

**AUDIT REPORT ON**  
**THE LOW DOCUMENTATION LOAN PROGRAM**  
**AT THE WASHINGTON DISTRICT OFFICE**

**Audit Report No. 7-7-F-007-021**

**July 18, 1997**

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**U.S. Small Business Administration  
Office of Inspector General  
Washington, DC 20416**

<b>AUDIT REPORT</b>
<b>Issue Date: July 18, 1997</b>
<b>Number: 7-7-F-007-021</b>

To: Martin Gold, Acting District Director  
Washington District Office

From: Peter L. McClintock  
Assistant Inspector General for Auditing

Subject: Audit of the Low Documentation (LowDoc)  
Loan Program at the Washington District Office

We performed an audit on the LowDoc Loan Program of the Washington District Office. We reviewed a random statistical sample of loans approved from program inception through September 30, 1996. The summary section of the report provides a synopsis of the audit finding and recommendations.

The finding included in this report is the conclusion of the Auditing Division based upon the auditors' testing of the auditee's operations. **The finding and recommendations are subject to review and implementation of corrective action by your office following existing Agency procedures for audit follow-up and resolution.**

Should you or your staff have any questions, please contact Victor R. Ruiz, Director of Headquarters Operations, at (202) 205-7204.

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## SUMMARY

The purpose of the audit was to determine whether loans were processed, disbursed and used in accordance with SBA's requirements. Using random statistical sampling, we reviewed 30 loans, valued at \$1,907,000, which were approved by the Washington District Office from program inception to September 30, 1996. The sample was selected from the population of 589 loans valued at \$38.3 million. This audit was requested by the former Administrator.

We found that one loan valued at \$30,000 was approved for a borrower with poor credit, and one loan for \$100,000 was approved for a borrower with funds available elsewhere. These deficiencies were significant enough that the loans should not have been approved. As of March 31, 1997, the loan with poor credit was charged off, and the other was canceled by the lender. Based on a statistical projection of the sample results, we estimate that \$2.6 million was approved for loans that should not have been processed under LowDoc procedures (see Appendix A).

SBA had additional other processing or disbursing deficiencies in 22 of the 30 loans (including the two aforementioned). The deficiencies were the failure of lenders and SBA to follow LowDoc and regular 7(a) Program guidance. Out of the 30 loans in the sample, one loan was charged off, one was past due, and the remaining loans were either current, canceled, or committed as of March 31, 1997.

The most prevalent deficiencies included the following:

- Joint payee checks for non-working capital disbursements were not used, and use of proceeds was not verified. (13 loans and 12 loans respectively)
- Business or personal credit reports for partial owners were not obtained. (7 loans)
- Equity injection requirements were not verified. (6 loans)
- Internal Revenue Service (IRS) verifications were either not requested, not requested prior to loan disbursement, or were requested for only two of the required three years.  
(4 loans)
- The SBA Form 1050 (Settlement Sheet) was improperly completed. (4 loans)

The most frequent lender response for the deficiencies we found was that the lender lacked knowledge of the specific loan processing or disbursement requirement.

We recommend that the District Director, Washington District Office, take the following actions:

- Initiate recovery proceedings against the lender for Sample Number 7 in the amount of \$23,677.
- Ensure that the SBA Washington District Office receives personal financial statements on all individuals owning 20 percent or more of the business before approving any LowDoc loan greater than \$50,000.
- Notify LowDoc lenders of their responsibilities in processing and disbursing LowDoc loans and offer training and advice for those who need it.

The Acting Director of the Washington District Office reviewed a draft of this report and concurred with the recommendations.

## INTRODUCTION

### A. BACKGROUND

Section 7(a) of The Small Business Act of 1958, as amended, gives SBA the authority to provide financial assistance to small businesses. SBA provides financial assistance primarily through loan guarantees to lenders. In December 1993, SBA initiated the LowDoc Loan Program as an alternative to the regular 7(a) Loan Program. The LowDoc Program was piloted among SBA district offices in Texas and expanded nationally in June 1994. LowDoc provided a method to obtain smaller loans (\$100,000 or less) in a shorter time and with less documentation.

SBA relies on an applicant's personal and business credit histories as indicators of ability and willingness to repay. For loans of \$50,000 to \$100,000, the applicant must support repayment ability with past and/or projected cash flows. Although not a primary consideration of SBA, SBA expects participating lenders to apply traditional business credit criteria in the same manner as they would for their own commercial loans. A LowDoc applicant must have average annual gross revenues of \$5 million or less and 100 or fewer employees. In addition, LowDoc applicants must not have a criminal history, poor personal or business credit record, or previous bankruptcy within the past 10 years. To expedite the loan process, the documentation sent to SBA for loan approval was reduced from that required for other 7(a) loans. An application form, business tax returns, personal financial statements, and the lender's internal credit analysis are sent to SBA for loans greater than \$50,000. For loans of \$50,000 and less, only the application form is required. A lender may still request whatever additional information it requires to make an appropriate credit decision.

