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

RURAL DEVELOPMENT
LENDER SERVICING OF BUSINESS AND INDUSTRY GUARANTEED LOANS IN GEORGIA

Report No.
34601-4-At
JANUARY 2003

USDA

UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250

DATE: January 10, 2003

REPLY TO
ATTN OF: 34601-4-At

SUBJECT: Lender Servicing of Business and Industry Guaranteed Loans in Georgia

TO: John Rosso
Administrator
Rural Business-Cooperative Service

THROUGH: Sherie Hinton Henry
Director
Financial Management Division

This report presents the results of the subject audit. Your December 5, 2002, response to the draft report is included as exhibit E with excerpts and the Office of Inspector General's (OIG) position incorporated into the relevant sections of the report.

We agree with your management decisions for Recommendations Nos. 5, 9, and 10. Management decisions have not been reached for Recommendations Nos. 1, 2, 3, 4, 6, 7, and 8. We request additional action as outlined in the OIG Position.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned and the timeframe for implementing the corrective actions on the recommendations for which a management decision has not yet been reached. Please note that the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance, and final action to be taken within 1 year of each management decision. Correspondence concerning final actions should be addressed to the Office of the Chief Financial Officer.

Richard D. Long

RICHARD D. LONG
Assistant Inspector General
for Audit

EXECUTIVE SUMMARY

RURAL DEVELOPMENT
LENDER SERVICING OF BUSINESS AND INDUSTRY GUARANTEED LOANS IN GEORGIA

AUDIT REPORT NO. 34601-4-AT

RESULTS IN BRIEF

The primary audit objective was to determine if Rural Development (RD) and lenders complied with program regulations for loanmaking and servicing. Specific objectives were to determine whether the lenders ensured that (1) terms of conditional commitments were met, (2) loan funds were used for authorized purposes, (3) collateral was sufficient to protect the interest of the Government, (4) loans were properly serviced, and (5) servicing reports were submitted to RD timely.

As of January 11, 2001, there were 67 borrowers with 73 Business and Industry guaranteed loans totaling $214.2 million in Georgia. These loans were made from 1991 through 2000. Eleven of the borrowers with loans totaling $28.1 million were delinquent. We performed a detailed review of one of the defaulted borrowers with two loans totaling $5 million. (See table 1.)

Table 1

Lender	Borrower	Loan Date	Amount	Percent Guaranteed	Loan Status
A	A	3/2/99	$3,000,000	80	Liquidated
A	A	3/2/99	2,000,000	80	Liquidated
	Totals		**$5,000,000**		

The loans were used primarily to construct a high-speed sawmill.

Our review disclosed the following findings regarding the loans to Borrower A and RD and lenders' monitoring of borrowers.

- RD faces a loss of $3,771,866 on the 2 loans made to Borrower A primarily because Lender A did not (1) fulfill its responsibility to ensure that critical conditions for receipt of the guarantees were met, (2) obtain sufficient security to cover the loan losses, and (3) account for all security at the time of liquidation. In 1997 and 1998, Borrower A was approved for 2 loans totaling $5 million guaranteed at 80 percent to construct a high-speed sawmill. The sawmill was constructed with interim financing loan funds from the lender. On March 2, 1999, Lender A certified that the sawmill was complete and that all the requirements of the conditional commitment had been met. At that time, the lender received the $5 million in loan guarantees.

- Lender A did not fulfill its responsibilities for ensuring that the facility (1) was designed utilizing accepted architectural and engineering practices, (2) was completed with available funds, and (3) produced the quality and quantity of lumber called for in the application. The project failed because these specific requirements of the conditional commitment were not met. The sawmill was not properly designed, equipped, and completed after about $6.2 million ($5 million in guaranteed loan funds) was expended. Therefore, the sawmill could not produce the quantity of lumber called for in the loan application and on which cashflow projections were based. The lender allowed the owner, who did not have experience in architectural and engineering design and construction and construction cost estimating, to design the facility, estimate the cost, and serve as a general contractor. We concluded that Lender A could not support its certification that the facility had been properly designed and completed with available funds, and could produce the quantity of lumber called for in the application.

- The lender did not obtain adequate security to cover the loan losses. As of December 20, 2000, the principal and interest owed on the 2 loans totaled $5,901,007. Between February and August 2001, the loan collateral that was originally appraised for $10.9 million, was liquidated (sold) for $1,186,174. Therefore, loan losses exceed $4.7 million of which RD has paid the lender $3,706,908 as an estimated loss payment. The final loss amount could reach $3,771,866 (80 percent of $4.7 million) plus associated liquidation fees. The loan was under-secured primarily because the lender's appraisal of the sawmill machinery and equipment was based on an inappropriate valuation approach. Although the sawmill had not been constructed, and, therefore, had no production or income history, it was appraised as if it were a going concern for sale. Further, real estate security originally appraised at $1.3 million sold for only $657,030 because the appraised value was materially overstated.

- We also noted that the lender did not account for $610,501 of loan collateral at the time of liquidation and applied $75,000 of guaranteed loan funds to an unguaranteed loan it had made to the borrower.

On December 29, 2000, RD paid Lender A an estimated loss claim of $3,706,908 even though the lender did not obtain sufficient collateral to secure the loan, did not perform progress inspections to ensure that construction equaled the disbursement of loan funds, misrepresented borrower's adherence to the conditional commitments, and misused loan funds to pay off its unguaranteed loan to the borrower. As of February 1, 2002, the lender had not filed a final loss claim.

RD did not (1) ensure that lenders submitted their annual written reports on borrowers' financial health and (2) make annual lender visits timely to monitor their loan servicing actions. As of January 11, 2001, the RD State office tracking system showed that (1) lenders were delinquent in providing the agency with the annual reports and financial statements for 28 of 67 borrowers and (2) RD was delinquent in making annual visits to lenders servicing 22 of the 67 borrowers. RD stated the loans for many of the borrowers for whom the annual reports and visits were overdue were delinquent or in liquidation and, in those cases, it was difficult for the lenders to obtain financial statements from the borrowers. RD also stated that its files contained documentation of its work with the lenders servicing the subject loans. Without timely financial analyses, neither lenders nor RD can properly monitor the fiscal condition of the borrowers to determine if they are in compliance with the terms of the loan.

KEY RECOMMENDATIONS

We made a series of recommendations for corrective actions. Key among those recommendations was that RD (1) rescind the loan note guarantee for Lender A or substantially reduce the $3,706,908 estimated loss payment (see exhibit A), (2) reevaluate the use of appraisals that value new business developments as a going concern, and (3) require all lenders whose annual reports are overdue to submit them within 60 days and put the lenders on notice that failure to provide copies timely of the borrowers' annual reports is considered negligent servicing and could cause the loan guarantee to be unenforceable.

AGENCY RESPONSE

In its December 5, 2002, response to the draft report, RD agreed with the report's recommendation or proposed alternative solutions.

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INTRODUCTION

BACKGROUND

Program Background - Rural Development (RD) operates a variety of loan programs including the Business and Industry (B&I) Guaranteed Loan Program. The program assists business development in the nation's rural areas and the employment of rural residents. 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. The guarantee authority is not intended to be used for marginal or substandard loans or for the relief of lenders having such loans. RD administers the program through its State offices. Private lending institutions make the loans with RD guaranteeing payment of up to 90 percent, including interest, in the event of a loss.

