

**AUDIT OF
LIQUIDATION OF DISASTER LOANS**

*Report Number: 7-26
Date Issued: June 1, 2007*



U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Grady Hedgespeth
Director of Financial Assistance
/S/ original signed

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of Liquidation of Disaster Loans
Report No. 7-26

Date: June 1, 2007

This report presents the results of the Office of Inspector General's (OIG) audit of the process for liquidating delinquent disaster loans. The objective of the audit was to determine if the Small Business Administration (SBA) maximized its recovery of delinquent disaster loans through collateral liquidations and/or by referral to the U.S. Treasury. The audit work was conducted from July 2005 to January 2006, but the written report was delayed due to higher priority work. We believe that the results of this audit are still pertinent and the recommendations should improve the servicing of delinquent loans.

In performing our audit, we randomly selected five samples of secured and unsecured disaster loans in various stages of collection as of July 26, 2005. We examined SBA loan files maintained on SBA's information systems, conducted site visits at the Santa Ana Disaster Loan Liquidation Center, the El Paso and Birmingham Servicing Centers, and interviewed SBA officials in the Office of Financial Assistance. A more detailed description of our audit scope and methodology is provided in Appendix I.

Based upon our sample results, our audit showed that SBA did not maximize recovery on at least \$360.3 million sent to SBA's Liquidation Center and the U.S. Treasury because of miscoded loans, data system errors, and continued servicing activities after delinquent loans were transferred to the Disaster Loan Liquidation Center.

BACKGROUND

SBA provides direct disaster loans to help homeowners, renters, businesses and nonprofit organizations return to pre-disaster condition. SBA disaster loans are

the primary form of Federal assistance for non-farm, private sector disaster losses and are the only form of SBA assistance not limited to small businesses. SBA disaster loans are processed, serviced and liquidated at six centers¹ throughout the Nation.

Once loans become delinquent, SBA attempts to bring them into current status by contacting the loan recipients and establishing payment arrangements. When these attempts are not successful, the loans are classified as either “charged-off” or “in liquidation.” Unsecured loans that are charged-off and over 180 days delinquent are sent to Treasury, while secured loans and those in liquidation are referred to SBA’s Disaster Loan Liquidation Center in Santa Ana, California. The liquidation center may continue to attempt a workout with the borrower; however, when this is not possible, the center is responsible for identifying, assessing, protecting, and taking action against available collateral and additional assets. When the remaining loan balance is determined to be uncollectible, a portion or all of the loan balance may be charged-off and removed from SBA’s active receivable accounts. The charged-off loan would then be referred to Treasury for further collection action.

The Treasury attempts further recovery through its two collection programs— Treasury Offset Program (TOP) and its Servicing Program. Under TOP, agencies may collect delinquent debt through Treasury offsets against Federal payments due a debtor, such as income tax refunds, social security, and other Federal payments. The Treasury Servicing Program uses offsets and a variety of other debt collection tools, such as demand letters, referrals to private collections agencies, and telephone calls to debtors to collect on delinquent debt.

In accordance with the Debt Collection Act of 1996 (the Act), agencies not designated by the Office of Management and Budget (OMB) as a debt collection center are required to transfer loans that are 180 days or more past due to the U.S. Treasury for additional collection activities.

In January 2000, OMB granted SBA an exemption from transferring loans that are 180 days or more past due to the U.S. Treasury provided that the loans are under active repayment arrangements or the collateral/assets associated with the loan will be pursued by SBA. However, once SBA determines that a repayment arrangement is not feasible and has completed all liquidation and/or foreclosure activities, the remaining debt must be referred to the U.S. Treasury in accordance with the Act.

¹ The Birmingham Home Loan Servicing Center, El Paso Home Loan Servicing Center, Santa Ana Home Loan Servicing Center, Fresno Business Loan Servicing Center, Little Rock Business Loan Servicing Center, and the Santa Ana Liquidation Center.

