

**LOAN CLASSIFICATIONS AND
OVERPAYMENTS ON SECONDARY MARKET
LOANS**

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U.S. Small Business Administration
Office Inspector General

Memorandum

To: Grady Hedgespeth
Director, Office of Financial Assistance

Date: March 26, 2008

Jennifer Main
Chief Financial Officer
/S/ original signed

From: Debra S. Ritt
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Subject: Loan Classifications and Overpayments on Secondary Market Loans
Report No. 8-09

This report presents the results of our audit of loan classifications and overpayments on secondary market loans. SBA's secondary market program was created to encourage small business lending by allowing lenders to sell the guaranteed portion of their 7(a) loans to investors. Under the program, lenders retain servicing rights on the sold portion of their loans, and SBA's guarantee to the investors is backed by the full faith and credit of the United States. SBA reports that in most years, 40 to 50 percent of 7(a) loans are sold on the secondary market.

During a prior audit of loan information reporting by lenders, we identified errors in loan classifications and excessive interest accruals on secondary market loans that merited audit attention. To determine the extent of this problem, we initiated an audit of loan classifications and overpayments. The objectives of the audit were to determine whether SBA (1) classified secondary market loans appropriately, (2) purchased loans from the secondary market in a timely manner, and (3) pursued lenders for overpayments it made to secondary market investors.

To determine whether SBA classified secondary market loans appropriately, we obtained a June 30, 2007, report of defaulted secondary market loans identified by SBA's Fiscal and Transfer Agent, Colson Services Corp. This report included 2,756¹ loans for which interest was 60 days or more past due, of which 1,034²

¹ This number reflects only those loans that were reported to be in regular servicing.

were projected to be classified as current. SBA's share of the remaining principal balance of the 2,756 loans totaled approximately \$624 million. We reviewed a statistical sample of 64 of the loans for which SBA's share of the principal totaled approximately \$14 million. We compared status information reported by Colson with loan history information maintained by SBA as of June 30, 2007. A loan was considered to be in default if principal and/or interest payments were 60 days or more past due, regardless of whether a prior deferment of the loan had occurred. A deferment is a lender-approved postponement of any loan payment that is due.

To determine whether SBA purchased guarantees from the secondary market in a timely manner, we reviewed 2,030 loans that were purchased by SBA off the secondary market between October 1, 2005, and March 31, 2007. SBA's purchase amount totaled approximately \$503 million. We analyzed loan data in SBA's Guaranty Purchase Tracking System and the Electronic Loan Information Processing System. To determine whether SBA pursued lenders for overpayments it made to secondary market investors, we reviewed entries made to SBA's General Ledger Account entitled, *Due SBA for Overpayment Made to Secondary Participant*, for the 2,030 loans purchased between October 1, 2005, and March 31, 2007.

During the audit, we interviewed officials from Colson Services Corp. and SBA's Office of Financial Assistance, the National Guaranty Purchase Center and Office of the Chief Information Officer. The audit was conducted from April 2007 to November 2007 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

BACKGROUND

The Small Business Secondary Market Improvement Act of 1984 (P.L. 98-352) authorizes lenders to sell the guaranteed portion of their 7(a) loans to investors to provide lenders with greater liquidity and to expand the availability of commercial credit to small businesses. Loans can be sold individually or in pools. When the loans are sold, lenders retain responsibility for servicing the loans and earn a servicing fee on the guaranteed portions of the loans that are sold.

When a lender sells the guaranteed portion of a 7(a) loan, it enters into a *Secondary Participation Guaranty Agreement* (SBA Form 1086) with SBA and the investor. On a monthly basis, each lender is required to submit to Colson a *Guaranty Loan Status and Remittance Report* (SBA Form 1502) for all SBA loans

² We only reviewed loan classifications for the 64 loans in our sample. Based on our sample results, we projected the number of current loans on the June 30, 2007, default report to be 1,034. For more information on this projection, see Appendix I.

in its portfolio. The 1502 report identifies when the next installment is due and what the interest paid to date is for each loan reported. For sold loans, the lender pays Colson the guaranteed portion of a borrower's loan payment, net of its servicing fee. Colson then processes the payment, passing it on to the investor, net of SBA's and Colson's servicing fees.

Based on the time difference between the next installment due date and the month end date of the lender's 1502 report, Colson assigns each loan in regular servicing a status code. The code indicates whether the loan is:

- current or less than 30 days past due (code 1);
- 30 to 60 days past due (code 2); or
- over 60 days past due (code 3).

For loans with principal or principal and interest deferments, the loan is classified in deferred status (code 4) and the next installment due date is reported as the date when regular payments are to resume. SBA's Loan Accounting System is updated electronically on a monthly basis to reflect these classifications. SBA uses the classifications to assess portfolio risk, score lender performance ratings, develop financial reports and perform various other analyses.

Colson also prepares a monthly default report that is based on the interest paid to date. The default report, which is provided to SBA on or before the last business day of the month, lists the secondary market loans for which interest is 60 days or more past due. Under the 1086 agreement, SBA is required to contact the lenders for all loans on Colson's default report within 5 business days of receipt of the report. SBA is also required to contact lenders when a borrower has failed to pay within 60 days the full amount of any missed principal and interest payment. SBA, in consultation with the lender, will decide on an appropriate remedial action, such as a deferment, or will determine whether the lender will be offered the option to purchase the guaranteed portion of the loan from the investor. A decision is to be made within 10 business days after SBA's first contact with the lender.

If the lender is offered the option to purchase the guarantee and declines, SBA will purchase the loan from the secondary market. SBA is required to give the lender and Colson written notice of its intent to purchase, and within 5 business days of such notice, the lender and Colson are required to provide SBA with transcripts of all loan financial transactions. SBA will reconcile the transcripts, but if it cannot do so, will pay the guarantee based on Colson's transcript. Investors are entitled to all accrued interest up to the day of purchase, net of servicing fees charged by the lender, SBA and Colson, along with the guaranteed principal balance.

