



U.S. Department of Agriculture
Office of Inspector General
Southwest Region
Audit Report

LENDER SERVICING OF BUSINESS AND
INDUSTRY GUARANTEED LOANS
RURAL DEVELOPMENT
ALEXANDRIA, LOUISIANA



**Audit Report No.
34601-10-Te
JULY 2003**



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL
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DATE: July 23, 2003

REPLY TO
ATTN OF: 34601-10-Te

SUBJECT: Lender Servicing of Business and Industry (B&I) Guaranteed Loans

TO: Mr. Michael Taylor
State Director
Rural Development
Louisiana State Office

This report represents the results of our audit of Lender Servicing of B&I Guaranteed Loans in Louisiana. Rural Development's response to the official draft, dated July 3, 2002, is included in its entirety as exhibit B, with excerpts and the Office of Inspector General's (OIG) position incorporated into the Findings and Recommendations section of the report.

Based upon the information contained in the response, we have reached management decision on two of the recommendations in the report.

The documentation needed to reach management decision on the other recommendation is described in the OIG Position section of the report for that recommendation. In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframes for implementation of the audit recommendation. Please note that the regulation requires a management decision to be reached on the finding and recommendation within a maximum of 6 months from the report issuance and final actions to be taken within 1 year of the management decision.

We appreciate the courtesies and cooperation extended to us by members of your staff during the audit and your timely response to the audit report.

/s/ T. R. Milliken
TIMOTHY R. MILLIKEN
Regional Inspector General
for Audit

EXECUTIVE SUMMARY

LENDER SERVICING OF BUSINESS AND INDUSTRY GUARANTEED LOANS RURAL DEVELOPMENT ALEXANDRIA, LOUISIANA AUDIT NUMBER 34601-10-Te

RESULTS IN BRIEF

We performed a review in Louisiana as part of a nationwide audit of lender servicing of Business and Industry (B&I) guaranteed loans, and the results of this audit may be included in a report to the Rural Business-Cooperative Service (RBS) National Office. Our objective was to determine if lenders were properly servicing B&I guaranteed loans. However, we expanded our objective if problems with agency monitoring and/or loan making were identified while reviewing lender servicing.

The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities. B&I guaranteed loans achieve this purpose by bolstering the existing private credit structure through the guarantee of quality loans that provide lasting community benefits. RBS does not intend to use its guarantee authority for marginal or substandard loans or for the relief of lenders having such loans.

Of the nine loans reviewed, we found that Rural Development instructions for making or servicing B&I guaranteed loans were not followed for two loans. For one loan, the lender and the agency failed to apply Rural Development instructions and disregarded the borrower's poor financial history in approving a second \$2 million loan. The lender and agency continued to process the loan knowing the borrower had a delinquent Federal debt of over \$500,000 with no repayment schedule, and that part of the funds would be used by the borrower to repay the lender for a debt of over \$433,000 that had been written off by the lender 11 months prior to loan closing. Also, there were many other indicators to classify this loan as marginal or substandard. The borrower was delinquent on other accounts to the lender and had been having cash-flow problems for years. The lender continued to push for the loan to reduce its risk in the venture. In addition to the Federal debt of over \$500,000, over \$770,000 of the loan funds, including the \$433,000 in bad debt, were paid to the lender to

satisfy delinquent obligations of the borrower. The agency questioned the soundness of this loan several times; however, it agreed to the loan after being convinced by the lender that the borrower was in the process of expanding into foreign markets that would greatly increase its revenues. The agency did not require the lender to obtain a feasibility study by a qualified independent consultant to determine the reasonability of these potential foreign markets. For the other loan, the lender approved the loan when the borrower did not have sufficient collateral. This occurred because the lender did not follow Rural Development instructions or its own lending policy for discounting collateral. The loans have been liquidated, and the agency has paid losses of over \$2.2 million.

We did not find any material reportable conditions in our review of the other seven loans.

KEY RECOMMENDATIONS

We recommended that the agency implement an internal review process to ensure that independent feasibility studies are obtained and assessed for complex or specialized projects. We also recommended that the agency, on the advice of the Office of the General Counsel (OGC), determine if one lender should be debarred, and if the other lender should repay \$168,362 of the total loss payment attributable to insufficient collateral. Recommendations to improve the oversight by all Rural Development State Offices (SO) of lenders' loan making and servicing actions will be made to RBS in a nationwide audit report.

