “other equity” and these are also quite specifically defined. In addition, there is a five page itemized list of what is acceptable documentation to substantiate this cash requirement has been met.<sup>24</sup> The Farm Credit Administration Regulations (§614.4200)<sup>25</sup> and Statutes (12 U.S.C. 2048)<sup>26</sup>

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<sup>20</sup> <http://www.sba.gov/financing/fr7aloan.html> (no page)

<sup>21</sup> <http://www.sba.gov/library/pubs/lenders.doc> (p. 4)

<sup>22</sup> <http://www.sba.gov/ut/startup.html> (no page)

<sup>23</sup> One experienced lender described the website as “a beast.”

<sup>24</sup> See Freddie Mac Single -Family Seller/Servicer Guide, Volume 1, pp. 26-1, 261-26-2; (8/7/00) and Single -Family Seller/Servicer Guide (Bulletin 2002-1), pp. 37-67 – 37-69 and 37-87 – 37-88 (04/08/02).

<sup>25</sup> See Farm Credit Regulations Part 614 – Loan Policies and Operations, Subpart E – Loan Terms and Conditions, available on-line at:

also very specifically delineate what equity is required by their agency and how to document it.

### **Consequences of Unclear Guidance**

Today's lenders lament that the SBA is inconsistent in its decisions. Likely, the reason for this inconsistency is that the SOP is unclear. While the Small Business Act does mandate the Agency to pass along lending decisions to the private sector, there is no statement or implication that this delegation of authority requires an absence of guidance. Rather, the general underlying intent of the trend to outsource is premised on the fact that government should "steer, not row." This indicates that strict guidance and oversight are needed and expected by Congress.

The lack of clear guidance leads to confusion and increases opportunity for deception. Whether the result of mistakes or overt fraud, the outcome of unclear guidelines is additional cost to both the lender who must pay repairs or withdraw guarantees as well as to the SBA – ultimately to the taxpayer. Even experienced lenders seem uncertain about what to do in given cases. During field work for this report, the author was asked by an experienced lender what should be done about a gift letter which did not seem "quite right." Another lender had suspended all SBA lending for almost a year when they were faced with two repairs because of equity injection issues. The bank was genuinely surprised to find they were culpable in these incidents. Nothing in the SOPs had prepared them for these findings. They suspended all SBA lending until they could clarify for themselves what SBA expected and then build the infrastructure necessary to properly process these loans.

Along with lenders, the Farm Credit Administration representative responsible for Small Business Lending Company (SBLC) examinations noted a lack of clarity regarding SBA equity injection requirements, both in terms of substantiating the injection as well as determining what amount of injection is required. At a recent NAGGL regional conference, a speaker from a local SBA office held up the SOP and said it contained "nothing about equity injection."<sup>27</sup> These examples illustrate that all involved parties need direct communication that clarifies how much equity injection is required; what is acceptable equity; and how to adequately document the required infusion.

This lack of clarity and specificity has led to additional problems because of the competitive nature of SBA guaranteed lending. Lenders that expend the most effort to comply are often at a disadvantage when they require more documentation or a greater amount of equity injection. If a potential borrower does not want to meet the stricter, more SBA-compliant terms of a particular bank, s/he can readily find another lender who

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<http://www.fca.gov/handbook.nsf/327ac6bc1652f1c18525646b006af78b/e05bb077d140debd8525646b006b3228?OpenDocument>.

<sup>26</sup> See Farm Credit Statutes, 1971 Act as Amended, Title 1 Farm Credit Banks, 12 U.S.C. 2018 § 1.10, available on-line at:

<http://www.fca.gov/handbook.nsf/24123e431e73ccdb8525643c007e3fec/14f03e6b95fb3d228525643c007e05e2?OpenDocument>.

<sup>27</sup> See page 19 for detailed discussion.

more loosely interprets the SBA requirements. The following findings result from the overall unclear guidance to lenders.

## Methodology

This project is a meta-analysis of existing OIG work. Meta-analysis is a research method which synthesizes previously obtained research results and is more rigorous than a simple narrative discussion. Rather, existing works are meticulously analyzed for recurring patterns in a way that is comparable to a statistical analysis.<sup>28</sup> For this meta-analysis, audits, inspections, and investigations materials were major sources of information. Documents selected for review include recent OIG studies, reports, cases, and other documents related to the Section 7(a) guaranty loan program, including other special programs falling under those guidelines. Inspections and audit reports and memos were selected by word search of the SBA website, using the keyword “inject.” Summaries of investigations cases were similarly word searched. A manual search also was performed of recent files and other collections of OIG work, searching for related documents.

Additional documentation was also studied. SBA Standard Operating Procedures and Policy Notices, as well as various loan application forms were used as information sources. Finally, the legislative histories of bills that affect the Section 7(a) program were analyzed to gain information concerning Congressional intent regarding the Agency’s role.

In addition, several SBA program administrators were interviewed. These include representatives of the Office of Financial Assistance, the Office of Capital Access, the Office of Lender Oversight, the Office of Field Operations as well as the General Counsel and representatives from several District Offices. Several lenders were visited on-site and interviewed. Finally, representatives from agencies which have similar programs, were also interviewed.

To complete the meta-analysis, information from the existing OIG work and SBA documentation was synthesized with the interview data. These data were then analyzed for patterns and other indications that clarify the role of equity injection issues where inspections, audits and investigations have noticed problems.

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<sup>28</sup> See: Florax, Raymond, Henri de Groot and Ruud de Mooij, (2002) “Meta-analysis in Policy-Oriented Economic Research,” CPB Report 2002/1, available on-line at: [http://www.cpb.nl/nl/cpbreport/2002\\_1/cpbr021.pdf](http://www.cpb.nl/nl/cpbreport/2002_1/cpbr021.pdf) ; and Cooper, Harris and Larry V. Hedges (1994), **The Handbook of Research Synthesis**, New York: Russell Sage Foundation.