Guarantees are provided on loans made by traditional lenders, such as commercial banks, and to a lesser extent, on loans made by other non-traditional lenders, such as entities using investment capital and which are authorized by State law to engage in lending. The loans are made to most types of legal entities, including for-profit and nonprofit cooperatives, corporations, partnerships, individuals, public bodies, and Indian tribes. RD can guarantee up to 90 percent of private lending institutions' (banks, savings and loans, etc.) loans made to eligible borrowers. RD State offices can approve loans up to $5 million and generally offers a guarantee of 80 percent. The RD National office must approve loans over $5 million and generally offers a 70-percent guarantee for loans between $5 and $10 million, and 60 percent for loans exceeding $10 million. Currently, the maximum loan is $25 million.

Lenders are responsible for servicing the B&I guaranteed loans and for taking all actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. Lenders are responsible for notifying RD officials of any violations of loan agreements. The loan note guarantee will be 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 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.

Borrower/Lender A Loan Background - On October 17, 1996, Borrower A filed an application for a $3 million guaranteed loan to construct a high-speed state of the art sawmill. The applicant (an individual with a background in the lumber business) prepared the project's designs, developed cost estimates, and acted as the general contractor. Estimated cost of the project was $4,050,000. Funding sources were to be the $3 million guaranteed loan from local Lender A and $1,050,000 from other sources. (See table 3.)

Table 3

Source	Amount	Use of Funds	Amount
Guaranteed Loan	$3,000,000	Land and sawmill building	$1,000,000
Other Funding:		Equipment[1]	1,800,000
Export/Import Bank	250,000	Inventory	900,000
State Department of Community Affairs, Development Loan	450,000	Debt Refinancing	250,000
Equipment Lease	350,000	Fees	100,000
Total	**$4,050,000**		**$4,050,000**

[1]Includes labor cost to install equipment.

On March 10, 1997, RD issued a conditional commitment guaranteeing 80 percent of the $3 million loan. One of the conditions was that the guarantee would not be issued until the facility was complete. On July 7, 1998, the borrower filed an application for a subsequent loan of $2 million because the project was materially incomplete after the original $3 million had been used. The lender stated that the other funding sources for the $1,050,000 had dried up and costs were underestimated because (1) the borrower planned to pay the interim financing interest of $400,000 from other funds but was unable to do so, (2) the borrower's original design plans and cost estimates for the new sawmill were not certified by a professional engineering study, and (3) a wet winter slowed construction which increased labor and debt carrying cost. Table 4 shows the revised cost and funding sources.

Table 4

Source	Amount	Use of Funds	Amount
Guaranteed Lender Loan	$5,000,000	Land and sawmill building	$1,079,000
Unguaranteed Lender Loan	500,000	Equipment[1]	2,845,000
		Inventory	600,000
		Debt Refinancing	250,000
		Start-up	76,000
		Interest	400,000
		Appraisal and Consulting Fees	250,000
Total	**$5,500,000**		**$5,500,000**

[1]Includes labor cost to install equipment.

Although the lender had not acted to ensure the availability of the $1,450,000 of other funding ($1,050,000 + $400,000) called for in the first loan application, on September 19, 1998, RD issued a subsequent conditional commitment guaranteeing the $2 million. Added to the subsequent commitment were specific conditions that the lender ensure that the facility be (1) designed utilizing accepted architectural and engineering practices, (2) completed with available funds, and (3) produce the quality and quantity of lumber purposed in the original application. On March 2, 1999, the lender certified that all the requirements of the conditional commitments had been met and the 2 loan note guarantees were issued guaranteeing 80 percent.

During the week ending March 12, 1999, production began, but after several weeks it was halted when due to a billing dispute a vendor removed software that operated the equipment. The lender made the borrower a $500,000 non-guaranteed loan to reinstall the software and install a gang saw. Production resumed in June 1999.

On June 15, 1999, the borrower applied for a subsequent guarantee for a $1.5 million loan to pay off non-guaranteed loans owed to Lender A and to use as working capital. In its request to RD, the lender stated that the additional loan was needed because the borrower had under estimated the initial cost to build and equip the sawmill. The RD State office denied the request because the equity position was below 10 percent tangible balance sheet equity and questionable repayment ability.

On December 13, 1999, the sawmill was shutdown because production did not meet expectations and, therefore, would not generate sufficient cashflow to pay either operating expenses or debt service cost. On December 6, 1999, the borrower applied for another guarantee for a $340,000 loan to be used for working capital. The RD District office recommended that the State office approve the loan. Because the loans to the borrower had reached the State office's $5 million authority, it recommended approval to the national office. The RD National office denied the request because (1) the equity position was below 10 percent tangible balance sheet equity, (2) the loan would be unsecured, and (3) repayment ability was inadequate.

On January 29, 2000, the borrower applied for a direct B&I loan of $6,460,000 from RD. The borrower had determined that the sawmill would never be a viable operation as it stood at that time due to design and equipment problems. The purpose of the direct loan was to correct the production design problems, install additional equipment needed to increase production, pay off account payables, and provide working capital. The RD District office recommended to the State office that the loan be approved.

The State office concurred with the recommendation and forwarded it to the national office. The RD National office denied the request for several reasons concluding that the loan would be marginal or substandard, collateral was insufficient, and there was no reasonable assurance of repayment.

After the December 1999 shutdown, the sawmill never resumed production. On March 30, 2000, the borrower filed bankruptcy and on June 28, 2000, the bankruptcy was dismissed. During this time the borrower continued to sell off inventory and collect receivables that served as loan security. Because of the pending bankruptcy, the lender did not have access to the proceeds.

The borrower never made a payment on the loans. On December 29, 2000, RD paid Lender A an estimated loss claim of $3,706,908 (As of February 1, 2002, the lender had not filed a final loss claim).

OBJECTIVES

The primary audit objective was to determine if RD and the lenders complied with program regulations for loanmaking and servicing. Specific objectives were to determine whether lenders ensured that (1) terms of conditional commitments were met, (2) loan funds were used for authorized purposes, (3) collateral was sufficient to protect the interest of the Government, (4) loans were properly serviced, and (5) servicing reports were submitted to RD timely.

SCOPE

The audit, conducted in accordance with generally accepted government auditing standards, covered B&I guaranteed loan operations in Georgia for fiscal year (FY) 1998 through 2000. Other periods were reviewed as necessary. The audit was part of a nationwide audit of the B&I Guaranteed Loan Program. The U.S. Department of Agriculture (USDA) Office of Inspector General's (OIG) Southwest Regional office located in Temple, Texas, was the audit control point with overall responsibility for the audit.

As of January 11, 2001, there were 67 borrowers with 73 loans totaling $214.2 million in Georgia. Eleven of the borrowers with 12 loans totaling $28.1 million were delinquent. We selected one delinquent borrower for an indepth review. Our sample selection was based on the large dollar value and status of the loans. (See table 2.)

Table 2

Lender	Borrower	Loan Date	Amount	Percent Guarantee	Loan Status	Estimated Loss	Guaranteed Amount
A	A	3/2/99	$3,000,000	80	Liquidated	$2,780,181	$2,224,145
A	A	3/2/99	2,000,000	80	Liquidated	1,853,454	1,482,763
Totals			**$5,000,000**			**$4,633,635**	**$3,706,908**

Audit fieldwork was performed from February 2001 through January 2002, and included work at the RD State office in Athens, Georgia; RD District office in Cartersville, Georgia; lenders' office in Pine Mountain, Georgia; and the borrower's place of business in Mountain Springs, Georgia. We also interviewed customers of the borrower.