Adjustments to the purchase are charged against the lender's servicing fee, and any shortfall is billed to the lender as an accounts receivable.

RESULTS IN BRIEF

The audit disclosed that 10 of the 24 current loans reviewed, or 42 percent, were not classified appropriately in SBA's Loan Accounting System. These loans were classified as current when principal and/or interest were more than 60 days past due. In some instances loans were classified as current, but either no principal was ever paid on the loan or a principal payment had not been made for 1 year. Based on our sample results, we estimate that \$161 million, or 54 percent of the projected \$297 million in current loans reported on Colson's June 30, 2007 default report was actually 60 days or more past due.

The audit also disclosed that SBA did not purchase guarantees from the secondary market in a timely manner, and as a result, incurred \$7.4 million of additional interest expense. Of the 2,030 guarantees purchased by SBA from the secondary market between October 1, 2005, and March 31, 2007, we identified 1,198, or 59 percent, that had accrued interest in excess of 120 days. We determined that if SBA had not allowed lenders to accrue interest beyond 120 days, it could have saved \$6.1 million of interest expense. Further, an additional \$1.3 million could have been saved if SBA had processed the guarantees in a timelier manner.

The audit found that SBA generally pursued lenders for overpayments it made to secondary market investors. Overpayments occurred when a lender failed to submit a borrower's loan payment to Colson, and Colson, on behalf of SBA, covered the payment to the investor. We identified instances, however, where SBA had overbilled lenders by \$1.9 million on loans where transcripts either were not provided or were incomplete. SBA also did not account for all of these billings appropriately. Consequently, SBA will need to adjust its accounts receivable and may need to repay lenders for inappropriate billings.

Finally, we identified approximately \$1.1 million of income that SBA reported from ongoing guarantee fees it never collected from lenders for loans purchased between October 1, 2005, and March 31, 2007. Not only did SBA neglect to bill lenders for these fees, but it paid Colson the uncollected amount. When Colson refunded these fees to SBA, the Agency erroneously reported it as income.

To address the deficiencies identified by the audit, SBA should monitor and classify loans properly, limit interest accrual to 120 days on loans it purchases from the secondary market, adjust its accounts to eliminate the inappropriate billings and collections, conduct post purchase reviews on the loans with

inappropriate billings, and seek payment from lenders for accrued ongoing guarantee fees.

Management agreed with recommendations 9 and 10, partially agreed with recommendations 5, 6 and 7, disagreed with recommendations 1, 3, 4 and 11 and neither agreed nor disagreed with recommendation 8. Management also indicated it had already taken the proposed action for recommendation 2. Management stated that our recommendation to revise SBA's loan classification procedures may have been based on incorrect information. It also stated that the principal payment transaction is not a recommended means to classify loan currency. Further, management stated that re-amortization after a single deferment period is unnecessary and burdensome to the lenders. Management's comments and our corresponding response are discussed in more detail in the Agency Comments and Office of Inspector General Response sections of the report. Management's response is presented in its entirety in Appendix II. We have requested that management identify additional actions it will take to address recommendations 2, 5, 6, and 7, and will pursue resolution of recommendations 1, 3, 4, 8, and 11 through the audit resolution process.

RESULTS

An Estimated \$161 Million in Secondary Market Loans Was Reported as Current Even Though Loan Payments Were Delinquent

The audit disclosed that the loan classification in SBA's Loan Accounting System for the 2,756 loans on Colson's June 30, 2007 default report was generally accurate with the exception of those loans that were designated as current. SBA classified a projected 1,034 of the 2,756 loans listed on the default report as current. Of the 64 loans we reviewed, 24 were classified as current. However, we found that 10 of the 24 had delinquent loan payments. Based on the sample results, we project that 431 of the 2,756 loans were misclassified. These loans were valued at an estimated \$161 million. Details on the misclassified loans are summarized in Table 1.

Table 1. Misclassified Secondary Market Loans as of June 30, 2007

#	Loan No.	Outstanding Guarantee Balance	Days Since Last Principal Payment	Days Since Last Interest Payment	Reason For Misclassification
1	Exemption 2	\$86,553	604	114	Rolling due date
2	Exemption 2	\$102,549	213	88	Prior deferment
3	Exemption 2	\$462,375	298	101	Prior deferment
4	Exemption 2	\$569,600	302	138	Prior deferment
5	Exemption 2	\$1,086,983	263	131	Rolling due date
6	Exemption 2	\$559,238	365	67	Rolling due date
7	Exemption 2	\$59,400	386	73	Rolling due date
8	Exemption 2	\$592,860	364	63	Rolling due date
9	Exemption 2	\$10,063	194	194	Rolling due date
10	Exemption 2	\$78,801	141	141	Prior deferment
	Total	\$3,608,422			

Source: SBA's Guarantee Loan History Reports

We found that SBA's reliance on the next installment due dates reported by lenders was the major reason why loans were inaccurately classified. SBA assesses the currency of loans based on the next installment due date that is reported by lenders. This is not an effective measure of a loan's currency because in some cases the date is based on the last payment, regardless of whether it covered any of the principal that was owed. This is a particular problem for loans that have been deferred for 3 months or more where the lender has not re-amortized the note and payments following the deferment must be applied to prior interest before principal can be paid down. For example, on one loan with a \$569,600³ outstanding principal balance, the borrower was playing catch up after a 5-month deferment period, but was never able to make enough payments to bring interest current. Consequently, none of the borrower's payments after the deferment period had been applied against the principal owed on the loan, and interest was still 4 months in arrears as of Colson's June 30, 2007, default report. The lender kept moving the next installment due date every time an interest-only payment was made. Because the next installment due date reported on the June 30, 2007, default report was within 30 days of the report end date, this loan was classified as current even though the borrower had not paid down any of the principal in 6 months.

