

**AUDIT OF**  
**THE SBA*EXPRESS* AND COMMUNITY EXPRESS LOAN PURCHASE**  
**AND LIQUIDATION PROCESS**

**AUDIT REPORT NUMBER: 7-08**

**December 29, 2006**



US SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
Washington, DC 20416

<b>AUDIT REPORT</b>
<b>Issue Date: December 29, 2006</b>
<b>Number: 7-08</b>

**To:** Janet A. Tasker, Acting Associate Administrator,  
Office of Financial Assistance

**/s/ Original Signed**

**From:** Debra S. Ritt, Assistant Inspector General  
For Auditing

**Subject:** Audit of the SBA*Express* and Community Express Loan Purchase and  
Liquidation Process

Attached is a copy of the subject audit report. The report contains three findings and twelve recommendations addressed to your office. Your response is synopsised in the report and included in its entirety at Appendix D.

The recommendations in this report are subject to review and implementation of corrective action by your office in accordance with the existing Agency procedures for audit follow-up. Please provide your management decision for the recommendations to our office within 30 days of the date of this report using the attached SBA Forms 1824, Recommendation and Action Sheet.

Any questions or discussion of the finding and recommendation contained in the report should be directed to Robert Hultberg, Director, Credit Programs Group, at (202) 205-[**Exemption 2**].

Attachments

## DRAFT

### EXECUTIVE SUMMARY

The objective of the audit was to determine if the *SBAExpress* and Community Express Loan Purchase process adequately identified lender deficiencies that would have affected purchase decisions and whether SBA adequately monitored the liquidation process for both loan programs. The audit examined two statistical samples drawn from all 2,729 *SBAExpress* and Community Express loan disbursements approved after January 1, 2000 and purchased before February 1, 2005, which were valued at \$130.6 million.

We statistically sampled 45 *SBAExpress* and Community Express loan purchases, with an original gross amount valued at \$2 million to determine whether SBA adequately identified lender deficiencies. We reviewed information contained in both SBA and lender files for these loans. To assess whether SBA adequately monitored the technical assistance requirement, we statistically sampled 43 loans with an original gross amount totaling \$935,000.

Our audit disclosed that SBA purchased *SBAExpress* and Community Express loans without obtaining information needed to assess whether lenders verified borrowers' use of loan proceeds, determined eligibility and creditworthiness, or verified borrower financial information. As a result, SBA did not detect lender deficiencies in 44 of the 45 loans sampled, which caused SBA to make improper purchase decisions. Based on the high rate of deficiencies, we estimate that \$128 million to \$130.6 million in disbursements on the 2,729 loans approved after January 1, 2000, and purchased before February 1, 2005, were not properly reviewed by SBA.

When projecting the results of our sample to the universe of 2,729 purchased loans, Lender deficiencies went undetected because guidance provided to lenders did not identify all of the necessary documents needed to make proper purchase decisions and conflicted with instructions provided by SBA Headquarters concerning IRS tax verifications.

Our review also determined that lenders did not disclose material facts on two loans that were purchased for \$27,134, which would have impacted the purchase decisions. Specifically, the lenders did not reveal that one borrower used loan proceeds for an unauthorized purpose and that another borrower had previously been denied an SBA loan. Consequently, SBA should be released from its liability for its guarantees on these loans. These deficiencies were documented in the lender files and would not have been detected through the current purchase review process.

SBA also erroneously paid lenders approximately \$304,000 in additional guarantees on 43 Community Express loans that were ineligible for additional guaranty coverage because the lenders provided no evidence that the borrowers were provided the required technical assistance. This occurred, in part, because many lenders were directed by SBA not to provide evidence of technical assistance, and SBA purchase reviewers were instructed not to review loan files for evidence of technical assistance. SBA should either

obtain proof of technical assistance or recover those portions of the guarantees that were improperly paid.

Further, SBA did not timely refer \$25 million in purchased loans that were over 180 days delinquent to the Department of Treasury for collection, as required by the Debt Collection Act. Approximately 79 percent of these loans were delinquent over 2 years as of March 1, 2005. SBA officials believed the Agency was exempt from this requirement and placed a low priority on loan liquidations due to the increasing volume of defaulted express loans. Consequently, SBA missed opportunities to reduce losses on loans purchased under the expedited loan processes.

Given the high rate of deficiencies identified by the audit, we recommend that SBA review all loans approved after January 1, 2000, and purchased before February 1, 2005, to ensure lenders complied with program requirements and revise program guidance to ensure that; (1) adequate documentation is provided and reviewed before purchase decisions are made, and (2) defaulted loans are properly and timely referred to the Department of Treasury for collection. We also recommended that SBA mitigate its losses on defaulted loans by:

- pursuing recovery of a \$7,414 guarantee on a loan that was awarded to an ineligible type of business, and denying liability for \$23,033 in guarantees on four loans where purchase reviewers missed lender deficiencies;
- seeking recovery of \$27,134 for two guarantee purchases for which the lenders failed to disclose material facts that would have affected the purchase decisions;
- pursuing recovery of some or all of the \$304,000 in additional guarantees provided lenders who did not demonstrate they provided the required technical assistance to borrowers; and
- referring \$25 million in purchased loans that are more than 180 days delinquent to the Department of Treasury for collection.

Management concurred with 6 of the 12 report recommendations and proposed corrective actions that are responsive to 2 other recommendations. Management's proposed actions on all but 1 of these recommendations (recommendation 2) are fully responsive.

Management did not agree to take actions that will responsibly address the remaining four recommendations. Specifically, management:

- neither agreed nor disagreed to recover \$7,414 from a lender who awarded an SBA loan to an ineligible company until it obtains additional information (recommendation 3).
- did not agree it should ensure lenders are eligible for the additional guarantee coverage provided under the Community Express program by obtaining evidence

that technical assistance was offered to borrowers on the 43 loans we reviewed (recommendation 8).

- disagreed that it should refer to Treasury \$25 million in loans that were over 180 days delinquent and not in a bona fide workout status, as required by the Debt Collection Act (recommendation 10).
- did not agree to place adequate emphasis on liquidation follow-up and to ensure controls are in place to refer eligible non-tax debts to the Department of Treasury because it believed this recommendation had already been implemented, even though the audit identified instances where this had not occurred (recommendation 11).

Consequently, the OIG will pursue resolution of the remaining four recommendations through the audit resolution process, and seek additional actions from management on recommendation 2.

## INTRODUCTION

### Background

The *SBAExpress* Loan Program was established as a pilot program on February 27, 1995 in response to diminishing SBA personnel resources and increasing loan demand. The program, which was made permanent on December 8, 2004, was intended to:

- increase the Agency's effectiveness in delivering financial assistance to the Nation's small business community;
- enhance the efficiency and reduce the cost of processing SBA loans for both the Agency and its lending partners;
- reduce the required paperwork and procedures to further streamline the Agency's approval process; and
- encourage greater lender participation in SBA loan programs.

Under the *SBAExpress* Loan Program, lenders are allowed to use their own loan analyses and procedures in exchange for a lower SBA guarantee of 50 percent. Lenders must, however, apply all SBA business loan requirements, including those in the Small Business Act, the Code of Federal Regulations, and SBA's standard operating procedures, unless otherwise specified in the *SBAExpress* Program Guide. SBA performs a cursory review of the loans during the approval process, but a more thorough review of lender loan administration is required after a loan goes into default and the lender submits a guarantee purchase request to SBA.