RESULTS IN BRIEF

SBA did not maximize recovery on at least \$360.3 million in delinquent disaster loans that were sent to SBA's Disaster Liquidation Center and the U.S. Treasury. Specifically, SBA:

- Did not actively pursue a projected \$261.5 million in delinquent loans because of conflicting guidance in its operating procedures;
- Did not transfer a projected \$24.7 million in delinquent loans to Treasury because the loans were improperly coded; and
- Did not refer to Treasury Servicing all responsible parties on a projected \$74.1 million of charged-off loans because loans were not coded properly and loan details, such as the name and identification numbers, were not entered into the Portfolio Management Treasury Offset System (PMT) database.

We recommend that SBA revise Standard Operating Procedure (SOP) 50 51 2, *Loan Liquidation and Acquired Property*, and clarify existing guidance to better explain the requirements of the Debt Collection Act. We further recommend that SBA implement controls to ensure the liquidation of collateral and assets are actively pursued to the fullest extent possible at the Disaster Loan Liquidation Center and that loans are properly coded and transferred to Treasury and/or the center in accordance with the Debt Collection Act.

Management was generally responsive to the audit findings and recommendations, disagreeing with recommendation 1 and agreeing with recommendations 2 through 7. Management did not believe that a revision to the SOP is needed or warranted because it has long been SBA's loan servicing policy that cooperative disaster victims who become delinquent on their loans be given every opportunity to repay their debts through restructured obligations wherever possible. Management's comments are discussed in more detail in the Agency Comments section of the report and the response is presented in its entirety in Appendix IV. Our corresponding comments are presented in the OIG Response section of this report. We will pursue resolution of recommendation 1 through the audit resolution process.

RESULTS

Collateral and Assets Were Not Actively Pursued During Liquidation of at least \$261.5 Million in Delinquent Disaster Loans

Standard Operating Procedure (SOP) 50 51 2, *Loan Liquidation and Acquired Property*, requires that liquidation actions on delinquent disaster loans maximize recoveries in a minimum amount of time. However, SBA continued to service loans transferred to the Disaster Loan Liquidation Center instead of liquidating collateral and delayed liquidations actions because of inadequate staffing levels.

Our review of 59 statistically sampled loans² disclosed that SBA had not pursued \$8.5 million in collateral and/or additional assets on 46 loans with an outstanding balance of \$2.8 million.³ Collateral or available assets for the remaining 13 loans were pursued, released, or exempt from collection activities. Based on the sample results, we estimate that SBA did not pursue recovery of collateral and assets associated with at least \$261.5 million in delinquent disaster loans. According to SOP 50 51 2, once a payment workout agreement (workout) has been determined infeasible, the non-performing loan should be transferred to liquidation to maximize recovery through the liquidation of collateral and available assets. However, the SOP also requires liquidation personnel to continue to negotiate workouts with delinquent borrowers to re-establish payments on delinquent loans. Consequently, the SOP provides conflicting guidance to loan specialists that emphasizes servicing activities over liquidation.

During our audit, we also found that only 16 employees were assigned to work the nearly 4,000 loans at the center. The 16 employees consisted of 8 loan specialists, 4 assistants, and 4 contractors. This staffing level adversely impacted the center's ability to effectively locate, assess, protect, and ultimately liquidate collateral and available assets. Following our audit, a solicitation was submitted to outsource the liquidation function through the OMB A-76⁴ contracting process. The contract was awarded to the Agency's employees, referred to as the Most Efficient Organization (MEO), on March 31, 2006, and included an increase in staffing of up to 48 employees based on the actual volume of liquidation cases. Currently, the MEO is in the process of hiring additional staff to augment its present staffing of 12 loan specialists, assistants, and contractors.

² Loans were randomly sampled from a universe of 4,536 delinquent loans at the center.

³ Collateral and asset values are based on the values reported at the time of loan application. Although the collateral and/or additional assets may exceed the outstanding balance, SBA would only collect the remaining loan balance.

⁴ OMB Circular No. A-76 establishes Federal policy for the performance of recurring commercial activities and encourages public and private competition.