Another reason why the next installment due date should not be relied upon for classifying the status of loans is because lenders can roll the date forward at will (referred to as a rolling due date) without approval from SBA. In fact, it is in the lenders' best interest to alter these dates to show loans in their portfolio as being current as the loan currency rate is an important component of SBA's evaluation of their portfolio risk.

³ This amount reflects SBA's guaranteed portion of the outstanding principal balance.

We identified six loans where lenders had inappropriately changed the next installment due date. On one of the loans, the lender reported the next installment due date as December 20, 2007, even though the borrower had not made a loan payment of either principal or interest since December 2006. While the lender did not report the loan in deferment, advancing the next installment due date had the same effect as a deferment.

In addition to relying on the next installment due date, we found that SBA was not monitoring the monthly default reports submitted by Colson to determine which loans were delinquent. For example, had it reviewed this report, SBA would have seen that the two loans described previously were not current in principal payments and should not have been classified as current. SBA also does not have a mechanism to identify loans with no principal reduction for 60 days or more.

Loans with deferments, including unjustified installment date advances, which are not re-amortized, pose additional risk to SBA. If a borrower is unable to bring interest current and post-deferment payments are never applied to principal, SBA will be responsible for a higher principal amount at purchase. If the loan is re-amortized after the deferment period, however, a portion of the post-deferment payments will be applied to principal, and SBA's loss will be reduced. To compensate for the additional risk, loans that are not re-amortized after a deferment should not be classified as current.

The standard commercial lending practice is to put loans in a non-accrual status when principal or interest payments are 90 days in arrears and collateral is insufficient to cover the debt. Loans that are in a non-accrual status are considered to be non-performing and are not classified as current. Unfortunately, this standard cannot be applied to SBA loans because SBA does not have a non-accrual policy. Furthermore, loans sold in pools on the secondary market cannot be placed in a non-accrual status as investors are guaranteed all accrued interest up to the date of purchase. Nevertheless, for illustrative purposes, if the commercial lending standard was applied to the 10 loans in Table 1, it is possible that all 10 of the loans would have been considered non-performing and not classified as current.

When loans are not properly classified as being delinquent, SBA will underestimate portfolio risk, and inappropriately rate lenders' performance. Other portfolio analyses may also be affected. Further, failure to identify problem loans precludes SBA from controlling its interest expenses by making timely purchases.

Consequently, SBA will need to revise its classification procedures to ensure that loan currency is not solely based on the next installment due date, and that data from monthly default reports and principal payment information is also

considered. Additionally, lenders should be directed to comply with the requirements for reporting next installment due dates on 1502 reports to ensure dates are only rolled forward when a full loan payment is received, and left as past due when a payment is missed or only a partial payment is made. A mechanism should be developed to identify loans with no principal reduction for 60 days or more. These loans should not be classified as current and monitored regularly in accordance with the 1086 agreement. Lenders should also be required to re-amortize loans after each deferment period. We also believe monitoring the loans reported on the monthly default reports is an important control activity that SBA should engage in to verify whether lenders are accurately reporting the status of their loans.

Guarantees Were Not Purchased Timely from the Secondary Market

SOP 50 50 4 states that because delays can significantly increase the amount of interest SBA has to pay, loan servicing and liquidation personnel in the field offices and servicing centers must act expeditiously on guarantee purchase actions. For loans SBA purchases directly from the secondary market, it must pay investors all accrued interest up to the date of purchase.

Despite the requirement to expeditiously process guarantee purchases, we found that 59 percent, or 1,198, of the 2,030 loans reviewed were not processed timely, resulting in \$7.4 million of excess interest payments. For these loans, an average of 240 days of interest accrued before SBA purchased the guarantees. Most of this delay was attributed to lenders not promptly demanding purchases and SBA not taking action to purchase when timely demands were not received. Lenders allowed 194 days of interest on average to accrue before making demands for purchase. Waiting for lenders to request purchase from the secondary market is not an adequate control since it is generally in the lenders' best interest to accrue servicing fees until the loan is purchased.

To limit excess interest accrual, SBA should monitor Colson's default reports as required under the 1086 agreement. These reports provide SBA with the data necessary to identify problem loans. When questioned about the lack of monitoring, SBA stated it has been unable to monitor these reports on a regular basis due to a staffing shortage at the Herndon National Guaranty Purchase Center. For example, as of November 2007, the Center had 22 vacancies. These staffing shortages have restricted the Center's ability to work with the lenders on remedial actions and to pursue purchase of the guarantees in a timely manner.

Further, once purchase demands were made, SBA was not always prompt in purchasing the loans from the secondary market. SBA's processing time averaged 46 days. However, SBA procedures indicate the process should take no more than

30 days. Purchases did not occur timely because purchase staff was spending excessive time awaiting receipt of lender transcripts and other information in an attempt to reconcile the transcripts prior to purchase. When lenders cannot provide transcripts, SBA procedures instruct that transcripts from Colson should be used to facilitate timely purchase. However, we found that SBA officials were not using transcripts from Colson appropriately. In some cases, officials waited as much as 189 days to receive transcripts or other information from lenders. Additionally, as discussed above, inadequate staffing at the Herndon Center prevented timely purchases.

To hold lenders accountable for making timely purchase demands, SBA should modify the 1086 agreement with lenders to require them to request purchase when interest is 120 days past due. Doing so would also be consistent with interest limits imposed on loans that SBA purchases directly from lenders. If after the agreements are modified, lenders continue to allow interest to accrue in excess of 120 days, SBA should seek reimbursement from the lenders for the excess interest.