In May 1999, SBA established another express loan program known as the Community Express Program. This program was designed to increase lending to pre-designated geographic areas comprising low and moderate income areas and to women, minorities, and veterans. The Community Express Program generally conforms to the *SBAExpress* Loan Program policies and procedures except that borrowers under the Community Express Program must receive technical and management assistance from a local non-profit provider and/or from participating lenders. The technical assistance must be coordinated and when necessary, paid for by the Community Express lenders. To encourage lenders to participate and to offset the additional costs for the technical assistance, SBA offers Community Express lenders up to an 85-percent guarantee.

Applications for *SBAExpress* and Community Express loans are processed at the loan processing center in Sacramento, California, while loan purchases and liquidations are performed at the Agency's commercial loan servicing centers in Fresno, California and Little Rock, Arkansas.

From fiscal years (FY) 1999 to 2005, SBA disbursed 197,618 *SBAExpress* and Community Express loans totaling over \$10 billion. By the end of FY 2005, the total loan portfolio in both SBA programs exceeded \$4.6 billion.

Prior to June 2002, lenders making *SBAExpress* and Community Express loans were required to complete liquidation actions before submitting a purchase request to SBA. Due to lender concerns and complexities associated with these relatively small loans, in June 2002, SBA issued Procedural Notice 5000-803, allowing the expedited purchase of defaulted loans that met certain conditions. Under expedited purchase procedures, SBA can immediately purchase loans originally approved for \$50,000 or less without lender substantiation of the disposition of business assets. For loans exceeding \$50,000, the purchase may be expedited if the liquidation process is expected to be protracted. Lenders are also required to fully pursue loan liquidations to conclusion and provide SBA with a liquidation status report every 180 days until the liquidation is completed. At the conclusion of the liquidation process, the lender must prepare a summary report of all collections and remittances to SBA.

In July 2002, SBA issued Procedural Notice 5000-813, which allowed for the expedited purchase of loans having a principal balance of \$50,000 or less at the time of the purchase, instead of \$50,000 or less in the original approved amount. Although both policy notices expired in 2003, SBA continues to apply them to the express loan programs.

From FY 1999 to FY 2003, the default rate of *SBAExpress* and Community Express loans averaged between 7 percent and 20 percent.

### **Objectives, Scope and Methodology**

The audit was initiated based on concerns over the high default rate of express loans. The objectives of the audit were to determine whether: (1) the *SBAExpress* and Community Express Loan purchase processes adequately identified lender deficiencies that would have affected purchase decisions; and (2) SBA adequately monitored the liquidation process for both loan programs.

To determine whether purchase decisions adequately identified lender deficiencies, we selected two statistical samples. The first sample of 45 *SBAExpress* and Community Express loans valued at \$2 million was selected from a universe of 2,729 express loan disbursements valued at \$130.6 million that were approved after January 1, 2000, and purchased before February 1, 2005. Twenty-five of the loans were purchased by the Little Rock Servicing Center, 18 were purchased by the Fresno Servicing Center, and 2 were purchased by other SBA offices. Our sample size allowed us to extrapolate our audit results at a 90-percent confidence level with a precision rate of  $\pm 1.3$  percent. A listing of the 45 loans reviewed is provided in Appendix A.

To determine whether the purchase process focused on whether technical assistance was provided by lenders in the Community Express program, we selected a second sample of 43 Community Express loans. The 43 loans, valued at \$935,000, were selected

from a universe of 513 loans totaling \$11.6 million that were approved after January 1, 2000, and purchased before February 1, 2005. Twenty-eight of the loans were purchased by the Little Rock Servicing Center and 15 were purchased by the Fresno Center. A listing of the 43 sampled loans is included in Appendix B.

We examined documentation contained in SBA and lender loan files to assess the adequacy of SBA's purchase review. For material lender deficiencies, we calculated the amount of potential recovery by considering the impact of the deficiency on the performance of the loan. We interviewed officials at SBA's Office of Lender Oversight, Office of Financial Assistance (OFA), and the Fresno and Little Rock Commercial Loan Servicing Centers. Officials at the National Community Reinvestment Coalition were interviewed to obtain background information regarding the Community Express Program.

To address the second objective, we determined the length of time that 1,078 expedited purchased loans at both servicing centers had been in liquidation status as of March 31, 2005. We reviewed the loan files to evaluate SBA liquidation monitoring activities. We also interviewed servicing center officials regarding follow-up procedures and systems in place. The audit was performed from March 2005 to July 2006 in accordance with *Government Auditing Standards* as prescribed by the Comptroller General of the United States.



## RESULTS OF AUDIT

### **The SBAExpress and Community Express Loan Purchase Process Did Not Detect Material Lender Deficiencies**

The SBAExpress loan purchase review process did not detect material lender deficiencies in 44 of the 45 loans sampled, which caused SBA to make improper purchase decisions. Our review of SBA's purchase files disclosed that SBA purchased loans without obtaining documentation to ensure that lenders:

- verified appropriate use of loan proceeds;
- obtained critical background information about the borrower (Form 1919);
- obtained an Internal Revenue Services (IRS) verification of borrower financial information; or
- determined borrower eligibility.

Lender deficiencies were not detected during the purchase review process because SBA did not obtain or require lenders to submit all necessary documentation needed to make proper purchase decisions. Neither the lender purchase demand kit nor the SBA purchase review checklist identified all of the information required for the purchase review process. Also, OFA notified the purchase centers that IRS tax verifications were not required for loans that were credit scored, which conflicts with direction in the SBAExpress Program Guide.

In addition to the deficiencies that should have been identified in the loan files, our review of lender files disclosed that lenders did not report to SBA information that was material to SBA's decision on two loans that were purchased for \$27,134. One lender did not inform SBA that loan proceeds were used to refinance borrower debt owned by the bank, and the other lender did not report that the borrower had been previously denied for a SBAExpress loan. Although neither of these imprudent lender actions would have been identified under existing procedures at the time of purchase, recovery of the guarantees paid on both loans is warranted.

Based on the high rate of deficiencies identified by the audit, we estimate with 90 percent confidence that \$128 million to \$130.6 million<sup>1</sup> in disbursements were not properly reviewed by SBA.

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<sup>1</sup> The confidence interval is based on a precision rate of 1.3 percent. The numbers reported have been rounded from \$127,965,339 and \$130,616,719. We reduced the upper limit of the confidence interval by \$16,590 to reflect the amount of disbursements we found were correctly verified by lenders.

### ***SBA Did Not Ensure the Lender Verified Use of Loan Proceeds***

SBA did not determine whether lenders took appropriate measures to ensure that loan proceeds were used as authorized. In accordance with the loan authorizations, lenders must maintain evidence or a system to reasonably ensure that loan proceeds are used for business purposes. SBA files for 44 of the 45 SBA loans we sampled did not contain evidence that proceeds were used in accordance with the loan authorization. For the remaining loan, the lender documented the use of proceeds for approximately \$17,000 out of the \$50,000 it disbursed. The Center directors admitted that SBA did not ensure that loan proceeds were used as authorized. Instead, they told us that they generally relied on lender self-certifications as proof that proceeds were used for business purposes.