## Findings

A widespread recent OIG investigation centers around a Dallas, Texas loan packager who prepared almost 40 SBA loan packages with a total value of over \$14.5 million. To date, this case has resulted in over 20 indictments, and more are expected. This packager conspired with others including additional loan packagers, loan brokers, loan officers, appraisers, borrowers, title company officials, and IRS verification personnel to prepare false documents. Consistently, false equity injection activity has been a factor in these cases.<sup>29</sup> These and other closely related schemes involved capital injection activity, such as using loan proceeds from one closing as injection for another loan; third parties providing, for a fee, the capital injection until closing, and various false documentation.<sup>30</sup>

Congress has been aware of, and focused on the need for strict oversight in recent years. Repeatedly, testimony at Congressional hearings has included such comments as “it is the intent of the committee that PLP usage be monitored carefully;”<sup>31</sup> “programs like Section 7(a) and Section 504 that have a significant potential impact on the economy should not lie outside the normal checks and balances of our system of government;”<sup>32</sup> as well as concern expressed about “the SBA failure to provide timely and regular examinations of SBA-licensed lenders.”<sup>33</sup> Complicating matters, both the Senate and the House have instructed the Agency to delegate more and more of its loan making function and authority to private lenders and to reduce delays to the lenders, especially Preferred Lenders.<sup>34</sup> At one point in 1995, the duality of these instructions is stressed. In a hearing, the Small Business Committee instructed the Agency to enhance and enlarge the Preferred Lender Program, but, at the same time, directed the Agency to “ensure that the safety and soundness of SBA business loan activity not be sacrificed” and develop an audit and procedure manual to standardize PLP reviews.<sup>35</sup>

It is clear that Congress intends exactly what has been stated in these meetings – the SBA is supposed to delegate its lending authority, but it is to do so in conjunction with methods that protect against risk. Specific guidance and direction are inherent in the effort to oversee the lenders. In order to meet Congress’ mandate and ensure that the safety and soundness of SBA business loan activity is not sacrificed, specific directions, guidelines, and training must be developed and stressed to all SBA lenders.

The Office of Management and Budget (OMB) recently revised its Circular A-129, “Policies for Federal Credit Programs and Non-Tax Receivables,” which includes policies and procedures for justifying, designing, and managing Federal credit

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<sup>29</sup> Semiannual Report of the Inspector General, U. S. Small Business Administration, September, 2001, p. 13. Available on-line at: <http://www.sba.gov/IG/sar9-01.pdf>.

<sup>30</sup> Semiannual Report of the Inspector General, U. S. Small Business Administration, Fall 2002, p. 7. Available on-line at: <http://www.sba.gov/IG/sar9-02.pdf>.

<sup>31</sup> S. Rep. 104-139, p. 6 (September 12, 1995).

<sup>32</sup> HR. Rep. 104-239, p. 8 (1995) – testimony of Philip Lader, SBA Administrator.

<sup>33</sup> S. Rep. 105-62, p. 9 (1997).

<sup>34</sup> See for instance HR. Rep. 103-885, p. 108 (1995); S. Rep. 104-129, p. 10 (1995); HR Rep. 104-750, p. 64 (1996).

<sup>35</sup> S. Rep. 104-139, p. 102 (1995).

programs.<sup>36</sup> Based on such statutes as the Federal Credit Reform Act of 1990, the Federal Debt Collection Procedures Act of 1990, and the Chief Financial Officers Act of 1990, Circular A-129 directly addresses both the minimum amount of equity injection that should be required, as well as documentation requirements. First, OMB directs that private lenders should “bear at least 20 percent of the loss from a default.”<sup>37</sup> This section further mandates that: “Borrowers should have an equity interest in any asset” financed with credit assistance and “business borrowers should have substantial capital or equity at risk in their business.”<sup>38</sup> Further, agencies are directed to “explicitly define the components of the loan to value ratio” for guaranteed loan programs.<sup>39</sup> The issue of adequate documentation is also addressed: “Accurate and complete documentation is critical” to processing claim payments for guaranteed loans.<sup>40</sup> The importance of these issues is further confirmed by including these items in the “Checklist for Credit Program Legislation, Testimony, and Budget Submissions.”<sup>41</sup>

As stated above, Congress has been very clear in their mandate to take specific steps to reduce the Agency’s risk in guaranteeing loans. OMB has issued Circular A-129 that further clarifies steps the SBA and all other federal credit programs should take. The remainder of this section describes the major changes that need to be made to align the SBA with the Congressional mandate and OMB instructions in order to overcome the current problems with equity injection.

### **Finding I – SOPs and Policy Notices are not specific enough**

Existing references to and instructions regarding equity injection requirements for Section 7(a) guaranteed loans are inadequate and obscure. The SBA published Standard Operating Procedures (SOPs) are perhaps most heavily relied on and referred to for guidance and direction. However, SOP information regarding equity injection requirements, both for acceptable documentation as well as adequate percentage of the total loan, is insufficient. This leads to problems. In May, 2001, the Los Angeles District Office newsletter reported an increase in the number of guaranty repairs as well as voluntary releases by participants. They reported that the main reason was because lenders were not properly documenting the files at underwriting. One of the leading causes named in the newsletter was “failure to verify cash injection.”<sup>42</sup> This newsletter followed a 1998 audit of 30 Section 7(a) loans from the Los Angeles District Office which concluded that in many cases the required equity injections were not made, were not verified, borrowers could not provide acceptable documentation and/or lenders’ files lacked adequate evidence.<sup>43</sup>

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<sup>36</sup> <http://www.whitehouse.gov/omb/circulars/a129/a129rev.html> (Nov 2000).

<sup>37</sup> Circular A-129, §II.3.a. (1) (Nov 2000).

<sup>38</sup> Circular A-129, §II.3.a. (2) (Nov 2000).

<sup>39</sup> Circular A-129, §III.A 3 b (Nov 2000).

<sup>40</sup> Circular A-129, §III.A 2 (Nov 2000).

<sup>41</sup> Circular A-129, Appendix B (Nov 2000).

<sup>42</sup> SBA NEWS!, newsletter of the Los Angeles District Office, (May, 2001), p. 2.

<sup>43</sup> Audit 8-8-F002-028 (September 30 1998). Available on-line at: <http://www.sba.gov/IG/8-8-f-002-028.pdf>



Numerous other audits have revealed situations where injections were not verified or properly documented. These include a Summary audit of Section 7(a) Loan Processing which included 240 loans. Results were that lenders repeatedly did not require or if they did require, failed to verify equity injections.<sup>44</sup> Additional audits of districts in Kansas City,<sup>45</sup> Washington DC,<sup>46</sup> Santa Ana,<sup>47</sup> show the same results – equity injection requirements are not verified, not properly documented, or not entered in the Loan Authorization.