As a 7(a) loan, LowDoc loans are also subject to standard 7(a) eligibility and use of proceeds requirements. LowDoc loans were subject to a 90 percent guarantee by SBA until October 1995 when the maximum guarantee was lowered to 80 percent.

At the request of the former SBA Administrator, we initiated a follow-up audit to determine if a larger number of loans would yield the same results (see follow-up on prior audits section for the results). The audit was conducted at district offices in Washington, DC; Atlanta, GA; Dallas, TX; and Santa Ana, CA.

As of September 30, 1996, the Washington District Office approved the following LowDoc loans:

Size of Loan	Number	Amount (millions)
\$50,000 or less	257	\$9.4
\$50,001 to \$100,000	332	\$28.9
Total	589	\$38.3

## **B. AUDIT OBJECTIVE AND SCOPE**

The audit objective was to determine whether LowDoc loans were processed, disbursed, and used in accordance with SBA's requirements. From the population of 589 loans (valued at \$38.3 million) approved by the Washington District Office from the program's inception in December 1993 to September 30, 1996, we randomly selected 30 loans for review. Descriptions of the statistical sampling methodology and the projected results based on our audit are provided in Appendix A. Appendix B lists the loans selected for our sample.

The auditors reviewed lender and SBA file documentation for each loan in the sample; interviewed borrower, lender, and SBA Washington District Office personnel; and visited businesses to review records, as deemed necessary. Audit field work was performed between December 1996 and March 1997. The audit was conducted in accordance with Government Auditing Standards.

## **C. FOLLOW-UP ON PRIOR AUDITS**

The Office of Inspector General issued an audit report on the LowDoc Loan Program on September 30, 1996. The report disclosed that, in a sample of 70 loans approved nationwide between the program's inception and May 31, 1995, five loans had borrowers with questionable repayment ability and two loans were made to ineligible borrowers. Also, 54 of the 70 loans had at least one processing deficiency. The report stated that the deficiencies may have been the result of limited guidance concerning LowDoc procedures and limited monitoring of lenders and SBA district offices.

In addition to recovery actions for the guarantees issued for the seven loans found to lack either repayment ability or eligibility, the report recommended the development of performance standards and the establishment of a review program for both lenders and district offices. Also, the report recommended the development of criteria to evaluate other sources of income used to supplement repayment ability. Program officials concurred with the recommendations, but as of the audit report date, have not taken final action to implement them.

## RESULTS OF AUDIT

### **FINDING: LowDoc Loans Were Not Always Processed According to SBA's Requirements**

Out of the sample of 30 loans, SBA approved one loan valued at \$30,000 for a borrower with poor credit and another loan valued at \$100,000 for a borrower who had funds available elsewhere. As of March 31, 1997, the first loan was charged off, and the other was canceled prior to disbursement. These deficiencies were significant enough that the loans should not have been approved. Such risks may lead to losses that could either increase the tax supported subsidy rate or fees to borrowers or lenders. Based on the sample results, we estimate that 39 loans totaling \$2.6 million did not meet the requirements to be processed under LowDoc procedures.

Twenty-two loans (including the two aforementioned) had at least one processing or disbursing deficiency. These deficiencies are the failure of lenders and SBA to follow LowDoc Program guidance.

The most frequent of these deficiencies were:

- Joint payee checks for non-working capital disbursements were not used, and the use of proceeds was not verified. (13 loans and 12 loans respectively)
- Business or personal credit reports for partial owners were not obtained. (7 loans)
- Equity injection requirements were not verified. (6 loans)
- Internal Revenue Service (IRS) verifications were either not requested, not requested prior to loan disbursement, or were requested for only two of the required three years. (4 loans)
- Settlement Sheets were improperly completed. (4 loans)

### **Loans made to ineligible borrowers**

The Administrator's announcement to expand the LowDoc Program provided implementation guidance. It stated that SBA would rely on the individual applicant's personal and business credit history and a lender's experience and judgment regarding the character of the business owner as the principal indication of ability and willingness to repay a



loan. Published lender instructions concerning borrower credit worthiness stated, in part, that primary considerations include:

- Credit history shows willingness to pay debts. Co-signers may be considered if applicants have no credit history.
- Historical or expected earnings evidences repayment ability.
- Requested financing provides the business a good chance of achieving success.

The announcement also stated that on loans between \$50,000 and \$100,000 the applicant must support repayment ability with past and/or projected cash flows.