METHODOLOGY

To accomplish the audit objectives, we performed the following procedures:

- Interviewed RD officials and reviewed policies and procedures governing the B&I Guaranteed Loan Program.
- Reviewed records at the RD State office for the loans selected for review, and performed a detailed review of lender and borrower business and financial records related to the loans.
- Interviewed lender representatives responsible for the two loans made to Borrower A. Borrower A refused to talk with the auditors.
- Inspected the business site of the project.
- Contacted vendors and customers of Borrower A to determine the status of accounts payables and receivables.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	LENDER A WAS DEFICIENT IN ITS RESPONSIBILITY FOR LOANMAKING AND SERVICING

RD faces a loss of $3,771,866 on loans made to Borrower A because Lender A did not (1) fulfill its responsibility to ensure that critical conditions for receipt of the guarantees were met, (2) obtain sufficient security to cover the loan losses, and (3) account for all security at the time of liquidation. In 1997 and 1998, Borrower A was approved for 2 loans totaling $5 million (guaranteed at 80 percent) to construct the high-speed sawmill. The lender provided the borrower with interim financing to construct the sawmill (see exhibit B, photographs). Before issuance of the loan guarantees, construction was to be completed and the lender was to ensure that the sawmill was designed utilizing accepted architectural and engineering practices, was completed with available funds, and would produce the quality and quantity of lumber called for in the loan applications. Although these conditions were not met, Lender A certified that they were met and received the loan note guarantees. Because the sawmill was not completed and equipped as originally designed, it failed. It experienced operational problems from the beginning and would not produce the quantity of lumber needed to generate sufficient cashflow to pay debt service and operating expenses. The plant only operated for 7 months and the borrower made no payments on the loans.

The lender did not obtain adequate security to cover the loan losses. As of December 20, 2000, the principal and interest owed on the 2 loans totaled $5,901,007. Between February and August 2001, the loan collateral that was originally appraised for $10.9 million, sold for $1,186,174. Therefore, loan losses exceeded $4.7 million of which RD has paid the lender $3,706,908 as an estimated loss payment. The final loss amount could reach $3,771,866 (80 percent of $4.7 million) plus associated liquidation fees. The collateral was insufficient because of an inappropriate appraisal method for valuing the sawmill's machinery and equipment and a defective appraisal of real estate. We also noted that the lender did not account for $610,500 of loan collateral at the time of liquidation and disbursed $75,000 of loan funds for unauthorized purposes.

After the borrower defaulted, a RD National office review found serious problems with the loans. In a December 12, 2000, memorandum, the National office reported the loans were closed with inadequate working capital and equity, poor management, and a faulty appraisal.

By the lender not obtaining sufficient collateral, not performing progress inspections to ensure that construction progress equaled the disbursement of loan funds, and representing that critical conditional commitments were met when they were not, should be justification for RD to rescind the loan note guarantee or substantially reduce the $3,706,908 loss payment.

FINDING NO. 1

CONDITIONAL COMMITMENT REQUIREMENTS NOT MET

Several critical conditional commitment requirements applicable to the sawmill were not met which led to its failure. Specific conditions that were not met were that the facility (1) be designed utilizing accepted architectural and engineering practices, (2) be completed with available funds, and (3) produce the quality and quantity of lumber called for in the application. This occurred because Lender A did not fulfill its responsibility to ensure that critical conditions for receipt of the loan guarantees were met. Due to design problems and substantial cost overruns, the sawmill was not completed and properly equipped after about $6.2 million ($5 million in guaranteed loan funds) was expended. Therefore, the sawmill failed because it could not produce the quantity of lumber called for in the loan application and on which cashflow projections were based. The lender did not require that the borrower obtain the services of a professional engineer to design the sawmill including machinery and equipment specifications and provide reliable cost estimates. Instead, the lender allowed the owner, who did not have experience in architectural and engineering design and construction and construction cost estimating, to design the facility, estimate the cost, and serve as general contractor.

Details of the design, cost overruns, and production problems are presented below and in exhibit C.

<u>Project Not Designed Using Accepted Architectural and Engineering Practices</u> - The conditional commitment requirement that the project be designed using accepted architectural and engineering practices was not met. The lender allowed the borrower, who was not an architect or engineer, to design and estimate the cost of the high-speed sawmill, rather than a professional engineer experienced in the design and analysis of similar facilities. In addition, the borrower served as the general contractor. The borrower did not have experience in designing, estimating cost, and constructing industrial production facilities. Because of the borrower's experience in the lumber industry, the lender believed he could design and construct a properly equipped sawmill with available funding which would hold down cost. According to RD officials, the program regulations neither prohibit nor permit the borrower from serving as the design engineer and general contractor. Therefore, it is up to the lender to approve or disapprove an applicant’s requests to perform these functions.

RD regulations[1] state that the lender is responsible for ensuring that all program requirements for loanmaking and servicing are met, including adequate supervision of construction of a facility that will become loan collateral. The lender must also ensure that the facility is designed using accepted architectural and engineering practices.[2]

The sawmill was to be designed to produce 350,000 board feet of lumber per week increasing to 450,000 per week. The borrower started planning for the sawmill by acquiring used sawmill equipment at auctions over the years. The borrower's design plans were general drawings of the site layout, building elevations, equipment system locations in relation to each other, and general layout of the trimmer/edger and log yard system. According to the lender, the borrower based the design on experience in the lumber business and took it to a draftsman who drew it up on the blueprint.

There were no engineering analyses that showed what equipment and its capacity would be needed in order to achieve the desired production levels or engineering designs and specifications to show the proper equipment configurations needed to support a milling process that would be generating 450,000 board feet weekly. Adequate design and engineering specifications should have anticipated the equipment capabilities and interfaces needed to meet production goals and provided realistic estimates of the cost to construct such a facility. (See exhibit C.)

RD instructions[3] provide that the lender normally would have inspections made by a qualified individual prior to making progress payments. To draw funds, the borrower submitted forms showing the total amount of the draw supported by an itemized listing showing the date, check number, amount, and payee for each payment. The lender did not perform progress inspections to determine if the amount of the draws were justified based on the percentage of completed construction and equipment installations.

When applying for the subsequent $2 million guaranteed loan, the lender stated that it would retain the services of a third party engineer with experience in the sawmill field to provide inspections of the property and equipment through the completion of the project. However, such services were not obtained. The lender stated that the services of an engineer were not obtained as agreed because of the desire to keep down cost. The lender also stated that this was

[1] 7 Code of Federal Regulations (CFR) Ch. XLII sec. 4279.1 (b) and 4279.30 (a)
[2] 7 CFR Ch. XLII sec. 4279.156 (a)
[3] RD Instruction 4279.156 dated December 23, 1996.

the first loan for a complex manufacturing facility that it had made and that in hindsight it should have required a professional engineer familiar with this type of project to design and estimate the cost of the project. The lender stated that because of confidence in the borrower's experience in the sawmill business, the design and cost estimates were accepted.

RD personnel stated that it was the lender's responsibility to ensure the project was adequately designed and equipped.

We concluded that Lender A did not sufficiently evaluate the technical feasibility of the sawmill. The lender did not require the borrower to obtain the expertise of a professional engineer to identify constraints or limitations in facility construction or design related factors that would adversely affect the success of the project.

