AUDIT OF

EARLY DEFAULTED DISASTER LOANS

NORTHRIDGE EARTHQUAKE

AUDIT REPORT NUMBER 9-09

March 31, 1999

U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

To: Alfred Judd, Area Director
Sacramento Disaster Office - Area 4

Steve Waddell, Director
Santa Ana Loan Servicing and Liquidation Office

From: Peter L. McClintock, Assistant Inspector General
for Auditing

Subject: Audit of Early Defaulted Disaster Loans - Northridge

Attached is a copy of the subject audit report. The report contains two findings with one recommendation for the Santa Ana Loan Servicing and Liquidation Office.

The recommendation in the report is subject to review and implementation of corrective action by the Santa Ana Loan Servicing and Liquidation Office in accordance with existing Agency procedures for audit follow-up. Please provide your management response to the recommendation within 30 days from the date of this report using the attached SBA Form 1824, Recommendation Action Sheet.

Any questions or discussions of the issues contained in this report should be directed to Garry Duncan at (202) 205-[FOIA Ex. 2].

Attachment

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SUMMARY

The Northridge Earthquake occurred in the Los Angeles metropolitan area on January 17, 1994. In response, SBA approved over 124,000 loans totaling about $4 billion under the Disaster Assistance Program. As of December 1997, SBA records show that 9,144 (7.4 percent) of the loans valued at $286.1 million were in default. We reviewed a random sample of 75 defaulted loans valued at $1.5 million to determine if SBA had opportunities to reduce the losses on defaulted disaster loans.

Insufficient cash flow was found to be the cause of default on 59 loans ($1.3 million) of the 75 loans we reviewed. The cash flow problems existed at loan origination for 19 loans. For the remaining 40 loans, cash flow problems resulted from

- reduced borrower business or employment income (28 loans),
- additional fixed debts (6 loans),
- increased family expenses (4 loans), and
- health problems (2 loans).

Of the 16 remaining loans, borrowers for 10 loans ($169,500) had sufficient cash flow at default, but skipped or ignored payments. Borrowers for 3 loans ($20,900) could not be located, and borrowers for 3 loans ($55,000) were never in default.

The audit identified two major categories of loans where SBA had opportunities to reduce losses on disaster loans: decreasing origination defects and contacting borrowers for collection on older loans.

The 19 loans ($764,400) with loan origination defects had cash flow and credit deficiencies. SBA accepted unsupported projected sales and income, made cash flow calculation errors, and approved borrowers with poor credit. According to SBA management, these errors were caused by many reasons including the use of inexperienced personnel to process a large number of loans. Based on the results of our statistical sample, we estimate that 2,316 loans (25 percent of the defaulted loans) totaling 31 per cent of the outstanding dollars, or $90.1 million, had loan origination deficiencies that resulted in defaults.

The Associate Administrator for Disaster Assistance has implemented corrective actions under a quality review program to improve loan underwriting; therefore, recommendations to ensure borrowers have sufficient cash flow or credit are not required.

Thirty-six of the 75 loans had assets and/or income available for payment on their SBA debt. Prior to our audit, SBA had identified 15 of these loans totaling $200,196 and had collections in place. We found an additional 21 loans totaling $682,251 with assets and income available for potential recovery. Borrowers for 14 of the 21 loans made loan payments totaling $58,460 after we contacted them, and SBA personnel followed up on our contacts. According to the loan servicing and liquidation offices, SBA could have identified more available assets and income because resources were insufficient and borrower contacts were not a priority. Based on the sample

results from the 21 unidentified loans, we estimate that SBA has not identified 2,560 loans totaling $80.3 million with assets or income available for potential recovery.

Based on the conditions identified, we recommend appropriate corrective action be taken by the Director, Santa Ana Loan Servicing and Liquidation Office, to

- provide adequate SBA staff for loan liquidations,
- contact the borrowers of defaulted loans, and
- annually search for the availability of assets and income until the statute of limitations expires.

The Director, Santa Ana Loan Servicing and Liquidation Office did not respond to the draft report.

The findings in this report are the conclusions of the OIG's Auditing Division based on statistical sampling of disaster loans in the Northridge earthquake defaulted loans universe, testing of the auditees' operations, borrower interviews, review of borrower records and loan files, and other related audit work. The findings and recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for follow-up and resolution.

INTRODUCTION

A. BACKGROUND

SBA's disaster loan program is the primary Federal disaster assistance program for funding recovery from earthquakes and other physical disasters. SBA makes two types of disaster loans - physical disaster and economic injury. Physical disaster loans are made to business owners and individuals to fund rebuilding, restoring, or replacing damaged and/or destroyed property to its pre-disaster condition. Physical disaster loans are also used to replace lost or damaged personal property. Economic injury loans are made to businesses that suffered disaster related economic losses.

SBA is authorized to make disaster loans under 15 U.S.C. 636(b), (c) and (f) as implemented by Title 13, Code of Federal Regulations (CFR), Part 123. SBA disaster loans must be repaid, thus SBA must have reasonable assurance that the loans will be repaid and borrowers are creditworthy. Standard Operating Procedure (SOP) 50 30 provides specific policy and procedural guidance for disaster loans.

After loans are approved and proceeds fully disbursed, the loan files are transferred to SBA loan servicing centers. The servicing centers monitor the loans and take collection actions if necessary. Once loans become seriously delinquent or legal proceedings are initiated, such as bankruptcy and foreclosure, the loans are transferred to a loan liquidation unit. The Northridge, California, earthquake resulted in over 124,000 SBA loans valued at over $4 billion. The loans in our sample were approved and disbursed by the Sacramento Disaster Office - Area 4. The fully disbursed loans were transferred to the Fresno Commercial Loan Servicing Center (business loans), the Santa Ana Loan Servicing and Liquidation Center (home loans), and the El Paso Home Loan Servicing Center (home loans). As liquidation was required, the loans were transferred to the Santa Ana Loan Liquidation Center, a sub-unit of the Santa Ana Loan Servicing and Liquidation Center.