To expedite the purchase process and reduce excess interest accrual attributable to the Agency, SBA should purchase guarantees within 30 days of the lender's demand and use Colson's transcript when the lender's transcript is not submitted or is incomplete.

During the audit, SBA acknowledged the Center's inability to monitor Colson's default reports and stated that the servicing centers would take a more active role. SBA also agreed that it could modify the 1086 agreement to require lenders to request guarantee purchase when interest is 120 days past due.

SBA Generally Pursued Lenders for Overpayments to Secondary Market Investors but Improperly Billed Lenders for \$1.9 Million in Purchased Guarantees

When a lender does not forward to Colson a borrower's monthly loan payment for a pooled loan,⁴ Colson, acting on behalf of SBA, still pays the investor its share of the payment to ensure the investor is kept whole. When SBA purchases loans from the secondary market, it sends Colson the outstanding principal balance on the guaranteed portion of the loan as reported on Colson's transcript plus all accrued interest to date. In some cases, this results in SBA overpaying Colson because Colson's report of the loan's outstanding principal balance will be overstated if the lenders have not submitted all borrower payments to Colson as required. When this happens, in effect, SBA has paid the investor an amount that

⁴ Loans are pooled together and packaged as securities for sale to investors in the secondary market.

should have been paid by the lender. When SBA identifies an overpayment, it establishes an accounts receivable and the amount is billed to the lender.

The audit disclosed that SBA properly established receivables when overpayments to investors were made and generally collected amounts owed in a timely manner. However, we identified 15 loans where SBA had inappropriately billed lenders for \$1.9 million in SBA guarantees because the lenders had either not provided or provided incomplete transcripts of financial transactions associated with the loans. SBA's normal practice is to obtain these transcripts before it purchases the loans to ensure they reconcile with Colson's records. When transcripts are not provided or cannot be reconciled, SBA's procedures require that purchase be made based on Colson's transcript and that reconciliation occur post purchase.

While we found that SBA purchased the 15 loans based on Colson's transcripts, it inappropriately billed the lender for either the entire guaranteed amount or the interest portion of the guarantee, which in effect, constituted a denial or repair of the guarantees. SBA procedures do not authorize employees to bill lenders for the guarantee portion of loans solely due to the lenders' failure to submit complete transcripts. Of the 15 loans, 11 did not have transcripts and 4 had incomplete transcripts.

The \$1.9 million billed to lenders was erroneously added to the Agency's accounts receivable, overstating the balance in this account during two financial reporting periods—fiscal years 2006 and 2007. As of September 30, 2007, approximately \$30,000 of the accounts receivable remained on the Agency's financial statements. This amount reflects \$956,000 in collections and a \$912,000 adjustment to correct a portion of the overbillings. SBA will need to make the appropriate adjustments to eliminate the remaining \$30,000, and repay lenders the \$956,000 it collected erroneously unless SBA determines through post purchase reviews that the guarantees should be repaired or denied based on lender deficiencies in originating, closing, servicing, or liquidating the loans.

SBA Did Not Collect \$1.1 Million of Ongoing Guarantee Fees from Lenders

On every guaranteed loan, SBA charges lenders an ongoing guarantee fee. The fee is collected monthly throughout the life of the loan. Upon loan default, however, the fees are not paid and continue to accrue up until the time the loan is purchased. Consequently, SBA must seek payment of those fees from the lender.

The audit disclosed that not only did SBA neglect to bill the lender for ongoing guarantee fees the Agency accrued after loan default, but it also added the amount of its unpaid ongoing guarantee fees to the total purchase payment it wired to Colson. In effect, SBA paid Colson the amount that the lender owed SBA. When

Colson received the purchase payment, it refunded SBA's ongoing guarantee fee portion back to SBA. When SBA did not receive payment, it should have deducted what the lender owed from the loan servicing fee that SBA was going to pay the lender at the time of purchase. We also found that when SBA received its erroneous payment back from Colson, it inappropriately recorded the fees as earned income in the "guarantee fees earned" account. As a result, SBA claimed approximately \$1.1 million of income on its fiscal year 2006 and 2007 financial statements that it did not collect.

SBA should discontinue its practice of including in the purchase payments the amount of its ongoing guarantee fees. Instead, SBA should reduce the servicing fees owed the lender at the time of purchase by the amount of the ongoing guarantee fees owed SBA from the lender. When we brought this issue to the attention of SBA officials during the audit, they expressed surprise that they were reporting the uncollected fees as income.

RECOMMENDATIONS

We recommend that the Director, Office of Financial Assistance:

1. Revise its procedures for classifying loans in the Loan Accounting System to ensure that loan currency is not solely based on the next installment due date, and that data from monthly default reports and principal payment information is also considered.
2. Take additional actions to ensure lenders comply with the requirements for reporting next installment due dates on 1502 reports to ensure dates are (1) only rolled forward when a full loan payment is received, and (2) left as past due if a payment is missed or only a partial payment is made.
3. Develop a mechanism to identify loans with no principal reduction for 60 days or more. These loans should not be classified as current and monitored regularly in accordance with the 1086 agreement.
4. Require lenders to re-amortize the SBA note after each deferment period.
5. Ensure that SBA is in compliance with the 1086 agreement by actively monitoring the Fiscal and Transfer Agent's monthly default reports, adhering to all requirements, and taking appropriate action on the reported loans.
6. Modify the 1086 agreement to require lenders to request guarantee purchase when interest is 120 days or more days past due and seek reimbursement from

lenders for interest accrued in excess of 120 days on loans SBA purchases directly from the secondary market.