- <u>Project Not Completed with Available Funds</u> - The conditional commitment requirement that the sawmill be completed with available funds was not met. During the week ending March 12, 1999, production began. However, in order to begin production with the approved funding, the mill was scaled back substantially and did not include all essential equipment called for in the original design. (See exhibit C.) On March 26, 1999, the plant was shut down when a vendor removed the software used to operate the equipment because of a billing dispute. At that time, the borrower notified the lender that significant cost overruns had occurred and additional funds would be required to bring the mill up to acceptable production levels.

  The original estimated cost to complete the facility and start up the business was $4,050,000. As of January 20, 2000, the estimated completion cost had risen to $12,651,069. (See table 5.)

Table 5

Item	Budget		Amount Disbursed (6/30/99)	Cost Over/ (under) Run	Direct Loan Request (1/20/00)	Total Cost to Complete
	First Loan (10/17/96)	Second Loan (7/7/98)				
Land	$ 250,000	$ 250,000	$ 250,000	$ 0	$ 0	$ 250,000
Building and Mill Structure	750,000	829,000	838,786	9,786	0	838,786
Equipment and Labor[1]	1,800,000	2,845,000	3,748,974	903,974	2,350,000	6,098,974
Fees	100,000	250,000	143,345	(106,655)	0	143,345
Inventory/Working Capital	900,000	600,000	500,000	(100,000)	4,110,000	4,610,000
Start-up	0	76,000	0	(76,000)	0	0
Debt Refinancing	250,000	250,000	250,000	0	0	250,000
Interest	0	400,000	459,964	59,964	0	459,964
Totals	**$4,050,000**	**$5,500,000**	**$6,191,069**[1]	**$691,069**	**$6,460,000**	**$12,651,069**

[1]**Additional disbursement from un-guaranteed lender loans.**

The collateral appraisal for the second loan was performed by a firm with experience in appraising sawmills. The appraiser told us that $5 million was not enough to construct such a sawmill. In his opinion at least $10 million was needed just to construct the sawmill not counting working capital. The appraiser also told us in his past experiences that installing used equipment into sawmills costs as much as purchasing new equipment after paying installation costs and working out the problems. When purchasing the equipment new, the manufacturer normally installs it as part of the purchase price. The appraiser said the borrower had the overall knowledge of how to operate a sawmill, however, in the appraiser's opinion the borrower did not have knowledge of how the components (computer software, etc.) operated on the type of sawmill being constructed.

- Production Goals Not Met - The conditional commitment requirement that the sawmill produce the quantity of lumber called for in the application was not met. The application called for the sawmill to produce 350,000 board feet of lumber per week during the first 6 months, 400,000 board feet per week for the second 6 months, and 450,000 per week thereafter.

  After the sawmill resumed operations in June, it operated until the end of November. For the 25 weeks that it operated, weekly production averaged 168,258 board feet with operating losses amounting to $595,797. Although the borrower never made a payment on the loans, when debt-service cost was considered, the mill incurred a cashflow shortfall totaling $956,157 over the 25-week period. (See table 6.)

Table 6

	June	July	Aug.	Sept.	Oct.	Nov.	Totals
Operating Weeks	3	4	4	5	4	5	25
Average[1] Weekly Production	52,787	101,536	121,651	168,436	268,761	247,624	168,258[2]
Sales	$127,843	$157,607	$176,757	$246,083	$289,862	$542,668	$1,540,820
Operating Expenses	190,754	300,398	312,043	291,542	372,524	669,356	2,136,617
Loss from Operations	$62,911	$142,791	$135,286	$45,459	$82,662	$126,688	$595,797
Debt Service	$60,060	$60,060	$60,060	$60,060	$60,060	$60,060	$360,360
Total Loss	**$ 122,971**	**$ 202,851**	**$195,346**	**$ 105,519**	**$142,722**	**$186,748**	**$956,157**
[1]Board feet of lumber.							
[2]Total production of 4,206,453 board feet/25 weeks.							

In the January 2000 application for the direct B&I loan (see exhibit C), the borrower attributed the low production to system design problems, machinery downtime, bottlenecks to the milling process caused by lack of sufficient equipment, and other equipment limitations that held down production.

On May 14, 1999, the RD State Director requested an Office of General Counsel's (OGC) opinion on whether the lender provided misleading information in order to induce issuance of the loan guaranty. The agency had concerns that the lender could not support its compliance with the conditional commitment requirements that the project was completed with available funds and provided lumber in the quantity proposed in the application. OGC recommended that RD perform a review to determine if the lender certified to misleading information. On June 7, 1999, the RD staff visited the lender and discussed the pending submission of a subsequent guaranteed loan request of $1.5 million, and performed a brief review of the bank's credit files. On the same day (June 7, 1999), the RD reviewer wrote a memorandum to the file which stated (1) review of advance versus itemized bills found the two consistent and expense items appeared eligible, and (2) no documentation was noted in the lender's credit file which was inconsistent with representations made to RD.

We found no evidence that the RD reviewer made any reviews, inquiries, etc., to determine if the terms of the conditional commitment were complied with. The RD reviewer told us that it was not determined, as part of the review, whether or not the conditional commitment requirements were met.

On December 29, 2000, RD paid Lender A an estimated loss claim of $3,706,908. As of February 1, 2002, the lender had not filed a final loss claim. However, the lender's certification that the conditional commitments were met, when they were not, should be grounds for rescinding the loan note guarantee or substantially reducing the loss payment.

RECOMMENDATION NO. 1

In consultation with the OGC, rescind the loan note guarantee or substantially reduce the $3,706,908 loss payment due to the lender's failure to exercise due diligence in ensuring that the construction of the sawmill was properly planned, designed, and equipped with available funding to produce the quantities of lumber sufficient to meet debt service.

RD Response

In its December 5, 2002, written response, RD stated the following:

> *We have met with the National Office OGC and have been advised that the Loan Note Guarantee cannot be determined unenforceable due to negligent servicing by the lender. Furthermore, the lender's lack of due diligence during the processing of the loan may be used to deny the Loan Note Guarantee or reduce the guaranteed loan loss payment only when such action, or lack thereof, can be linked to either a material noncompliance with the governing regulation or terms of loan approval as provided in the Conditional Commitment for Guarantee and/or fraud or misrepresentation of which the lender had knowledge, condoned, and participated in. However, the Rural Business-Cooperative Service (RBS) National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to determine to what extent the loss payment can be reduced due to the lack of due diligence during loanmaking and negligent servicing by the lender. Upon such determination, the State Office is to notify the lender of the finding and proceed to reduce/recover the amount of the loss, if any, occasioned by the lender's negligent servicing. Notification to the lender on action regarding this recommendation will be completed not later than May 31, 2003. * * **

OIG Position

To achieve management decision, we will need (1) the results of the OGC determination including the amount that the loan note guarantee will be reduced and (2) documentation that the lender has been billed for the loss payment reduction.

RECOMMENDATION NO. 2

Establish controls to ensure future projects involving new development be designed and the cost be estimated by an independent professional (i.e., engineer) using accepted engineering and design practices.