As of December 1997, Northridge earthquake loans in default totaled 9,144 loans valued at $286.1 million. For this audit, we defined as defaulted loans those that were delinquent 61 or more days, in liquidation, or charged off.

B. AUDIT OBJECTIVES AND SCOPE

The overall audit objective was to determine if SBA had opportunities to reduce losses on defaulted disaster loans. Specifically, we determined whether (1) cash flow was sufficient to repay the loan, (2) assets and income were available for SBA recovery, and (3) loan proceeds were used for intended purposes. The audit focused on cash flow at origination, at the time of default, and at the time of our review.

We selected a random statistical sample of 75 disaster loans from the universe of 9,144 Northridge earthquake defaulted loans as of December 1997. The sample loans totaled $1.5 million out of the $286.1 million in default, including 55 home, 11 business, and 9 economic injury loans.

For each loan, we reviewed SBA files; contacted, interviewed and visited borrowers; talked to their representatives; and reviewed income tax returns to determine why borrowers defaulted. We also examined borrowers' financial and accounting records and inspected properties to determine if loan proceeds were used properly. SBA and public record databases, credit reports, bankruptcy filings, and property profiles were searched to determine whether borrowers had assets and/or income available to repay their SBA debt. The audit was conducted in accordance with Government Auditing Standards between January 5, 1998 and December 4, 1998.

RESULTS OF AUDIT

Borrowers for 59 of 75 loans totaling $1.3 million defaulted due to insufficient cash flow. The distribution of the 59 loans with cash flow problems were divided into two groups - problems present at loan origination and problems that arose after origination, including

- reduced borrower business or employment income,
- additional fixed debts,
- increased family expenses, and
- health problems.

Borrowers for 10 of the 75 loans had sufficient cash flow at default, but skipped or ignored payments. Borrowers for 3 loans could not be located and 3 other loans were never in default. Of all the conditions noted, only loan origination defects were controllable by SBA. If the loans with insufficient cash flow or unsatisfactory credit at origination had been declined, SBA could have avoided losses on 19 loans. Estimating these results for the defaulted audit universe indicates borrowers for 2,316 loans, totaling $90.1 million, had loan origination deficiencies (see Appendix A).

Borrowers for 36 of the 75 loans had assets and/or income available for potential SBA recovery. Prior to our audit, SBA had contacted borrowers and identified 15 loans totaling $200,196 with assets and income and had taken appropriate collection actions. We identified an additional 21 loans totaling $682,251 with collectible assets or income. According to SBA officials, the 21 loans had not been previously identified because staffing was insufficient to work the loans and because borrower contact was not a priority. With adequate staffing and effective asset/income identification techniques, we believe some or all of the funds on the 21 loans could be recovered. Estimating these results for the defaulted audit universe indicates borrowers for 2,560 loans with balances of $80.3 million have unidentified assets or income for potential recovery (see Appendix A).

Borrowers for 6 of the 75 loans misused a portion of their loan proceeds totaling $74,388. One loan was referred for civil misuse of the funds.

FINDING 1. Loans were Approved for Borrowers without Sufficient Cash Flow or Credit

Nineteen of the 75 loans in our sample had cash flow or credit defects at origination which resulted in failure of the loans. The 19 loans totaling $764,400 at disbursement were approved because SBA loan officers accepted unsupported revenue (10 loans), made errors in cash flow analysis (7 loans), and approved loans to borrowers who were not creditworthy (2 loans). Based on our sample results, we estimated that 2,316 loans (25 percent) totaling $90.1 million had origination defects.

Unsupported projected sales or income

For 10 loans (*sample numbers 3, 9, 13, 25, 27, 33, 44, 48, 65, and 67*) valued at $303,800, SBA accepted unsubstantiated projected sales or income with little or no history of past performance or ignored declining sales trends.

SOP 50 30 3, par. 84 states, "Cash flow, not collateral, is the basis for establishing repayment ability for any disaster loan. SBA must have reasonable assurance of an applicant's ability to repay any proposed loan…. For business loans, this is determined by the results of the financial analysis performed on the business as documented in the (loan officer report)." SOP 50 30 3, Appendix 20, Economic Injury Disaster Loan Addendum, provides additional criteria for determining normal sales and identifying and applying trends. Section Wa(1) states normal sales are those which would have been attained had the disaster not occurred. Before normal sales can be determined, historical sales figures must be reviewed and trends must be identified and applied to those historical figures. Section Wa(2)b states if a sales trend is downward, use the most recent year prior to the disaster as normal. Unsupported projected sales or income errors are demonstrated by the following example.

> SBA approved an economic injury loan for $24,200 (*sample number 9*) in April 1994. Two companion disaster loans were also disbursed for $158,700. Sales for the borrower, a computer repair business, for 1990 through 1992 were $999,000, $773,600, and $272,700. Based on the criteria, the most recent year's sales ($272,700) should have been used. Instead, the loan officer noted in the file that a $600,000 projected sales level "appears reasonable when compared to the past 3 years (FY) average of $681,800." Based on this projection, the loan officer calculated cash available to service SBA's debt at $87,000 per year. Using $272,700 instead, we calculated cash availability as negative $19,200. The file contained no basis for projecting an increase over 1992. Six contracts were canceled in late 1991 which according to the borrower, caused a financial loss "devastating to the day to day operations as well as the cash flow." Also, the owner was sued by the landlord, causing the business to move to the borrower's home, followed by filing a Chapter 7 bankruptcy in October 1992. No payments were made on this loan. The default resulted in a loss to SBA of $24,200 plus additional losses of $158,700 on companion loans approved under the same conditions.

Errors in cash flow analysis

SBA made cash flow analysis errors for 7 loans (s*ample numbers 12, 21, 24, 38, 43, 51 and 54*) with disbursements of $425,600. SBA did not adequately consider all fixed expenses in calculating cash availability, accepted unsubstantiated borrower written or oral statements that understated expenses, or accepted unsupported borrower statements.