At least \$24.7 Million in Delinquent Loans Were Not Transferred to Treasury for Collections Because of Improper Coding

Our audit of 104 statistically sampled loans from a universe of 3,074 delinquent loans disclosed that 55 loans totaling about \$3.9 million had not been transferred to Treasury as required by the Debt Collection Act. The 55 loans included 34 unsecured loans at the servicing and field offices and 21 secured loans at the Santa Ana Liquidation Center that were improperly coded as workouts. Based on the sample results, we estimate that SBA missed the opportunity for additional recoveries of at least \$24.7 million on loans that were not transferred to Treasury for collections. The Act requires all agencies not designated by OMB as debt collection centers to refer all loans that are 180 days past due to Treasury for collection. On January 3, 2000, Treasury exempted SBA from the mandatory transfer requirement for loans in active workout status. However, once SBA determines that a workout is not feasible and, in the case of collateralized loans, completes its liquidation/foreclosure, any remaining debt is subject to the mandatory transfer provision of the Act.

Loans were not referred to Treasury because the servicing centers and field offices improperly coded them in the Loan Accounting System as workouts. However, in order to meet the requirements of a workout as stated in SOP 50 50 4, SBA must: (1) document the workout in a modification to the loan terms; (2) perform a financial analysis; (3) conduct a legal review;⁵ (4) assess collateral; and (5) evaluate the tax status of the borrower. If the obligor negotiates a workout agreement, SBA codes the loan as a workout, which will prevent the loan from being referred to Treasury. The 55 loans that were improperly coded did not meet the requirements for a workout. SBA did not identify the miscoding of these loans because it did not routinely review loans in a workout status to ensure that the borrowers were meeting the requirements of the workout agreements. The improper use of the workout code delayed referral of the loans to Treasury for further collection as required by the Debt Collection Act.

SBA Missed Collection Opportunities on at Least \$74.1 Million by Not Referring All Loans and Responsible Parties to Treasury

Procedural Notice 5000-619, *Treasury Debt Collection*,⁶ requires that all charged-off loans be referred to both TOP and Treasury Servicing. The Notice also requires that information on all responsible parties on collectable debt be made available to TOP. However, our review of 118 statistically sampled loans with an outstanding balance of about \$2.2 million from a universe of 16,582 charged-off

⁵ Not required for unsecured loans.

⁶ Although the notice has expired, SBA continues to apply the policy.

loans disclosed that SBA did not fully transfer 88 loans with an outstanding balance of \$1.5 million to Treasury. Based on the sample results, we estimate that SBA missed an opportunity to collect at least \$74.1 million because loans and all responsible parties were not fully referred to Treasury.

Of the 88 loans, 58 with an outstanding balance of \$363,405 were miscoded as “65” in the Loan Accounting System, causing them to be referred only to TOP (see Appendix II). Instead, the referral coding should have been left blank so that the loans would go to both TOP and Treasury Servicing. Field personnel we interviewed believed Code 65 would refer the loans to TOP and Treasury Servicing collections or were not aware that there were two Treasury programs. This occurred because detailed instructions for referral have not been incorporated into SOP 50 50 4. Subsequent to the audit field work, SBA officials informed us that the center no longer uses Code 65.

The audit also disclosed that SBA did not forward names and identification numbers for all co-obligors and guarantors on the other 30 charged-off loans with an outstanding balance of \$1.1 million, preventing Treasury from contacting all responsible parties on loans transferred by SBA (see Appendix III). Pursuant to Procedural Notice 5000-619, Treasury Debt Collection, information on all responsible parties on legally collectable debt that is 180 days past due must be made available to TOP. For loans that are charged-off and/or 180 days past due, SBA enters the names and identification numbers of all co-obligors and guarantors in its database, Portfolio Management Auxiliary Name and Address System (PMN). Once the data is entered, it should be automatically transferred to another SBA database, the Portfolio Management Treasury Offset System (PMT), where it is made available to Treasury for offset collections through TOP.

For 27 of the 30 loans, all the necessary information for the co-obligors and guarantors was entered into the PMN system, but only one of the names or identification numbers was found in the PMT database. For the remaining three loans, the names and identification numbers for all co-obligors and guarantors were not entered into the PMN database system. Consequently, the information in SBA’s databases were not transferred to Treasury. Officials at SBA’s Treasury Liaison Group stated that they were aware of the database issues, but had been unable to resolve the problem. Additionally, the Office of Financial Assistance had not established procedures or assigned responsibility for verifying the transfer of information between the databases.