When projecting the results of our sample to the universe of 2,729 purchased loans, we are 90 percent confident that \$128 million to \$130.6 million in disbursements were not properly reviewed by SBA. This deficiency rate, coupled with SBA's lack of purchase review controls over the use of loan proceeds, put the agency at significant risk of making improper payments.

### ***SBA Did Not Detect Missing Borrower Information***

SBA requires that all lenders submit a Form 1919, *SBA Borrower Information Form*, with their purchase requests. The form requires the borrower to declare whether he/she is a U.S. citizen, has a criminal record, has delinquent Federal debt, or used a packager or broker, all of which could adversely affect eligibility for a *SBAExpress* loan. If a lender cannot supply the form at the time of purchase, SBA is required to notify the lender that it cannot process the purchase request until the lender submits the form. The importance of obtaining a complete SBA Form 1919 before honoring a purchase request is reflected in a recent OIG Fraud Alert Notice issued in June 2006. The notice informed SBA personnel about fraud schemes being perpetrated by loan packagers and brokers who recruited borrowers to submit loan applications for businesses that did not exist or contained false business histories.

The SBA Form 1919 was either missing or incomplete for 2 of the 45 loans in our review that were purchased for \$14,232. Although the lender's purchase request on one of the loans acknowledged that the Form 1919 was missing, SBA did not follow-up with the lender to either obtain the form or discuss the impact on the guarantee if the form could not be located. For the other loan, the lender's purchase request included the Form 1919, but it was missing information on the borrower's citizenship. Consequently, borrower eligibility for both loans could not be determined at the time the SBA honored the guarantees.

### ***SBA Did Not Check for IRS Verifications***

The *SBAExpress* Program Guide requires that lenders verify tax return information if business revenue is included in credit scoring. Our review disclosed that IRS tax verifications were missing for two loans purchased for \$9,015 which defaulted within 24

months of disbursement. Although revenue was a key component of the credit scoring in both loans, loan servicing centers did not pursue verifications based on direction from Headquarters that IRS tax verifications were not necessary for loans that were credit scored, even if business revenue was included. This direction conflicts with the *SBAExpress* Program Guide, which requires verification of business income.

Had SBA verified business income for the two borrowers, it would have identified a weakness in the borrowers' creditworthiness. Because the lenders failed to comply with the tax verification requirement in the *SBAExpress* Program Guide, SBA should not have purchased the guarantees.

### ***SBA Did Not Identify an Ineligible Borrower***

SBA purchased a \$7,414 loan that was made to a borrower whose business was a check cashing service. According to 13 CFR 120.110(b), businesses primarily engaged in lending, such as banks and finance companies, are ineligible for SBA business loans. Based on the North American Industry Classification System code assigned to the company, this business was a credit intermediary. As such, the company was not eligible for SBA financing. Thus, SBA should not have purchased the loan and has adequate basis for recovering \$7,414 from the lender.

### ***Deficiencies Were Not Detected Because of Missing Documentation***

Lender deficiencies were not detected primarily because SBA did not request that lenders submit all of the necessary documentation needed to make proper purchase decisions. Neither the lender Purchase Demand Kit nor the SBA Pre-Purchase Review checklist identified all of the information required for the purchase review process. The Purchase Demand Kit was developed by SBA to assist lenders in determining which documents must be submitted to SBA with the purchase request. The kit requires lenders to submit a wrap-up report, transcript of account, copy of the note, wire instruction, detail of expenses, SBA Forms 1919 and 1920, and all collateral documents. However, the kit does not require refinancing justifications, proof that proceeds were used as authorized, a credit analysis, or evidence that borrower citizenship was verified. Instead, SBA relies on lender self-certifications that loans are originated, closed, serviced and liquidated, in accordance with SBA regulations.

The SBA Pre-Purchase Review checklist is used at each commercial loan servicing center to guide loan servicing assistants through the purchase process and to confirm that completed forms are received. It does not, however, provide for a determination on the soundness of the loan origination. For example, the checklist does not require analysts to determine whether collateral acquired meets the lender's internal collateral policies and procedures for its own commercial loans. In addition, while the checklist includes a broad question regarding whether the lender closed and serviced the loan in accordance with the terms of the loan authorization, it does not require loan servicing assistants to determine whether:

- critical borrower information was obtained on the Form 1919, including adverse information that would have prevented the applicant from receiving an SBA guaranteed loan;
- debt refinancing was properly justified;
- a credit analysis was obtained and analyzed;
- the applicant was eligible for an SBA-guaranteed loans;
- all fees included with the purchase were allowable;
- loan proceeds were used in accordance with the loan authorization;
- the borrower had alternative sources of capital, such as liquid assets; or
- the borrower was previously denied SBA assistance.

As a result of the high rate of purchase review deficiencies identified by the audit, there is no assurance that any of the 2,729 *SBAExpress* and Community Express loans approved after January 2000 and purchased before February 2005 were properly reviewed to assure lender compliance with SBA rules and regulations and prevent improper payments before the loan guarantees were honored.

### ***Lenders Did Not Disclose Material Information***

A review of lender files for two loans that were purchased for \$27,134 and made by different lenders disclosed that one lender did not inform SBA that loan proceeds were used to refinance borrower debt owned by the bank, and that the other lender did not report that the borrower had been previously denied for a *SBAExpress* loan. Specifically, one lender did not disclose to SBA that \$40,000 of a \$50,000 loan was used to refinance borrower debt with the lender. Lenders are required under 13 CFR 120.140(j)(3) to notify SBA when loan proceeds will be used to refinance debt due the same lender or to an associate of the lender. To qualify for refinancing, the lender must ensure that the existing loan no longer meets the needs of the applicant, the new loan will result in a 20-percent increase in cash flow and that the existing debt has been current for 36 months. The loan was purchased by SBA for \$20,503.

The lender's purchase request did not include any information showing that loan proceeds would be used to refinance a debt owned by the lender or evidence that the refinanced debt met the required conditions. Moreover, the loan authorization restricted the use of loan proceeds for working capital only. Thus, not only did the lender fail to disclose a material fact to SBA, the lender violated the terms of the loan agreement by using loan proceeds to refinance borrower debt.

We also found that a second loan purchased for \$6,631 was made to an ineligible borrower. The *SBAExpress* Program Guide provides that a loan is not eligible for the *SBAExpress* Program if the lender is aware that the application was previously denied under any SBA loan program. The lender noted in an internal memo that the borrower was previously declined by another lender for a \$25,000 *SBAExpress* loan and recommended approving the loan for a lower amount. The lender, however, did not disclose this material fact in the appropriate section of the eligibility form submitted to SBA. Consequently, the lender made a loan to an applicant that was not eligible for the loan under program guidelines.

According to 13 CFR 120.524 (a)(4), SBA is released from liability on a loan guarantee if the lender fails to disclose a material fact to SBA regarding a guaranteed loan in a timely manner. Under current Express Loan purchase procedures, it is unlikely that SBA would identify these deficiencies because the purchase process did not require a review of the lender's loan file. Due to the materiality of the information withheld from SBA, corrective actions against the lenders are warranted. Although neither of these imprudent lender actions would have been identified under existing procedures at the time of purchase, recovery of the guarantees paid on both loans is warranted.