SOP 50 30 3, Appendix 26, paragraph 2b(3) states financial information reported on the application should be consistent with the Federal tax returns or other verified sources in the loan case file. Paragraph 2b(6) states that income of self-employed applicants needs to be examined more carefully. On a case-by-case basis, it may be necessary to obtain additional information if Federal tax returns are not current or are not representative of present operations. Cash flow analysis errors are demonstrated by the following:

A home loan for $218,900 was approved and disbursed in August 1994 (*Sample number 54*). The loan officer accepted the borrower's projected self-employed gross income for 1993 of $47,150 and calculated cash was available to service additional debt. The loan officer did not deduct business expenses from the projected gross revenues. We obtained the borrower's actual tax return for 1993 and recalculated the borrower's cash flow at negative $1,443 per month. The loan officer's error significantly understated the borrower's cash flow shortage.

The borrower told us he defaulted on the loan because he didn't have the income "as work comes and goes." He also told us his income since 1994 has totaled only $15,000 to $18,000 annually. The borrower made sporadic payments, most recently in September 1998. As of November 30, 1998, the borrower had made 28 payments totaling $42,690 and the loan was in liquidation, 412 days delinquent.

Borrowers not creditworthy

SBA loan officers approved two loans for borrowers who had bankruptcy filings, judgments, foreclosure proceedings, repossessions, and delinquent accounts.

SOP 50 30 3 requires a borrower to have satisfactory credit and character, and requires loan officers to address and discuss derogatory items in the borrower's credit reports. Generally, a history of minor, isolated instances of poor credit or late payments is acceptable as long as the lapse is satisfactorily explained and the applicants have other credit accounts that show satisfactory payment records. Applicants that have filed for bankruptcy must meet specific conditions, such as a satisfactory credit history since bankruptcy, repayment ability, and an explanation that shows the bankruptcy circumstances were beyond the applicant's control.

Details of the two loans follow:

- The credit report for the borrowers of a $25,000 home loan (*sample number 59*) approved in April 1994 showed a Chapter 13 bankruptcy filing, automobile repossession, three delinquent accounts, and two judgments in 1993. In addition, in 1994, prior to loan approval, a foreclosure procedure was instituted against the borrower. The loan officer did not address or discuss these deficiencies and did not explain how he determined the borrowers' credit was satisfactory. The borrowers made 31 payments totaling $5,312. As of November 30, 1998, the loan was in liquidation and 511 days delinquent.

- A $10,000 home loan (*sample number 58*) was approved in May 1994. The borrower's credit report showed he had declared Chapter 7 bankruptcy in March 1993 and had eight delinquent accounts as of March 1994. The loan officer had not determined if the delinquent accounts were from the bankruptcy or if these were an indication of an unsatisfactory credit history subsequent to the bankruptcy. The borrower made 11 payments totaling $265. As of November 30, 1998, the loan was in liquidation and 1,154 days delinquent.

SBA initiated actions and management responses

The Associate Administrator for Disaster Assistance and Area Director, Disaster Assistance Area 4 agreed with the finding. The Associate Administrator in response to our September 1977 report entitled "Approval of Disaster Home Loans" stated that corrective actions had been instituted to correct disaster loan origination problems. He also mentioned the following actions that have been taken to alleviate the problems mentioned in this and the previous audit reports.

- The disaster program implemented the mandatory use of IRS #8821 which gives SBA tax return transcripts directly from IRS. IRS information is relied on rather than that supplied by individual applicants to prove income.
- Annual quality assurance reviews have been started in each area office.
- Numerous processing errors have been eliminated by fully implementing the Home Automated Loan Officer Report and partially implementing the Business Automated Loan Officer Report.
- A standardized training manual is being finalized which consists of a comprehensive, consistent training guide for new loan officers.
- As a part of the Disaster Business Process Reengineering, a modified form of credit scoring will be used to ensure credit bureau reports will be taken into account.

See Appendix C for the complete responses.

Evaluation of management responses

The actions taken or planned are responsive to the audit finding; accordingly no new recommendations are required.

FINDING 2. SBA was not Pursuing Available Borrower Income and Assets

Borrowers for 21 defaulted loans had assets and/or income that were not being pursued by SBA prior to our audit. When we examined the loans, they had been in default for an average of 672 days with a total outstanding balance of $682,251. After our borrower contacts, we advised

SBA of the assets and income identified and SBA contacted the borrowers. Fourteen borrowers made payments totaling over $58,000 in new loan payments. SBA personnel stated they did not identify available assets and income for potential recovery prior to the audit because staff resources were insufficient to initiate and maintain borrower contacts. Based on our statistical sample, we estimate that SBA could have increased recoveries from 2,560 of the defaulted loans where borrowers had assets or income. Although specific recoveries cannot be identified, we estimated total recoveries would exceed $80 million for these loans. Appendix A provides details on the statistical projection.

Borrowers with available assets and income

We found that borrowers' willness to repay the loan increased as their job or business situation improved, as family expenses were reduced, or as we contacted them and asked for payment. Borrowers' assets and income available for recovery are listed below.

Recoverable Assets and/or Income	Number of Borrowers
Wages	13
Business income	2
Combination of wages and business income	2
SBA collateral: Home	9
Non-SBA collateral: home, stocks, and bonds	1
Non-SBA collateral: undeveloped land	1
Non-SBA collateral: commercial property	1

The following are 21 loans for borrowers with assets and/or income available for SBA recovery. Fourteen of these borrowers made payments to SBA after our audit contacts.

