THE QUALITY OF LOANS PROCESSED UNDER THE EXPEDITED DISASTER LOAN PROGRAM

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Prepared by the
Office of Inspector General
U. S. Small Business Administration

U.S. Small Business Administration
Office Inspector General

Memorandum

To: Herbert L. Mitchell
Associate Administrator
Office of Disaster Assistance

Date: September 28, 2007

[Exemption 6]

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Report on the Quality of Loans Processed Under the Expedited Disaster Loan Program
Report No. 07-34

This report presents the results of our audit of the Expedited Disaster Loan Program. The magnitude of the Gulf Coast Hurricane disasters significantly increased the need for SBA disaster loan assistance. Four months after Hurricane Katrina, SBA had received over 200,000 disaster loan applications which created a considerable backlog and resulted in loan processing delays. In response to the delays, the Associate Administrator for Disaster Assistance authorized the Expedited Loan Program to accelerate the underwriting of disaster loans.

This report addresses whether the expedited loan application process resulted in appropriate loan approvals. To determine if loan decisions were appropriate, we reviewed a statistical sample of 76 Gulf Coast Hurricane home and business loans processed under expedited procedures. We conducted the audit from March 2006 to July 2007 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States. A more detailed description of our audit scope and methodology is provided in Appendix I.

BACKGROUND

The Small Business Administration (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.

The Expedited Loan Program was established as a pilot in November 2005 to reduce the processing time for underwriting disaster loans. The pilot was revised in December 2005 with an expiration date of May 15, 2006, and then extended four times. The program used credit scores and a series of critical questions[1] as the means to underwrite loans and to make general loan approvals. Nearly 45 percent of all Gulf Coast disaster loans made by SBA were approved under expedited procedures. As of April 9, 2007, SBA had approved 69,035 expedited loans totaling $3.7 billion for the 2005 Gulf Coast hurricanes.

If a disaster victim is denied an SBA loan based on insufficient income or a lack of repayment ability, he/she may be referred to the Federal Emergency Management Agency (FEMA) for grant assistance. FEMA provides disaster grants for housing and other needs.

RESULTS

$1.5 Billion in Loans Were Awarded to Applicants Who Lacked Repayment Ability

Our audit disclosed that 24 of 76, or about 32 percent, of the Gulf Coast Hurricane loans approved under the Expedited Program we sampled were made to applicants who lacked repayment ability. Based on sample results, we estimate that approximately 21,802 loans, totaling $1.5 billion, were awarded to high-risk applicants who may not be able to repay their loans. These loans would not have been approved if they had been processed under standard loan processing procedures. For example, a borrower, who reported no income at the time of loan application, received a $9,600 home loan. In another example, SBA awarded a $36,700 home loan to a borrower who had a negative cash flow, which would have disqualified him for the loan. Appendix III contains a listing of borrowers we identified as lacking repayment ability.

Our audit results are similar to SBA's June 13, 2006, Quality Assurance Review, which showed that 62, or 28 percent, of the 225 applicants processed under the Expedited Program potentially could not repay their loans. Consequently, there is a high probability that a significant number of loans processed under expedited procedures will default. More importantly, had these borrowers been declined for loans, SBA would have referred them to FEMA for possible grant assistance.

Inappropriate loan decisions were made under the Expedited Program largely because loan approvals were not based on a cash flow analysis as required under

[1] Critical questions relate to the applicant's current status on student loans, child support, flood insurance, and federal obligations.

standard processing procedures. Loan decisions under the Expedited Program were based primarily on credit scores, regardless of an applicant's income level and expenses. Applicants with credit scores of 620 and above received automatic loan approval, with loan amounts established as follows:

- A score of 620 to 639 qualified an applicant for a loan of up to $50,000;
- A score of 640 to 699 qualified an applicant for a maximum loan amount of $150,000;
- A score of 700 and above qualified an applicant for loans of up to $250,000.
- Scores below 620 were referred for standard processing.