AGENCY RESPONSE

The agency's response dated July 3, 2003, is included as exhibit B of the report. We have incorporated applicable portions of the response along with our position in this section and in the Findings and Recommendations section of the report. In summary, the State Director for Rural Development in Louisiana issued a memorandum to the RBS Program Director outlining the policy required for obtaining feasibility studies on Louisiana B&I guaranteed loans. Also, RBS reviewed the one lender's past and current participation with the United States Department of Agriculture (USDA) loan program and found no appearance or pattern of negligence. However, if a pattern of negligence is later discovered, RBS will seek advice from OGC to determine if debarment is warranted. Further, RBS will consult with OGC to determine if the other lender should repay \$168,362.

OIG POSITION

We agree with Rural Development's proposed corrective actions and have reached management decisions on two of the recommendations. The documentation needed to reach management decision on the other recommendation is described in the OIG Position section of the report for the recommendation.

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INTRODUCTION

BACKGROUND

RBS is an agency of USDA's Rural Development mission area. The mission of RBS is to enhance the quality of life for all rural residents by assisting new and existing businesses and cooperatives through partnerships with rural communities. RBS accomplishes this, in part, through the B&I Guaranteed Loan Program.

The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities with a population of less than 50,000. B&I guaranteed loans achieve this purpose by bolstering the existing private credit structure through the guarantee of quality loans, which provide lasting community benefits. RBS does not intend to use its guarantee authority for marginal or substandard loans, or for the relief of lenders having such loans.

Generally, the total amount of agency loans to one borrower cannot exceed \$10 million. This limit includes the guaranteed and nonguaranteed portions, outstanding principal, and interest balance for any new loan requests. The Administrator, with the concurrence of the Under Secretary for Rural Development, may grant an exception to the \$10 million limit under certain circumstances. Total guaranteed loans to one borrower may not exceed \$25 million under any circumstances. Generally, the maximum guaranteed percentages are 80 percent for loans of \$5 million or less, 70 percent for loans between \$5 million and \$10 million, and 60 percent for loans exceeding \$10 million. For a guaranteed percentage above 80 percent, a written request must be forwarded to the national office for approval.

The lender is responsible for servicing the entire loan and for taking all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. The loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes, negligent servicing, or failure to obtain the required security interest regardless of the time at which the agency acquires knowledge of the foregoing. This responsibility includes, but is not limited to, the collection of payments, obtaining compliance with the covenants and provisions in the loan agreement, obtaining and analyzing financial statements,

checking on payments of taxes and insurance premiums, and maintaining liens on collateral.

OBJECTIVE

The audit objective was to determine if lenders were properly servicing B&I guaranteed loans. However, we expanded our objective because problems with agency monitoring and/or loan making were identified while reviewing lender servicing.

SCOPE

We performed this audit as part of a nationwide review of the B&I Guaranteed Loan Program. Louisiana was selected based on the number of loans outstanding and the total dollar value of those loans, the total delinquent amount, and total loss payments made by the agency to honor its guarantees. We conducted the fieldwork from April 11, 2001, to October 31, 2001, at the Louisiana Rural Development SO in Alexandria, Louisiana; lenders' offices in Many and Welch, Louisiana; and a borrower's site in Mansfield, Louisiana. Coverage included B&I guaranteed loan activity during fiscal years 1998, 1999, and 2000.

Since January 1, 1990, the SO has issued 100 loan note guarantees with lending institutions totaling over \$168 million, a segment of the 3,150 loans totaling over \$4.1 billion made nationwide by the agency. As of October 17, 2000, the Louisiana B&I guaranteed loan portfolio had 76 loans totaling \$130 million on loans made since January 1, 1990, a segment of the 2,420 loans totaling over \$3.2 billion nationwide. From this universe, we judgmentally selected for review nine loans with emphasis on loan amounts and delinquent loans. These loans involved six lenders and six borrowers, and totaled \$9.9 million. From these, we identified two loans totaling \$3.3 million with potential problem areas for an indepth evaluation.