Loans with Assets and/or Identified Income

At Time of Loan Review			Audit Identified			
Sample Number	**Loan Balance**	**Days Delinquent**	**Date of Last SBA Contact**	**Date of OIG Contact**	**Assets and/or Income Identified**	**Payments After OIG Contact Through 11/30/98**
4	$8,424	281	8-4-97	1-21-98	Assets/Inc	$1,001
6	5,302	1,076	4-19-95	2-24-98	Income	600
7	54,369	740	4-16-95	2-12-98	Assets	300
8	1,707	305	6-20-97	2-11-98	Income	63
17	8,601	363	12-16-97	2-27-98	Income	
20	10,640	571	3-11-97	5-20-98	Assets	1,100
21	32,914	500	7-14-97	2-26-98	Assets/Inc	145
25	102,007	542	12-17-96	2-20-98	Assets	
32	18,263	1,043	12-19-96	4-21-98	Assets/Inc	258
36	15,645	387	5-20-97	5-14-98	Assets/Inc	1,664
40	7,407	1,247	5-31-96	5-14-98	Income	
41	11,222	918	12-12-97	5-7-98	Income	
45	675	695	12-31-96	5-7-98	Income	678
46	6,347	924	8-12-96	4-21-98	Income	
49	30,669	455	7-30-97	4-21-98	Assets/Inc	300
51	111,089	806	5-26-98	5-28-98	Income	48,740
54	208,134	287	4-9-98	4-29-98	Assets	3,130
58	11,350	1,008	11-14-95	7-6-98	Income	
60	9,702	830	7-22-96	8-4-98	Assets/Inc	200
61	8,011	498	10-27-97	6-4-98	Assets/Inc	
76	19,773	635	12-23-97	8-19-98	Assets/Inc	281
(21)	**$682,251**	**14,111**				**$58,460**
Average	**$32,488**	**672**				

The following examples discuss assets and /or income available to borrowers:

- Two borrowers *(sample number 4)* had salaries totaling $124,000 and a home valued at $150,000 with equity of $144,000 which could be used to repay SBA. During our borrower contacts, the borrowers reported their cash flow improved after filing for Chapter 13 bankruptcy in November 1997. Based on the borrowers' information, we determined that their 1998 cash flow was sufficient to repay the SBA loan. We examined their bankruptcy and found that SBA was not listed as a debtor. We reported these facts to the Santa Ana Loan Liquidation Center in February 1998 and the borrower subsequently made loan payments totaling $1,001.

- Two borrowers *(sample number 6)* had business income and wages which could be used to repay SBA. SBA had no servicing or liquidation contacts with the borrower after May 1995. During our interview in May 1998, the borrowers told us that they had bought a home in the prior month and that they had received a cash settlement from the wife's automobile accident in January 1998. They had used the settlement to reduce credit card debts and to make the down payment on the house. Based on the interview and our cash flow analysis, the borrowers had sufficient income to repay the SBA loan. We reported these facts to the Santa Ana Loan Liquidation Center in May 1998. In June 1998, the borrowers resumed making monthly payments of $100.

- Another borrower *(sample number 7)* had cash, stocks and bonds, interest and dividend income, and equity in a home which could be used to repay SBA. According to the borrower's loan application, she had $33,000 in cash and $96,000 in stocks and bonds. The borrower's latest tax return showed $8,600 in interest and dividend income. The public records disclosed that the borrower owned a condominium with equity totaling $22,000. We contacted the borrower in February 1998 and were told that she did not believe the debt was owed after the lenders foreclosed on the collateral property, a six-unit apartment building. We explained that the borrower still had a general debt obligation due SBA. We reported these facts to the Santa Ana Loan Liquidation Center in March 1998. Beginning in July 1998, the borrower began making $50 monthly payments to SBA.

Liquidation and servicing centers rationale for lack of borrower contacts

The Santa Ana Loan Liquidation Center Deputy Director told us the Center was understaffed and had other priorities. Only 40 per cent of the Center's portfolio of 6,000 loans were assigned to loan officers as of November 1998. According to the Deputy Director, loans were unassigned because of insufficient loan officer staff. The Center's priorities were to complete the required work on borrower bankruptcies and notices of default and work with borrowers on borrower initiated workouts. These priorities made it difficult to assign all the loans and to contact borrowers.

Collections from borrowers

Using the information the borrowers provided us, SBA contacted the borrowers. As a result, 14 of the 21 delinquent borrowers made payments of $58,460 on their defaulted SBA loans from the date of our initial audit contact through November 1998. These collection results demonstrated that identification of borrowers' assets and/or income coupled with borrower contacts could result in delinquent borrowers making their SBA loan payments.

Recommendation

We recommend that the Director, Santa Ana Loan Servicing and Liquidation Office, take the following action:

2.A. Identify improvements in disaster loan borrowers' ability to repay SBA until the statute of limitations expires by contacting borrowers, researching the availability of assets and income annually, and providing adequate SBA staff for loan liquidations.

SBA management response

The Associate Administrator for Financial Assistance and the Director, Loan Servicing & Liquidation Office generally agreed with the finding and recommendation. The Associate Administrator stated that improvement in staffing of the Santa Ana Liquidation Center has been achieved and staffing requirements needed to implement the recommendation will continue to be supported, within budget constraints. The Director, Loan Servicing & Liquidation Office stated that progress is being made to implement the recommendation within the constraints of established priorities and budget limitations.

Evaluation of management response

The response meets the intent of the recommendation. We recognize that budget constraints can affect the Santa Ana Liquidation Center's ability to implement the recommendation.

OTHER MATTERS

Misuse of Loan Proceeds

In 69 of the 75 loans reviewed, loan proceeds were used in accordance with the loan authorization and agreement. Borrowers for 6 loans partially misused loan proceeds totaling $74,388 (5 per cent of the total dollars disbursed for the 75 loans). Borrowers for four of the six loans misused amounts under $6,200 and one borrower misused $13,500. One borrower misused funds totaling $47,000 and was referred to the Santa Ana Western Litigation Unit for possible civil misuse of the loan proceeds.

Fraud Referral

One borrower (*sample number 12*) was referred to the Investigations Division for potential fraud at loan origination. The borrower materially understated his credit union debt in order to establish adequate cash flow at loan origination.