Borrowers we identified as lacking repayment ability had credit scores in the first three of the four categories listed. We also found that approval decisions made by loan officers did not receive supervisory review.

Given that both the OIG and SBA analyses estimated that almost one-third of the borrowers lacked repayment ability, we believe SBA needs to identify those individuals among the 69,035 borrowers who did not qualify for their loans so that remedial action can be taken to refer ineligible borrowers to FEMA. While we understand reviewing such a large volume of loans will require substantial effort, such a review would be the only fair way of ensuring that disaster victims receive the proper benefits to which they are entitled. SBA will also need to determine how to remedy the award of a loan for which the borrower did not qualify. For example, if loans have been fully disbursed, the FEMA grants could be used to offset outstanding loan balances. Further, if some loans have not been fully disbursed, SBA can determine whether the loan amounts should be reduced. Lastly, those who cancelled their loans should be notified of their potential eligibility for FEMA assistance.

Agency Replaced the Expedited Loan Program with Rapid Processing Pilot Program (RAPID)

On April 9, 2007, after we briefed the Office of Disaster Assistance on our audit findings, SBA terminated the Expedited Loan Program on April 9, 2007. In its place, on June 22, 2007, SBA introduced the RAPID Pilot Program. The RAPID program was initiated as part of the Administrator's Action Commitment Excellence (ACE) Campaign.

The RAPID program, which only applies to home loan applicants, limits the maximum amount that applicants can borrow to $50,000. It also raises the minimum score for approval from 620 to 640. Individuals with credit scores of 640 and above will undergo an abbreviated analysis of their repayment ability prior to loss verification. Applicants with credit scores between 639 and 580 will be routed to standard processing, and applicants with credit scores below 579 will be automatically declined. The RAPID program will be monitored through bi-weekly quality assurance reviews conducted by experienced loan officers of at least one loan processed under these new procedures.

While the RAPID program is an improvement in processing current and future loan applications, the Agency has not indicated what it intends to do to re-evaluate the estimated 69,035 loans that were previously approved.

RECOMMENDATIONS

We recommend that Associate Administrator for Disaster Assistance:

1. Review all 20,708 cancelled loans that were approved under expedited procedures to identify applicants who lacked repayment ability, notify those applicants of their potential eligibility for FEMA assistance, and make the appropriate FEMA referrals.

2. Initiate proposed action to review the creditworthiness of borrowers associated with the 615 undisbursed home loans and refer those borrowers to FEMA, as appropriate.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On July 23, 2007, we provided SBA with a draft of the report for comment. On September 6, 2007, SBA submitted its formal response, which is contained in its entirety in Appendix IV. SBA generally did not concur with the original recommendations and commented on several issues raised in the report. A summary of management's comments and our response follows.

Comment 1

SBA believes the assistance that disaster victims could have received from FEMA does not provide sufficient recovery funds to repair or replace their disaster related damages. By comparison, according to the agency, the average SBA disaster home loan was more than $64,000. According to SBA, FEMA's average Individuals and Homeowners Program (IHP) grant award was $6,094. SBA claims that SBA home loans have provided many households the opportunity to rebuild and replace their homes. Additionally, SBA suggests that Congress, having recognized the insufficiency of FEMA's grant awards, appropriated $16.7 billion in Community Development Block Grants for use in the five states affected by the 2005 hurricanes.

OIG Response

While disaster victims may receive more financial assistance from their SBA home loans than they would from the FEMA grants, SBA has not addressed our concern that many borrowers were approved for loans that they have no ability to repay. In the short-run this may appear to have been beneficial for the victims; however, when the repayment period begins, many of these borrowers will be faced with the undue burden of trying to repay a loan which they cannot afford or defaulting on their loans.