7. Ensure that guarantees are purchased within 30 days of the lender's demand and that the Fiscal and Transfer Agent's transcript is used when the lender's transcript is not submitted or is incomplete.
8. Conduct post purchase reviews of the 15 loans with inappropriate billings to determine if the \$956,000 of collections should be refunded to the lenders or if recoveries should be sought due to lender deficiencies.
9. Discontinue the practice of including the amount of SBA's ongoing guarantee fees in the purchase payment to the Fiscal and Transfer Agent.
10. Reduce the servicing fees owed the lender at the time of purchase by the amount of ongoing guarantee fees owed SBA from the lender and bill the lenders for any shortfalls.

We recommend that the Chief Financial Officer:

11. Make the appropriate adjustments to the Agency's accounting records to eliminate the \$30,000 of accounts receivable and any portion of the \$956,000 collected from lenders that SBA determines should be refunded.

AGENCY COMMENTS

The Agency provided written comments on a draft of this report. The full text of these comments, which are summarized below, can be found in Appendix II. Management agreed with recommendations 9 and 10, partially agreed with recommendations 5, 6 and 7, and disagreed with recommendations 1, 3, 4 and 11. Finally, management indicated it had already taken the proposed action for recommendation 2, and neither agreed nor disagreed with recommendation 8.

Management did not agree with recommendation 1 to revise its classification procedures to ensure that loan currency is not solely based on the next installment due date and that data from monthly default reports and principal payment information is also considered. Management stated that this recommendation may have been based on incorrect information because loan classification procedures involved in identifying loan currency are not solely based on the next installment due date, as the interest paid to date is also considered. Management included an excerpt from the "1502 field description," which showed that loan status is reported as current if the interest paid to date is less than 31 days from the month ending date. Management also stated that the principal payment transaction is not

a recommended method to classify loan currency, since a full payment will not reduce the principal balance in situations where the borrower may have missed a previous payment, been granted a deferment by the lender, or was significantly late in making the scheduled payment. Management considers a loan to be current if a full payment is received in the month in which it is due regardless of its impact on the principal balance.

Management disagreed with the need for recommendation 2, stating that it has already been directing lenders to comply with all 1502 reporting requirements, including next installment due dates and loan status indicators.

Management disagreed with recommendation 3 to develop a mechanism to identify loans with no principal reduction for 60 days or more. Management reiterated its position provided in response to recommendation 1 of not using principal payment transactions as a means to classify loan currency.

Management disagreed with recommendation 4 to require lenders to re-amortize the SBA note after each deferment period. Management stated that re-amortization after a single 90-day deferment would not be necessary, explaining that re-amortizing a loan after a deferment would be time consuming and burdensome to the lenders. Management also stated that for loans sold in the secondary market, any and all modifications to the loan must receive the prior written approval from the secondary market investors.

Management partially agreed with recommendation 5 to ensure that SBA is in compliance with the 1086 agreement by actively monitoring the Fiscal and Transfer Agent's (FTA) monthly default reports, adhering to all requirements, and taking appropriate action on the reported loans. However, management did not agree to follow up on loans reported on the FTA's default report that are 60 days past due, as many loans consistently pay late and following up on them would be an inefficient use of time and resources.

Management partially agreed with recommendation 6 to modify the 1086 agreement to require lenders to request guarantee purchase when interest is 120 days or more past due and to seek reimbursement from lenders for interest accrued in excess of 120 days on loans SBA purchases directly from the secondary market. Management agreed that it could modify the 1086 agreement to place the burden of initiating the purchase process with the lenders; however, this would only solve the problem for loans sold after the 1086 agreement modification is made. Also, management stated it should bill the lender for excess interest only if the delay in purchase was caused by the lender. Further, based on the new policy presented in response to recommendation 5 of monitoring only those loans that are 90 days or more delinquent, management stated that purchasing over 120 days of interest

would not be unusual. Furthermore, management stated that the interest purchase would also be substantially higher if the lender granted a 90-day deferment.

Management partially agreed with recommendation 7. It stated it would use the FTA's transcript to expedite the purchase process. Management, however, did not state whether it agreed that guarantees should be purchased within 30 days of the lender's demand.

Management did not indicate whether it agreed or disagreed with recommendation 8 to conduct post purchase reviews of the 15 loans with inappropriate billings to determine if the \$956,000 of collections should be refunded to the lenders or if recoveries should be sought due to lender deficiencies.

Management agreed with recommendation 9 to discontinue the practice of including SBA's ongoing guarantee fee in the purchase payment to the FTA, contingent on its determination of the feasibility of implementing the recommendation as changes in the current processes will need to be explored. Management proposed that the FTA may be able to report the fee as a separate line item on its transcript of account. The fee could then be deducted from the purchase disbursement, but modifications to the Guaranty Purchase Tracking System (GPTS) may be required.

Management agreed with recommendation 10 to reduce the servicing fees owed the lender at the time of purchase by the amount of ongoing guarantee fees owed SBA from the lender and bill the lenders for any shortfalls. Management stated, however, that it would also explore the feasibility of implementing this recommendation. Management stated that it may be possible for the FTA to calculate the fees, but GPTS modifications would have to be made to properly account for the fees in the purchase transaction and SBA's loan accounting system.

Management disagreed with recommendation 11 to make adjustments to the Agency's accounting records to eliminate the \$30,000 of accounts receivable and any portion of the \$956,000 collected from lenders that SBA determines should be refunded. Management indicated it would not make any adjustments to the accounting records because the Office of the Chief Financial Officer reviewed the accounting records and supporting documentation for the 15 loans identified, and stated it appears that the purchase and subsequent transactions on the loans were properly recorded. Management, however, stated that as a result of our audit, the National Guaranty Purchase Center now uses the FTA's transcripts to record the purchases rather than setting up receivables.