Insurance Payments

Another borrower (*sample number 56*) received $16,500 in loan proceeds for the disaster loss that had already been funded by insurance payments because SBA endorsed insurance checks to the borrower without reducing the SBA loan amount. We advised the Santa Ana Loan Servicing and Liquidation Office of the error, but no corrective action was taken because the borrower has always been current on the loan and the mistake was not the borrower's fault.

Appendix A

Statistical Sampling Techniques and Results

We reviewed data from a statistical sample of past-due loans and a statistical sample of charged-off loans to develop our estimates of population values. These estimates have measurable precision or sampling errors. The precision is a measure of the expected difference between the values found in the samples and the values of the same characteristic that would have been found if 100 percent reviews 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 past-due and charged-off loans in the populations, the resulting values would be between the lower and upper limits, with the population mid-point estimates being the most likely amounts. We used the mid point estimate amount, however, the amounts could be as high as the upper limits and as low as the lower limits..

The following population estimates and lower and upper limits were calculated using the U.S. General Accounting Office 'SRO-STATS' program at a 90-percent confidence level. We used the population mid-point estimates as the statistical projections for this report. These projections are applicable solely to the past due and charged-off loans in the period of our review.

	Point Estimate Amount	**Lower Limit**	**Upper Limit**	**Point Estimate Number**	**Lower Limit**	**Upper Limit**
Faulty Loan Origination	$90,147,650	$42,240,110	$148,484,000	2,316	1,488	3,144
Defaulted Loans with Assets and/or Income	$80,338,600	$34,550,130	$136,094,600	2,560	1,707	3,413

Loans Reviewed - Results of Audit

At Sample Selection						Results of Audit					At Close of Audit (11/30/98)		
Sample Number	Loan Number	Borrower	Loan Type	Servicing Office	Disbursed Amount ($)	(1)Types of Origination Defeciencies	(2)Other Default Reasons	Misuse of Loan Proceeds	Identified Assets/Income	Loans Payments($) After Contact	Days Delinquent	Loan Status	Loan Balance ($)
1			Home	0429	$10,000		H				1,471	Chrg Off	$9,327
2			Business	0946	40,500		H				0	Paid in Full	0
3			Home	0946	25,000	UNSUP					873	In Liq	26,892
4			Home	0927	10,000		FE		Assets/Income	$1,001	266	In Liq	7,692
5			Home	0632	5,600		FE				0	Paid in Full	0
6			EIDL	0946	5,000		E/B		Income	600	14	Reg Serv	4,715
7			Business	0946	48,000		PA		Assets	300	1,038	Chrg Off	54,636
8			Home	0632	1,800		FE		Income	63	598	Chrg Off	1,644
9			Business	0946	24,200	UNSUP					1,316	In Liq	28,387
10			Home	0632	2,600		E/B				558	Chrg Off	1,555
11			Home	0946	3,600		E/B				0	Reg Serv	3,255
12			Home	0373	19,500	CF ERROR					956	Chrg Off	19,925
13			EIDL	0946	4,900	UNSUP					1,336	Chrg Off	5,159
14			Home	0927	25,000		E/B				5	Reg Serv	23,829
15			Home	0632	1,700		PA				0	Paid in Full	0
16			Home	0946	25,000		E/B				1,234	In Liq	28,315
17			Home	0927	10,000		FE		Income		640	Chrg Off	8,720
18			Home	0632	2,700		E/B				1,477	Chrg Off	377
19			Home	0927	10,000		PA				0	Reg Serv	5,554
20			Home	0946	13,000		PA		Assets	1,100	615	In Liq	9,732
21			Home	0927	31,200	CF ERROR			Assets/Income	145	719	Reg Serv	33,198
22			Business	0931	1,300		E/B				839	Chrg Off	915
23			Business	0946	10,000		E/B				774	Chrg Off	9,455
24			Home	0946	21,100	CF ERROR					1,031	Chrg Off	6,960
25			Home	0946	94,000	UNSUP		X	Assets		825	In Liq	104,800
26			Home	0927	20,400		E/B				0	Paid in Full	0
27			Business	0946	62,300	UNSUP					528	In Liq	62,786
28			Home	0632	9,900		DA				678	Chrg Off	5,649
29			EIDL	0946	4,100		E/B				1,118	Chrg Off	2,726
30			EIDL	0946	32,800		E/B				1,028	In Liq	36,050

Ex 4 & 6

(1) See Explanation of Codes: Types of Origination Deficiencies
(2) See Explanation of Codes: Other Default Reasons

Loans Reviewed - Results of Audit

At Sample Selection						Results of Audit					At Close of Audit (11/30/98)		
Sample Number	Loan Number	Borrower	Loan Type	Servicing Office	Disbursed Amount ($)	(1)Types of Origination Defeciencies	(2)Other Default Reasons	Misuse of Loan Proceeds	Identified Assets/Income	Loans Payments($) After Contact	Days Delinquent	Loan Status	Loan Balance ($)
31			Business	0946	5,000		E/B				638	In Liq	3,699
32			Home	0946	16,600		E/B		Assets/Income	258	1,174	In Liq	18,456
33			EIDL	0946	19,400	UNSUP					1,266	In Liq	22,489
34			EIDL	0992	25,000		E/B				494	In Liq	25,266
35			Home	0946	18,500		E/B				0	In Liq	10,517
36			Home	0927	16,200		PA		Assets/Income	1,664	70	Reg Serv	14,278
37			EIDL	0946	5,000		NA				0	In Liq	2,512
38			Home	0632	10,000	CF ERROR					828	Chrg Off	9,422
39													
40			Home	0927	7,700		E/B	X	Income		1,411	Chrg Off	7,407
41			Business	0946	10,200		E/B		Income		1,125	In Liq	11,454
42			Home	0632	2,200		DA	X			546	Chrg Off	1,527
43			Home	0946	19,600	CF ERROR					1,014	Chrg Off	20,298
44			EIDL	0946	3,900	UNSUP					1,163	In Liq	3,716
45			Business	0946	4,300		PA		Income	678	0	Paid in Full	0
46			Home	0632	6,700		E/B		Income		1,117	Chrg Off	6,347
47			Home	0946	29,600		DA				881	Chrg Off	26,855
48			Business	0946	46,100	UNSUP					578	Chrg Off	48,274
49			Home	0946	31,800		E/B		Assets/Income	300	592	Chrg Off	30,369
50			Home	0927	10,000		E/B				0	Reg Serv	9,026
51			Home	0946	105,300	CF ERROR			Income	48,740	898	In Liq	63,226
52			Home	0632	9,600		DA				872	In Liq	8,263
53			Home	0927	46,100		E/B				0	Reg Serv	43,421
54			Home	0927	218,900	CF ERROR			Assets	3,130	412	In Liq	207,469
55			Home	0946	10,000		E/B				1,024	Chrg Off	9,945
56			Home	0946	25,000		NA	X			0	In Liq	22,883
57			Home	0927	25,000		NA				0	Reg Serv	23,530
58			Business	0946	10,000	CREDIT		X	Income		1,154	In Liq	11,510
59			Home	0927	25,000	CREDIT					511	In Liq	23,441
60			Business	0946	9,600		E/B		Assets/Income	200	921	In Liq	9,648