Processing SOP 50-10(4) devotes several pages to instructions regarding equity injection.<sup>48</sup> Instructions regarding real estate are specifically stated: “More than 90% of real estate cost is not eligible under PLP.”<sup>49</sup> However, regarding “Adequacy of Equity” lenders are instructed to “decide whether equity is adequate on a case-by-case basis.”<sup>50</sup> “Use a case-by-case basis” does not give the lenders enough information to make decisions. The “Debt to Equity Ratio” is addressed, where lenders are cautioned to generally discount soft values because they have little or no tangible value, but in the same sentence, it states that “they may well provide an indication of strength in the business.”<sup>51</sup> The “Value of Assets other than Cash Injected as Equity” section instructs lenders to “carefully evaluate the value of assets other than cash,” noting that applicants may overvalue or undervalue their assets.<sup>52</sup> While subparagraph 5 states that “generally, standby debt from non-owners is not acceptable as the entire net worth of an applicant,” the following subparagraph 6 alters that by adding that “if the lender agrees to a formal standby of payment,” then “the borrowed funds may be deemed to be equity.”<sup>53</sup> These instructions are confusing and self-contradictory.

Other unclear directions include: “Normally treat personal credit as debt financing not equity injection” – but borrowed funds “may be deemed to be equity.”<sup>54</sup> This sort of language is confusing. These comments are non-specific, including such qualifiers as “generally”, or “usually.” In addition, these instructions are self contradictory – being told that borrowers may under- or over-value their assets or that standby debt may or may not be acceptable equity is inadequate and baffling.

Additional comments about equity injection are interspersed throughout the SOP. Like the real estate example, construction projects receive some clear attention. It is stated that such funds “should be used prior to first disbursement.”<sup>55</sup> However, other explanations throughout the SOP are also vague and ambiguous. For instance, PLP lenders are instructed to “analyze whether the injection is adequate and discuss the

<sup>44</sup> Audit 0-03 (January 11 2000). Available on-line at: <http://www.sba.gov/IG/audit0-03.pdf>

<sup>45</sup> Audit 9-16 (August 4 1999). Available on-line at: <http://www.sba.gov/IG/9-16KC7a.doc>

<sup>46</sup> Audit 7-7-F-007-021 (July 18, 1997). Available on-line at: <http://www.sba.gov/IG/77f007021.pdf>

<sup>47</sup> Audit 7-7-F-009-020 (July 8, 1997). Available on-line at: <http://www.sba.gov/IG/ldstana.html>

<sup>48</sup> Processing SOP 50-10(4), Chapter 4, Credit, paragraph f (pp. 85-88)

<sup>49</sup> Processing SOP 50-10(4), Chapter 4, Credit, paragraph f (pp. 85).

<sup>50</sup> Processing SOP 50-10(4), Chapter 4, Credit, paragraph f (1) (p. 85-86).

<sup>51</sup> Processing SOP 50-10(4), Chapter 4, Credit, paragraph f (2) (p. 86).

<sup>52</sup> Processing SOP 50-10(4), Chapter 4, Credit, paragraph f (4) (pp. 86-87).

<sup>53</sup> Processing SOP 50-10(4), Chapter 4, Credit, paragraph f (5) (6) (pp. 86-87).

<sup>54</sup> Processing SOP 50-10(4), p. 87.

<sup>55</sup> Processing SOP 50-10(4), paragraph (5) (c), p.111.

sources and uses of funds.”<sup>56</sup> LowDoc lenders are instructed to consider, on a case-by-case basis, “other factors to offset marginal owner equity.”<sup>57</sup> To be told to analyze whether injection is adequate, or to use a case by case basis where marginal equity is an issue is insufficient without stated Agency requirements. A discussion of sources and uses of funds does not adequately meet the OMB requirement for accurate and complete documentation. These sorts of directions are internally inconsistent and vague.

SOP 50 50 4, Loan Servicing, includes even less information about equity injection. Lenders are instructed to include copies of “evidence of equity injection.”<sup>58</sup> The Servicing SOP includes a purchase checklist that mentions “Evidence of Borrower Injection.”<sup>59</sup> However, neither of these SOPs gives any mention at all regarding the acceptable percentage of, or how to document that the equity injection has been made at all.

In addition to the SOPs, the Agency recently released Policy Notice 5000-831, effective October 2, 2002 which speaks to the Section 7(a) Loan Guaranty Purchase Policy. Under the heading “Guidance and Instructions on Specific Purchase Issues,” Section D, Borrower’s Injection, requires lenders to “verify injections prior to disbursing,” as well as instructs them to “maintain the evidence in their loan files.” This section also includes some guidance on documentation and repeats the admonition in SOP 50-10(4) to carefully determine value of assets.<sup>60</sup>

A new Purchase Request Checklist issued in conjunction with Policy Notice 5000-831 includes “Evidence of Borrower Injection” in the list of required documents. The updated checklist includes a column on the left side of the form titled “Req’d of Bank,” where items such as the Loan Authorization, settlement sheets, PLP loan eligibility determination, and LowDoc loan eligibility checklist are indicated to be “Required of Bank.” However, the specific item “Evidence of Borrower Injection” is not checked in that column – which could imply that this Evidence is not required.<sup>61</sup> So, while this Policy Notice provides some guidance on the need to document equity injection, and is therefore an improvement, it is important to note that the Purchase Request Checklist does not indicate that documentation is required.

Regarding percentage requirements for injection, the Policy Notice states that “a relatively large injection is generally more instrumental to the business’ success than a small injection.” The section also states that “lack of evidence of a small injection usually is not a significant factor in the failure of the business unless this failure is combined with a number of other lender deficiencies.”<sup>62</sup> So, while the Policy Notice provides some additional information, it does not provide the explicit guidance that such a unique concept requires. In addition, the Policy Notice is not available to the general

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<sup>56</sup> Processing SOP 50-10(4), Subpart D, §8, paragraph b, (1), p. 346.

<sup>57</sup> Processing SOP 50-10(4), Appendix 5, §6, p. 578-580.

<sup>58</sup> SOP 50 50 4, Chapter 9, Purchasing SBA’s Guaranty, §4 (1) pp. 9-2 – 9-3.