RD Response

In its December 5, 2002, written response, RD stated the following:

> *RD Instruction 4279-B, section 4279.156(a), provides for all project facilities to be designed utilizing accepted architectural and engineering practices and conforming to applicable Federal, State, and local codes and requirements. The Agency will consult with OGC to determine if this instruction provides the latitude to develop an Administrative Notice (AN) to clarify that such architectural and engineering practices include cost estimates by an independent professional. If this option is utilized, the AN will be developed and issued by March 31, 2003. In the event an AN is not feasible, then the Agency will revise RD Instruction 4279-B, section 4279.156(a), to incorporate the recommendation of the OIG. If this option is utilized, the Rural Development Instruction will be developed as a proposed rule to be published in the Federal Register by December 31, 2003. * * **

OIG Position

Use of an AN to implement the recommended actions is an acceptable interim measure. However, the recommended actions should be permanent requirements incorporated into RD's instructions. To achieve a management decision, we will need clarification from RD that the recommended actions will be incorporated into RD's instructions.

RECOMMENDATION NO. 3

Implement controls to ensure that lenders have construction progress inspections made by a qualified inspector prior to making progress payments in the future.

RD Response

In its December 5, 2002, written response, RD stated the following:

> *RD Instruction 4279-B, section 4279.156(b)(1), provides that the Agency will normally expect the lender to have inspections made by a qualified individual prior to any*

*progress payment. The Agency will consult with OGC to determine if this instruction provides the latitude to develop an AN to clarify that the lender is directed to comply with this provision. If this option is utilized, the AN will be developed and issued by March 31, 2003. In the event an AN is not feasible, then the Agency will revise RD instruction 4279-B, section 4279.156(b), to incorporate the recommendation of the OIG. If this option is utilized, the Rural Development Instruction will be developed as a proposed rule to be published in the Federal Register by December 31, 2003. * * **

OIG Position

Use of an AN to implement the recommended actions is an acceptable interim measure. However, the recommended actions should be permanent requirements incorporated into RD's instructions. To achieve a management decision, we will need clarification from RD that the recommended actions will be incorporated into RD's instructions.

FINDING NO. 2

LOAN SECURITY WAS INADEQUATE

The lender did not ensure that the value of collateral securing the guaranteed loans was sufficient to cover losses. The loan collateral that originally appraised for $10.9 million sold for only $1,186,174. As of February 2002, a final loss claim had not been filed, however, losses in excess of $4.7 million were expected for which RD could be liable for 80 percent. The loan was under-secured primarily because the lender's appraisal of machinery and equipment collateral was based on an inappropriate valuation approach. Although the sawmill had not been constructed, and therefore, had no production or income history, the machinery and equipment was appraised as if it were part of a going concern for sale. Further, real estate security originally appraised at $1.2 million sold for only $657,034 because the appraised value was materially overstated.

RD instructions[4] provide that the lender is responsible for ensuring that appraisal values adequately reflect the actual value of the collateral. Instructions provide that chattels will be evaluated in accordance with normal banking practices and generally accepted methods of determining value. This regulatory requirement is important because sufficient collateral minimizes the risk of loss to the Government in the event that a loan cannot be repaid. Regulations[5] require sufficient collateral value to reasonably assure repayment of the loan.

[4] RD Instruction 4279.144 dated December 23, 1996.
[5] RD Instruction 4279.131 (b) dated December 23, 1996.

A significant disparity existed between the appraised values of the collateral at loan closing and the value of the collateral at the time of liquidation. Security for the initial $3 million loan was 99 acres of land with 2 existing buildings, a purposed 50,000 square foot building that would house the sawmill, 223 pieces of used machinery and equipment that the borrower owned at that time, plus new machinery and equipment to be purchased with loan funds. An October 2, 1996, appraisal, valued the 99 acres and the existing and purposed buildings at $725,000. On March 20, 1997, RD rejected the appraisal because of various discrepancies and required the lender to obtain another appraisal. On April 22, 1997, the borrower purchased the 99 acres of land, with the 2 existing buildings for $250,000. County property tax records for 1998, assessed the value of the property at $217,561 (land $120,171 and existing buildings $97,930.) On January 18, 1999, the lender obtained a second appraisal that valued the property with the purposed 50,000 square-foot sawmill building at $1,230,000 based on the construction cost approach.

The October 10, 1996, appraisal showed the value-in-use of the 223 pieces of used equipment at $1,522,887. This equipment was to be installed in the new sawmill. The in-use value was the appraiser's projected value of what the equipment would be worth after it was installed and the sawmill was complete. The appraiser defined value-in-use as assets used as an integrated part of an operating enterprise with consideration given to the age, condition and utility, and the used market but without consideration as to whether the earnings justify an investment in the assets' amount.

Because the original $3 million loan was insufficient to complete construction, on September 15, 1998, a subsequent loan of $2 million was approved. Inventory, accounts receivables, and equity on 224 acres of farmland in Coweta County, Georgia, were added as collateral. In addition, a second appraisal was obtained for the machinery and equipment, which valued it at $8,643,000.

Table 7 shows the variance between the appraisal values at loanmaking and the liquidation sale proceeds for the collateral.

Table 7

Collateral	Appraised Value		Sale Proceeds		Variance
	Amount	Date	Amount	Date	
99 Acres	$145,000	1/18/99	$157,000	8/16/01	$12,000
Sawmill Building	1,085,000	1/18/99	16,000	2/28/01	(1,069,000)
224 Acres	1,050,000	8/5/98	500,034	4/01	(549,966)
Machinery & Equipment	8,643,000	6/5/98	513,140	02/28/01	(8,129,860)
Totals	**$10,923,000**		**$1,186,174**		**$(9,736,826)**

As of December 20, 2000, the principal and interest owed after the loan default was $5,901,007. However, the collateral sold for only $1,186,174 resulting in losses of $4,714,833 ($5,901,007 - $1,186,174) not including fees, etc., associated with liquidation.

Our review showed the following deficiencies and issues regarding appraisal valuations for the machinery and equipment, 224 acres, and sawmill building.

- <u>Machinery and Equipment</u> - The loan was under-secured primarily because the appraisal approach valued the machinery and equipment as being installed in a going concern rather than valuing the collateral based on liquidation or auction value for repayment of the loan in the event of default. Although the sawmill had not been constructed, and therefore, had no production or income history, the lender had the machinery and equipment appraised as if it were installed in a going concern for sale.

  In order to obtain the second loan guarantee, on June 5, 1998, an appraiser, different from the one who performed the October 10, 1996 appraisal, evaluated the machinery and equipment. The second appraisal estimated the market value of the equipment at $8,643,000 based on an in-place and in-use approach. The machinery and equipment sold at the auction for only $513,140.

  After the borrower defaulted, Lender A requested the appraiser to explain the difference in value between the June 5, 1998, appraisal (second appraisal for $8,643,000) and a June 14, 2000, appraisal for liquidation purposes. The liquidation appraisal valued the machinery and equipment at $709,000. In a December 13, 2000, letter, the appraiser stated:

  > *The most important difference is the fact that the first appraisal was an in-place in-use appraisal and now the plant is shut down. As you know at an auction we cannot retrieve any of the high cost of concrete work, electrical installation, engineering, or installation labor. These are costs that need to be recouped from operating. Unfortunately this plant did not operate long enough to help in this area.*

  The June 5, 1998, appraisal was performed by a firm experienced in appraising sawmills. The appraiser told us he explained the various methods of appraising the property to the lender and was told to use the in-place, in-use method. He stated that he is not often asked to use this method. He said the advantage of using this method results in a substantially higher appraisal. The lender stated that the business had to be valued as a going concern in order to make the loan.