Ex 4&6

(1) See Explanation of Codes: Types of Origination Deficiencies
(2) See Explanation of Codes: Other Default Reasons

Loans Reviewed - Results of Audit

At Sample Selection						Results of Audit					At Close of Audit (11/30/98)		
Sample Number	Loan Number	Borrower	Loan Type	Servicing Office	Disbursed Amount ($)	(1)Types of Origination Defeciencies	(2)Other Default Reasons	Misuse of Loan Proceeds	Identified Assets/Income	Loans Payments($) After Contact	Days Delinquent	Loan Status	Loan Balance ($)
61			Home	0927	10,000		E/B		Assets/Income		40	Reg Serv	7,321
62			Home	0927	8,300		PA				0	Paid in Full	0
63			Home	0927	22,600		PA				7	Reg Serv	20,948
64			Home	0946	10,000		UNK				772	In Liq	9,050
65			Business	0946	22,500	UNSUP					863	In Liq	22,129
66			Home	0632	9,300		E/B				957	Chrg Off	9,292
67			Home	0632	1,500	UNSUP					1,469	Chrg Off	1,540
68			Home	0927	6,700		UNK				312	Chrg Off	2,374
69			Home	0927	2,500		PA				0	Paid in Full	0
70			Home	0927	4,600		DA				1,419	Chrg Off	4,417
71			Home	0927	10,000		DA				532	Chrg Off	9,660
72			Home	0927	12,800		E/B	X			0	Reg Serv	9,043
73			Home	0429	10,000		E/B				1,179	Chrg Off	9,515
74			Home	0632	4,200		UNK				1,466	Chrg Off	4,341
75			Home	0946	42,900		PA				0	Reg Serv	39,343
76			Home	0927	18,200		E/B		Assets/Income	281	704	Reg Serv	19,521
Total	75				$1,543,600	19	56	6	21	$58,460	48,346		$1,365,996
Average					$20,581						645		$18,213

Ex 4 & 6

(1) See Explanation of Codes: Types of Origination Deficiencies
(2) See Explanation of Codes: Other Default Reasons

Loans Reviewed – Results of Audit
Explanation of Codes

Note (1) Types of Origination Deficiencies

(UNSUP) Unsupported projected sales or income

(CF ERROR) Errors in cash flow analysis

(CREDIT) Borrowers not creditworthy

Note (2) Other Default Reasons

Insufficient Cash Flow
(H) Health
(FE) Family Expenses
(E/B) Employment/Business Decline
(DA) Debt Accumulation

Sufficient Cash Flow
(PA) Payment Avoidance

Other
(NA) Not Applicable
(UNK) Unknown

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

Date: March 8, 1999

To: Peter L. McClintock,
Assistant Inspector General for Auditing

From: Bernard Kulik
Associate Administrator for Disaster Assistance

Subject: Draft Audit of Early Defaulted Disaster Loans - Northridge

We have reviewed the cases mentioned in your audit and concur with your findings.

As you indicate, these loans were mainly processed at the opening stages of the recovery effort from the Northridge earthquake by a relatively new, inexperienced work staff. In response to your audit of disaster home loans issued in September 1997, we informed you of the corrective actions we had instituted. In addition, I would like to mention subsequent actions we have taken which are also directed towards alleviating the problems mentioned in both audits:

1) In October 1995, the disaster program implemented the mandatory use of IRS #8821 which gives SBA tax return transcripts directly from the IRS. We rely on these, rather than on information supplied by individual applicants, to prove income;
2) In FY 1998, we started conducting quality assurance reviews in each area office annually;
3) We have fully implemented the Home Automated Loan Officer Report and partially implemented the Business Automated Loan Officer Report. This has eliminated numerous processing errors;
4) We are in the process of finalizing a standardized training manual which consist of a comprehensive, consistent training guide targeted to train new loan officers, and;
5) As part of our modernization effort (Disaster Business Process Reengineering), we plan on using a modified form of credit scoring to ensure credit bureau reports will be taken into account.

Ex6

Bernard Kulik

U. S. Small Business Administration
Disaster Assistance - Area 4
P. O. Box 13795
Sacramento, California 95853-4795

(916) 566-7240
(800) 488-5323

Date: March 18, 1999

Reply to the attention of: Area Director

Subject: Draft of Audit of Early Defaulted Disaster Loans - Northridge

To: Peter L. McClintock
Assistant Inspector General for Auditing

Thank you for providing a copy of the subject draft for our review and comments.

Roger Garland, our Assistant Area Director for Loan Processing, and I have carefully reviewed the draft. Generally, we find the draft to be accurate and clearly presented. We offer only a few comments:

On page 3, in the second paragraph, we suggest the word "avoided" might be preferable to the word "reduced" in the clause reading "SBA could have reduced losses on 19 loans."