### ***Recommendations***

We recommend that the Associate Administrator for Financial Assistance:

1. Determine if loan proceeds on the 45 loans sampled during our audit were used in accordance with the terms of the loan authorizations, and take appropriate corrective actions against lenders that are not able to substantiate an appropriate use of proceeds.
2. Determine if lender actions warrant a denial of liability on \$14,232 in guarantees associated with the two loans that were either missing a Form 1919 or where the form was incomplete; and \$9,015 on guarantees on another two loans that were missing IRS tax verifications.
3. Recover \$7,414 from the lender that awarded an SBA loan to an ineligible company.
4. Revise the purchase demand kit and review checklists to require that lenders provide SBA staff with use of proceeds documentation, complete SBA Form 1919s, IRS tax verifications, and any other documentation needed to determine lender compliance with applicable requirements.
5. Review the 2,729 loans for compliance with SBA rules and regulations and improper payments.
6. Recover \$27,134 for the two purchased SBA Express loans reviewed for which the lender failed to disclose material facts.

## ***Management Comments and OIG Evaluation***

### ***Recommendation 1***

OFA agreed with the recommendation to determine if loan proceeds were used in accordance with the terms of the loan authorization. The Office has also agreed to re-examine the 45 loan files for lender and/or borrower certifications within 90 days after the loans files are returned by the OIG. The examination will also review the loan authorization requirements for use of proceeds verification.

OFA's agreement to re-examine loan files to determine if use of proceeds were properly verified by lenders is responsive to the recommendation.

### ***Recommendation 2***

OFA has agreed to review the files for two loans that had missing or incomplete 1919 forms to determine if lender actions warrant a denial of liability. These reviews will be performed within 90 days of the return of the loan files.

OFA's comments are not fully responsive to the recommendation. While management agreed to review two loan files, it did not indicate what action it planned to take on two other loans, totaling \$9,015 in guarantees, which were missing IRS tax verifications. Consequently we will pursue action on these loans through the audit resolution process.

### ***Recommendation 3***

OFA took a neutral position until further information is obtained regarding the nature of the business. If the business is found to have been ineligible, they will take appropriate action to recover the amount indicated.

Because management neither concurred or non-concurred with the proposed recommendation, we will pursue a more definitive response through the audit resolution process.

### ***Recommendation 4***

OFA agreed with the recommendation and will review the purchase demand kit to ensure documents required to make a prudent purchase decision are included within 90 days from issuance of this report. OFA's comments are responsive to the recommendation.

*Recommendation 5*

OFA did not agree with the recommendation to review the entire universe of 2,729 loans. However, an alternative solution was proposed. A review will be performed on the sample of 45 loans reviewed during the audit. If significant issues are identified during the review, then a determination will be made with regard to identification of additional purchases for disbursements exceeding \$50,000.

OFA's comments offer an acceptable alternative, which satisfies the intent of the recommendation. Although management doesn't believe that traditional verification is needed for working capital loans, prudent lending involves reasonable measures to verify use of loan proceeds. As mentioned in the report, The OIG Fraud Alert Notice issued in June 2006, highlighted loan applications for businesses that did not exist or contained false business histories. Holding borrowers accountable for use of loan proceeds may serve to deter such practices.

*Recommendation 6*

OFA preliminarily agreed with the recommendation, subject to further review. OFA will review loan documentation prior to making a decision to seek recovery. OFA's comments were responsive to the recommendation.

## **Lenders Received Higher Guarantees without Evidence of Technical Assistance**

SBA loan servicing assistants did not ensure that Community Express lenders provided the required technical assistance to borrowers before honoring the guarantees at the full amount. Because Community Express loans are considered high-risk,<sup>2</sup> the technical assistance component is critical to the success of the business and prevention of losses to SBA.

SBA Policy Notice 5000-605 requires that Community Express lenders provide borrowers with technical and management assistance. The technical assistance must be coordinated, arranged and, when necessary, paid for by Community Express lenders. To offset these costs and encourage lenders to participate, SBA offers Community Express lenders a guarantee of up to 85 percent rather than the 50 percent guarantee available to SBAExpress lenders.

We reviewed SBA and lender files for 43 Community Express loans purchased for \$760,000 to test whether the purchase process assessed the technical assistance component of the program. We also reviewed each borrower's action plan for technical assistance needs. Although the action plans often listed the critical needs of the borrowers, we found no evidence that the technical assistance requirement was met on any of the 43 loans we reviewed. This occurred because SBA had directed several Community Express lenders to not provide supporting evidence for technical assistance and instructed its loan servicing assistants to not review loan files for evidence of technical assistance. At the direction of OFA, on September 11, 2003, the Fresno Commercial Loan Servicing Center issued a letter to its lenders, stating that:

*“Community Express lenders are no longer required, as part of the purchase process, to submit any documentation whatsoever in relation to technical assistance program requirement. CLSC-Fresno staff is now permitted to assume, without any further investigation or inquiry, that SBA Community Express lenders are providing Technical Assistance consistent with the Community Express Program Guidelines.”*

*“...In those cases where Lenders elect to affirmatively disclose within their purchase demand that Technical Assistance was not provided, there may be instances where the Center staff will engage Lenders in so-called “repair” negotiations. These negotiations may result in – among other types of adjustments – a reduction in the guarantee from 85 percent to a lower rate.”*

Without the supporting documentation for technical assistance, SBA cannot determine if lenders are eligible for the additional guarantee coverage provided Community Express loans. Consequently, SBA erroneously paid lenders \$304,000 when it honored the full guarantee amounts on the 43 Community Express loans sampled, without evidence that lenders provided the required technical assistance. Projecting these results to the

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<sup>2</sup> In FY 2003, Community Express loans had a 16-percent higher default rate than SBAExpress loans.



universe of Community Express loans approved after January 1, 2000 and purchased before February 1, 2005, we estimate that SBA made \$2 million in erroneous payments.

### ***Recommendations***

We recommend that the Associate Administrator for Financial Assistance:

7. Require the Fresno and Little Rock Commercial Loan Servicing Centers ensure lenders have provided technical assistance before purchasing guarantees above 50 percent.
8. Obtain evidence from lenders that technical assistance was provided to borrowers on the 43 Community Express loans reviewed. If no evidence is provided, seek recovery of those portions of SBA guarantees that exceeded the 50-percent level.
9. Direct the Fresno Commercial Loan Service Center to rescind its September 11, 2003, guidance and inform lenders that proof of technical assistance is a program requirement.

### ***Management Comments and OIG Evaluation***

#### ***Recommendation 7***

OFA disagreed with the finding and partially agreed with the recommendation. Management disagrees that technical assistance was not provided simply because adequate documentation was not submitted during the purchase review process, but agrees that the Agency should publish enhanced guidance for lenders. Management stated that, as noted in the report, each borrower was evaluated by a technical assistance provider and an action plan was developed for the borrower, both of which constitute the provision of Technical Assistance. Further, they want lenders to make a good faith effort to ensure the borrower follows up and receives the technical assistance. The guidance would clearly specify what SBA expects of lenders in the providing technical assistance. The guidance would also set forth SBA's minimum required documentation required with submission of a purchase request.