RECOMMENDATIONS

We recommend that the Director, Office of Financial Assistance:

1. Revise SOP 50 51 2 to instruct liquidation staff to pursue liquidation of loan assets instead of servicing and workouts.
2. Develop and implement procedures to ensure that loans coded as workouts are in compliance with the requirements of SOP 50 50 4.
3. Require Servicing and Liquidation Center staff to routinely review all charged-off loans designated as workouts to determine whether the workout designation is appropriate.
4. Develop and implement procedures, which ensure that the Treasury referral code at servicing centers is left blank so that loans requiring both TOP and Treasury Servicing are referred to Treasury for collections as required.
5. Develop and implement procedures to ensure that all the names and identification numbers of delinquent borrowers are entered into the PMN database and transferred to the PMT system for referral to Treasury.
6. Incorporate detailed instructions for transferring charged-off loans to Treasury into SOP 50 50 4.
7. Follow up on the 88 loans that were miscoded or which did not identify all responsible parties to ensure that Treasury was sent the correct or missing information.

AGENCY COMMENTS

On April 5, 2007, we provided SBA with a draft of the report for comment. On May 18, 2007, SBA provided its formal response, which is contained in its entirety in Appendix IV. SBA disagreed with recommendation 1, agreed with recommendations 2 through 7, and provided comments on several issues. However, management did not supply sufficient details to assess whether further action is required for recommendation 2 and did not provide target dates for completing proposed actions for recommendations 3 through 7.

Management disagreed with recommendation 1 to revise SOP 50 51 2 to instruct liquidation staff to pursue liquidation of loan assets instead of servicing and workouts. SBA explained that cooperative borrowers who become 180 days delinquent and have their loans transferred to the Santa Ana Center should still be

given the opportunity to repay their debts through workouts if feasible. SBA further stated that this determination can be made promptly and if the borrower cannot or will not comply with reasonable repayment requirement, enforced liquidation will be pursued. SBA also stated that it has adopted a more disciplined and analytical approach towards deciding whether to work with the borrower or pursue liquidation, which has reduced the number of loans in liquidation.

Management agreed with recommendation 2 that SOP requirements for workouts should be followed and stated that adequate guidance and oversight exists in the centers for compliance with the recommendation. Management noted that the primary SOPs applicable to disaster loans in liquidation status at NDLC are SOP 50 51 2, *Loan Liquidation and Acquired Property*, and SOP 50 52 1, *Consumer Loan Servicing and Collection for Disaster Home Loans*, rather than SOP 50 50 4, *Loan Servicing*.

OFFICE OF INSPECTOR GENERAL RESPONSE

We believe the actions proposed by SBA on recommendations 3 through 7 are responsive. However, we believe the Agency should establish target dates for completing final action on each of the recommendations.

With respect to recommendation 1, we agree that disaster victims should be given every opportunity to repay their debts. However, once a workout agreement has been determined infeasible, the non-performing loan should be transferred to liquidation to maximize recovery through the liquidation of collateral and available assets. As stated in our audit report, the current SOP provides conflicting guidance as it requires liquidation personnel to continue to negotiate workouts even though a workout was deemed infeasible. This not only duplicates the workout process performed during servicing, but further delays the recovery of collateral, increasing SBA's losses due to dissipating collateral. Therefore, the SOP should be revised to emphasize that further attempts should not be pursued if a workout has already been explored and that enforced recovery should begin.

SBA further stated that it is currently using a more disciplined and analytical approach for deciding when to work with the borrower or pursue liquidation, which has resulted in a significant decline in liquidations. This new approach provides another reason for revising the SOP. SBA should describe this method in the SOP to clarify for staff when enforced recovery should begin. SBA also did not provide details on how the decline in liquidations was achieved, and consequently it is unclear whether the decline is due to keeping defaulted loans in a workout status longer or charging off the loans — neither of which would help SBA maximize recoveries.

