

**AUDIT OF DEFICIENCIES IN OFA's
PURCHASE REVIEW PROCESS FOR
BACKLOGGED LOANS**

Audit Report Number: 6-35

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**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20416**

AUDIT REPORT
Issue Date: September 29, 2006
Report Number: 6-35

TO: Janet A. Tasker
Acting Associate Administrator for Financial Assistance

/s/ original signed

FROM: Debra S. Ritt
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SUBJECT: Deficiencies in OFA's Purchase Review Process for Backlogged Loans

This report summarizes deficiencies we identified in the Office of Financial Assistance's (OFA) purchase reviews of backlogged loans at the National Guaranty Purchase Center (Center) in Herndon, Virginia. Backlogged loans were those with purchase demands dated prior to March 13, 2004. We reviewed SBA and, as necessary, lender loan files for 13 loans¹ we judgmentally sampled from 115 backlogged loans that had been transferred to liquidation within 18 months of loan approval, and had a purchase review before August 31, 2004. The purpose of our audit was to evaluate the quality of the purchase review process to determine if it was sufficient to reduce improper payments to lenders. The audit was conducted in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

We separately issued audit reports on 5 of the 13 loans which we determined resulted in a total of \$1,044,567 in improper payments. We recommended, and SBA agreed, to seek recovery of the overpayments.

BACKGROUND

In January 2004, SBA established the National Guaranty Purchase Center in Herndon, Virginia to centralize the 7(a) guaranty purchase process. The purchase process involves an assessment of lender compliance with SBA loan requirements to establish whether payment of the guaranty is appropriate, a repair or denial of liability on the guarantee is warranted, or whether funds should be recovered from either the lender or secondary market holder. Thus, the purchase review process serves to minimize erroneous payments by ensuring that SBA purchases only those loans which were originated, closed, serviced and liquidated in accordance with the

¹ Ten of the 13 loans were selected because they had relatively large outstanding loan amounts, 1 was a companion loan to one of the original 10 selected, and the remaining 2 loans were made to the same borrower within 3 days of each other and purchased at the same time.

loan authorization, prudent lending standards, SBA regulations, and other Agency requirements.

When the Center was established in January 2004, until it began processing lender purchase requests in March 2004, a backlog of 1,039 requests accrued. In order to eliminate the backlog, in April 2004, 18 Headquarters personnel from OFA were detailed to the Center to perform the reviews of the backlogged purchase requests. While this was a one-time special process implemented to eliminate the backlog, the Office of Capital Access indicated that supplemental resources may be assigned if future issues arise at the Centers.

RESULTS IN BRIEF

We identified deficiencies in the purchase reviews of 9 of the 13 loans sampled, 2 of which had multiple deficiencies. While the problems we noted are not reflective of the Center's current purchase review procedures, the significant number of deficiencies identified in our sample indicates that a high rate of improper payments may have occurred for the backlogged loans transferred to liquidation within 18 months of loan approval. Our review determined that OFA did not identify:

- \$107,261 in overpayments on two CAPLines loans and missing information on another CAPLines loan that was needed to accurately determine the guarantee purchase amount;
- inadequate support for equity injection on four loans;
- unsupported use of proceeds on three loans; and
- unsecured collateral and a lender's over-accrual of interest on one loan.

We also identified a conflict of interest on one loan that was not identified in the lender's purchase request to SBA, reiterating the importance of reviewing lender loan files prior to purchasing high-risk loans. Individual loan details are provided in Attachment 1.

We are recommending the Acting Associate Administrator for Financial Assistance (1) re-examine backlogged loans with a high-risk of improper payments, and (2) develop a purchase review Form 327 for CAPLines loans to ensure these types of loans are adequately reviewed in the future.