We disagree with management's position for two reasons: (1) the report does not state that technical assistance was not provided, but instead says the lack of documentation provides no assurance that technical assistance was given to borrowers; and (2) the technical assistance plans are simply plans, which may or may not have been executed. Further, when borrowers fail to take advantage of available technical assistance, lenders are required to document their efforts to provide technical assistance; including submitting to SBA a copy of the correspondence they sent the borrower strongly urging him/her to take advantage of the technical assistance. We found no evidence of such documentation in the files.

Because SBA requires that lenders must show they attempted to provide technical assistance to obtain the additional SBA guarantee, a plan does not provide proper evidence that the borrower actually received technical assistance. Although management disagreed with the finding, it agreed to publish enhanced guidance for lenders, which is responsive to the recommendation.

*Recommendation 8*

OFA did not agree with the recommendation to obtain evidence that technical assistance was provided. Management referred to our report as evidence that management assessment and technical assistance action plans were developed for the loans in question. Management believes this forms the basis for concluding that substantive technical assistance was provided. Thus, OFA has no basis to recover any guarantee purchase amounts for these loans, under existing program guidance.

We do not consider OFA's comments to be responsive. As noted above in our evaluation of management's comments for recommendation number 7, technical assistance plans are not adequate evidence that technical assistance was offered to borrowers. Lenders are required to document their efforts to provide technical assistance, including submitting to SBA a copy of the correspondence they sent the borrower strongly urging him/her to take advantage of the technical assistance. Despite developing management assessments and technical assistance action plans, lenders did not document good faith efforts, as required. Based on management's non-concurrence, we will pursue corrective action on this recommendation through the audit resolution process.

*Recommendation 9*

OFA agreed with our recommendation to rescind its September 11, 2003 guidance. In addition, community express lenders will be required to certify that they attempted to provide technical assistance in connection with each loan submitted for purchase. OFA's comments were responsive to the recommendation.

## **SBA Did Not Monitor \$25 Million in Potential Collections on SBAExpress and Community Express Loans**

Generally, lenders must complete loan liquidation actions on SBAExpress and Community Express loans prior to seeking a guarantee purchase from SBA. An exception to this rule allows SBA to expedite the purchase process in advance of liquidation activities under certain conditions, such as when loans are in bankruptcy or when they have balances under \$50,000. When the purchase is expedited, the Agency is required to monitor lender liquidation activities to ensure they are performed timely.

Our audit showed that SBA did not monitor or follow-up on the liquidation of 1,078 loans purchased for \$25 million through expedited purchase procedures. Management at the service centers provided the following statistics on purchased loans in liquidation as of March 31, 2005. We did; however, discover errors in this data. As shown in Table 1 below, 850 purchased loans, or 79 percent, were in liquidation status since 2004 or earlier.

**Table 1**  
**Expedited Purchased Loans in Liquidation**  
**(as of March 31, 2005)**

<b>Calendar Year Purchased</b>	<b>Number of Loans</b>	<b>Purchase Amount</b>	<b>Percentage of Total Loans</b>	<b>Cumulative Percentage Total</b>
2002	94	\$1,877,935	9	9
2003	313	\$7,378,501	29	38
2004	443	\$10,479,315	41	79
2005	228	\$5,301,957	21	100
<b>Total</b>	<b>1,078</b>	<b>\$25,037,708</b>	<b>100</b>	

SBA requires<sup>3</sup> lenders to provide SBA with a status report every 180 days for loans placed in liquidation. Loans in liquidation for 180 days or more must be reviewed by SBA every 90 days. SBA must review a sample of 25 percent of the loans that are in liquidation for less than 180 days. These follow-up activities are required to ensure lenders are completing liquidation procedures in a timely manner and that SBA receives its proportionate share of any subsequent collection.

Under the Debt Collection Improvement Act of 1996, Federal agencies are required to refer eligible non-tax debts over 180 days old to Treasury for collection actions. We found that a January 3, 2000, letter from the Department of Treasury granted SBA an exemption for the 180-day transfer rule in cases where SBA is actively negotiating a repayment schedule with the borrower (referred to as in “workout” status). However, once it is determined that a workout is not feasible and, in the case of collateralized loans, SBA completes its liquidation actions, any remaining delinquent debts are subject to the mandatory transfer provision of the Debt Collection Act.

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<sup>3</sup> SBAExpress Program Guide.

We reviewed a judgmental sample of the above loans and found that very few files contained evidence of follow-up. We requested 100 files (50 files from each center) and found evidence of follow-up for only four loans. Twenty files had not been in liquidation status long enough to require monitoring actions. Thus the agency performed adequate follow-up on only 4 out of 80 loans.

SBA officials at the loan servicing centers indicated that liquidation follow-up procedures were considered a low priority due to the expanding loan portfolio of defaulted express loans and the lack of staff. Most of the centers' resources were devoted to purchasing and various other duties.

Consequently, by allowing expedited purchased loans to go unmonitored, SBA missed opportunities to reduce \$25 million in losses on loans purchased under the expedited process by referring them to the Department of Treasury for additional collections activities as required under the Debt Collection Act.

### ***Recommendations***

We recommend that the Associate Administrator for Financial Assistance:

10. Review the \$25 million of loans in liquidation and refer to the U.S. Department of Treasury those loans that are more than 180 days delinquent and are not in bona fide workout arrangements
11. Ensure that adequate emphasis is placed on liquidation follow-up and that controls are in place to refer eligible non-tax debts to the Department of Treasury within 180 days of delinquency as required by the Debt Collection Act.
12. Require the Fresno and Little Rock Commercial Loan Servicing Centers to obtain updated status reports from lenders on loans currently in liquidation status and charge loans off as appropriate.

### ***Management Comments and OIG Evaluation***

#### ***Recommendation 10***

OFA did not agree with the recommendation to refer \$25.1 million in loans to the U.S. Department of Treasury. Management believes the recommendation would be appropriate for loans that are not in litigation or foreclosure. SBA will refer loans to Treasury following completion of recovery efforts.

We modified this recommendation to take into consideration the comments from OFA. While OFA's response indicates that it agrees to make timely referrals, the key to doing so is timely monitoring of purchased loans, which are being liquidated by lenders. Given the age of some of these delinquencies, it appears likely that some loans are not in litigation or foreclosure and should be charged off.

Under any circumstance, the Service Center should review the status of these liquidations, and refer to Treasury those that are not in a workout arrangement and are 180 days or more overdue. Nevertheless, we plan to pursue action on this recommendation through the audit resolution process.

*Recommendation 11*

OFA partially agreed with the recommendation and has indicated that centers are exploring ways to redirect or supplement existing staff resources for this function. Management believes this recommendation has already been implemented since an automated referral to Treasury is initiated shortly after charge-off.

While automated referral is already in place, referrals are only made when loans have been charged off. Charge offs occur at the end of the liquidation process. However, our audit showed that SBA did not monitor or follow-up on the liquidation of 1,078 loans to ensure that loans were charged off when workouts were no longer feasible. Consequently, many loans were in liquidation for several years. Also, while management stated that adequate emphasis is now placed on charging off loans within a very short time period after purchase; it provided no evidence to support its assertion. Consequently, we do not consider management's comments to be responsive to the recommendation and will pursue corrective action through the audit resolution process.