OFFICE OF INSPECTOR GENERAL RESPONSE

Management's comments were not fully responsive to the recommendations. We are requesting that management identify additional actions it will take to address recommendations 2, 5, 6, and 7, and will pursue resolution of recommendations 1, 3, 4, 8, and 11 through the audit resolution process.

The excerpt from the "1502 field description" provided in response to recommendation 1 does not describe how loans are classified in SBA's Loan Accounting System (LAS), which is the basis for the recommendation. We have revised the report language and recommendation 1 to clarify that procedures for classifying loans in LAS need to be revised. Although the FTA's default report is prepared based on the interest paid to date, when the FTA electronically transmits the loan information to SBA, via the Office of the Chief Information Officer (OCIO), the next installment due date is used to officially classify the loan in LAS. Further, while the procedures state that the interest paid to date could be used if the next installment due date is not provided, this did not occur for any of the loans in our statistical sample.

Although management stated that it has already been directing lenders to comply with all 1502 reporting requirements, our audit determined that lenders inappropriately rolled next installment due dates forward without approval from SBA. As a result, the lenders are not complying with the reporting requirements even though SBA has reminded them of the requirements. Therefore, we have revised recommendation 2 to recommend that SBA take additional actions to ensure that lenders are not rolling forward next installment due dates.

Management's position in response to recommendation 3, that the principal payment transaction is not a recommended means to classify loan currency, is not consistent with industry practices. As discussed in our report, loans with no principal reduction for 90 days or more generally would not be classified as current by commercial lending institutions. Furthermore, management's position is not in accordance with the 1086 agreement which requires SBA to contact lenders when a borrower has failed to pay within 60 days the full amount of any missed principal and interest payment. Lastly, management's position is not in line with SBA's definition of default and guidance for when a purchase request can be made. The earliest uncured payment default is the date of the earliest failure by the borrower to pay a regular installment of principal *and/or* interest when due (emphasis added). Additionally, a lender can request purchase of a loan if the borrower is in default on any installment for more than 60 calendar days and the default has not been cured. If a borrower makes interest only payments, they have not "cured" the principal payment amount due. Although it is common for a full payment from the borrower not to reduce the principal balance because of a

previously missed payment, approved deferment, or significantly late payments, it is not prudent for such loans to be classified as current as these situations are indications of problems.

Management's response to recommendation 4 that re-amortizing would be unnecessary and burdensome for lenders is unfounded and contrary to what the Deputy Associate Administrator for Capital Access proposed as a solution. It is unclear why the creation of an allonge, or amendment, to the original note and execution by the lender and borrower would be overly burdensome to the lender. Furthermore, as 90 percent of loans sold on the secondary market are sold in pools, secondary market investor approval is not required for loan modifications, such as deferments or re-amortizations, unless they extend beyond the maturity date of the pool. We are also puzzled why management did not agree with the recommendation as the proposed action was suggested by the Deputy Associate Administrator for Capital Access at the exit conference as a solution to the classification issue discussed above. If loans were re-amortized after deferment periods, a portion of subsequent payments would be applied to principal and the loan could then be appropriately classified as current.

Management's comments on recommendation 5 are responsive to our recommendation and we believe the monitoring of loans that are 90 days past due is a reasonable solution to the issues discussed in our audit report. However, as the 1086 agreement currently requires monitoring of loans that are 60 days or more past due, it will need to be modified to reflect the change in policy and close out our recommendation.

We believe management's comments are not fully responsive to recommendation 6. We agree that modification of the 1086 agreement to place the burden of initiating the purchase process on lenders would only affect loans sold after this policy is implemented. However, we do not agree that SBA should only bill the lender for excess interest on loans it purchases directly from the secondary market if the delay is caused by the lender. SBA's policies should be consistent for all loans. Lenders who purchase their loans from the secondary market themselves or do not sell their loans on the secondary market are now limited to 120 days of interest even if they have granted a deferment. Therefore, the same policy should apply to secondary market loans that are purchased by SBA. SBA's revised policy of monitoring only those loans that are 90 days delinquent should not be an excuse to allow lenders to accrue more than 120 days of interest. Whether or not SBA has contacted a lender regarding a loan's delinquency, the lender should be aware of it internally and know that a purchase request may be necessary.

Management's response to recommendation 7 was incomplete. While it agreed that the FTA's transcript should be used to expedite the purchase process and

reduce accrued interest payable, management did not comment on whether or not it would ensure that guarantees are purchased within 30 days of the lender's demand. Therefore, management's comments were not fully responsive to the recommendation.

Management's comments did not adequately address recommendation 8. Management indicated that post purchase reviews on the 15 loans we identified with inappropriate billings may not be necessary. It stated that the purchase and subsequent transactions on the loans were appropriately recorded and that SBA has revised its procedures to use the FTA's transcript to record the purchase rather than setting up receivables as it did for these 15 loans. SBA's procedures, however, already required SBA employees to use the FTA's transcript to record the purchase and never authorized employees to bill lenders and establish receivables for the guarantee portion of loans solely due to the lenders' failure to submit complete transcripts. Therefore, we disagree that the purchase and subsequent transactions were appropriately recorded for the 15 loans and we continue to support our position that post purchase reviews need to be completed on these loans to determine if collections should be refunded or recoveries should be sought.

Management's proposed actions were not fully responsive to recommendations 9 and 10. Due to the inappropriate accounting resulting from the current procedure of including the amount of SBA's ongoing guarantee fee in the purchase payment to the FTA and the failure to collect accrued ongoing guarantee fees from the lenders at purchase, the proposed actions or other alternative actions must be taken timely rather than simply explored.