Purchase Reviews of Three CAPLines Loans Did Not Identify Overpayments and Missing Information Needed to Determine the Guarantee Purchase Amount

SBA CAPLines loans are used to finance cyclical, recurring, or other identifiable short-term operating capital needs of small businesses. Purchase reviews of three CAPLines loans [**EXEMPTION 6**] disclosed multiple deficiencies. OFA did not identify (1) \$107,261 in over-disbursements on two of the loans, and (2) missing cash flow information needed to accurately determine the guarantee purchase amount on another loan. The over-disbursement of one of the

loans included both lender overpayments, as well as an overpayment of the guarantee amount.

The purchase reviewers may not have identified these deficiencies because SBA's Purchase Review Form 327, *Modification and Administrative Action*, does not identify specific review requirements for CAPLines loans. Furthermore, all three CAPLines loans were missing or had incomplete reports on loan disbursements and repayments (Form CAP 1050). The absence of completed forms for two of the three loans made it impossible for purchase reviewers to determine whether the loans had been over-disbursed.

Purchase Reviews Did Not Question Inadequate Support for Equity Injection on Four Loans

Purchase reviewers did not verify \$613,970 of required equity injections on four loans: [EXEMPTION 6]. For example, one borrower claimed the source of a portion of its equity injection was a loan from another business. However, we could find no standby agreement or other evidence in the loan file to support the borrower's claim. The purchase reviewers accepted inadequate documentation for the required equity injections and should have requested the additional documentation prior to making their purchase decisions on these loans.

Purchase Reviews Did Not Question Unsupported Use of Proceeds for Three Loans

Purchase reviewers did not obtain support for how borrowers used \$885,159 in proceeds before approving the purchase of three loans: [EXEMPTION 6]. For example, one lender did not provide support to substantiate that \$177,159 in loan proceeds was used to purchase inventory. During the audit, lenders provided adequate support documenting how borrowers used their loan proceeds; however, purchase reviewers should have requested this documentation prior to making purchase decisions on these loans.

Purchase Review Did Not Identify Unsecured Collateral and Over-accrual of Interest for One Loan

The purchase reviewer on one loan [EXEMPTION 6] did not detect that approximately \$25,000 of collateral was not properly secured by the lender, which impacted the recovery of the loan. Furthermore, the purchase reviewer did not identify that the lender improperly recorded the loan disbursements on its transcript, resulting in over-accrued interest of \$1,399.

A Lender File Was Not Reviewed Prior to the Guarantee Purchase of a High-Risk Loan

We identified one high-risk loan [EXEMPTION 6] involving an undetected conflict of interest between the borrower and the valuator of the assets to be acquired with loan proceeds, which was not included in the lender's purchase request documentation. This conflict of interest went undetected because SBA did not review the lender's loan files as it is now required to do for purchases over \$250,000 that default within 12 months of final disbursement. We recommended and SBA agreed to seek recovery of the \$373,258 guarantee paid the lender for this loan.

Poor Quality of Purchase Reviews Due to Time and Resource Constraints

A former SBA official, who was responsible for overseeing the purchase reviews of the backlogged loans, informed us that Headquarters personnel who reviewed the backlogged loans were under significant pressure from senior managers to eliminate the backlog. This was confirmed by a Center official, who stated that the demands placed on purchase review staff were especially intense between June and August 2004. Daily production reports for a 10-day period in June 2004 showed that each backlog purchase reviewer processed an average of 2.3 reviews per day. This rate exceeds the 2-per-day purchase review standard established by SBA officials. The significant number and materiality of purchase review deficiencies identified in our sample indicate the reviewers may not have been allowed sufficient time for proper reviews of these loans.

Recommendations

We recommend that the Acting Associate Administrator for Financial Assistance:

1. Perform a risk analysis of the backlog loan portfolio to identify loans with a high-risk of improper payment (for example, early defaulted loans with large purchase amounts) and perform thorough purchase reviews of these loans to identify improper purchases and seek recovery from lenders as necessary.
2. Develop a Purchase Review Form 327 for CAPLines loans to ensure these types of loans are adequately reviewed in the future.