*A. Loan Made To Borrower With Poor Credit*

For one loan in our sample, the applicant's credit history did not show a willingness to pay debts. The following paragraph provides details about the loan.

Sample Number 7 On August 9, 1994, SBA approved a \$30,000 loan for fixed assets. The lender's application stated that the owner had "some public record notations, and one slow payment." The lender concluded, however, that the borrower was an "acceptable risk" because the owner was able to bring his mortgage current and pay off the judgment in full. According to the lender, the judgment was paid in full in December 1993. Documents in the lender's file revealed, however, that the borrower had not paid off all of the judgment at the time of the Lender's loan approval request. Instead, documentation in the file revealed that the owner did not pay the judgment in full until August 30, 1994. This was not only after the SBA approval date, but also after the loan disbursement date of August 26, 1994. Lender documentation also disclosed a lien for \$927 which was not disclosed to SBA, and was not paid in full until August 23, 1994. The LowDoc loan became past due on June 23, 1995, and was charged off by SBA on May 24, 1996.

*B. Loan Approved To Borrower With Funds Available Elsewhere and Questionable Repayment Ability*

For one loan in our sample, the borrower not only had funds available elsewhere, but also had questionable repayment ability, as described below.

Sample Number 29 On March 26, 1996, SBA approved a \$100,000 loan for machinery and equipment. The borrower's application showed that the business was owned by four people, each of whom owned 25 percent of the company. Prior to loan approval, the lender sent to SBA personal financial statements on three of the four owners. SBA requested the personal financial statements of the fourth owner, but approved the loan prior to receiving those statements. Two weeks after the loan was approved, the lender obtained the personal financial statements which revealed that the owner had \$1.2 million in marketable securities. Title 13, Code of Federal Regulations (CFR) Section 120.102(a) states that an applicant for a

business loan must show that the desired funds are not available from the personal resources of any 20 percent or more of the equity of the applicant. Furthermore, the lender's application requires that personal financial statements be obtained for all owners. The lender should not have requested, and SBA should not have provided, loan approval prior to receiving and reviewing all personal financial statements. Shortly upon learning about the marketable securities, the bank canceled the loan.

In addition, the borrower had questionable repayment ability for this loan even though funds were available elsewhere. SBA's Standard Operating Procedure (SOP) 50 10 3 states that the ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process. The owner's personal assets (funds available elsewhere) are not considered when calculating business cash flow. The businesses' cash basis income statement for 1996 showed a projected operating loss of \$165,000 and insufficient cash flow to service the proposed debt. The lender concluded that, based on the businesses' cash balances, there was repayment ability. The lender's application stated that the businesses' cash balances from equity and investor loan injections were sufficient to cover debt service for the first year of operations. The lender should have evaluated repayment ability based on cash flow rather than the cash balance. As a result, SBA had no assurance that the borrower could repay the loan based on business cash flow.

### **There were lending deficiencies in 22 of 30 loans**

We identified a total of 55 deficiencies for 22 of the 30 LowDoc loans in the statistical sample. Lenders were responsible for 53 of 55 deficiencies, and SBA for 2. The deficiencies noted on the two loans previously discussed were significant enough to preclude loan approval. The lender was solely responsible for one of the these two loans being ineligible while both the lender and SBA were responsible for the second loan being ineligible. The remaining deficiencies could indirectly impact the applicant's repayment ability, eligibility, or the LowDoc Program's integrity.

The deficiencies were violations of either the Authorization and Loan Agreement (ALA), or other SBA loan processing policies as discussed in the following paragraphs. The current status as of March 31, 1997 is also provided.

- For four loans, IRS verifications were either not requested, not requested prior to loan disbursement, or were requested for only two of the required three years. An IRS verification was not requested at all for two of these four loans. In October 1994, SBA initiated a requirement that lenders obtain IRS tax return information for verification of applicants financial data before disbursement. All four loans were current.
- For thirteen loans, joint payee checks were not used to disburse loan proceeds designated as other than working capital. SOP 70 50 2, paragraph 3.F(1), and the Settlement Sheet require that the lender use joint payee checks to disburse loan proceeds not designated as working capital. Twelve of these loans were

current. Although not attributed to the lack of joint payee checks, one loan was charged off for \$23,677.