<sup>59</sup> SOP 50 50 4, Chapter 9, Purchasing SBA’s Guaranty, Appendix 26 (no page).

<sup>60</sup> SBA Policy Notice Control No.: 5000-831, effective 10/02/2002, pp. 10.

<sup>61</sup> SBA Policy Notice Control No.: 5000-831, effective 10/02/2002, “Attached” Checklist, p. 1-2.

<sup>62</sup> SBA Policy Notice Control No.: 5000-831, effective 10/02/2002, pp. 11.

public on-line. Finally, while the documentation requirements are addressed to a certain extent in this Notice, many private sector lenders structure their organizations so that loan officers who originate the loan would not necessarily be aware of Purchase Request requirements because those would be handled by a different employee. Thus, this Policy Notice is not a direct way of getting the still limited if somewhat improved information to the lenders and staff who need to be fully aware of equity injection requirements.

## **Finding II – Imprecise Loan Authorization Boilerplates**

An Audit Memoranda reveals one consequence of the confusion that unclear directions cause. In this instance, a borrower applied for a Section 7(a) loan, planning to use the funds to finance a portion of the equity injection required for a companion Section 504 loan<sup>63</sup> to be made by a different lender. The total loan package was \$1.2 million. The SBA loan officer stated that she was unaware of the intended use of the Section 7(a) loan proceeds because the loan application was submitted under PLP processing procedures. The lender's loan officer stated that she was unaware of the regulatory prohibition and that use of loan proceeds for equity injection was an oversight. The District Office Finance Division Chief noted that the documentation for the Section 504 loan did not disclose that a portion of the equity injection was to be obtained from Section 7(a) proceeds.<sup>64</sup> This "oversight" is prohibited by SOP 50 10(4) but the restriction is buried in Chapter 2, Business Loan Eligibility, §11, subsection g, item (4).<sup>65</sup> In this case, neither the Agency nor the lender was aware of the inappropriate Section 7(a) loan. Such situations as this indicate that Section 7(a) equity injection guidance is often inadequate. These flaws can allow SBA borrowers and lenders to slip through the cracks. The cost to the Agency is substantial. Like the SOPs and Policy Notices, the Loan Authorization Boilerplate does not provide adequate equity injection information.

The U. S. Small Business Administration National 7(a) Authorization is the ruling document between the lender and the Agency for specific SBA guaranteed loans. This document provides the terms and conditions under which the SBA will guarantee a given loan. The 7(a) Authorization stipulates the conditions of the guaranty. Lenders choose from standardized boilerplate language to customize a document specific to each individual loan.<sup>66</sup> Authorization requirements are directed to the lender who must obtain necessary information, documents and certifications from the borrowers necessary to meet SBA's requirements for a guaranty. If a lender requests that SBA honor its guaranty, the Agency requires that lender to present evidence that the loan was properly closed, serviced, and liquidated in accordance with the Authorization, which is based on

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<sup>63</sup> The Section 504 Certified Development Company (CDC) Program provides growing businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings. Typically, a Section 504 project includes a loan secured with a senior lien from a private-sector lender covering up to 50 percent of the project cost, a loan secured with a junior lien from the CDC (backed by a 100 percent SBA-guaranteed debenture) covering up to 40 percent of the cost, and a contribution of at least 10 percent equity from the small business being helped. For complete information, see <http://www.sba.gov/financing/frcdc504.html>.

<sup>64</sup> Audit 7-7-F-019-024 (September 25, 1997). Available on-line at: <http://www.sba.gov/IG/77f019024.pdf>

<sup>65</sup> See SOP 50 10(4), p. 59-2.

<sup>66</sup> Boilerplate is available on-line at <http://www.sba.gov/banking/national/a7a42.pdf>.

SBA policies.<sup>67</sup> The boilerplate indicates that some options are required in every loan situation. Other selections are marked “optional.”

Equity Injection information is displayed in subsection (letter) I, “Additional Conditions,” part 5, prominently displayed as “Optional” (See Appendix I).<sup>68</sup> Because the Boilerplate is based on SOP 50 10(4), it is no more clear than is the SOP. Page 2 of the Boilerplate states that its purpose is to “provide Lender with the specific conditions which must be met for SBA to provide a guarantee of the loan.”<sup>69</sup> This is repeated, and expanded upon in Appendix C, where it is stated that SBA directs lenders to obtain the necessary information, documents, and certifications in order to meet the Agency guaranty requirements.<sup>70</sup> Given that lenders are delegated the authority to make loan requirement decisions, coupled with the prominent label of “Optional,” a lender might assume that equity injection is not important. It is essential for the Loan Authorization to be more clear and specific regarding expectations for minimum equity injection requirements and adequate documentation.

### **Finding III – Inadequate Forms**

Like the Loan Authorization, other forms provide inadequate information for lenders and borrowers. The lack of clear and direct information has led to increased investigations and audits resulting from issues related to equity injection. In 2002, a case in Florida resulted from the borrower falsifying documents to cover the fact that he had borrowed the funds for the required equity injection and then used the working capital portion of the SBA loan to pay off the first lender. These abuses can be wide-reaching – another 2002 OIG investigation revealed a situation where a packager had likely made improper payments to key bank officials in addition to making false statements regarding equity injection. A similar situation investigated showed that a borrower allegedly falsified capital injection and likely conspired with a broker and bank official. Ambiguous and imprecise instructions provided in SBA lender and borrower forms make it more likely that these kinds of abuses will occur. It also makes it more difficult to prove criminal intent necessary for most fraud convictions.

Closely related to the previous findings that existing SOPs and Policy Notices as well as the Loan Authorization are unclear is the third finding: relevant lender and borrower forms do not emphasize, and in most cases do not even mention the need for equity injection. Appendix II includes copies of all forms discussed in this section.

#### **Lender Loan Forms**

Currently, only the Low-Doc application form 4-L, Lender’s Application for Guarantee, includes some reference to equity injection requirements. Section G, (page 2) notes, “If the loan is for a start-up or purchase of existing business, the lender must denote the amount of applicant injection.” Spaces are provided for cash, assets, stand-by debt, and “Other.” The lender is further instructed to provide a breakdown in the Comments

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<sup>67</sup> <http://www.sba.gov/banking/national/a7a42.pdf>, Appendix C-2, FAQ 1.

<sup>68</sup> <http://www.sba.gov/banking/national/a7a42.pdf>, p. 23.