The appraisal process includes several approaches for establishing value and weighing those approaches to develop a final opinion of value. To make an informed decision on the value of the collateral, the lender should have required appraisal reports that included more than one valuation approach. Use of the fair market value in-place, in-use approach may be acceptable for appraising the value of a business offered for sale as a profitable going concern. However, it is not appropriate for assessing future value of special use collateral, located in a rural area, in the event of loan default when the business is not a going concern.

- <u>224 Acres</u> - To obtain the second loan, the borrower pledged equity in another 224 acres he owed. On August 5, 1998, the 224 acres were appraised at $1,050,000. A first lien was attached to the property to secure a mortgage balance of $273,000 the borrower owed another lender. The equity left as security for the guaranteed loan was $777,000. The property sold for $500,034. After paying off the first mortgage, which had grown to $311,500, the net realized proceeds left to apply to the guaranteed loans was only $188,534.

The $1,050,000 value assigned to the 224 acres was materially overstated because of a defective appraisal. After foreclosure, the 224 acres were listed for sale with a real estate broker. At that time, the broker obtained another appraisal that valued the acreage at $566,000 – – a disparity of $484,000 (46 percent).

In a February 3, 2001, letter to RD, Lender A stated that the original appraised value of $1,050,000 was overstated because the properties that the first appraiser used as comparables were not representative of the 224 acres.

<u>Sawmill Building</u> - Although loan funds of $836,786 were used to construct the sawmill building, it was sold as salvage for only $16,000 – – a loss of $822,786. The purchaser disassembled and removed it from the site.

RECOMMENDATION NO. 4

To the extent that the loss payment is not recovered in Recommendation No. 1, recover it due to the lender's failure to obtain security of sufficient value to cover loss.

RD Response

In its December 5, 2002, written response, RD stated the following:

> *The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to determine to what extent the loss payment can be reduced based on the lender's failure to obtain security of sufficient value to cover the loss. Upon such determination, the State Office is to notify the lender of the finding and proceed to reduce/recover the amount of the loss, if any, occasioned by the lender's failure to obtain sufficient collateral to cover the loss. Notification to the lender in regard to this recommendation will be completed no later than May 31, 2003. * * **

OIG Position

To achieve management decision, we will need (1) the results of the OGC determination including the amount that the loan note guarantee will be reduced and (2) documentation that the lender has been billed for the loss payment reduction.

RECOMMENDATION NO. 5

Evaluate options and implement an appraisal process for realistically valuing a startup manufacturing business with specialized machinery and equipment. Options may include deep discounting of going concern appraisals or reduced guarantee percentages for such appraisals.

RD Response

In its December 5, 2002, written response, RD stated the following:

> *The Agency agrees with this recommendation. Revisions to RD Instruction 4279-B will be published as a proposed rule in the <u>Federal Register</u> to address this recommendation by December 31, 2003. * * **

OIG Position

We agree with the management decision.

FINDING NO. 3

LOAN COLLATERAL WAS MISSING

Lender A did not account for all machinery and equipment items when liquidating the collateral. This occurred because the lender did not keep a list of new machinery and equipment items acquired with loan funds, reconcile machinery and equipment collateral items with those sold at liquidation, and account for missing items. In addition, the lender did not attempt to collect outstanding receivables after the loan was foreclosed. Liquidation proceeds were reduced as the missing equipment items, originally valued at $610,500, and a receivable of $3,598 were not applied to the loan.

Lenders are required to develop a plan for liquidation of all loan collateral.[6] The plan should provide for maximizing collection of the indebtedness and actions for acquiring and disposing of all collateral.

Equipment Missing - The State of Georgia Financing Statement, Form UCC-1, showed that the borrower pledged 223 pieces of equipment valued at $1,522,887 as collateral for the loan. (See table 8.)

Table 8

	Appraised Value At Loan Making 10/16/96	
	No.	**Amounts**
Gear Boxes	42	$84,700
Electrical	69	185,400
Motors	49	62,250
Sawmill Equipment	24	667,400
Construction Equipment & Building Material	25	124,887
Decks	4	51,500
Planer Equipment	6	248,500
Band Saws and Filing Equipment	4	98,250
Totals	**223**	**$1,522,887**

In addition, new machinery and equipment purchased with loan funds was also to serve as collateral for the loan. The lender did not keep an accounting of additional machinery and equipment items that were purchased with loan funds. On June 14, 2000, the machinery and equipment was appraised for liquidation at $709,000.

On February 28, 2001, the machinery and equipment was sold at the auction for $513,140.

[6] RD Instruction 4287.157(b) dated December 23, 1996.

We compared the collateral items shown on the Form UCC-1 with those sold at the auction and found 53 pieces originally valued at $586,701 that were missing. (See table 9 and exhibit C.)

Table 9

Items	No. of Items on UCC-1	Appraised Value (10/10/96)	No. of Items Sold at Auction	Unaccounted for Items	
				No.	Value
Gear Boxes	42	$ 84,700	0	42	$ 84,700
Sawmill Equipment	24	667,400	15	9	412,000
Planer Equipment	6	248,500	4	2	90,000
Total	**72**	**$1,000,600**	**19**	**53**	**$586,700**

We also compared the list of equipment items shown on the June 14, 2000, liquidation appraisal with those sold at the auction and found 6 items valued at $23,800 that were missing. (See table 10.)

Table 10

Item	No. of Items	Appraised Value (6/14/00)
90” Hourglass Roll Case	1	$ 8,500
20’Ladder Back Log Conveyor	1	3,500
Manual Mar Lift	1	1,200
36'x24" Belt Conveyor	1	2,500
Double Bunk Log Trailer	1	4,600
Indelco Screw Compressor SN P632686	1	3,500
Total	**6**	**$23,800**

The lender believed that most of the unaccounted machinery, equipment and an undetermined amount of other machinery and equipment acquired with loan funds was incorporated into the sawmill as components of larger systems during construction but no separate accounting was made of each component's disposition.

<u>Outstanding Account Receivable Not Collected</u> - The lender did not attempt to collect outstanding receivables after foreclosing on the loans. As of June 15, 2000, the borrower's records showed that 5 customers owed $15,208. The lender did not contact the customers to attempt collection. Our contacts with the five customers showed that four had paid their bills but the borrower had not posted the payments to their accounts. The other customer reported that the borrower had not billed for a May 22, 2000, delivery totaling $3,598. When we brought it to the lender's attention, the $3,598 was collected from the customer and applied to the loan account. The lender stated that because of the small amount of the receivables, it did not take any action to collect on them.

RECOMMENDATION NO. 6

To the extent that the loss payment is not recovered in Recommendation No. 1, reduce the guaranteed amount paid to Lender A by the $610,501 of collateral not accounted for at liquidation.

RD Response

In its December 5, 2002, written response, RD stated the following:

> *The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to develop a notification to the lender to reduce the loss payment by $601,501, based on the lender's failure to account for collateral equal to that amount during liquidation to the extent that the loss payment is not recovered in Recommendation No. 1. Notification to the lender regarding this recommendation will be completed not later than May 31, 2003. * * **

OIG Position

To achieve a management decision, we will need documentation that the lender has been billed for the questioned cost.

RECOMMENDATION NO. 7

Establish controls to ensure that lenders keep an inventory accounting of all collateral items and to reconcile the inventory of equipment items with those sold during liquidation.