Management's response to recommendation 11 that it appears the purchase and subsequent transactions were appropriately recorded for the 15 loans we identified with inappropriate billings is incorrect. As discussed above, it was never the Center's procedure to bill lenders and establish receivables for the guarantee portion of loans solely due to the lenders' failure to submit complete transcripts. Therefore, the accounts receivable established for these loans and subsequent collections from lenders may need to be adjusted based on the results of the post purchase reviews that should be performed in response to recommendation 8.

ACTIONS REQUIRED

We are requesting that the Director, Office of Financial Assistance, respond with additional actions planned for recommendations 2, 5, 6, 7, 9 and 10.

We appreciate the courtesies and cooperation of the Small Business Administration during this audit. If you have any questions concerning this report,

please call me at (202) 205-7203 or Robert Hultberg, Director, Credit Programs Group, at (202) 205-[Exemption 2]

APPENDIX I. STATISTICAL SAMPLING PROCESS AND PROJECTION RESULTS FOR LOAN CLASSIFICATIONS

To determine whether SBA classified secondary market loans appropriately, we obtained a June 30, 2007 report of defaulted secondary market loans identified by SBA's Fiscal and Transfer Agent, Colson Services Corp. This report included 2,756⁵ loans for which interest was 60 days or more past due. From this population universe, we selected a statistical sample of 64 loans to evaluate SBA's loan classification process. In statistical sampling, the projected estimates in the population universe have 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.

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

Using the Defense Contract Audit Agency's 'EZ Quant' software program, we determined based on the universe size, a confidence level of 90 percent and a 10 percent error rate, that a sample size of 64 loans was required. We used IDEA (Interactive Data Extraction and Analysis) software to select the sample records from the universe.

We calculated the following population point estimates and the related lower and upper limits using Defense Contract Audit Agency's 'EZ Quant' software program's ratio method at a 90 percent confidence level.

Value	Occurrences in Sample of 64 Loans	Population Point Estimate	Lower Limit	Upper Limit
Loans with Classification Errors	10	431	243	689
\$ Value of Loans with Classification Errors⁶	\$3,608,422	\$161,279,216	\$68,732,691	\$253,825,742
Number of Current Loans in Universe	24	1,034	758	1,334
\$ Value of Current Loans in Universe⁷	\$6,645,457	\$297,020,262	\$198,022,253	\$396,018,271

⁵ This number reflects only those loans that were reported to be in regular servicing.

⁶ This amount reflects SBA's share of the remaining principal balance of the loans with classification errors.

⁷ This amount reflects SBA's share of the remaining principal balance of the current loans in the universe.

APPENDIX II. AGENCY COMMENTS

DATE: March 3, 2008
TO: Debra S. Ritt, Assistant Inspector General, Auditing Division
FROM: Grady Hedgespeth, Director, OFA
 Jennifer E. Main, CFO
SUBJECT: Responses to Audit Recommendations on Project No. 7020
 Draft Audit Report on Loan Classifications and Overpayments on
 Secondary Market Loans

We appreciate the opportunity to jointly provide our responses to your recommendations on this draft audit, which are set forth below.

We recommend that the Director, Office of Financial Assistance:

- 1. Revise its classification procedures to ensure that loan currency is not solely based on the next installment due date, and that data from monthly default reports and principal payment information is also considered.**

OFA RESPONSE: The OIG recommendation may be based on incorrect information. Loan classification procedures involved in identifying loan currency are not solely based on the next installment due date, but on the next installment due date as well as the interest paid-to-date. Set forth below is an excerpt from the “1502 field description” that is available on the FTA’s website.

- 3. Next Installment Due Date:** The date the borrower is scheduled to make its next payment. Based on the status of the loan, the next installment due date is reported as follows:

- Current - date of next scheduled payment due
- Past Due - date of the first missed scheduled payment
- Deferred (status 4) - date borrower is to resume making payments
- In Liquidation (status 5) - leave blank
- Paid-in-Full (status 6) - leave blank
- Transferred (status 7) - leave blank
- Purchased by SBA (status 8) - leave blank
- Fully Undisbursed (status 9) - leave blank

Special situations: Newly disbursed and large principal balance loans (where payments are made late), and loans in work-out (without a deferment) — if the full payment amount as called for in the note is made but applied solely to interest, report next installment due date as next payment date. If full payment amount as called for in the note is not made, report next installment due date as date of first missed full payment. Next installment due date advances to the next payment date once the full payment amount is received.

4. Status: Leave blank if the loan is current, 31-60 days past due or over 60 days past due as of the month ending date. For all other statuses, refer to the status box at the bottom of the SBA Form 1502 and enter the appropriate status code number.

- **Current** - interest paid-to-date is less than 31 days from the month ending date. For example, loan's interest is paid to 3/2/YY for the period ending 3/31/YY. Leave Status Code column blank.
- **31-60 Days Past Due** - interest paid-to-date is 31-60 days from the month ending date. For example, loan's interest is paid to 2/12/YY for the month ending 3/31/YY. Leave Status Code column blank.
- **Over 60 Days Past Due** - interest paid-to-date is over 60 days from the month ending date. For example, loan's interest is paid to 1/3/YY for the month ending 3/31/YY. Leave Status Code column blank.
- **Status 4: Deferred** - principal or principal and interest (P&I) payments have been deferred. For example, loan's P& I payments are deferred and are to resume on 5/1/YY. Report Next Installment Due Date as 5/1/YY, Status Code 4, Interest To Date and Guaranteed Portion Closing Balance as of last payment received.