<sup>69</sup> <http://www.sba.gov/banking/national/a7a42.pdf>, refers to CFR 120.10.

<sup>70</sup> <http://www.sba.gov/banking/national/a7a42.pdf>, p. C-2.

section “if the injection is in the form of assets other than cash.” The instructions include the following definitions: “Cash is money reported on a personal financial statement; Assets are those assets reported on a personal financial statement; Stand-by debt is any obligation which will be placed on stand-by; and Other includes gifts, inheritances and other sources not already mentioned.” However, the LowDoc form 4-L does not provide enough guidance for lenders in terms of determining how much equity is adequate or how to document that the required equity has indeed been injected into the project.

The other lender forms are inadequate in giving direction to lenders. Form 4-I, Lender’s Application for Guaranty or Participation, does not have a specific section for Equity Injection information or include any directions. In training, NAGGL suggests that the CONDITIONS OF LENDER section could be used for this.<sup>71</sup> If this suggestion is followed, the form should specifically state that Equity Injection information is to be entered in that space.

### **Borrower Loan Forms**

Form 4, (Borrower’s) Application for Business Loan, and the Short Form 4 (to be used for non-LowDoc loans \$50,000 and under), also do not address the issue of equity injection. Given the inadequate guidance in the SOPs, the inadequate or nonexistent instructions found on lender and borrower forms contribute to the lack of specific guidance for lenders and borrowers. The lack of direct guidance in the SOPs is compounded by the inadequate attention to equity injection requirements on both lender and borrower forms.

### **Finding IV – Inadequate, Inconsistent Training for Lenders and SBA employees**

A recent investigation illustrates the existing ambiguity regarding equity injection. The borrower was required to inject a total of \$300,000; however the lender never verified the source. The borrower and his wife jointly claimed on their previous federal tax return an income of only \$40,000. In spite of this income, modest compared to the promised amount, the lender never verified the source of the pledged equity injection. Repeating a pattern noticed by OIG in cases where equity injection deficiencies are an issue, the borrower defaulted within six months of closing. In an interview with an OIG Investigator, the loan officer stated that he did not explain to the borrower how equity injection works, nor did he question how the borrower would come up with the \$300,000. The Loan Agreement stated only that the borrower would bring proof of the injection to the closing. In this situation, the SBA lost almost \$1 million. Likewise, audits have uncovered situations where the Agency does not hold the lender or the borrower responsible for the failure to make an equity injection.<sup>72</sup>

Such situations point to the need for quality lender training. Training for lenders is inconsistent and inadequate. SBA loans are quite different from any conventional commercial loans and require great depth of knowledge and experience. In today’s fast-paced market environment, lenders must receive detailed, specific training.

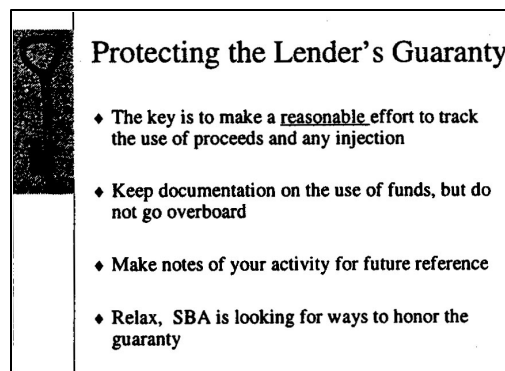
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<sup>71</sup> Author’s notes from NAGGL Workshop, “SBA Application Processing.”

<sup>72</sup> Audit 6-5-002-022 (September 30 1996). Available on-line at: <http://www.sba.gov/IG/87f005002.pdf>

Closely related to the need for training is the necessity for SBA offices to standardize requirements and expectations. Many of today's SBA lenders work with more than one local office and they complain about the lack of consistency. While the vague and unclear SOPs have contributed to this problem, the fact is that lenders and local offices alike need to reach a common understanding of the principles and requirements underlying SBA loans.

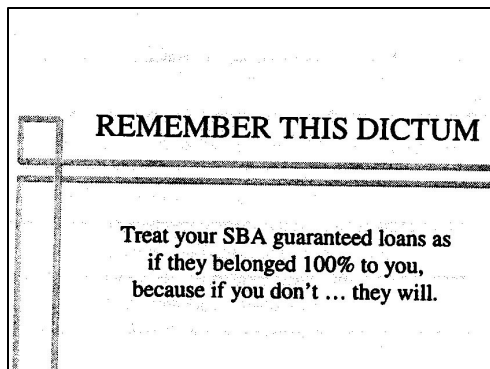
At a recent NAGGL regional conference, two speakers from the same SBA office led workshops. One speaker included a slide in his presentation that encouraged lenders to make reasonable efforts to track use of proceeds and injection, encouraged them to keep documentation without going overboard, and concluded with the thought that SBA is looking for ways to honor the guaranty:



**Protecting the Lender's Guaranty**

- ◆ The key is to make a reasonable effort to track the use of proceeds and any injection
- ◆ Keep documentation on the use of funds, but do not go overboard
- ◆ Make notes of your activity for future reference
- ◆ Relax, SBA is looking for ways to honor the guaranty

Immediately following the session where the above slide was used, a speaker from the same SBA office led a different session. His conclusion included a warning to lenders to be very cautious with their SBA loans:



**REMEMBER THIS DICTUM**

**Treat your SBA guaranteed loans as if they belonged 100% to you, because if you don't ... they will.**

Together, the above slides comprise a striking example of the conflicting messages that lenders receive. It is often noted that regional differences account for the many inconsistencies that are problematic in Section 7(a) loans, but in this case, there are extremely different views about equity injection being offered by SBA officials from the same office offered in adjoining NAGGL workshops. Once stricter, clearer guidelines and standards are established, training for all lenders and SBA personnel should be required in order to bring about uniformity and consistency regarding equity injection requirements. Interviews with SBA lenders revealed that those who enjoy the most success require borrowers to submit and document their equity injection well prior to closing the loan. One lender always asks:

- Where is it?
- How did you get it?
- What are you doing with it?
- How can you prove it?

This is the sort of preciseness and standardization that training can bring about. OIG recognizes there is a hope of simplifying and even moving to allow lenders to use their own forms. However, because of the basic differences between the private and public sectors' motivation and procedure; as well as SBA's current inadequate information, it is unlikely that most private lenders will recognize the need for adequate equity injection and its documentation without adequate training.