We conducted this audit in accordance with Government Auditing Standards issued by the Comptroller General of the United States.

METHODOLOGY

To accomplish the audit objective, we performed the following procedures. At the SO, we: (1) interviewed staff to determine the policies and procedures for approving and servicing B&I guaranteed loans, (2) obtained and reviewed borrower loan files, and (3) selected the lenders and borrowers to be reviewed for this audit.

At the lenders' offices, we: (1) interviewed lender personnel to determine their understanding of the loan program and their responsibilities for servicing the B&I loans, (2) reviewed the lending policy as it relates to collateral and use of loan proceeds, and (3) reviewed the borrowers' loan files to ensure compliance with guaranteed conditions. For one loan in our indepth review, we conducted a collateral inspection at the borrower's site. For the other loan in our indepth review, we did not conduct a collateral inspection because the borrower used patents as collateral.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	LENDERS AND AGENCY DID NOT COMPLY WITH RURAL DEVELOPMENT INSTRUCTIONS FOR MAKING AND SERVICING B&I GUARANTEED LOANS
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Of the nine loans selected for review, we found that Rural Development instructions for making or servicing B&I guaranteed loans were not followed for two loans. For one loan, the lender and agency failed to apply Rural Development instructions and disregarded the borrower's poor financial history in approving a second \$2 million loan to the borrower. The lender and agency continued to process the loan for approval when the borrower had a delinquent Federal debt with no repayment schedule. Also, the lender and agency agreed to the distribution of loan funds for the repayment of a loan between the borrower and lender that had not been current in the past 12 months. Further, documentation available to the lender and agency at the time of loan request, approval, and closing contained numerous indicators that should have classified the loan as marginal or substandard. This occurred because the lender continued to push for the loan to reduce its risk on outstanding obligations of the borrower. The agency recognized the problems and rejected the loan several times, but finally approved the loan based on the lender's contention that the borrower planned to expand its business in foreign markets that would greatly increase its revenue. The agency relied on the lender's information and did not perform its own analysis. For the other loan, the lender approved the loan when the borrower did not have sufficient collateral. This occurred because the lender did not follow Rural Development instructions or its own lending policy for discounting collateral. As a result, the loans have been liquidated and the agency has paid losses of over \$2.2 million.

Rural Development instructions state that the lender is responsible for servicing the entire loan and for taking all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed.¹ Additionally, the instructions state that it is the responsibility of the lender to ascertain that all requirements for making, securing, servicing, and collecting the loan are complied with.² Further,

¹ Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996.

² Rural Development Instruction 4279-A, section 4279.1(b), dated December 23, 1996.

administrative procedures of Rural Development provide that the State Director has the primary responsibility for ensuring that the lender is servicing the loan in a prudent manner as required by the lender's agreement, the regulations governing the program, and loan documents.³

FINDING NO. 1 – LENDER AND AGENCY OVERLOOKED RURAL DEVELOPMENT INSTRUCTIONS AND BORROWER'S HISTORY OF FINANCIAL PROBLEMS IN APPROVING MARGINAL LOAN

Lender A and the agency did not comply with Rural Development instructions in approving a \$2 million guaranteed loan to a marginal borrower. This occurred because of the lender's ulterior motive of reducing its risk in outstanding financial obligations with borrower A. The lender convinced the agency that the borrower would have increased income from projected contracts in foreign markets; therefore, the agency overlooked numerous indicators showing the borrower's

poor financial history and did not have an independent feasibility study performed to evaluate the projected new income. As a result, the loan has been liquidated and the agency has paid a loss of almost \$1.5 million.

Guidelines for the B&I Guaranteed Loan Program provide that processing of a loan to a borrower with a delinquent Federal debt may continue only when the debtor satisfactorily resolves the debt. Also, existing lender debt may be included in a B&I loan provided that the existing lender debt has been current for at least the past 12 months. Further, B&I guaranteed loans are not intended for marginal or substandard loans, or for the relief of lenders having such loans.