- For twelve loans, lenders did not verify that loan proceeds were used as required by the Loan Guaranty Agreement. Eleven of these loans were current. Although not attributed to the lack of loan proceeds verification, one loan was charged off for \$23,677.
- For six loans, there was no evidence that the lender verified the equity injection as required by the ALA. Five loans were current and one loan was past due.
- For one loan, the Settlement Sheet was signed while blank. The Settlement Sheet was signed by the borrower, but other items were left blank except for the payee and lender names. This loan was current.
- For four loans, the Settlement Sheet was improperly completed. For example, the disbursement date was omitted on the Settlement Sheet for one loan, and an incorrect payee was stated on another. The Settlement Sheet requires that the lender state the payee, date and amount of disbursement, and purpose. All four loans were current.
- For two loans, the loans proceeds were not disbursed in accordance with the ALA. In one loan, the proceeds were not spent in accordance with the authorized purposes and amounts approved by SBA. For the second loan, a portion of the loan proceeds was disbursed later than six months from the ALA date, without obtaining prior SBA approval. Both loans were current.
- For seven loans, either a business credit report or a personal credit report on a partial owner was not obtained, or the personal credit report was not current. The lender's application for guaranty requires that a business credit report be obtained, as well as personal credit reports on all owners. Five of these loans were current, one loan was committed, and one loan was canceled.
- For one loan, the lender did not send the financial statements of the business being purchased to SBA. The lender's application for guaranty requires that the financial statements on the existing business be sent to SBA for those loans which are used to purchase an existing business. This loan was current.
- For one loan, SBA personnel did not follow proper guidelines by approving a loan without the borrower attesting to criminal history. Although not attributed to the above violation, the loan was charged off.

### **Deficiencies by lender status**

The less experienced lenders were responsible for the majority of the deficiencies. Out of the 53 lender deficiencies found, 5 were made by preferred lenders, 2 were made by certified lenders, and 46 were made by regular lenders. (see Appendix C).

The less experienced lenders had a higher level of deficiencies per loan than the more experienced lenders. This indicates the need for better monitoring of the less experienced lenders' actions.

**Reasons for lender deficiencies**

Lenders gave the following explanations for the 53 deficiencies where they failed to follow SBA procedures:

lack of knowledge of the requirement	14 deficiencies
other miscellaneous reasons	12 deficiencies
loan officer error	12 deficiencies
the requirement was not practical	6 deficiencies
did not know	6 deficiencies
the requirement was just ignored	3 deficiencies

**Recommendations**

We recommend that the District Director, Washington District Office, take the following actions:

1. Initiate recovery proceedings against the lender for Sample Number 7 in the amount of \$23,677.
2. Ensure that the SBA Washington District Office receives personal financial statements on all individuals owning 20 percent or more of the business before approving any LowDoc loan greater than \$50,000.
3. Notify LowDoc lenders of their responsibilities in processing and disbursing LowDoc loans and offer training and advice for those who need it.

**Management's Response**

The Acting Director of the Washington District Office concurred with the recommendations as follows:

Recommendation 1: "The Washington District Office has initiated recovery, as recommended, against [FOIA Deletion] for \$23,677. A letter will be forwarded to the Bank within a week of this submission. The Washington District Office is prepared to recommend legal action, if necessary, to recover the funds."

Recommendation 2: “All Washington District Office loan officers were counseled on July 11, 1997 on the requirement to ensure all required documentation, including personal financial statements are reviewed before loan recommendations are made. Periodic reminders of the requirement will be made by Chief FD until LowDoc processing is centralized.”

Recommendation 3: “An overview of LowDoc loan requirements will be given to lenders attending our next Lender’s Quality Circle Meeting. Specific training for all LowDoc lenders will be required and given by the Washington District Office Loan staff. Training will be conducted within a 3 month period.”

**Statistical Sampling Techniques and Results**

We randomly selected a sample of 30 loans from the population of 589 loans valued at \$38.3 million. Because we reviewed data from a statistical sample of LowDoc loans to develop our estimates of population values, these estimates have a measurable precision, or sampling error. This is a measure of the expected difference between the value found in the sample and the value of the same characteristic that would have been found if a 100 percent review had been made using the same techniques.

Sampling precision is indicated by ranges, or confidence intervals, that have upper and lower limits and a certain level of confidence. Calculating at a 90 percent confidence level means the chances are 9 out of 10 that if we reviewed all of the LowDoc loans in the population, the resulting values would be between the lower and upper limits, with the population estimates being the most likely amounts of inappropriately approved LowDoc loans.

We calculated the following population estimates and lower and upper limits using the U.S. General Accounting Office ‘SRO-STATS’ program at a 90 percent confidence level.

LowDoc Loans with deficiencies that should have precluded approval

VALUE	POPULATION ESTIMATE	LOWER LIMIT	UPPER LIMIT
Gross Approval Amount	\$2,552,334	\$130,000*	\$5,915,564
Number of Loans	39	8	106

\*The calculated value in this case was negative, indicating the impossible situation of negative loan amounts approved to ineligible borrowers; therefore, the lower limit indicated is the sum of the actual dollar amounts identified in the sample.

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