Management Comments and Office of Inspector General Response

During a September 11, 2006, exit conference we shared our report findings and recommendations with officials from the Office of Financial Assistance. They generally concurred with our findings and recommendations and agreed to take action on the recommendations. We consider management's actions to be responsive to the report

We appreciate the courtesies and cooperation of SBA representatives during this audit. If you have any questions concerning this report, please call Steve Seifert, Director of Credit Programs, at (703) 487-[REDACTED 2].

Attachments (2)

Individual Loan Details

[EXEMPTION 2 AND 6]

The purchase review did not identify that the lender had not performed the required analysis prior to each loan disbursement on this Standard Asset Based CAPLines loan. Consequently, SBA did not detect that the lender had over-disbursed the loan by between \$78,210 and \$276,008. In Audit Report No. 6-17, we recommended and SBA agreed to seek recovery of \$88,269 from the lender on the guarantee paid.

[EXEMPTION 2 AND 6]

The purchase review did not identify that the lender over-disbursed this Contract CAPLines loan, and the reviewer used the incorrect transcript to compute the guarantee purchase amount. As a result, SBA overpaid the lender by \$18,992 when it purchased the guarantee. In Audit Report No. 6-16, we recommended and SBA agreed to seek recovery of \$18,992 from the lender on the guarantee paid.

[EXEMPTION 2 AND 6]

The purchase review did not identify that the lender had not obtained required month-to-month cash flow projections needed to determine appropriate disbursement and repayment time frames on this Contract CAPLines loan. The loan authorization required the lender to obtain cash flow projections covering the contract term prior to the initial disbursement on each contract. Since each sub-note under this loan was for a different contract, the lender should have obtained a cash flow projection before making the initial disbursement on each sub-note. However, there was no evidence in the lender's file that any cash flow projections were obtained. As a result, it appeared the sub-note repayment time frames were inappropriate. For example, seven projects to be completed in 90 days or less had 1-year maturity dates.

If month-to-month cash flow projections had been obtained, more appropriate maturity dates and repayment time frames could have been established and enforced. Furthermore, if the lender identified deficiencies in the borrower's cash flow, some of the sub-notes may not have been approved. Consequently, the lender could have received additional repayments and reduced the outstanding loan balance at the time of default. We did not pursue recovery on this loan due to the time and resources required to identify overpayments.

The loan authorization also required the lender to obtain evidence that the borrower was current on all Federal and State taxes and had made appropriate withholding tax deposits on advances for payroll prior to the initial disbursement on each contract. However, the purchase reviewer did not question whether the lender verified that the borrower was current on its taxes or that appropriate withholding deposits had been made prior to each initial disbursement. Consequently, SBA purchased the \$221,020 guarantee and upon loan default, the borrower had past due payroll taxes.

[EXEMPTION 2 AND 6]

The purchase review did not disclose that the lender had not verified \$75,920 of the required \$100,000 of equity injection for this \$430,000 loan. Specifically, the source of a cashier's check and a down payment could not be verified. Furthermore, a loan from another business was claimed as equity injection when there was no standby agreement or evidence to show the loan payments were to be made from a source other than the borrower, as required. In fact, there was evidence the borrower was repaying the loan from the cash flow of the business. As a result, only \$24,080, or 24 percent, of the required equity injection was supported, and SBA made a \$308,960 improper payment when it purchased the guarantee.

The lender also did not provide support for a \$55,000 loan disbursement for the purchase of inventory with its purchase package, and the purchase reviewer did not question the missing documentation prior to approving purchase of the \$308,960 guarantee. However, the lender subsequently submitted adequate support for the disbursement in response to our audit.

Further, the purchase review did not identify the lender's failure to properly secure approximately \$25,000 of collateral. The purchase reviewer did not recognize that several used cars, which were found on the business premises during the lender's site visit, were collateral on the loan. Due to the lender's failure to secure the used car collateral at the time of the site visit, there was no recovery on the loan.