2. On page 6, under the heading "SBA Initiated Actions," the draft states that "According to the Area Director, the size of the Northridge disaster required the hiring of inexperienced loan officers, many with limited lending experience, thus leading to origination mistakes." This statement conveys a narrower message than I intended, and makes an inaccurate impression. It is true that we had to hire a large number of inexperienced loan officers, and that some of them had only limited lending experience. However, many of the cases your audit identified with serious processing lapses were written and/or reviewed by loan officers with significant SBA disaster lending experience. For this reason, the language in the draft may be misleading.

Some of these processing lapses might have been the result of physical and mental exhaustion, as the loan officers worked demanding hours for a protracted period. If so, changes in our procedures will not eliminate this problem in any future disaster with such an overwhelming workload. Additionally, as I tried to explain to the audit staff, some of these cases involved loan officers from all four Area Offices who are experienced and who hold senior positions. In the circumstances of Northridge, our reviewers devoted their attention to the less experienced staff. In hindsight, we learned that some of those we should have been able to count on did not meet our expectations. To the extent the work of these loan officers can be and is carefully reviewed, the problems can be avoided. However, to the extent another large disaster again makes such oversight impossible, these problems could be repeated.

Mr. Peter L. McClintock page 2

We also offered another related observation. A very large disaster that results in large backlogs creates strong pressures to expedite actions and take reasonable shortcuts. In this context, misunderstandings and mistakes of kinds noted in this audit could be repeated, despite the general improvements that apply in most other circumstances. It is probably not realistic to expect that our processing can approach perfection in very large disasters. Instead, we should strive to achieve a standard where the shortfalls are within acceptable levels.

Please contact either Mr. Garland or me if you would like any elaboration on or clarification of these points.

Again, thank you for the opportunity to review and comment on the draft.

Ex6

Alfred E. Judd

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

DATE: March 31, 1999

TO: Peter L. McClintock
Assistant Administrator
For Auditing

Ex 6

FROM: Jane Palsgrove Butler
Associate Administrator
For Financial Assistance

SUBJECT: Draft Audit of Early Defaulted Disaster Loans – Northridge

The Office of Financial Assistance (OFA) appreciates the opportunity to comment on this report in draft form. We have reviewed the subject draft audit report on early defaulted disaster loans from the Northridge earthquake, a copy of the comments from the Director, Santa Ana Loan Servicing and Liquidation Office (LS&LO) are enclosed.

The OFA comments relate only to Finding #2 in the report. OFA does not dispute the facts in the OIG report, but concludes that, as written, the report conveys a very distorted impression of the ongoing operations of the Santa Ana LS & LO. As the director has indicated in his comments, there are a number of background issues that are not addressed in the report despite the fact that they are germane to its ultimate conclusions. In addition, the Director offers a number of technical comments on page 3 and 4 of his response.

Recommendation 2A: recommends that the Director, Santa Ana Loan Servicing and Liquidation Office take action to identify improvements in disaster loan borrowers' ability to repay until the statute of limitations expires by contacting borrowers, researching the availability of assets and income annually, and providing adequate SBA staff for loan liquidations. As noted by the Director, Santa Ana LS&LO, we have already made significant strides in improving staffing of the Santa Ana Liquidation Center and will continue to support that requirement. However, several current agency initiatives may impact the current, as well as future level of staffing dedicated to the Santa Ana center. The first initiative is the statutorily mandated contracting out of 30 percent of the disaster home loan portfolio. The second initiative is the development of an asset sales program that may result in the sale of disaster loans, including early defaulted disaster loans. These initiatives may result in a reduction in the SBA workload relative to disaster loan portfolio.

In addition, a number of other budget related factors are currently impacting the funds that are available for the purpose of Disaster Loan Servicing. These budget related factors, coupled with Agency priorities and the current hiring freeze, will effect the availability of staff in the Santa Ana Center.

The Office of Financial Assistance will provide more detailed comments in response to the final report.

Enclosure

U.S. SMALL BUSINESS ADMINISTRATION
200 W. SANTA ANA BOULEVARD, SUITE. 700
SANTA ANA, CALIFORNIA 92701

Date: March 16, 1999

Reply to Attn of: John S. Waddell, Director, Loan Servicing & Liquidation Office

Subject: Draft Audit of Early Defaulted Disaster Loans - Northridge

To: Ned Shepperson, AA/FPO

I have reviewed the subject audit. Finding Number 1 addresses loan origination issues. Finding Number 2 addresses loan servicing and liquidation issues. I concur, in general, with Finding Number 2 that pertains to the Santa Ana Loan Servicing and Liquidation Office (LS&LO).

The finding that pertains to our office, however, results from only one, recent example of SBA's difficulty in absorbing large numbers of new delinquent disaster loans in California. For at least the past 25-30 years, California District Offices have been regularly swamped by disaster loans requiring liquidation that have resulted from a continuing series of substantial disasters. In Los Angeles the San Fernando Earthquake (1971) produced more than 40,000 loans; the Los Angeles (1978-80) area floods produced 50,000 loans; the Whittier earthquake (1987) produced 8,500 loans. Northridge (1994) produced 125,000 loans. In the San Francisco District, the Loma Prieta Earthquake (1989) produced almost 18,000 disaster loans. Each of these disasters ultimately sent large numbers of problem disaster loans to district offices. Other disasters have resulted in substantial liquidation portfolios at the Fresno, Sacramento, San Diego and Santa Ana Districts.

Following each of these disasters, SBA Districts (and most recently the Santa Ana Loan Servicing & Liquidation Office) have struggled to develop new resources and capacities to liquidate a large influx of delinquent loans. These delinquencies normally arrive at SBA offices over a very short time – most frequently within three years after a disaster. Complicating SBA's response is SBA's complex liquidation system, time consuming hiring processes, and in districts, important other Agency priorities.