RD Response

In its December 5, 2002, written response, RD stated the following:

> *RD Instruction 4287-B, section 4287.157(c), requires the lender to submit a written liquidation plan to the Agency prior to initiating liquidation of a borrower's loan. RD Instruction 4287-B, section 4287.157(d)(2), provides that the lender's liquidation plan is to include a full and complete list of all collateral including any personal and corporate guarantees. The Agency will consult with OGC to develop an AN to clarify and/or reiterate that the lender is to comply with this provision. The AN will be developed and issued by March 31, 2003. * * **

OIG Position

Use of an AN to implement the recommended actions is an acceptable interim measure. However, the recommended actions should be permanent requirements incorporated into RD's instructions. To achieve a management decision, we will need clarification from RD that the recommended actions will be incorporated into RD's instructions.

FINDING NO. 4

UNAUTHORIZED USE OF LOAN FUNDS

Lender A improperly applied $75,000 of guaranteed loan funds to an unguaranteed loan it had made to Borrower A. The lender disregarded the fact that conditional commitments did not provide for any loan funds to be used to repay the existing debt. As a result, the loss claim will be overstated $60,000 (80 percent) because of improper use of loan funds.

RD instructions[7] prohibit the agency from assuming an obligation for interim loans advanced before the conditional commitment is issued. Refinancing of interim loans is permitted only if RD approves an application that proposes the repayment of prior debts.

On September 13, 1996, the lender made a $75,000 loan to the borrower. On October 8, 1997, the $75,000 loan was repaid with interim financing funds that RD subsequently guaranteed. The borrower paid the accrued interest on the loan with personal funds. The lender stated that the borrower used the funds in the initial planning of the project. Neither the initial nor subsequent loan application, or conditional commitments provided for using loan funds to repay the $75,000 debt.

RECOMMENDATION NO. 8

To the extent that the loss estimated payment is not recovered in Recommendation No. 1, recover from Lender A 80 percent ($60,000) of the $75,000 that was advanced to the borrower prior to the issuance of the conditional commitment.

RD Response

In its December 5, 2002, written response, RD stated the following:

> *The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC in the development of a notification to the lender to reduce the loss payment by $60,000, based on the lender's advance of $75,000 to the borrower prior to the*

[7] RD Instruction 4279.113, dated December 23, 1996.

*issuance of the Conditional Commitment, to the extent that the loss payment is not recovered in Recommendation No. 1. Notification to the lender regarding this recommendation will be completed no later than May 31, 2003. * * **

<u>OIG Position</u>

To achieve a management decision, we will need documentation that the lender has been billed for the questioned cost.

CHAPTER 2	RD AND LENDERS WERE DELINQUENT IN THEIR MONITORING RESPONSIBILITIES

FINDING NO. 5

RD did not (1) ensure that the lenders submitted their annual written reports on borrowers' financial health and (2) make annual lender visits timely to monitor their loan servicing actions. As of January 11, 2001, the RD State office tracking system showed that (1) lenders were delinquent in providing the agency with the annual reports and financial statements for 28 of 67 borrowers and (2) the agency was delinquent in making annual visits to lenders servicing 22 of the 67 borrowers. RD stated the loans for many of the borrowers for whom the annual reports and visits were overdue were delinquent or in liquidation and, in those cases, it was difficult for the lenders to obtain financial statements from the borrowers. RD also stated that its files contained documentation of its work with the lenders servicing the subject loans. Without timely financial analyses, neither lenders nor RD can properly monitor the fiscal condition of borrowers to determine if they are in compliance with terms of the loan.

<u>Annual Lender Reports</u> - RD instructions[8] state that

> ** * * The lenders must obtain from the borrower and forward to the agency the financial statements required by the Loan Agreement. The lender must submit annual financial statements to the agency within 120 days of the end of the borrower's fiscal year. The lender must analyze the financial statements and provide the agency with a written summary of the lender's analysis and conclusions, including trends, strengths, weaknesses, extraordinary transactions, and other indications of the financial conditions of the borrower.*

Information in the State office's tracking system showed that as of January 11, 2001, annual reports with accompanying financial statements had not been received from lenders responsible for 28 of the 67 borrowers. The 28 borrowers had loans totaling $90.1 million. All of the reports were overdue for at least one year and in some cases no reports had been received for 4 consecutive years. (See table 11.)

[8] RD Instruction 4287.107©, dated December 23, 1996.

Table 11

Last Year of Report	No. of Borrowers	Amount	No. of Borrowers Current	Delinquent	In Liquidation
None	16	$ 49,033,200	12	3	1
1997	1	3,925,000	0	1	0
1998	11	37,099,200	6	3	2
Total	**28**	**$90,057,400**	**18**	**7**	**3**

RD stated that the ability to obtain annual financial statements from delinquent borrowers and those in liquidation was difficult. We agree with RD for those accounts in liquidation. However, for delinquent accounts, the annual reports are even more important.

An example of an overdue report follows:

> The borrower received a loan in the amount of $3,360,000 on October 8, 1998, to refinance an existing debt and complete construction on a medical office building. The conditional commitment required year-end audited financial statements of the business and personal financial statements of the borrower. The lender was supposed to analyze the statements and provide RD with a written summary of the analysis and conclusions. The agency has never received an annual report and financial statement from the lender since the loan was made. As of January 31, 2001, the loan balance was $3,423,780 and the borrower was past due $69,080.
>
> RD stated that the project encountered construction delays which slowed rent up. The borrower was focused on completing spaces for occupancy and soliciting tenants. RD further stated that the facility was not occupied by enough tenants to provide debt-service coverage and was obvious without the financial statements.
>
> Businesses must have periodic financial statements and, in the case of loan C, audits of those statements as well as the borrower's personal financial statements were required. The fact that the loan was delinquent is even more reason for compliance so that the financial circumstances of both the business and borrower would be monitored.

<u>Annual Servicing Visits to Lenders</u> - RD instructions[9] places responsibility on the lender for servicing guaranteed loans and taking all necessary servicing actions. RD is responsible for ensuring that the lender is servicing the loan in a prudent manner as required by the lender's agreement, the regulations

[9] RD Instruction 4287.107, dated December 23, 1996.

governing the program, and loan documents. To accomplish this, the instructions require that the agency hold meetings with the lender at least annually and at a minimum remind the lender of its servicing responsibilities, review the lender's latest financial analysis, check the loan classification, and review the application of loan payments. The results of the visits are to be documented. Annual lender servicing visits are intended as a preventive rather than curative measure to identify servicing problems early and take corrective actions.

As of January 11, 2001, the State office's tracking system showed that RD had not made the annual visits to lenders servicing 22 of the States' 67 borrowers. All of the visits were overdue for more than a year and in some cases a visit had not been done since the loan was made. (See table 12.)

Table 12

Year Last Visit Made	No. of Borrowers	Loan Amount	No. of Borrowers		
			Current	Delinquent	In Liquidation
1999	12	$ 34,146,400	8	2	2
1998	3	3,480,000	2	0	1
1997	1	5,000,000	0	0	1
None	6	19,546,000	3	2	1
Totals	**22**	**$ 62,172,400**	**13**	**4**	**5**

For accounts in liquidation, RD stated annual lender visits were not determined because its staff was working with and documenting on going concerns/issues with lenders regarding liquidation. We agree with RD for those loans in liquidation. However, in the case of delinquent accounts, RD visits to lenders is even more important to ensure proper lender servicing due to the increased risk of losses.