The certified transcript submitted to SBA with the purchase package showed the lender did not properly record loan disbursements, and as a result, accrued excess interest of \$1,399. The purchase reviewer did not identify this error and as a result, SBA overpaid the lender \$1,399 when it honored the guarantee.

The equity injection, collateral and interest accrual findings were presented in Audit Report No. 5-21 and SBA recovered the \$308,960 guarantee paid to the lender.

[EXEMPTION 2 AND 6]

The purchase reviewer did not verify the entire \$87,000 of required equity injection for this \$375,000 loan because she believed the equity injection was immaterial to the failure of the business. Since this loan defaulted within 5 months of loan disbursement, a direct link between the business failure and lack of equity injection should have been assumed in accordance with purchase review policy. As a result, SBA made a \$255,088 improper payment when it purchased the guarantee.

This finding was presented in Audit Report No. 5-26 and SBA agreed with the recommendation to seek recovery of \$255,088, less subsequent recoveries, from the lender on the guarantee paid.

[EXEMPTION 2 AND 6]

The purchase reviewer accepted a withdrawal slip as proof of the required \$364,000 of equity injection without sufficient evidence for the source of the funds. During the audit we obtained a bank statement from the lender which showed the funds were provided from the principal's personal bank account, and therefore constituted equity. The purchase reviewer, however, should have requested and obtained this additional documentation before purchasing the \$654,126 guarantee.

Support for the \$653,000 in proceeds was not provided in the lender's purchase package as required. During the audit, the lender provided a copy of the disbursement check to address this issue. The documentation should have been requested and obtained by the purchase reviewer prior to the purchase of the \$654,126 guarantee.

[EXEMPTION 2 AND 6]

The purchase reviewer accepted checks written on the business accounts as support for the \$87,050 required equity injection. Since the business was an existing business at the time the loan was made, there was no assurance the checks represented equity injection rather than business funds. During our audit, the lender explained that the source of the equity injection was the borrower's existing used car business. The lender considered the used car business to be separate from the repair business for which the borrower was obtaining the SBA loan. Therefore, the injection of funds from the borrower's existing used car business to the new repair business constituted equity. The purchase reviewer should have requested and obtained this clarification prior to purchasing the \$378,553 guarantee.

[EXEMPTION 2 AND 6]

The lender did not provide adequate documentation to substantiate the use of \$177,159 in loan proceeds approved for the purchase of inventory. Documentation in the purchase package showed the proceeds were used to pay off a commercial loan made by the lender after the SBA loan was approved, but prior to disbursement. There was no evidence to support that the commercial loan was a bridge loan used for the purchase of inventory. Documentation provided by the lender in response to our audit, however, showed the loan was a bridge loan and was used to purchase inventory. The purchase reviewer should have requested and obtained this documentation prior to the purchase of the \$279,883 guarantee.

[EXEMPTION 2 AND 6]

During our audit, we identified a conflict of interest between the borrower and the valuator of the assets to be acquired with loan proceeds. The lender was aware of the valuator's lack of independence prior to loan disbursement, but did not inform SBA of the conflict as required. We also determined that the lender made a false statement to SBA regarding the independence of the valuation of the asset injection.

Because these deficiencies were determined from information included in the lender's

file, they would not have been identified during the May 2004 purchase review, which only considered documentation included in the lender's purchase request to SBA. However, as of January 2005, in response to Recommendation 1A of the OIG's audit report, No. 3-15, OFA agreed to request the entire lender file for any loan where SBA's purchase will exceed \$250,000 and the loan defaulted or experienced loan problems within 12 months from final disbursement. As this loan defaulted within 4 months after final disbursement and its purchase amount was \$373,258, a review of the lender's file would be required under current purchase review procedures. Therefore, deficiencies of this nature should be identified in the future. This example reiterates the importance of reviewing lender loan files prior to the purchase of high-risk loans. Our finding was presented in Audit Report No. 6-22 and SBA agreed to seek recovery of the \$373,258 guarantee paid.

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