It is our understanding that the Expedited Program was implemented to assist in processing the backlog of over 200,000 applications and not to relax the loan approval requirements. We found no evidence that the Program actually improved the process. As stated in the report, an additional estimated 21,802 loans were approved for borrowers who did not have repayment ability and whose loans would not have been approved under the standard process. Loss verifications were performed for most, if not all, of these loans. Loan processors spent considerable time on these loans as well, all of which diverted resources away from processing loans for borrowers with repayment ability. Because these estimated 21,802 loans would not have been approved under standard processing, the Expedited Program created an additional burden upon the system. Further, as stated in the Agency's response, many of these applicants did not actually want these loans and because they were unable to repay them, 20,708 cancelled their loans. In fact, approximately half of all Gulf Coast Hurricane loans that were cancelled were Expedited loans.

We found that the average SBA home loan for the Gulf Coast hurricanes was about $52,740 for those 60,276 home loans processed through the Expedited program. The amount presented in ODA's response of $64,851 was solely for Hurricane Katrina.

Recommendations 1 and 2
In our draft report, we recommended that SBA review all 69,035 expedited loans and, if the borrowers were found to lack repayment ability, determine whether any remedies exist to modify the loan through offsets of FEMA grants.

ODA categorized the 69,035 expedited loans as follows:

Loan Status	Number of Loans
Fully Disbursed	44,098
Partially Disbursed	3,454
Undisbursed Home	615
Undisbursed Business	128
Cancelled	20,708
Not categorized by ODA	32
Total	**69,035**

ODA stated it does not believe that it could or should modify a disbursed loan that was previously approved where the borrower's circumstances have not changed since the time of approval. SBA indicated that of the 69,035 loans, 44,098 have been fully disbursed and 20,708 have been cancelled, leaving 3,454 in various stages of disbursement and 743 that have not been disbursed. SBA offered no remedy for the partially or fully disbursed loans or the 20,708 cancelled loans other than its proposal to review cancelled loans if reinstatement is requested. Of the 743 undisbursed loans, ODA stated that 615 are home loans that could possibly be cancelled and referred to FEMA. However, ODA believes the best approach is to review the current status of the 615 undisbursed home loans in order to determine if the borrowers are creditworthy.

OIG Response

We acknowledge that contacting all 69,035 applicants may place an undue burden on the Agency and that it would be impractical for SBA to modify the 44,098 loans that have been fully disbursed. We also agree that SBA's proposal to review the current status of the 615 undisbursed home loans for possible referral to FEMA is a reasonable approach, and have revised recommendation 2 to reflect this action.

However, we believe that SBA reasonably can and should review the 20,708 loans that were cancelled. We found that many of these borrowers lacked repayment ability and only applied to SBA because they could not obtain FEMA grant assistance until they were declined for an SBA loan. Once their loans were approved; however, the borrowers realized their inability to repay and cancelled them. In most cases, the borrowers are now ineligible to be referred to FEMA for possible grant assistance. Therefore, SBA should review all cancelled loans and identify those borrowers who are potentially eligible for FEMA assistance so that it can remedy, as best as possible, the need these individuals may still have for disaster assistance. Accordingly, we have revised recommendation 1 to suggest that the Agency review of all 20,708 cancelled loans that were approved under expedited procedures to identify applicants who lacked repayment ability. As part of that recommendation we are also suggesting that SBA notify those applicants of their potential eligibility for FEMA assistance and make the appropriate FEMA referrals.

Because management's response is not fully responsive to the revised recommendations, we are requesting that additional actions be taken and that target dates for implementation be provided. If the Agency is willing to review all of the cancelled loans and implements its proposal to review the 615 undisbursed home loans, we would consider these actions to be responsive to our findings and recommendations. If SBA does not provide an acceptable response, we plan to pursue a management decision through the audit resolution process.