#### **Finding V – Standardized Checklists Needed**

Recent OIG investigations reveal cases where false equity injection documents are used to gain 100% financing for Section 7(a) loans. In Arizona, a couple came up with a no-money-down scheme for clients who were otherwise not qualified for a loan or lacked necessary funding. They submitted false documents to non-bank lenders saying that borrowers had met cash injection requirements. A Connecticut dry cleaning business owner also submitted false documents to fraudulently substantiate equity injection. She reported to the bank that the business had previously purchased equipment. However, the business had actually borrowed the money from a private lender using a different company name. The private lender had first lien position on the equipment which was also pledged to the SBA lender. Both the lender and the SBA were unable to recover their losses. Adequate documentation as well as substantiation of the equity injection can greatly reduce the occurrence of such schemes.

Many local offices have developed application processing checklists specific to their own offices; NAGGL also has one, as has at least one software vendor. Thus, a myriad of application processing checklists exist. Each office may have individual standards and expectations based on experiences within their local area. However, today's market environment has led to numerous SBA lenders who function on a national level. It is unrealistic to expect any given lender to comply with one set of standards in one given locale, and an altogether different set of standards just a state or even region away. By standardizing a checklist that is specific and thorough, the Agency can do much to reduce the incidence of fraudulent documentation.

## **Conclusion**

SBA loans are quite different from and may be more complex than conventional private sector business loans. It is more complicated to determine whether the potential earnings of a business can service the loan payment than it is to ensure that adequate collateral exists. It is quite difficult and time-consuming to assure that non-cash equity injection assets are available and owned by the borrower, in addition to properly documenting those findings. The pronounced differences between public and private sector motives and focus require that the Agency provide clear and direct guidance to its lenders. Conscientious lenders who want to participate in SBA loans must have a level playing field. Anecdotal examples from the field reveal that as more and more lenders enter the market and compete for borrowers, some report that they lose business to others who are willing to be more lenient on the requirements. Without specific guidance from the Agency, this is more likely to happen.

The Agency has followed the Congressional mandate regarding allowing lenders to make credit decisions. However, the second aspect of the mandate, that of strict oversight and monitoring, has not been as enthusiastically fulfilled by the Agency. Congress clearly demands strict oversight and monitoring of the private sector lenders. OMB has issued Circular A-129 with direct requirements for guaranteed loans. Private sector lenders must have explicit directions regarding all aspects of the entire processing, servicing and liquidation of SBA guaranteed loans. This assessment of the widespread and growing problems with equity injection coupled with the vague guidelines in the SOPs as well as inadequate application forms reveals that much more specificity and clarity is needed to overcome the lack of information and certainty on the part of private lenders. For that reason, the following Recommendations are submitted.

## **Recommendations**

The central finding is that the current guidelines are unclear and inconsistent. All of the following recommendations flow from that finding. The SOPs, Boilerplates, lender and borrower forms, SBA loan officer checklist, and training all need to be modified and strengthened to emphasize the importance and necessity of adequate equity injection and supporting documentation and to ensure consistency throughout SBA guidance materials.

### **Recommendation I.**

Processing SOP 50 10(4) needs to be revised to clarify:

- The minimum amount and/or percentage of equity that the applicant must inject into the project.
- What verification the Agency will accept as proof that the applicant's injection has occurred.
- What verification the Agency will accept as proof that the applicant's injection is not encumbered.



## **Recommendation II**

The National 7(a) Authorization Boilerplate should be amended to include precise directions that are more specifically stated regarding equity injection. These instructions should include both the amount required, as well as what constitutes adequate documentation. This recommendation extends to all specialized 7(a) boilerplates, including the National EWCP Authorization Boilerplate, and the National CAPLines Authorization Boilerplate.

Specifically, boilerplates should:

- Remove the Optional heading
- Scrupulously detail the minimum amount of injection that is required
- Identify the form of the injection
- Specify the source of the injection
- Detail documentation that is used to verify the above requirements

## **Recommendation III**

Loan forms need to be revised:

- Lender form 4-L, should show amount of injection, and provide a place to substantiate verification that the injection has occurred and is not encumbered.
- Lender form 4-I should be revised to include the amount, and verification that injection has occurred and is not encumbered.
- Borrower form 4, and the short form 4, should be revised to include the amount, and verification that injection has occurred and is not encumbered.
- Because only page 1 of these forms is submitted for Preferred Lender loans, the above information should appear on the first page of lender and borrower forms.

## **Recommendation IV**

- Adequate training for all lender employees involved with SBA loan origination should be provided to them immediately.
- Adequate training for all SBA employees involved with SBA loan origination should be provided to them immediately.
- Training should be standardized so that all receive the same instructions.

## **Recommendation V**

In the interest of uniformity and consistency, a master Application checklist should be developed that covers all the core, essential items. Because of the fundamental requirement for equity injection, documentation and proof should be prominently displayed on the checklist.

## **Agency Comments and OIG Response**

OIG received comments from the Agency in response to our draft report. The Office of Financial Assistance (OFA) did not agree with the recommendation regarding the establishment of a firm minimum quantifiable equity injection level and did not address the other four recommendations. As discussed in the exit conference with the OFA Associate Administrator, the report findings and recommendations regarding equity injection amounts speak to the issue of clarification of guidance for the lenders and SBA. The Agency may take corrective action using any of several approaches to resolve the lack of information that currently exists. Our recommendation to establish a minimum amount or percentage of equity that the applicant must inject could vary from industry to industry if that is what SBA believes needs to be done. We agree that flexibility is important and envision a variety of ranges, suggested levels tied to different types and amounts of loans, or other sorts of guidance the Agency may wish to provide for lenders regarding equity injection.

OFA also cited the use of one illustration of fraudulent activity as justification for equity injection requirements. As noted in the Background section (p. 1), equity injection is identified as a major and recurring problem in both investigations and audits of the 7(a) program. The methodology section (p. 9) states that the findings and recommendations in this report derive from many sources. The numerous selected illustrations are included to serve as examples of the kinds of fraud and abuse where the OIG has found problems contributed to by the existing lack of guidance. Each recommendation is based on the cited documentation. SOP 50 10 (4), the Loan Authorization and loan application forms all lack sufficient guidance for the lenders. Based on the lack of clarity regarding equity injection guidance, the lack of comment from OFA on the remaining four recommendations, and the equity injection problems noted over the years, we believe all the recommendations are valid. For that reason, we reaffirm that SBA should take action on each of the five recommendations. Therefore, we will seek resolution of the recommendations through SBA's follow up process.