Delinquent Federal Debt

OMB Circular A-129 states that processing of applications should be suspended when applicants are delinquent on Federal tax or nontax debts. Processing may continue only when the debtor satisfactorily resolves the debt (e.g., pays in full or negotiates a new repayment plan).⁴ Additionally, Rural Development instructions state that the lender must analyze all credit factors associated with each proposed loan and apply its professional judgment to determine that the credit facts, considered in combination, ensure loan repayment.⁵

31 U.S.C., section 3720B, reads "A person⁶ may not obtain any Federal financial assistance in the form of a loan or loan insurance or guarantee

³ Administrative procedures attached to Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996.

⁴ Office of Management and Budget (OMB) Circular A-129, section III. A.1.b, dated January 11, 1993.

⁵ Rural Development Instruction 4279-A, section 4279.30(b), dated December 23, 1996.

⁶ A person may be defined as partnerships, corporations, or associations. (See VI-56, p.2.)

administered by the agency if the person has an outstanding debt with any Federal agency which is in a delinquent status. Such a person may obtain additional loans or loan guarantees only after such delinquency is resolved in accordance with those standards.”

Prior to closing the second \$2 million guaranteed loan, the lender and agency were aware that the borrower owed over \$500,000 to the IRS for delinquent employment taxes. There was no repayment schedule or agreement with the IRS to reschedule the unpaid tax liability. The lender should not have processed the loan application without a rescheduled payment plan or other agreement with the IRS. Delinquent employment taxes indicate serious credit/financial problems, also indicating that this borrower was not credit worthy.

Existing Lender Debt

Rural Development instructions state that eligible loan purposes include refinancing outstanding debt when it is determined that the project is viable and refinancing is necessary to improve cash flow and create new or save existing jobs. Existing lender debt may be included provided that, at the time of application, the loan has been current for at least the past 12 months.⁷ Additionally, Rural Development instructions state that the loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes * * *⁸

The lender disbursed loan funds from the second loan to the borrower so the borrower could repay an old debt of \$433,098 with the lender. An official for the lender sent a document dated February 5, 1997, addressed to its loan committee, documenting that the borrower became delinquent on a line of credit, and the loan was written off by the lender. Therefore, the loan had not been current for the past 12 months as required by Rural Development instructions. In fact, the document further stated that the borrower agreed to repay the bad debt in order for the lender to approve the request for the additional \$2 million guaranteed loan from Rural Development. Therefore, the lender knowingly disbursed funds for an unauthorized purpose for its own benefit.

Marginal or Substandard Loan

Rural Development instructions⁹ state that loan authority is not intended for marginal or substandard loans or relief of lenders having such loans.

⁷ Rural Development Instruction 4279-B, section 4279.113(q), dated December 23, 1996.

⁸ Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996.

⁹ Rural Development Instruction 4279-B, section 4279.101(b), dated December 23, 1996.

Rural Development instructions¹⁰ also provide procedures designed to provide reasonable assurance that the borrower is creditworthy and has the ability to repay the loan. As part of these procedures, an assessment of the credit quality should cover the borrower's cash-flow and business equity, the sufficiency of collateral, the financial stability of the industry, and the education, experience, and motivation of management. Both Rural Development¹¹ and the lender⁸ are responsible for ensuring that these requirements are met. Rural Development instructions¹² also state that the agency may require an independent feasibility study by a qualified independent consultant for startup businesses or existing businesses when the project will significantly affect the borrower's operations.

The following events and information present a timeline to show a history of the borrower's financial problems. This information was available to the agency through the lender and, in our opinion, should have been a strong indicator to classify the second loan as marginal or substandard and the lender as having marginal loans for which it was seeking relief.

On August 16, 1995, the borrower received its first B&I guaranteed loan¹³ of \$2 million through the lender. The borrower projected that the loan would create and/or save over 160 jobs. Funds were to be used for:

- Debt Refinancing \$830,000
- Inventory \$600,000
- Working Capital \$570,000

The use of funds for this first B&I loan indicated the borrower was already having cash-flow problems by needing over \$800,000 for accumulated delinquent debts.

Also in August 1995, the lender extended a \$450,000 line of credit to the borrower for working capital. This further demonstrated the borrower's cash-flow problem. The borrower had just received \$570,000 in working capital from the B&I loan and already needed additional funds.