Although management agreed with recommendation 2, it did not propose any additional actions because it believes adequate guidance and oversight already exists to comply with the recommendation. While we agree that adequate guidance exists, we are unable to assess whether existing oversight is sufficient to ensure loans coded as workouts are in compliance with the guidance as management did not provide specific details on its existing oversight practices. As a result, we do not consider management's comments to be fully responsive and are requesting that management provide us with specific details of its oversight activities.

ACTIONS REQUIRED

Because SBA provided no target dates for completing proposed actions for recommendations 3 through 7, we are requesting that target dates be provided by June 29, 2007. We are also requesting that SBA provide details on controls in place at the centers for ensuring loans coded as workouts comply with SBA guidance to fully address recommendation 2. We plan to pursue a final decision on recommendation 1 through the audit resolution process.

We appreciate the courtesies and cooperation of the Office of Financial Assistance representatives during this audit. If you have any questions concerning this report, please call me at (202) 205-[Exemption 2] or Robert Hultberg, Acting Director, Disaster Programs Group, at (202) 205-[Exemption 2].

APPENDIX I. AUDIT OBJECTIVE, SCOPE, AND METHODOLOGY

Our audit objective was to determine if the Small Business Administration maximized its recovery of delinquent disaster loans through collateral liquidations and/or by referral to the U. S. Treasury. To address our audit objective, we randomly selected five samples of secured and unsecured disaster loans from SBA's Loan Accounting System using a 95 percent confidence level and a 5 percent error rate. These loans were classified as charged-off, in liquidation, or were coded as being in a workout status as of July 26, 2005. We assessed the reliability of the information provided by the Loan Accounting System by comparing the data in the system with original documents contained in the loan files. We did not identify any errors that would preclude the use of the data.

We reviewed a total of 281 loan files as well as data from SBA's information management system. Tables 1 and 2 detail the number and size of loans in our sample and the corresponding universe. The sample in Table 1 was used to determine whether collateral and assets were available to pursue collection on outstanding loan balances.

Table 1. Available Collateral and Assets Not Pursued

	Universe		Sample	
	Number of Loans	Outstanding Balance	Number of Loans	Outstanding Balance
Loan Status - In Liquidation	4,536	\$330,354,100	59	\$3,158,558

The first sample in Table 2 was used to determine if the code for workout agreements (Code 99) was used appropriately, and the next sample was used to determine if the code for transferring loans to Treasury Only (Code 65) was used properly. The final sample was used to determine if SBA transferred all the responsible parties on legally collectible debt to Treasury.

Table 2. Missed Collection Opportunities by Not Referring All Loans and Responsible Parties to Treasury

	Universe		Sample	
	Number of Loans	Outstanding Balance	Number of Loans	Outstanding Balance
Miscoded as a Workout Agreement (99)				
Loan Status - Charged Off & Coded 99	2,957	\$42,351,439	58	\$1,146,804
Loan Status - In Liquidation & Coded 99	117	11,249,692	46	5,827,135
Total Reviewed	3,074	\$53,601,131	104	\$6,973,939
Miscoded as Treasury Offset Only(65)				
Loan Status - Charged Off & Coded 65	8,845	\$77,684,591	59	\$373,554
Responsible Parties Were Not Referred to Treasury				
Loan Status - Charged Off	7,737	\$83,462,601	59	\$1,873,200

APPENDIX I. AUDIT OBJECTIVE, SCOPE, AND METHODOLOGY

We also contacted SBA personnel at Servicing Centers, the Santa Ana Liquidation Center, District Offices, Office of Financial Assistance and Office of Chief Information Officer. We conducted our audit from July 2005 to January 2006 in accordance with *Government Auditing Standards* as prescribed by the Comptroller General of the United States, and included such tests as we considered necessary to provide reasonable assurance of detecting abuse or illegal acts.