## **Appendix**

## **Appendix I, Selected Boilerplate Pages**

[Go to 7a Index](#)

[Appendix A](#)

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[Appendix C](#)

[Appendix D](#)

U.S. Small Business Administration

# National 7(a) Authorization Boilerplate

Version 4.2

October 1, 2002

use **paragraph h.** if you are trying to keep the Borrower in the present location regardless of where the collateral is located.

SOP 50-10(4), pg. 91-93, Subpart "A", Chapter 4, Paragraph 1.h.(5)—Collateral on Leased Property

- d. **Lease**—Current lease(s) on all business premises where collateral is located with term, including options, at least as long as the term of the Loan.
- e. **Lease**—Current lease(s) on all business premises where collateral is located, with an adequate term, including options, appropriate to the maturity of the Loan, considering location, type of business, and type of leasehold interest.
- f. **Lease**—Current lease(s) on all business premises where collateral is located with term, including options, at least as long as the term of the Loan plus **[number of years]** years.
- g. **Lease**—Current lease(s) on all business premises with a term, including options to renew exercisable by the Borrower, at least as long as the term of the Loan.

#### **Agreement of Franchisor (OPTIONAL)**

Note: Each option within the Agreement of Franchisor (options (1) to (4) ) is optional

- h. **Agreement of Franchisor :**
  - (1) That Lender and SBA can have access to Franchisor's books and records relating to Borrower's billing, collections and receivables.
  - (2) That upon Loan payment default or deferment, to defer payment of franchise fees, royalties, advertising, and other fees until Borrower brings Loan payments current **[OPTION—or for [months] months, whichever is less]** .
  - (3) To give Lender 30 days notice of intent to terminate the Franchise Agreement.
  - (4) To give Lender an opportunity to cure any defaults. Deferment of fees will not be cause for franchise termination.

For 7a Wizard users:

Additional Conditions (Part II) starts here...

#### **INJECTION (OPTIONAL)**

SOP 50-10(4), pg.86-88, Subpart "A", Chapter 4, Paragraph 1.f.—SBA Injection Policy

#### **5. Injection**

**Lender must obtain evidence that prior to disbursement:**

**Select one or more of the following paragraphs (a to d)**

- a. **Cash Injection**—At least \$ **[Amount]** cash has been injected into the business as equity capital. This cash is for **[Description]**.
- b. **Standby Debt Injection**—At least \$ **[Amount]** cash has been injected into the business. This cash is for **[Description]**. Borrower may obtain this cash from a loan that is Standby Debt until Borrower pays Lender in full.

SBA Loan Number: **[Loan Number]**  
SBA Loan Name: **[Loan Name]**

Page 23

- c. **Equity Injection / Standby Debt Injection**—At least \$ **[Amount]** cash has been injected into the business. The cash is for **[Description]**. Borrower may obtain cash from personal resources or from a loan that is Standby Debt until Borrower pays Lender in full. Any such debt must be covered by a standby agreement substantially equivalent to SBA Form 155, with no payment permitted.
- d. **Asset Injection**—Assets with a fair market value of not less than \$ **[Amount]** have been injected into the business as equity capital.

**STANDBY AGREEMENT (OPTIONAL)**

NOT OPTIONAL if "Standby Debt Injection" is selected above  
 SOP 50-10(4), pg.86-88, Subpart "A", Chapter 4, Paragraph 1.f.—SBA Standby Injection Policy

**6. Standby Agreement**

*The following section must be repeated for each standby creditor*

- a. Lender to obtain Standby Creditor's Agreement from **[Name]**, for \$ **[Amount]**, plus all accrued and future interest (Standby Debt).

**[SELECT one of the following repayment options -**

No payment of principal or interest is to be made on Standby Debt during the term of the Loan.

**OR** Monthly payments of interest on Standby Debt, at **[Rate]** % per year, may be made if Borrower is not in default under the Note.

**OR** Monthly payments of \$ **[Amount]**, consisting of principal and interest on Standby Debt, at **[Rate]** % per year, may be made if Borrower is not in default under the Note.

**OR** Monthly payments of \$ **[Amount]**, consisting of principal and interest on Standby Debt, at **[Rate]** % per year, beginning **[Begin Date]** may be made if Borrower is not in default under the Note.

**OR (Write Your Own) ]**

Standby Creditor must subordinate any lien rights in collateral securing the Loan to Lender's rights in the collateral, and take no action against Borrower or any collateral securing the Standby Debt without Lender's consent. Lender must attach a copy of the Standby Note evidencing the Standby Debt to the Standby Creditor's Agreement. Lender may use its own form or SBA Form 155.

**APPRAISAL (OPTIONAL)**

SOP 50-10(4), pg. 101-104-2, Subpart "A", Chapter 5, Paragraph 3—SBA Appraisal Requirements

**7. Appraisal**

**Prior to disbursement, and in accordance with SOP 50-10, Lender must obtain:**

*The 4 following options can be used several times if necessary*

- a. **Real Estate Appraisal** on the real property located at **[Address]**, showing a fair market value of at least \$ **[Amount]**.

- b. **Equipment Appraisal** on the equipment (and fixtures if not included in a real estate appraisal) described as **[Description]**, showing a fair market value of at least \$ **[Amount]**.
- c. **Marine Survey and Appraisal** on the vessel named **[Name]**, showing a fair market value of at least \$ **[Amount]**.
- d. **Aircraft Appraisal** on the following aircraft—Make: **[Make]**, Model: **[Model]**, Year: **[Year]**—showing a fair market value of at least \$ **[Amount]**.

**CONSTRUCTION PROVISIONS (OPTIONAL)**

This section should appear in any Authorization where the use of proceeds include constructing a new building or putting a major addition on an existing one.  
 SOP 50-10(4), pg. 110-111, Subpart "A", Chapter 5, Paragraph 6.e.—SBA Construction Loan Requirements. See also pg. 191-192, Subpart "B", Chapter 1, Paragraph 1—Bonding Requirements.