*Recommendation 12*

OFA agreed with the recommendation and they are exploring ways to redirect staff resources to review purchased loans in liquidation status. OFA's proposed actions are responsive to the recommendation.

**Lender Deficiencies in  
SBAExpress and Community Express Loans Reviewed**

#	LOAN NUMBER	APPROVAL DATE	GROSS LOAN AMOUNT	SBA GUARANTY AMOUNT	SBA PURCHASE DATE	SBA PURCHASE AMOUNT	DEFICIENCY CODES
1	EX. 2	1/28/2000	\$60,000	\$30,000	11/1/2004	\$9,252	UP, 1919
2	EX. 2	2/11/2000	\$100,000	\$50,000	8/4/2004	\$49,899	UP
3	EX. 2	2/18/2000	\$35,000	\$17,500	3/22/2001	\$18,089	UP
4	EX. 2	2/24/2000	\$50,000	\$25,000	1/27/2004	\$25,000	UP, MRJ,
5	EX. 2	5/2/2000	\$25,000	\$12,500	3/12/2002	\$10,865	UP
6	EX. 2	5/26/2000	\$10,000	\$5,000	9/26/2003	\$3,082	UP
7	EX. 2	6/2/2000	\$50,000	\$25,000	6/18/2003	\$24,942	UP
8	EX. 2	6/20/2000	\$150,000	\$75,000	9/10/2003	\$35,710	UP
9	EX. 2	7/24/2000	\$100,000	\$50,000	8/10/2004	\$48,970	UP
10	EX. 2	8/25/2000	\$100,000	\$50,000	3/12/2003	\$49,970	UP
11	EX. 2	8/30/2000	\$15,000	\$7,500	2/27/2002	\$6,631	UP, ND, LPD
12	EX. 2	9/8/2000	\$45,000	\$22,500	10/24/2003	\$17,459	UP
13	EX. 2	9/14/2000	\$100,000	\$50,000	2/6/2002	\$50,000	UP
14	EX. 2	9/22/2000	\$75,000	\$37,500	11/19/2003	\$36,765	UP
15	EX. 2	10/13/2000	\$20,000	\$10,000	5/30/2003	\$10,000	UP
16	EX. 2	10/23/2000	\$50,000	\$25,000	11/18/2003	\$5,826	UP, MRJ
17	EX. 2	11/30/2000	\$43,800	\$21,900	4/27/2004	\$19,422	UP
18	EX. 2	12/13/2000	\$7,500	\$3,750	2/20/2003	\$3,609	UP
19	EX. 2	1/10/2001	\$52,000	\$26,000	8/3/2004	\$18,548	UP
20	EX. 2	1/19/2001	\$125,000	\$62,500	11/25/2003	\$56,106	UP
21	EX. 2	1/29/2001	\$25,000	\$12,500	10/29/2003	\$9,610	UP
22	EX. 2	3/30/2001	\$10,000	\$5,000	11/13/2002	\$4,980	UP, 1919
23	EX. 2	5/9/2001	\$50,000	\$25,000	7/9/2004	\$24,969	UP
24	EX. 2	7/2/2001	\$50,000	\$25,000	11/18/2003	\$19,635	UP
25	EX. 2	8/22/2001	\$25,000	\$12,500	7/29/2004	\$7,304	UP
26	EX. 2	8/29/2001	\$50,000	\$25,000	8/26/2003	\$20,503	UP, RD, MRJ
27	EX. 2	9/18/2001	\$50,000	\$25,000	8/18/2003	\$22,784	UP

## Appendix A

#	LOAN NUMBER	APPROVAL DATE	GROSS LOAN AMOUNT	SBA GUARANTY AMOUNT	SBA PURCHASE DATE	SBA PURCHASE AMOUNT	DEFICIENCY CODES
28	EX. 2	11/1/2001	\$85,000	\$42,500	11/12/2003	\$38,315	UP
29	EX. 2	11/19/2001	\$25,000	\$12,500	6/19/2003	\$12,500	UP
30	EX. 2	1/25/2002	\$50,000	\$25,000	6/8/2004	\$24,602	UP, MRJ, RD
31	EX. 2	4/30/2002	\$100,000	\$50,000	3/22/2004	\$49,235	UP
32	EX. 2	7/22/2002	\$50,000	\$25,000	12/21/2004	\$25,000	UP, ND
33	EX. 2	7/26/2002	\$10,000	\$8,500	3/23/2004	\$7,414	UP, ND, IBT
34	EX. 2	8/22/2002	\$50,000	\$25,000	11/9/2004	\$24,875	UP
35	EX. 2	10/4/2002	\$5,000	\$4,250	12/16/2003	\$3,908	UP
36	EX. 2	10/10/2002	\$6,000	\$3,000	8/26/2003	\$2,884	UP
37	EX. 2	10/17/2002	\$10,000	\$8,500	7/1/2003	\$8,319	UP, TA
38	EX. 2	12/2/2002	\$50,000	\$25,000	12/15/2003	\$21,882	UP
39	EX. 2	12/5/2002	\$25,000	\$12,500	10/27/2004	\$11,389	UP
40	EX. 2	3/26/2003	\$5,000	\$4,250	2/12/2004	\$4,078	UP, TV
41	EX. 2	5/15/2003	\$10,000	\$5,000	12/17/2004	\$4,843	UP
42	EX. 2	6/6/2003	\$25,000	\$12,500	11/4/2004	\$12,500	UP
43	EX. 2	8/11/2003	\$6,000	\$5,100	8/25/2004	\$4,937	UP, TA, TV
44	EX. 2	8/22/2003	\$5,000	\$4,250	4/15/2004	\$4,119	UP, TA
45	EX. 2	10/29/2003	\$10,000	\$8,500	9/3/2004	\$8,281	UP

### LEGEND

Area of Deficiency	Code
Missing Verification for Use of Proceeds	UP
Missing Refinancing Justifications	MRJ
Technical Assistance not Provided	TA
Nondisclosure of Previous SBA Assistance Request	ND
Missing or Incomplete SBA Form 1919	1919
Tax Verification not Performed	TV
Failure to Disclose Refinanced Debt	RD
Loan Previously Denied by SBA	LPD
Multiple Loans to One Borrower	ML
Ineligible Business Type	IBT