ACTIONS REQUIRED

We appreciate the courtesies and cooperation of the Office of Disaster Assistance representatives during this audit. We request that the Agency consider the revised recommendations and provide a response to our office within 14 days. The response should indicate agreement or disagreement with the revised recommendations; and where there is agreement, the target dates for implement ting proposed actions. If you have any questions concerning this report, please call me at (202) 20 [Ex-2] or Pamela Steele-Nelson, Director, Disaster Programs Group, at (202) 205 [Exemption 2]

APPENDIX I. SCOPE AND METHODOLOGY

The objective of our audit was to determine if the expedited loan application process resulted in appropriate loan approvals. We statistically sampled 76 of 69,035 Gulf Coast hurricane loans that were approved between November 21, 2005 and April 9, 2007 under the Expedited Disaster Loan Program. The sample size allows extrapolation to the universe of loans with a 95-percent confidence level and a 5-percent precision rate. For each sampled loan, we determined the borrower's ability to repay the loan in accordance with the fixed debt method as outlined in Standard Operating Procedure (SOP) 50-30-5, Appendix 26. Specifically, we evaluated each loan for repayment ability based on the information provided in the loan application, using the applicant's latest source of verifiable income and Credit Bureau Report. Determination of repayment ability was based on the amount of cash available from the borrower's monthly gross income. Our analysis of business loans was conducted in accordance with the "cash available to service additional debt" method outlined in SOP 50-30-5, Appendices 19 and 25.

To test the reliability of the data in SBA's Disaster Credit Management System (DCMS), we compared DCMS data on credit scores, application numbers and original loan amounts, with source documents. The audit was conducted between March 2006 and August 2007 in accordance with *Government Auditing Standards* as prescribed by the Comptroller General of the United States, and included such tests as was considered necessary to provide reasonable assurance of detecting abuse or illegal acts.

APPENDIX II. STATISTICAL SAMPLING METHODOLOGY

From the population universe of 69,035 approved Expedited loans, we randomly selected a statistical sample of 76 to compute our estimate of population values. In statistical sampling, the estimate of attributes in the population universe has a measurable precision or sampling error. The precision is a measure of the expected difference between the value found in the sample and the value of the same characteristics that would have been found if a 100-percent review had been completed using the same techniques.

We calculated the following population point estimates and the related lower and upper limits for the selected attributes using the Defense Contract Audit Agency's "EXZ Quant" Software program at a 95 percent confidence level. Accordingly, 24 of 76 loans or 32 percent may have been declined.

Loans Lacking Repayment Ability	Occurrence in Sample of 76 Loans	Population Point Estimate	Lower Limit	Upper Limit
Number	24	21,082	14,774	29,893
Dollar value	$1,568,000	$1,531,598,367	$1,010,373,076	$2,052,823,659

APPENDIX III. EXPEDITED LOANS AWARDED TO BORROWERS THAT LACKED REPAYMENT ABILITY

Loan Sample	Application Number	Original Amount Approved	Loan Type
4	[Exemption 2]	$41,600	business
5		$26,000	home
7		$30,300	home
11		$73,600	home
12		$56,800	business
18		$18,300	home
21		$86,700	home
22		$50,000	home
24		$36,700	home
25		$75,900	home
30		$89,100	home
38		$40,000	home
43		$8,400	home
44		$79,500	home
52		$35,000	home
55		$50,000	home
60		$55,900	home
61		$9,600	home
62		$138,700	home
67		$36,000	home
68		$10,000	home
71		$122,500	home
73		$40,000	home
75		$45,000	home
TOTALS		**$1,255,600**	

APPENDIX IV. AGENCY COMMENTS

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

Date: September 6, 2007

To: Debra S. Ritt
Assistant Inspector General for Auditing

From: Herbert L. Mitchell, Associate Administrator
Office of Disaster Assistance

Subject: Draft Report on the Quality of Loans Processed
Under the Expedited Disaster Loan Program
Project No. 7403

Thank you for the opportunity to respond to this draft audit report on the quality of loans processed under the expedited disaster loan program.

A major concern of the audit is that the Office of Disaster Assistance (ODA) made loan decisions under the expedited program that were not based on cash flow analyses, as would have been required under standard processing procedures.