In March 1996, the lender notified the agency that the borrower became delinquent on the first B&I loan. In October of the same year, the lender wrote off the borrower's \$450,000 line of credit as a bad debt. In our opinion, a lender writes off a loan when it has

¹⁰ Rural Development Instruction 4279-B, sections 4279.131 and 161, dated December 23, 1996.

¹¹ Rural Development Instruction 4279-B, section 4279.165(a), dated December 23, 1996.

¹² Rural Development Instruction 4279-B, section 4279.150, dated December 23, 1996.

¹³ We did not question this first loan. Details of the loan are presented for informational purposes as related to the approval on the second loan.

determined the borrower is not financially able to repay the loan, and a prudent lender would closely review the borrower for future loans.

On February 5, 1997, the lender sent a letter to the SO stating that the borrower had requested a second \$2 million B&I guaranteed loan in order for the borrower to consolidate delinquent obligations and obtain additional working capital. The letter also stated that: (1) the borrower had agreed to reimburse the lender for the charged-off line of credit in order for the bank to approve the request, and (2) this would strengthen the position of the bank in that the bank would only be exposed to \$400,000 (nonguaranteed part of second loan - \$2 million x 20 percent) as opposed to the \$450,000 previously charged off. The letter further showed proposed loan proceeds would be used as follows:

- Debt Refinancing \$959,041
- Merchandise Inventory \$210,000
- Working Capital \$830,959

The debt refinancing included the written-off debt of over \$400,000 to the lender and the outstanding Federal debt (delinquent employment taxes) of over \$500,000.

On March 14, 1997, the SO issued a conditional commitment that stated the lender would furnish Rural Development a certified disbursement statement at loan closing showing how all loan funds were to be disbursed. The disbursements in the conditional commitment were listed the same as in the lender's request letter of February 5, 1997 (shown above).

On September 23, 1997, the borrower received the second B&I loan for \$2 million and provided the certified disbursement statement at closing as required by the conditional commitment. However, the statement showed disbursements as follows:

- Debt Refinancing \$1,493,605
- Inventory \$ 210,000
- Working Capital \$ 296,395

As shown above, \$534,564 (\$1,493,605 – \$959,041) more was spent on debt refinancing than required by the conditional commitment, leaving only \$296,395 for working capital. Further documentation on September 23, 1997, showed that part of the extra disbursements for debt refinancing was for \$244,523 accrued

interest owed on the first B&I loan to the lender and miscellaneous accounts payable of almost \$68,000 to the lender. Also, almost \$28,000 of the remaining working capital of \$296,395 was used to reimburse the lender for attorney fees associated with the borrower. In all, over \$770,000¹⁴ went to the lender to satisfy delinquent obligations of the borrower.

In January 1998 (4 months after loan closing), the borrower became delinquent on the second B&I loan. SO personnel said the projected foreign markets failed to develop, and the borrower had trouble collecting accounts receivable.

The business has closed and has no employees, the lender has liquidated the loan, and the agency has paid a total loss claim of \$2.2 million to the lender on both loans (\$718,945 on October 2, 2001, for the first loan and \$1,495,503 on December 27, 2001, for the second loan).

Based on the information above, we conclude there were numerous indicators to classify the second loan as marginal or substandard. The borrower was having financial problems for years. The borrower had over \$800,000 of debt refinancing when the first B&I loan was received, and even though it received over \$500,000 for working capital, the lender had to extend the borrower a \$450,000 line of credit for additional working capital the same month. The borrower became delinquent on the B&I loan 7 months later. About 7 months after that, the lender had to write off the borrower's line of credit as a bad debt. Then about 4 months later, the lender came back to the agency for another \$2 million B&I guaranteed loan for the borrower showing that over \$900,000 would be needed for debt refinancing and over \$800,000 for working capital. However, almost \$1.5 million was used for debt refinancing, leaving less than \$300,000 in working capital for a business with a history of poor cash-flow. We conclude it was not reasonable for the lender to ask for an additional \$2 million loan for a borrower that: (1) had recently not been able to repay a \$450,000 loan to the lender, (2) had accumulated over \$500,000 in delinquent taxes, (3) was delinquent on the first B&I loan with over \$200,000 in accrued interest, and (4) had numerous other unpaid obligations to the lender. Therefore, we conclude the lender did not present a sound loan package to the agency for the second loan and was only concerned with reducing its risk in this venture.