**Appendix B**

**Community Express Loans Reviewed to Determine Whether Lenders Provided Technical Assistance**

Sample #	Loan#	Servicing Center	Disbursed Amount	Guarantee Amount	Purchase Amount (Principal & Interest)
1	Ex. 2	Little Rock	\$ 6,000	\$ 5,100	\$ 4,696
2	Ex. 2	Little Rock	\$ 149,516	\$127,089	\$127,089
3	Ex. 2	Little Rock	\$ 50,000	\$ 42,500	\$ 42,500
4	Ex. 2	Fresno	\$ 100,000	\$ 85,000	\$ 84,567
5	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 3,956
6	Ex. 2	Fresno	\$ 14,994	\$ 12,745	\$ 12,750
7	Ex. 2	Little Rock	\$ 10,000	\$ 8,500	\$ 8,174
8	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,175
9	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 3,811
10	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,586
11	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,899
12	Ex. 2	Little Rock	\$ 116,000	\$ 87,000	\$ 85,923
13	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 4,117
14	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,909
15	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 3,828
16	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 3,991
17	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,143
18	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,053
19	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,921
20	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,079
21	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,871
22	Ex. 2	Little Rock	\$ 85,000	\$ 72,250	\$ 67,195
23	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,163
24	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,070
25	Ex. 2	Fresno	\$ 10,000	\$ 8,500	\$ 7,818
26	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,136
27	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,250
28	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,220
29	Ex. 2	Little Rock	\$ 36,600	\$ 29,280	\$ 28,562
30	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,808
31	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 3,986
32	Ex. 2	Little Rock	\$ 50,000	\$ 40,000	\$ 37,978
33	Ex. 2	Little Rock	\$ 6,000	\$ 5,100	\$ 4,920
34	Ex. 2	Little Rock	\$ 150,000	\$127,500	\$127,397
35	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 4,120
36	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,171
37	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 4,186
38	Ex. 2	Little Rock	\$ 6,000	\$ 5,100	\$ 4,725
39	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 3,931
40	Ex. 2	Little Rock	\$ 5,000	\$ 4,250	\$ 4,047
41	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,673
42	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,667
43	Ex. 2	Fresno	\$ 5,000	\$ 4,250	\$ 3,898



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U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, D.C. 20416

**DATE:** December 4, 2006  
**TO:** Debra S. Ritt, Assistant Inspector General for Auditing  
**FROM:** Janet A. Tasker, Acting Associate Administrator for Financial Assistance  
**SUBJECT:** Draft Audit of the SBAExpress and Community Express Loan Purchase and Liquidation Process

Thank you for the opportunity to respond to the subject report. Overall, we agree we can make some changes to the express process for liquidations and purchases that will strengthen internal controls. However, OFA believes that significant conclusions in the audit are based on an incomplete understanding of the requirements of the programs. First, the standard for verifying use of proceeds for working capital loans is described in SOP 50 51 and does not require the lender to document the use of proceeds due to the fluid nature of working capital loans. Second, while OFA believes the technical assistance component of Community Express loans is a key factor in this program, the fact that the technical assistance was not specifically verified does not translate into the conclusion that no technical assistance was provided. In fact, as noted in the audit report, each borrower was evaluated by a T/A provider and a T/A action plan was developed for the borrower, both of which constitute the provision of T/A. It appears that clear actions were taken by lenders to ensure that technical assistance was provided in good faith. OIG should note that borrowers are not required to take the technical assistance, however, OFA wants lenders to make a good faith effort to ensure the borrower follows up and receives the T/A.

Please see our responses below to the specific recommendations to your draft audit report. We appreciate the opportunity to comment. Please let us know if OIG has any questions or wishes to discuss OFAs response to the draft audit report.

- 1. Determine if loan proceeds on the 45 loans sampled during our audit were used in accordance with the terms of the loan authorizations, and take appropriate corrective actions against lenders that are not able to substantiate an appropriate use of proceeds.**

**Response:** OFA concurs with this recommendation within the parameters described below.

Reflecting the special nature and philosophy of the SBAExpress loan program, particularly the level of authority and autonomy delegated to lenders participating in the program, the requirements for lender verification of the use of loan proceeds are not as strictly defined and rigorous as those for regular 7(a) loans. In this regard, it is noted that for regular 7(a) loans, lenders are not required to document the disbursement of loan proceeds for working capital through the issuance of joint payee checks or a substitute method (SOP 50-51 2B, chapter 13, paragraph 22). The nature of the SBAExpress

program is such that most loans are for the purpose of providing working capital. As a recent example, of 50,203 SBAExpress and Community Express loans processed in fiscal year 2006 through E-Tran, 44,972 loans (just under 90%) had working capital designated for all or a portion of the use of proceeds. While we attempted to ascertain the use of proceeds for the actual sample of loans used by the OIG, none of the loans were processed in E-Tran. (We believe this is due to the fact that the time frame for the audit is before E-Tran was extensively used for SBAExpress loan applications as it is today.) We also attempted to review the actual loan files to ascertain use of proceeds. However, in all but two cases, OIG still holds the files. In the two files we were able to review, the use of proceeds was working capital.

The SBAExpress program guide (10/1/02) states that lenders must use reasonable methods to ensure that loan proceeds are used for business-related purposes verification procedures at least as thorough as those used for their non-SBA loans. Also, lenders must communicate to borrowers that SBA loan proceeds can only be used for business purposes. Lenders must include this requirement in the loan authorization and must obtain a certification from the borrower that loan proceeds will be used for business purposes (in SBA Form 1919 the borrower certifies that, "I agree that all SBA loan proceeds will be used only for business related purposes as specified in the loan application...").

Consequently, within 90 days once the files are returned from OIG, we will re-examine the 45 loans sampled during your audit to determine if:

- There is a lender certification that it verified loan proceeds were used for business purposes following internal procedures used on its non-SBA loans.
- There is a loan authorization requirement that loan proceeds will be used for business purposes.
- There is a borrower certification with regard to the use of loan proceeds for business purposes (Form 1919 or equivalent).

Appropriate corrective action will be initiated for those lenders who can not substantiate use of proceeds.

- 2. Determine if lender actions warrant a denial of liability on \$14,232 in guarantees associated with the two loans that were either missing a Form 1919 or where the form was incomplete; and \$9,015 on guarantees on another two loans that were missing IRS tax verifications.**

**Response:** OFA concurs with this recommendation.

The requirement for lender submission of Form 1919 in order for SBA to process a purchase was clarified in instructions sent to the centers in January 2006. Within 90 days of the return of the loan files from OIG, OFA will review the two loans with purchase amounts of \$9,252 and \$4,980 that had missing or incomplete 1919 forms to determine whether the lender can supply the missing form in one of the cases and the borrower's

citizenship information in the other. If appropriate documentation cannot be supplied, a determination will then be made with respect to the recovery of the guaranty purchase amounts disbursed.

**3. Recover \$7,414 from the lender that awarded an SBA loan to an ineligible company.**

**Response:** OFA cannot concur or non-concur with this recommendation without further information.

Within 90 days after the loan file is returned by OIG, OFA will review the loan file to determine the essential nature of the borrower's business since a check cashing operation, although dealing exclusively with cash and near cash inventory, can be deemed eligible because the business uses the cash to provide a service (cashing checks for a fee). See SOP 50-10 (4)(B), Subpart A, paragraph 8b(2)(d). If after further review, OFA determines that the loan was ineligible, we will take action to recover the amount indicated.

**4. Revise the purchase demand kit and review checklists to require that lenders provide SBA staff with use of proceeds documentation, complete SBA Form 1919s, IRS tax verifications, and any other documentation needed to determine lender compliance with applicable requirements.**

**Response:** OFA concurs with the recommendation to revise the purchase demand kit consistent with current guidance, as indicated below.

Within 90 days of the issuance of this report, OFA will review the purchase demand kit to ensure that it contains the three criteria for certification of the use of loan proceeds for business purposes as set forth in the first response above. We will also ensure that the kit makes explicit that a completed SBA Form 1919 is a prerequisite for purchase processing. The kit will further make clear that IRS tax transcript verification documentation is required for purchase processing on early default loans unless the lender used credit scoring that did not rely on business revenues or profits in the scoring process. In addition, if loan proceeds were used for refinancing, the lender will be required to submit its analysis and justification for the refinancing. Other revisions to the kit may be subsequently made based upon our review of the OIG purchases selected for audit.