APPENDIX II. LOANS THAT WERE MISCODED 65

	Loan Number	Outstanding Loan Balance
1	[Exemption 2]	\$568
2	[Exemption 2]	\$10,185
3	[Exemption 2]	\$9,713
4	[Exemption 2]	\$0*
5	[Exemption 2]	\$6,819
6	[Exemption 2]	\$9,202
7	[Exemption 2]	\$1,327
8	[Exemption 2]	\$6,978
9	[Exemption 2]	\$1,465
10	[Exemption 2]	\$1,588
11	[Exemption 2]	\$9,516
12	[Exemption 2]	\$4,717
13	[Exemption 2]	\$20,734
14	[Exemption 2]	\$3,141
15	[Exemption 2]	\$779
16	[Exemption 2]	\$174
17	[Exemption 2]	\$2,698
18	[Exemption 2]	\$22,336
19	[Exemption 2]	\$10,389
20	[Exemption 2]	\$5,942
21	[Exemption 2]	\$21*
22	[Exemption 2]	\$2,803
23	[Exemption 2]	\$4,111
24	[Exemption 2]	\$15,121
25	[Exemption 2]	\$24,063
26	[Exemption 2]	\$8,965
27	[Exemption 2]	\$9,732
28	[Exemption 2]	\$374
29	[Exemption 2]	\$6,441
30	[Exemption 2]	\$12*
31	[Exemption 2]	\$1,896
32	[Exemption 2]	\$12*
33	[Exemption 2]	\$4,954
34	[Exemption 2]	\$1,849
35	[Exemption 2]	\$716
36	[Exemption 2]	\$1,438
37	[Exemption 2]	\$1,720
38	[Exemption 2]	\$4,921
39	[Exemption 2]	\$19,801
40	[Exemption 2]	\$4,466
41	[Exemption 2]	\$6,116
42	[Exemption 2]	\$10,222
43	[Exemption 2]	\$0*
44	[Exemption 2]	\$3,908

APPENDIX II. LOANS THAT WERE MISCODED 65

	Loan Number	Outstanding Loan Balance
45	[Exemption 2]	\$6,862
46	[Exemption 2]	\$1,023
47	[Exemption 2]	\$8,395
48	[Exemption 2]	\$17,254
49	[Exemption 2]	\$416
50	[Exemption 2]	\$7,751
51	[Exemption 2]	\$1,347
52	[Exemption 2]	\$29,939
53	[Exemption 2]	\$9,657
54	[Exemption 2]	\$4,054
55	[Exemption 2]	\$2,356
56	[Exemption 2]	\$3,096
57	[Exemption 2]	\$1,937
58	[Exemption 2]	\$7,385
	Total	\$363,405

* While these were identified as exceptions in the sample, Treasury will not collect on amounts of \$25 or less.

APPENDIX III. LOANS WHERE ALL CO-OBLIGORS WERE NOT TRANSFERRED TO TREASURY

	Loan Number	Outstanding Loan Balance
1	[Exemption 2]	1,459
2	[Exemption 2]	1,621
3	[Exemption 2]	1,738
4	[Exemption 2]	4,054
5	[Exemption 2]	10,135
6	[Exemption 2]	10,721
7	[Exemption 2]	1,192
8	[Exemption 2]	20,901
9	[Exemption 2]	5,943
10	[Exemption 2]	7,281
11	[Exemption 2]	5,090
12	[Exemption 2]	12*
13	[Exemption 2]	111,610
14	[Exemption 2]	4,758
15	[Exemption 2]	10,308
16	[Exemption 2]	5,611
17	[Exemption 2]	1,662
18	[Exemption 2]	332,482
19	[Exemption 2]	20,437
20	[Exemption 2]	5,535
21	[Exemption 2]	327,440
22	[Exemption 2]	172,607
23	[Exemption 2]	2,644
24	[Exemption 2]	7,108
25	[Exemption 2]	4,825
26	[Exemption 2]	844
27	[Exemption 2]	4,119
28	[Exemption 2]	9,889
29	[Exemption 2]	1,518
30	[Exemption 2]	6,553
	Total	\$1,100,097

* While these were identified as exceptions in the sample, Treasury will not collect on amounts of \$25 or less.