All 69,035 loans identified by Office of Inspector General (OIG) were processed in accordance with the expedited processing procedures that were approved in response to the extraordinary number of applications received as a result of the 2005 Gulf Coast storms. Near the end of 2005, the agency faced a backlog of over 200,000 applications and ODA took a reasonable and appropriate approach in expediting these loan approvals by using credit scores at various loan levels to minimize the risk along with making sure that disaster victims had access to funds to rebuild as quickly as possible.

The draft report correctly states that if a disaster victim is denied an SBA loan based on insufficient income or a lack of repayment ability, he/she may be referred to the Federal Emergency Management Agency (FEMA) for possible additional grant assistance. However, the FEMA's Individual Assistance grant program is only available to homeowners and renters, and the FEMA assistance available to them does not provide sufficient recovery funds to allow them to rebuild/repair or replace their disaster related damages. Thus, this would leave many victims with no means of assistance to rebuild completely. FEMA makes grant assistance to individuals and homeowners for minimal real estate repairs prior to any lending decision by SBA, and the maximum grant assistance for Katrina victims for real estate repairs was $5,200. According to FEMA, the average Individuals and Homeowners Program (IHP) grant award for Hurricane Katrina victims was just over $6,000. The average SBA disaster loan amount was more than $64,000. By approving these loans SBA has provided many households the opportunities to rebuild or replace their home. Any funds that they may have received for repairs from FEMA to make their homes safe and habitable (which are not subject to a SBA decline) would have already been provided and taken into consideration during loan processing or disbursement and are not contingent upon their status with SBA. A referral to FEMA's Other Needs Assistance program (ONA) after SBA makes a processing decision only covers personal property (not real estate) and in most cases would not be sufficient to enable most disaster victims to recover.

The average FEMA IHP grant award was $6,094 which includes assistance that FEMA provided for items that are not allowed in the SBA program, such as: temporary rental assistance, transient accommodations, dental, funeral and medical expenses and transportation. FEMA grants for these expenses are paid to victims regardless of their SBA loan status and excluding these items would significantly reduce the total average grant award stated above. The average FEMA IHP grant also includes grant monies for minimal real estate repairs.

Congress apparently recognized the insufficiency of FEMA's grants to make whole the hurricanes' victims, since it appropriated $16.7 billion in Community Development Block Grant (CDBG) funds for use in the five states affected by the 2005 hurricanes.

In addition, loan officers had the authority to recommend a reduced payment or a repayment decline with a referral to the grant program if the applicant indicated that they could not afford the automatically generated payment.

Comments on the Recommendations:

Recommendation #1: Review all 69,035 Gulf Coast loans approved under expedited processing to identify those borrowers that did not have repayment ability.

Recommendation #2: Take appropriate action to remedy, as best as possible, those loans that should not have been approved. This may include offsetting loans with grants, reducing loan balances and notifying borrowers with cancelled loans of their potential eligibility for FEMA assistance.

ODA Response to Recommendations: All of these loans were processed in accordance with the approved policies and procedures adopted in response to the Gulf Coast Storms. We do not believe that SBA could or should now modify a disbursed loan that was previously approved under authorized procedures where the borrower's circumstances have not changed since the time of approval. At this time 44,098 of these loans have been fully disbursed, allowing those borrowers to rebuild their homes or purchase a new *residence and in some cases refinance their original mortgage under better terms and conditions. Of the remaining loans, 20,708 have been canceled and 3,454 are in various stages of disbursement with the majority of them over 50 percent disbursed. Of the remaining 743 undisbursed loans, 615 are home loans that could possibly be referred to FEMA if canceled because the borrower cannot afford the loan. Given the circumstances and the impracticality of declining a loan that has been fully or partially disbursed, ODA believes that the best approach is to review the current status of the 615 home loans that have not been disbursed in order to determine that the borrower is still creditworthy. Additionally, we intend to review borrowers with canceled loans if they request reinstatement.*

I appreciate the opportunity provided to respond to this draft audit report. If you have any questions concerning this response please call me at 202-20 [Ex-2] or James Rivera at
202-619 [Exemption 2]

Herbert L. Mitchell
Associate Administrator
Office of Disaster Assistance