**8. Construction Provisions**

- a. **Building Standards:** In the construction of a new building or an addition to an existing building, the construction must conform with the "National Earthquake Hazards Reduction Program Recommended Provisions for the Development of Seismic Regulations for New Buildings" (NEHRP), or a building code that SBA has identified as having substantially equivalent provisions. Lender must obtain from Borrower evidence of compliance with these requirements. The evidence must be either a certificate issued by a licensed building architect, construction engineer or similar professional, or a letter from a state or local government agency stating that an occupancy permit is required and that the local building codes upon which the permit is based include the Seismic standards.

The following Codes have been identified as substantially equivalent to NEHRP:

- (1) Uniform Building Code of the International Congress of Building Officials (ICBO), as amended,
- (2) Building Officials and Code Administrators (BOCA) National Building Code, as amended,
- (3) Southern Building Code Congress (SBCC) Standard Building Code, as amended.
- b. Lender may charge Borrower a one-time fee not to exceed 2% of the portion of the Loan designated for construction. The actual fee must not exceed the cost of the extra service.

**Select one of the 3 following options**

**Option 1—Construction Financing has SBA Guarantee; \$125,000 or less**

- c. **Compliance Form**—Lender must obtain SBA Form 601, Applicant's Agreement of Compliance, for projects where the construction costs exceed \$10,000.
- d. **Construction Safeguards**—Lender must take all normal construction Loan safeguards appropriate for the Loan. These safeguards may include reviewing plans and specifications, cost breakdowns, bonds, contracts, and builder's controls, and imposing necessary changes or requirements.



**Option 2—Construction Financing has SBA Guarantee; more than \$125,000**

- e. Prior to the commencement of any construction, Lender must obtain from Borrower:
- (1) **Bonds**—Evidence that the contractor has furnished a 100% performance bond and labor and materials payment bond. Only a corporate surety approved by the Treasury Department using an American Institute of Architect's form or comparable coverage may issue these bonds. Only Borrower may be named as obligee on the bonds.
  - (2) **Insurance**—Evidence that contractor carries appropriate Builder's Risk and Worker's Compensation Insurance.
  - (3) **Injection**—Evidence that Borrower has injected the required funds into the project prior to disbursement of the Loan, if Borrower is injecting funds into the construction project.
  - (4) **Plans and Specifications**—Final plans and specifications for Lender review.
  - (5) **Construction Contract**—One (1) copy of a Construction Contract with an acceptable contractor at a specified price not to exceed \$ **[Amount]**. The contract must include an agreement that Borrower will not order or permit any material changes in the approved plans and specifications without prior written consent of Lender and the surety providing the required bonds.
- f. **Lender must:**
- (1) **Cost Overruns**—Obtain evidence of Borrower's ability to pay cost overruns or additional construction financing expenses prior to approving any contract modification. Lender and SBA are not obligated to increase the loan to cover cost overruns.
  - (2) **Inspection**—Make interim and final inspections to determine that construction conforms to the plans and specifications.
  - (3) **Codes and Permits**—Obtain evidence that the building, when completed, will comply with all state and local building and zoning codes, and applicable licensing and permit requirements.
  - (4) **Compliance Form**—Obtain SBA Form 601, Applicant's Agreement of Compliance.
  - (5) **Lien Waivers** -Obtain lien waivers or releases from all materialmen, contractors, and subcontractors involved in the construction.
  - (6) **Construction Safeguards**—Take all normal other construction loan safeguards appropriate for the Loan.

**Option 3—Construction Financing without SBA Guarantee**

- g. **Financing**—Interim financing provided by **[name]** at its own risk.
- h. **Required Documentation**—At or prior to closing the Loan if any proceeds will be used to repay interim construction financing, Lender must obtain evidence that:
- (1) contractor has substantially completed construction;
  - (2) all elements of the construction are paid in full;
  - (3) Borrower or Operating Company occupies (or will shortly occupy in the case of an escrow closing) the property;
  - (4) the property complies with all zoning and necessary governmental permit and licensing requirements; and

**Appendix II, Selected Forms:**

<b>Borrower Form 4-I</b>	<a href="http://www.sba.gov/sbaforms/sba4-i.pdf"><u>http://www.sba.gov/sbaforms/sba4-i.pdf</u></a>
<b>Borrower Form 4-L</b>	<a href="http://www.sba.gov/sbaforms/sba4-L.pdf"><u>http://www.sba.gov/sbaforms/sba4-L.pdf</u></a>
<b>Lender Form 4</b>	<a href="http://www.sba.gov/sbaforms/sba4.pdf"><u>http://www.sba.gov/sbaforms/sba4.pdf</u></a>
<b>Lender Short Form 4</b>	<a href="http://www.sba.gov/sbaforms/sba4_sht.pdf"><u>http://www.sba.gov/sbaforms/sba4_sht.pdf</u></a>

**(This electronic version provides the above links to the appendix documents.)**

## **Appendix III, Agency Comments**

**Baebel, Emilie M.**

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**From:** Hammersley, James W.  
**Sent:** Monday, March 31, 2003 11:59 AM  
**To:** Baebel, Emilie M.; Martz, Mary Jeanne Reid  
**Cc:** Rivera, James E.; Oliver, Le Ann  
**Subject:** Draft report on equity injection

The following is OFA's comment on the draft

We appreciate the opportunity to comment on the Draft Inspection Report on Equity Injection. In general, we do not agree with the recommendations of the report. We do not believe that establishing a firm minimum quantifiable equity injection level is consistent with the mission of the loan program. Taking this step would remove much of the flexibility that is so important in the SBA program and is not practical in small business lending. The amount of equity injection will vary from industry to industry and from case to case. The report cites Freddie Mac, a home mortgage purchaser, as an example of an entity with rigorous equity injection requirements. There are many differences between lending to an individual for a home purchase and lending to a small business. The home mortgage business uses very specific loan approval guidance as a substitute for the type of credit analysis that is necessary to make loans to small business borrowers that do not qualify for conventional credit. We also note that in the case of loans purchased by Freddie Mac, the processor does not have an ongoing financial stake in the loan. In SBA lending, the lender typically has 15%-25% or more of the loan at risk. We also believe the report relies too heavily on the fraudulent activity of one packager as justification for the requirement of specific equity injection requirements. We would be happy to discuss this report further at your convenience.

4/8/2003