APPENDIX IV. MANAGEMENT RESPONSE

MEMORANDUM May 18, 2007

TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: Janet A. Tasker
Acting Director
Office of Financial Assistance

SUBJ: Response to Draft Report on Audit of Liquidation of Disaster Loans

Thank you for the opportunity to review the draft audit report on SBA's disaster loan liquidation process. As you note, the audit work is dated and the Office of Financial Assistance (OFA) believes it has already addressed many of the findings included in the draft report. We have addressed the specific recommendations made in the report below. As always, we appreciate the opportunity to work with your office to strengthen our lending programs. Please let us know if you have any questions regarding our response.

1. Recommendation: Revise SOP 50 51 2 to instruct liquidation staff to pursue liquidation of loan assets instead of servicing and workouts.

Response: OFA do not agree that a revision of the SOP is needed or warranted. The disaster loan program has the mandate to assist homeowners, renters, businesses and nonprofit organizations that suffer damage from a declared disaster to recover from damage sustained and return to their pre-disaster condition. It has long been SBA loan servicing policy that cooperative disaster victims who become delinquent on their loans be given the opportunity to repay their debts through restructured obligations wherever possible to avoid the loss of properties through foreclosure or being forced into a bankruptcy filing. Even after a borrower has become 180 days delinquent and transferred to the Santa Ana National Disaster Loan Resolution Center (NDLRC), SOP 50 51 2 (Loan Liquidation and Acquired Property) encourages SBA staff to explore the possibility of a workout if feasible. This determination can be made promptly and if the borrower cannot or will not comply with reasonable repayment requirements, then enforced liquidation will be pursued. This includes evaluating loan collateral to determine whether there is sufficient equity to justify a foreclosure action and the attendant costs of such action. Repayment agreements with cooperative borrowers serve to maximize SBA recoveries over the long run and should be pursued wherever possible even if a loan has been classified in liquidation. If the possibility of a workout has already been adequately explored, then further attempts will not be pursued and enforced recovery will begin. However, the NDLRC is taking a more disciplined and analytical approach towards making determinations as to whether to work with the borrower or pursue

APPENDIX IV. MANAGEMENT RESPONSE

liquidation. The results of this changed approach can be seen in the decline in loans in liquidation reported in the NDLRC. (See attached graph.) Therefore, OFA believes the intent of the recommendation is achieved.

2. Recommendation: Develop and implement procedures to ensure that loans coded as workouts are in compliance with the requirements of 50 50 4.

Response: We concur that SOP requirements for workouts should be followed, and we believe that adequate guidance and oversight now exists in the centers for compliance with this recommendation. However, the primary SOPs applicable to disaster loans in liquidation status at NDLRC are SOP 50 51 2 (Loan Liquidation and Acquired Property) and SOP 50 52 1 (Consumer Loan Servicing and Collection for Disaster Home Loans) rather than 50 50 4 (Loan Servicing). For disaster home loan workouts, the Birmingham and El Paso centers follow SOP 50 52 1 criteria. The NDLRC refers to SOP 50 50 4 in the rare instances where the process of workouts/liquidation are not specifically covered in SOP 50 51 2. It should also be noted that SOP 50 50 4 primarily addresses the 7(a) loan programs, with only occasional references to disaster loans.

3. Recommendation: Require Servicing and Liquidation Center staff to routinely review all charged-off loans designated as workouts to determine whether the workout designation is appropriate.

Response: We concur with this request. Each center servicing charged-off accounts coded 99 will routinely review those accounts to ensure that the workout designation is appropriate.

4. Recommendation: Develop and implement procedures which ensure that the Treasury referral code at servicing centers is left blank so that loans requiring both TOP and Treasury Services are referred to Treasury for collections as required.

Response: We concur with this recommendation. Instructions in this regard will be included in the charge-off chapters of SOP 50 51 2 (Chapter 18) and SOP 50 52 1 (Chapter 7), which will be revised to include comprehensive instructions on coding charged-off loans. It should be noted that there are special circumstances where it would be appropriate to have something other than a blank field at charge-off when referral to Treasury is not appropriate, such as 37 (litigation do not refer), 66 (real estate lien/mortgage refer to TOP / do not issue 1099C), 67 (bankruptcy Chapter 7 or 11), 69 (bankruptcy Chapter 13) and 68 (compromised). The majority of loans shown in Appendix III to the draft audit were charged off by centers other than NDLRC or by District Offices (only 3 of the 30 loans were the entered into the LAUD system by the NDLRC).