The agency recognized the borrower's financial problems and rejected the loan application several times over a 7-month period after receiving the

¹⁴ This figure is comprised of the following: prior loan - \$433,098; accrued interest \$244,523; miscellaneous accounts payable - \$67,780; and attorney fees - \$27,928.

lender's request for a second loan. However, an SO representative said it was finally approved after the lender and borrower's packager convinced the SO that the borrower's revenues and financial condition would improve. The lender presented a written summary and discussed how the borrower planned to increase revenues by pursuing foreign markets. The SO representative said the lender was very convincing and talked the agency into approving the loan. The agency did not require the lender to obtain a feasibility study by a qualified independent consultant of these projected future markets. The agency relied on the lender's convincing argument that these new markets would solve the borrower's financial problems. In retrospect, the agency said it should not have approved the loan.

We recognize that because the lender had informed the SO of the borrower's poor financial condition and history, no further actions on the \$1,495,503 loss are recommended. However, for future loans, we conclude the agency should obtain and assess a feasibility study when the project will significantly affect the business operations of the borrower, and the project¹⁵ is so complex or specialized that an effective evaluation would be difficult without the services of an independent consultant.

RECOMMENDATION NO. 1

Implement an internal review process to ensure that feasibility studies are obtained and assessed for all projects that will significantly affect the business operations of the borrowers and the projects are of a complex or specialized nature.

Rural Development Response

The State Director for Rural Development in Louisiana issued a memorandum dated June 16, 2003, to the RBS Program Director, outlining the policy required for obtaining feasibility studies on Louisiana B&I guaranteed loans. The memorandum, in part, stated that feasibility studies would be required, effective immediately, on all startups, existing businesses entering a new market area, and existing businesses where the loan will result in significant expansion of the business' current operations.

OIG Position

We agree with the action taken and accept management decision for this recommendation. We appreciate the State Director's timely action to address this issue.

¹⁵ Feasibility studies should be required for complex or specialized projects, such as the projected income from foreign markets presented in this finding.

RECOMMENDATION NO. 2

Evaluate the lender's past and current participation in USDA loan programs. Determine if the lender's participation shows a pattern of negligence. If so, on the advice

of OGC, debar the lender from further participation in USDA loan programs.

Rural Development Response

RBS presently has one loan account with the lender in question. The account is current and paying as agreed. In the past 2 years, RBS reviewed two applications from the lender that appeared to be adequately documented and conservatively based. The loan officer responsible for the loan in question is no longer employed with the lender. RBS presently has a good working relationship with the lender. From reviewing the lender's past and current participation with USDA loan programs, RBS finds no appearance or pattern of negligence. However, if a pattern of negligence is later discovered, RBS will seek advice from OGC to determine if debarment is warranted.

OIG Position

We agree with the action taken and accept the management decision for this recommendation.

FINDING NO. 2 – LENDER APPROVED LOAN WITHOUT SUFFICIENT COLLATERAL

Lender B approved a loan to borrower B when the borrower did not have sufficient collateral to cover the loan. This occurred because the lender did not follow Rural Development instructions and its lending policy for discounting collateral. As a result, the agency

suffered a loss of almost \$719,000 on the loan, of which \$168,362 was attributed to insufficient collateral.

Rural Development instructions state that collateral must have documented value sufficient to protect the interest of the lender and the agency, and * * * the discounted collateral value will normally be at least equal to the loan amount. Lenders will discount collateral consistent with sound loan-to-value policy.¹⁶

The borrower received a \$1,350,000 B&I guaranteed loan on December 14, 1998, to purchase real estate and equipment from the owner of a closed trailer manufacturing business and to reopen it. The

¹⁶ Rural Development Instruction 4279-B, section 4279.131(d), dated December 23, 1996.

agency guaranteed 90 percent of the loan or \$1,215,000. A waiver was obtained from the national office for the 90-percent guarantee. The agency said the lender would not have processed the loan without the 90-percent guarantee. The borrower projected that the business would create 175 new jobs. However, the business has closed and the lender has liquidated the loan.