**5. Review the 2,729 loans for compliance with SBA rules and regulations and improper payments.**

**Response:** OFA does not concur with this recommendation.

The OIG's conclusion in this regard appears to be largely based on the fact that use of proceeds were not verified. However, since the vast majority of SBAExpress loans are made for working capital purposes and, the SOP does not require traditional verification

procedures for working capital loans, we do not believe that improper payments have been made requiring such a comprehensive review. Consequently, we do not believe that it would be an efficient or cost-effective use of SBA resources to review for a second time all 2,729 purchases that were included in the OIG sample. This is particularly true with respect to the large number of purchase disbursements that were under \$10,000 which are subject to expedited reviews under current procedures (SOP 50-51 2B, chapter 13, paragraph 17). However, if significant issues are identified in our analysis of the 45 purchases selected for review by OIG, then we will make a determination with regard to the identification of additional purchases for a second review based on risk and SBA exposure (such as all early defaults with purchase disbursements over \$50,000).

**6. Recover \$27,134 for the two purchased SBAExpress loans reviewed for which the lender failed to disclose material facts.**

**Response:** OFA concurs preliminarily with this recommendation subject to further review.

Within 90 days after the loan files are returned by OIG, OFA will review the loan files for these two purchases and make a decision with respect to recovery of the purchase proceeds disbursed. Based on the summary contained in the OIG draft audit, however, it appears that recovery of the amounts in question is warranted.

**7. Require the Fresno and Little Rock Commercial Loan Servicing Centers ensure lenders have provided technical assistance before purchasing guarantees above 50 percent.**

**Response:** OFA partially concurs with this recommendation.

OFA does not agree with OIG's finding that technical assistance (T/A) was not provided on the 43 cited loans simply because adequate documentation substantiating the T/A was not provided during the purchase review process. Additionally, as the OIG notes, each borrower was evaluated by a T/A provider and a T/A action plan was developed for the borrower, both of which constitute the provision of T/A. OIG should note that borrowers are not required to take the technical assistance, however, OFA wants lenders to make a good faith effort to ensure the borrower follows up and receives the T/A.

However, OFA does agree that the Agency should publish enhanced guidance for lenders (1) to more clearly specify what SBA expects in the way of T/A from each lender under the program; and (2) to set forth SBA's minimum required documentation to substantiate the provision of T/A that will be required at the time of purchase. In this regard, OFA currently has in clearance procedural guidance (which OIG has cleared) addressing these two important program clarifications. Additionally, once that notice is published, we will revise our purchase process in Fresno and Little Rock to require the centers to obtain additional documentation substantiating the provision of the required T/A by Community Express lenders. This documentation will be a prerequisite to process the purchase of

any Community Express loan at an 85% guaranty level. OFA believes that publication of this notice will address this recommendation.

- 8. Obtain evidence from lenders that technical assistance was provided to borrowers on the 43 Community Express loans reviewed. If no evidence is provided, seek recovery of those portions of SBA guarantees that exceeded the 50-percent level.**

**Response:** OFA does not concur with this recommendation.

As noted above, the OIG has substantiated that the lenders ensured management assessments and T/A action plans were developed for the loans in question. Since this forms the basis for concluding that substantive T/A was provided, OFA has no basis to recover any guaranty purchase amounts for these loans under existing program guidance. OIG should note that borrowers are not required to take the technical assistance, however, OFA wants lenders to make a good faith effort to ensure the borrower follows up and receives the T/A. However, as noted above, OFA is in the process of publishing enhanced guidance on Community Express that will better define the Agency's expectations regarding the provision of T/A and its substantiation by the lender.

- 9. Direct the Fresno Commercial Loan Service Center to rescind its September 11, 2003 guidance and inform lenders that proof of technical assistance is a program requirement.**

**Response:** OFA partially concurs with this recommendation.

As noted above, OFA agrees with the need for publication of enhanced program guidance on Community Express T/A requirements. Accordingly, once this is done Fresno and Little Rock will require more complete substantiation of the provision of appropriate T/A by Community Express lenders for all purchases. In the meantime, Fresno will be immediately requested to rescind its September 11, 2003 guidance. The revised purchase checklist discussed in recommendation four will be require Community Express lenders to certify that they attempted to provide T/A in connection with each loan submitted for purchase and briefly describe how this was done.

- 10. Refer to the U.S Department of Treasury the \$15.1 million in loans that are more than 180 days delinquent and are not in bona fide workout arrangements.**

**Response:** OFA does not concur with this recommendation.

Until lenders have finished their recovery actions and SBA has completed its review of such actions and charged off the loan, the account is not eligible to be sent to Treasury for servicing. Your recommendation would be appropriate, but only for delinquent SBA

serviced accounts that are not in litigation or foreclosure. Treasury addresses lender serviced loans in its regulations at 13 CFR Part 285.12 (d)(6) as follows:

“...debts being serviced and/or collected in accordance with applicable statutes and/or regulations by third parties, such as private lenders or guaranty agencies are exempt...”

In the preamble to the Treasury regulations, this issue was discussed:

“Paragraph 285.12(d)(6) was added to the final rule to provide additional guidance on debts being collected by third parties. Several agencies, in accordance with statutory or contractual requirements, have debts more than 180 days past due that are being collected by third parties such as private lenders or guaranty agencies. In accordance with ... the provisions of this rule, the Secretary has determined that it is in the best interest of the Government that debts being collected by third parties be exempt ... because the transfer of such debts would interfere with the program goals and requirements of the subject debts. Debts more than 180 days past due must be transferred to FMS for collection ... upon their return to a creditor agency by a third party.”

Accordingly, as indicated above, SBA will transfer its loans to Treasury for administrative offset and other collection actions following completion of the lender’s recovery efforts and charge-off of the account by SBA.

However, as part of the President’s Management Agenda, SBA is conducting a review of its liquidation and purchase activities from the perspective of the Debt Collection Act and related regulations and guidance. OFA believes its practices are fully consistent with Treasury guidance, however, changes in practices may result from this internal assessment.

**11. Ensure that adequate emphasis is placed on liquidation follow-up and that controls are in place to refer eligible debts to the Department of Treasury within 180 days of delinquency as required by the Debt Collection Act.**

**Response:** OFA partially concurs with this recommendation.

See response to Recommendation 10 above with on referrals to Treasury. With regard to liquidation follow-up, as indicated below, the centers are exploring ways to redirect or supplement existing staff resources for this function. For Express loans submitted for purchase under the regular purchase process (not the expedited process) adequate emphasis is now placed on charging off the loan within a very short time period after purchase. The automated process for referral to Treasury is initiated shortly after the charge off is effected. OFA believes this recommendation has been implemented.

**12. Require the Fresno and Little Rock Commercial Loan Servicing Centers to obtain updated status reports from lenders on loans currently in liquidation status and charge loans off as appropriate.**

**Response:** OFA concurs with this recommendation.

The servicing centers are exploring ways to redirect or supplement existing staff resources to review purchased loans in liquidation status and obtain lender information as necessary for liquidation oversight and charge-off when appropriate. Within 180 days of the issuance of this report, OFA will have made appropriate organizational changes to address this recommendation.