A recent database study indicated that of approximately 80,000 loans charged off over the past ten years, over 18,000 were coded as referral to TOP only (code 65).

APPENDIX IV. MANAGEMENT RESPONSE

We will instruct OCIO to remove this code on all loans charged-off more than one year ago so the loans will be included in Treasury servicing as well as TOP

5. Recommendation: Develop and implement procedures to ensure that all the names and identification numbers of delinquent borrowers are entered into the PNM database and transferred to the PMT system for referral to Treasury.

Response: Based on OFA's assessment, it appears that all centers are doing their part in entering into the PNM database all the obligors associated with a loan even though only one of the EIN/SSN numbers may be captured through automated systems for transfer of information to Treasury. We are currently exploring this issue with OCIO and meeting with a Treasury working group to determine the nature of any problems and how they can be addressed. It should be noted that in the past 2-3 months the NDLRC has identified a number of cases where more than one co-obligor on the same loan has had tax refunds offset by Treasury.

6. Recommendation: Incorporate detailed instructions for transferring charged-off loans to Treasury into SOP 50 50 4.

Response: We concur that detailed instructions for transferring charged-off loans to Treasury should be incorporated in relevant SOPs, but as mentioned in the response to recommendation 4, these instructions should be included in the charge-off chapters of SOP 50 51 2 (Chapter 18) and SOP 50 52 1 (Chapter 7). They will be revised to include comprehensive instructions on coding charged-off loans.

7. Recommendation: Follow up on the 88 loans that were miscoded or which did not identify all responsible parties to ensure that Treasury was sent the correct or missing information.

Response: We concur with this recommendation. The centers will ensure that the loans handled by their respective offices will be recoded (where appropriate) to identify all responsible parties to ensure that Treasury was sent the correct or missing information. Also, the review noted in the response to recommendation 5 will be continued to resolve any systems problems that need to be addressed to ensure referral to Treasury of all responsible parties on a loan. The centers have developed standard Form 327 Administrative Actions that reflect the appropriate LAUD code for charged off loans based on bankruptcy, secured or unsecured, etc.

A review of the 58 loans listed in Appendix II shows that only (1) loan (Loan [Exemption 2]) was charged off by office 0946 (NDLRC). The remainder of the loans are broken down as follows:

- (24) Birmingham/0429
- (13) El Paso/0632

APPENDIX IV. MANAGEMENT RESPONSE

- (16) District Offices/Commercial Loan Centers
- (1) Santa Ana Home Loan Servicing Center/0927 (Office closed in April 2005)
- (2) CDSI/ACS/1112 (Handled by Santa Ana Liquidation Office)
- (1) Unable to identify loan number

As to the loan in the NDLRC, the code has been changed to “00” to reflect referral for TOP and DMS servicing. At this time we are unable to access the (2) 1112 or the (1) 0927 loan. When access becomes available the LAUD code will be left blank to reflect referral to Treasury for TOP and DMS servicing.

A review of the 30 loans listed on Appendix III shows that only (4) loans were charged off by office 0946 (one on behalf of 1112).

[Exemption 2] – names of both borrowers are in the *PML*E screen and loan shows ACTIVE DMS.

[Exemption 2] – names of both borrowers are in the *PML*E screen. Loan was referred to Treasury and loan was PIF on 2/13/04.

[Exemption 2] – names of both borrowers are in the *PML*E screen and loan shows ACTIVE DMS.

[Exemption 2] – names of both borrowers are in the *PML*E screen. However, loan is not showing ACTIVE TOP or DMS SERVICING. Comments on companion loan **[Exemption 2]** indicate that the loan was returned to SBA by Treasury as the borrowers were determined to be indigent.

APPENDIX IV. MANAGEMENT RESPONSE

Santa Ana Disaster Liquidation Portfolio
(historical by month end, and with end of most recent week)