In 1995 the Office of Financial Assistance in cooperation with the Office of General Counsel established the Loan Servicing & Liquidation Office (LS&LO), its Loan Liquidation Center and the affiliated Western Litigation Unit in great part to respond to the liquidation portfolios resulting from California Disasters. The Santa Ana Home Loan Center was placed under the LS&LO. In 1998, the LS&LO expanded its service area to include the San Francisco District Office territory.

With the LS&LO now in place, the SBA is for the first time in position to respond to rapid growth in disaster liquidation cases from disasters anywhere in California. The LS&LO's Liquidation Center is now staffed with 42 employees. They are highly motivated and productive and include an exceptionally strong legal staff. During 1998 our staff closed 2577 cases and collected over $15 million. We are successfully liquidating loans in the San Francisco District area and can expand our efforts to other parts of California in the near future, if requested.

Finding Number 2: The purpose of the audit was to "determine if SBA had opportunities to reduce losses on defaulted disaster loans." Finding number 2 concluded that "SBA (was) not Pursuing Available Borrower Income and Assets". Projecting from their sample, auditors estimated that SBA could obtain increased recoveries from 2560 defaulted loans for an amount in excess of $80,000,000.00. From our knowledge of Santa Ana operations and backlogs, these projections appear reasonable. And, I expect that most of the recovery projected by the audit will occur through our steadily increasing liquidation activity.

Finding Number 1 of this audit concerned loan making errors at the Sacramento Disaster Area-4 Office. The auditors quoted the Associate Administrator for Disaster Assistance as follows: "As we have stated on previous occasions, the quality of disaster loan making is subject to the availability of experienced personnel, the magnitude of the disaster, the number of disasters being handled and the working environment in which we are operating". The same factors determine the quality of disaster loan liquidation. Accordingly, I feel it is important to add the following comments:

The sample for this study was selected in December 1997. The Loan Liquidation Center began operations in November 1995 with 6 employees, under a 606 calling for 48. Only 28 staff members were on board by 1 October 1997. Less than one half of these personnel had a full year of SBA experience at that time. Between January 1996 and December 1997 the newly formed Center received approximately 8,600 delinquent loans. The Home Loan Center, on 1 October 1997, was staffed with 26 personnel, while attempting to manage an unseasoned portfolio of approximately 66,000 loans. This is approximately the same number of employees that serviced a seasoned portfolio of 20-25,000 loans before Northridge.

2. Unable to address the entire portfolio in the Loan Liquidation Center with 28 employees, we developed priorities. First priority was to protect SBA collateral and position. Accordingly, all bankruptcy notices received (average over 370 per month) were reviewed and appropriate documents were filed with bankruptcy courts. Every Notice of Default and Notice of Trustee Sale received (average 400 per month) was researched, and SBA position was analyzed to assure SBA assets were protected. Every probate notice was reviewed and notices of inclusion were filed where appropriate. Second priority was to respond to borrower requests for assistance. All requests for payment arrangements and collateral changes from borrowers were addressed with negotiations for payments to SBA. Third priority was to review all new cases arriving from the Fresno Service Center and from the Santa Ana Home Loan Center for appropriate action (over 230 new cases were received on average per month during 1997). Pure collection activity was extremely limited due to the

above more immediate priorities. In the Home Loan Center similar priorities were established which directed focus to customer service over collections.

3. These priorities were clearly and regularly reported to management. Monthly reports addressed our activities resulting from this choice of priorities. Clear descriptions of these priorities and our reasons for them were made to OFA managers during briefings at our office. During her visit to our office on February 19, 1997, Deputy Administrator Lew was fully briefed by me and my staff on our limited staffing and our consequent need to focus almost exclusively on the priorities noted above – at the expense of collection activity.

4. Our experience, once again, highlights the difficulty of quickly obtaining resources to manage a large, new disaster loan portfolio in California. Training new staff in SBA loan administration systems, liquidation procedures and office software applications requires substantial time and supervisory effort. Hiring our present staff of 42 employees has required more than three years of intense efforts. Our hiring difficulties have occurred in an Orange County market that has been saturated with highly qualified bankers, attorneys and FDIC staff looking for employment.

Audit Recommendation: Director of the Santa Ana Loan Servicing and Liquidation Office "Identify improvements in disaster loan borrowers' ability to repay SBA until the statute of limitations expires by contacting borrowers, researching the availability of assets and income annually, and providing adequate SBA staff for loan liquidations".

I concur. Substantial progress is being made. We are presently endeavoring to accomplish the recommendation within the constraints of established priorities and the hiring freeze presently in place.

Other Comments/Recommendations by the Santa Ana LS&LO:

1. Please refer to page 1 of the report, in the third paragraph under "A. Background". A more complete history of loan administration would reflect that newly delinquent business disaster and home loans were transferred from the Fresno Service Center, Santa Ana Home Loan Center and the Sacramento Area Office to the Los Angeles District Office from 1994 until February 1996. Approximately 3000 of these loans remained in servicing/liquidation in Los Angeles until April/May 1996 when all Los Angeles area disaster loans were transferred to the Santa Ana LS&LO.

2. Page I and page 9 of the Draft Audit Report indicates that the Liquidation Center Management reported that we did not contact borrowers because "borrower contacts were not a priority" and because we "had other priorities". These comments were possibly taken out of context. They are an inaccurate reflection of our policies. Please see paragraph 2 under Finding #2 above for an explanation of our priorities at the time that is the subject of this audit. Collection activity was secondary to protecting SBA assets and responding to borrower requests.

3. Page 10 of the Report refers to a borrower (sample number 56) who received a duplication of benefits due to oversight in the Home Loan Center. This case has been reviewed. Due to the time which has elapsed since this SBA error, and as the loan is fully current otherwise, we do not feel demand should be made on this borrower for pay down of his loan. However, as a result of the audit and this error, we have improved our processes for review of insurance checks to assure errors of this type will not occur in the future.

Appendix D

OFFICE OF INSPECTOR GENERAL

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Center Director, El Paso Home Loan Service Center	1
Associate Deputy Administrator for Management & Administration	1
Financial Administrative Staff Attn: Jeff Brown	1
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