The above excerpt clearly shows how the loan status is classified. In addition, the monthly default report from the FTA is based on interest paid-to-date. The principal payment transaction is not a recommended method to classify loan currency since it is a commonplace occurrence for a full payment from the borrower not to reduce the principal balance in situations where the borrower may have missed a previous payment, had been granted a deferment by the lender or was significantly late in making the scheduled payment. SBA considers a loan to be current if a full payment is received in the month in which it is due regardless of its impact on the principal balance.

2. Direct lenders to comply with the requirements for reporting next installment due dates on 1502 reports to ensure dates are (1) only rolled forward when a full loan payment is received, and (2) left as past due if a payment is missed or only a partial payment is made.

OFA RESPONSE: This is the current practice as explained in Section 3 above from the “1502 field description” (special situations). OFA and FTA have been directing lenders to comply with all 1502 reporting requirements, including next installment due dates and loan status indicators.

3. Develop a mechanism to identify loans with no principal reduction for 60 days or more. These loans should not be classified as current and monitored regularly in accordance with the 1086 agreement.

OFA RESPONSE: As expressed in OFA’s response to OIG’s first recommendation, the principal payment transaction is not a recommended means to classify loan currency since it is very common for a full payment from the borrower not to reduce the principal balance. This is the case in situations such as when the borrower has missed a payment, was on an approved

deferment or was significantly late in making the scheduled payment, especially early in a long term loan where the initial principal payment is very small. As mentioned previously, SBA considers a loan to be current if a full payment is received in the month it is due regardless of the payment's impact on the principal balance.

4. Require lenders to re-amortize the SBA note after each deferment period.

OFA RESPONSE: Re-amortizations would not be necessary after a single 90-day deferment. Also, each re-amortization of the loan must be documented by an amendment or allonge to the original note and must be executed by the borrower and lender. Another issue is that for loans sold in the secondary market, any and all modifications to the loan terms must receive prior written approval from the secondary market investors. This will be a major obstacle that will be time consuming and burdensome to the lenders.

5. Ensure that SBA is in compliance with the 1086 agreement by actively monitoring Colson's monthly default reports, adhering to all requirements, and taking appropriate action on the reported loans.

OFA RESPONSE: We agree that Colson's default reports should be monitored but that the centers should only follow up with lenders on loans that are more than 90 days past due since many loans consistently pay late (60-90 days), and following up on them would be an inefficient use of time and resources.

6. Modify the 1086 agreement to require lenders to request guarantee purchase when interest is 120 days or more days past due and seek reimbursement from lenders for interest accrued in excess of 120 days on loans it purchases directly from the secondary market.

OFA RESPONSE: Per the 1086 agreement it is the responsibility of SBA to follow up with the lender on delinquent loans. SBA should bill the lender for excess interest purchased only if a delay in purchase was caused by the lender. Purchase of over 120 days of interest is not unusual since when a loan is 90 days delinquent (the time when SBA would contact the lender), there is already 120 days of accrued interest that would need to be purchased. Assuming a 30-day purchase time period, the purchase would include 180 days interest. If the lender has granted a 90-day deferment (which can be done without SBA/FTA approval), the interest purchased would be substantially higher.

SBA could modify the 1086 agreement to place the burden of initiating the purchase process with lenders; however, this would only solve the program with loans sold after the modification and would not affect the outstanding portfolio of 7(a) loans. Each 1086 is a separate contract and such a modification would not be applicable to previously executed 1086s. In addition, SBA presently encourages lenders to purchase the guaranty directly from the secondary market holder and subsequently request SBA to honor the guaranty when recovery is completed (if the loan is not paid in full). This procedure results in lesser aggregate purchase amounts, and the subsequent guaranty purchases handled by SBA would be through the normal pre-purchase review process rather than a post-purchase review.

- 7. Ensure that guarantees are purchased within 30 days of the lender's demand and that Colson's transcript is used when the lender's transcript is not submitted or is incomplete.**

OFA RESPONSE: We agree that Colson's transcript should be used to expedite the purchase process and reduce accrued interest payable. Any differences with the lender's transcript could be reconciled after purchase. This is the practice currently employed by the National Guaranty Purchase Center.

- 8. Conduct post purchase reviews of the 15 loans with inappropriate billings to determine if the \$956,000 of collections should be refunded to the lenders or if recoveries should be sought due to lender deficiencies.**

OFA RESPONSE: OCFO's Denver Finance Center has reviewed accounting records in ELIPS along with supporting documentation for the 15 loans identified, and it appears that the purchase and subsequent transactions on the loans have been appropriately recorded. The National Guaranty Purchase Center has recently revised its procedures on secondary market loans so as not to account for purchases in the manner identified by OIG, and now uses the FTA's transcript to record the purchase rather than setting up receivables.

- 9. Discontinue the practice of including the amount of SBA's ongoing guarantee fees in the purchase payment to Colson.**

OFA RESPONSE: OFA will determine the feasibility of implementing this recommendation. However, changes in current processes will need to be explored. The FTA may be able to report the amount of this fee separately on the transcript of account provided in connection with the purchase of a secondary market loan. The amount would then be deducted from the purchase disbursement. Modifications to GPTS may be required.

- 10. Reduce the servicing fees owed the lender at the time of purchase by the amount of ongoing guarantee fees owed SBA from the lender and bill the lenders for any shortfalls.**

OFA RESPONSE: OFA will also explore the feasibility of implementing this recommendation to reduce any lender servicing fees by the amount of the unpaid annual service fee owed by the lender. It may be possible for the FTA to calculate the amount of the fees, with GPTS modifications made to properly account for the fees in the purchase transaction and SBA's loan accounting system.

We recommend that the Chief Financial Officer:

- 11. Make the appropriate adjustments to the Agency's accounting records to eliminate the \$30,000 of accounts receivable and any portion of the \$956,000 collected from lenders that SBA determines should be refunded.**

CFO RESPONSE: Please see response to Recommendation 8.