Insufficient Collateral

The lender did not discount the collateral according to Rural Development instructions and its lending policy. The lending policy states that collateral liquidation rarely generates the cash proceeds that are expected. Therefore, all collateral should be properly margined (discounted). In our opinion, this agrees with the Rural Development instruction that lenders will discount collateral consistent with sound loan-to-value policy.

We applied the lender’s discount formulas to compute the 80-percent value of real estate and the 60-percent value of used equipment, and found that the loan did not have sufficient collateral. The total discounted value of the real estate and equipment using the lender’s formulas was \$1,162,931. The guaranteed loan to the borrower was for \$1,350,000, making the total loan undercollateralized by \$187,069. (See table below.)

Collateral	Appraisal Value (1)	Lender’s Discount	Discounted Value	Orderly Liquidation Appraisal Value
Real Estate	\$ 700,000	80%	\$ 560,000	\$ 700,000
Used Equipment	1,004,885	60%	602,931	884,299
Totals	\$1,704,885		\$1,162,931	\$1,584,299
Loan Amount			\$1,350,000	\$1,350,000
Amount <Under> Collateralized			<\$187,069>	\$ 234,299

(1) Fair Market Value Appraisal

The lender should have discounted the collateral according to Rural Development instructions and its own lending policy and obtained additional collateral before closing the loan. The lender’s explanation for deviating from the lending policy was that it chose to use an orderly

liquidation¹⁷ appraisal in lieu of discounting the collateral because it felt this appraisal would give the collateral a reasonable value. However, the orderly liquidation method gave the collateral a much higher value as compared to discounting and allowed the existing collateral's value to exceed the total loan amount by \$234,299. As stated above, discounting the collateral would have shown that the loan was undercollateralized by \$187,069, a difference of \$421,368 between the two methods. This increased the total loss to the Government by \$168,362 (90 percent of \$187,069) when the collateral was liquidated.

RECOMMENDATION NO. 3

Consult with OGC to determine if the lender should repay \$168,362 of the total loss payment attributable to the insufficient collateral.

Rural Development Response

It was the opinion of the RBS State Office, and concurred upon by the State Executive Loan Committee, and national office review that a strong management team and large equity contribution of the owners mitigated the deficit in collateral after the discount was applied. However, RBS will consult with OGC to determine if the lender should repay \$168,362 of the total loss payment as opined by OIG.

OIG Position

We agree with the action taken. To reach management decision, please provide OIG documentation of RBS' determination based on its consultation with OGC.

¹⁷ A letter in the State office files explained an orderly liquidation market as: a sale within a certain timeframe allowing for proper advertising and preparation, such as an orderly auction, consignment, or sale to dealers.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
1	1	Lender Presented Marginal Loan Package	\$1,495,503	Questioned Loan-No Recovery
2	3	Loan Approved Without Sufficient Collateral	168,362	Questioned Loan-Recovery Recommended
TOTAL			\$1,663,865	

EXHIBIT B – RURAL DEVELOPMENT’S RESPONSE TO DRAFT REPORT

**U.S. DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
SOUTHWEST REGION
AUDIT REPORT No. 34601-10-Te
OFFICIAL DRAFT**

RESPONSE FROM LOUISIANA

Executive Summary

Key Recommendations:

We recommended that the agency implement an internal review process to ensure that independent feasibility studies are obtained and assessed for complex or specialized projects. We also recommended that the agency, on the advice of the Office of the General Counsel (OGC), determine if one lender should be debarred, and if the other lender should repay \$168,362 of the total loss payment attributable to insufficient collateral. Recommendations to improve the oversight by all Rural Development State offices (SO) of lender’s loan making and servicing actions will be made to RBS in a nationwide audit report.

Response:

RBS agrees with OIG’s recommendation and has since placed increased emphasis on obtaining complete, well-documented feasibility studies. The State Director for Rural Development in Louisiana issued a memorandum dated June 16, 2003, to the RBS Program Director, outlining the policy required for obtaining feasibility studies on Louisiana B&I guaranteed loans. The memorandum, in part, stated that feasibility studies will be required, effective immediately, on all startups, existing businesses entering a new market area, and existing businesses where the loan will result in significant expansion of the business’ current operations. RBS employees are required to review feasibility studies for compliance with RD Instruction 4279-B, paragraph 4279.150, Appendix A of the same subpart, and RD AN No. 3825 (4279-B) dated February 25, 2003. A feasibility study was obtained on the loan in question and was later revised to address concerns noted by RBS. Although RBS did not require an updated study on foreign markets, the borrower provided an extensive revised business plan including the projected foreign sales. The plan included detailed budget forecasts, pending and shipped international orders, revised management and sales structure, etc. The State Executive Loan Committee reviewed the revised submittal and rendered a conditional approval.

Additionally, in accordance with OIG's recommendation, RBS will evaluate the lender's past and current participation in USDA loan programs to determine if a pattern of negligence exists. If so, on the advice of OGC, RBS will seek to debar the lender from further participation in the USDA Loan programs.

RBS agrees to consult with OGC in determining if the second lender should repay \$168,362 as described in the report.

Findings and Recommendations:

Finding No. 1:

Lender and agency overlooked Rural Development instructions and borrower's history of financial problems in approving marginal loan.

Recommendation No. 1:

Implement an internal review process to ensure that feasibility studies are obtained and assessed for all projects that will significantly affect the business operations of the borrowers and the projects are of a complex or specialized nature.

Response:

RBS agrees with Recommendation No. 1 and has implemented an internal review process that will assure all feasibility studies meet RD Instruction 4279-B, paragraph 4279.150, Appendix A of the same subpart, and RD AN No. 3825 (4279-B) dated February 25, 2003. RBS will require complete feasibility studies on all start-ups, existing businesses entering a new market area, and on existing businesses where the loan will result in a significant expansion of the business' current operations. The State Director for Rural Development in Louisiana issued a memorandum dated June 16, 2003, to the RBS Program Director, outlining the policy required for obtaining feasibility studies on Louisiana B&I guaranteed loans. OIG agreed with the action taken and will document that a management decision and final action have been reached for this recommendation when the final report is issued.

Recommendation No. 2:

Evaluate the lender's past and current participation in USDA loan programs. Determine if the lender's participation shows a pattern of negligence. If so, on the advice of OGC, debar the lender from further participation in USDA loan programs.

Response:

RBS presently has one loan account with the lender in question. The account is current and paying as agreed. In the past two years, RBS reviewed two applications from the lender which appeared to be adequately documented and conservatively based. The loan officer responsible for the loan in question is no longer employed with the lender. RBS presently has a good working relationship with the lender. From reviewing the lender's past and current participation with USDA loan programs, RBS finds no appearance or pattern of negligence. However, if a pattern of negligence is later discovered, RBS will seek advice from OGC to determine if debarment is warranted.

Finding No. 2:

Lender approved loan without sufficient collateral.

Recommendation No. 3:

Consult with the Office of the General Counsel to determine if the lender should repay \$168,362 of the total loss payment attributable to the insufficient collateral.

Response:

RBS concurred with lender's assessment of collateral coverage for the mentioned loan. RBS further documented at loan approval that RD Instruction 4279-B, paragraph 4279.131(b)(3) states in part "do not reject B&I applications automatically when weak collateral is the only unfavorable factor. Other factors, such as a strong indication of repayment ability and managerial ability, can offset this deficiency." It was the opinion of RBS State Office, and concurred upon by the State Executive Loan Committee, and National Office review that strong management team and large equity contribution of the owners mitigates the deficit in collateral after the discount is applied.

Additionally, RD AN No. 3792 (4279-B), dated October 17, 2002, further clarifies the interpretation of RD Instruction 4279.131(b)(2) by stating in part "when you approve a loan with a loan-to-discounted value greater than 100 percent as allowed by section 4279.131(b)(2), the loan-to-value ratio must not exceed 100 percent."

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Considering this AN, the loan is properly collateralized.

Market Value:	
Real Estate	\$ 700,000
M&E	<u>\$1,004,885</u>
Total	\$1,704,885 Market Value

Loan amount \$1,350,000 divided by \$1,704,885 equals .79:1 loan-to-value ratio.

However, RBS will consult with OGC to determine if the lender should repay \$168,362 of the total loss payment as opined by OIG.