RECOMMENDATION NO. 9

Require all lenders whose annual reports are overdue to submit them within 60 days or provide sufficient evidence to support that they have exhausted full faith efforts in attempting to obtain them from the borrowers. Those lenders that do not comply should be put on notice that failure to timely provide copies of borrowers' annual reports is considered negligent servicing and could cause the loan guarantee to be unenforceable.

RD Response

In its December 5, 2002, written response, RD stated the following:

We have met with the National Office OGC and have been advised that the Loan Note Guarantee cannot be made *unenforceable due to negligent servicing by the lender. RD Instruction 4287-B, section 4287.107(d), requires the lender to obtain and forward to the Agency the financial statements required by the Loan Agreement within 120 days of the end of the borrower's fiscal year. The Agency will consult with OGC to develop an AN to clarify and/or reiterate that the lender is to comply with this provision. Furthermore, the Agency will include direction that the lender is to either submit any overdue borrower financial reports within 60 days of the date of notification or provide sufficient evidence to support that they have exhausted all full faith efforts in attempting to obtain them from the borrower. Lenders who do not comply will be notified that they may be negligent in servicing the borrower's loan, and that any loss occasioned by such negligent servicing will result in reduction of any loss payment request. The AN will be developed and issued by March 31, 2003. * * **

OIG Position

We agree with the management decision.

RECOMMENDATION NO. 10

Establish a control mechanism to ensure annual lender visits are made and documented.

RD Response

In its December 5, 2002, written response, RD stated the following:

*The Agency's Rural Development Application Processing Tracking System contains a field for tracking the requirement of RD Instruction 4287-B, section 4287.107(c), for annual Agency conferences with the lender on the condition of the borrower's loan. The Agency will develop an AN to Rural Development State Offices, not later than May 31, 2003, reiterating this requirement and monitor compliance at least semiannually on June 30 and December 31 each year. * * **

OIG Position

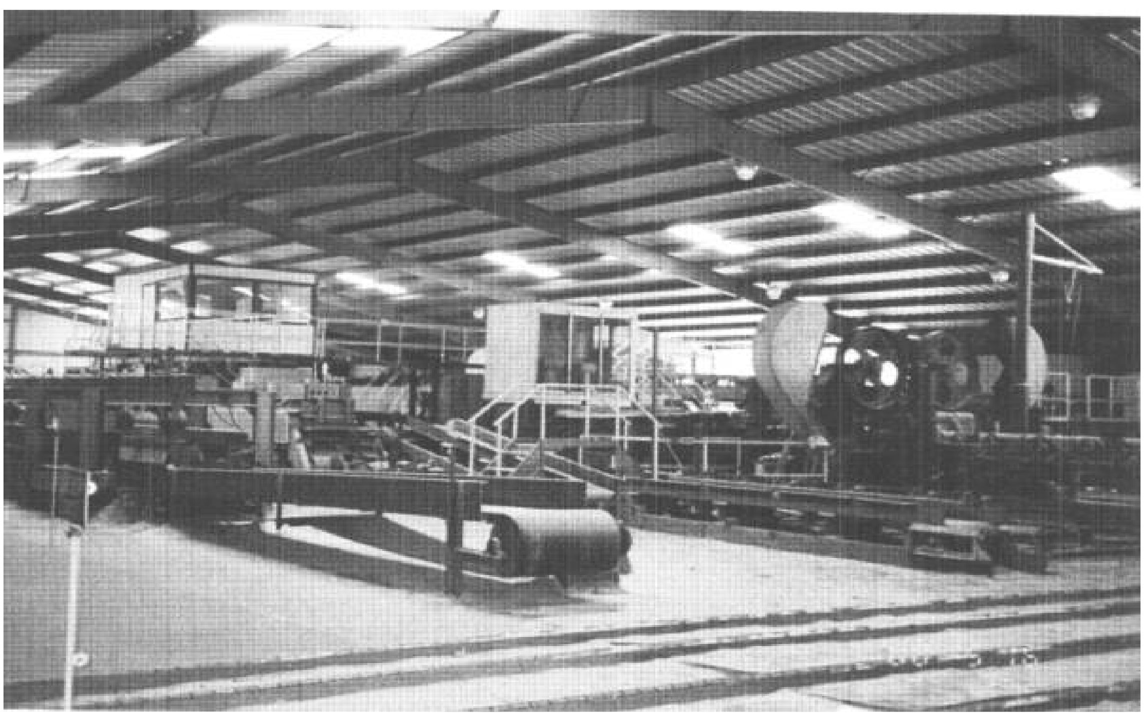
We agree with the management decision.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

Recommendation No.	Description	Amount	Category
1, 4, & 6	Lender A was deficient in ensuring terms of the conditional commitment were met and loan collateral was sufficient.	$ 3,706,908	Questioned costs/loan guarantees, recovery recommended
8	Lender A used B&I loan funds of $75,000 to repay a prior debt Borrower A owed.	$60,000	Questioned cost/loan guarantees, recovery recommended.
	Total	**$3,766,908**	

EXHIBIT B – EXTERIOR AND INTERIOR PHOTOGRAPHS OF SAWMILL

Exterior of Sawmill



Interior of Sawmill

EXHIBIT C - DISCUSSION OF DESIGN AND MACHINERY AND EQUIPMENT PROBLEMS

In the January 2000, application package for the $6,460,000 direct loan from RD, Borrower A discussed the sawmill's background, production problems, production capacity (at that time), and resources needed to achieve a production level to be profitable. In the package, the borrower detailed equipment and design problems that prevented meeting necessary production levels and the additional equipment needs to increase production. In the letter transmitting the package to RD, the Chief Financial Officer for the borrower stated, in part, the following.

> ** * * I want to apologize for our inexperience in estimating the true cost of this project from the beginning and for certain mistakes that could have been avoided. Although it is now clear that the project could never be financed for the original amount, I feel * * * company continues to represent a viable long-term business investment. Therefore this package focuses on the potential of the business once the project has been finalized.* * **

The application stated, in part, the following.

> *Background*
>
> *During June 1997, * * * received approval to begin constructing a sawmill in * * * Georgia. Throughout the approval process (which began with different lenders), the size of the project was scaled back from around $10 million to approximately $4 million. Management believed they could construct a profitable mill without some of the planned equipment until future operating profits would enable the equipment to be installed. The revised estimates did not properly consider the substantial cost that were required to build the base of a mill that could ultimately support all of the originally designed equipment. * * **
>
> * * * * * * * * *
>
> *Production*
>
> ** * *completed the first stage of construction on the sawmill in March 1999. In order to begin production with the*

*approved funding, the mill was scaled back substantially and did not include a gang, head rig, stack track or timber deck * * **

* * * * * * * * *

Current Capacity

** * * Specifically, there are a number of reasons why the mill will never be able to be a viable operation in its current state (i.e., fund the debt service). In order to understand the varying levels of production at the mill, it is essential to know that the majority of the loss in production is attributable to machinery downtime. However, the amount of lumber that can be processed through the trimmer/edger system is limited due to the design of the system and management believes this limitation will not allow an average of 80,000 feet a day even if the machinery downtime was reduced to a reasonable level. A majority of our down time is currently due to lack of logs at the chip-n-saw. This is primarily due to problems encountered with the log deck, the cut-up saw and the de-barker. In addition to these key problems, we are unable to stack the lumber on the green chain when production is at 10,000 feet per hour. Finally, * * * cannot process the larger logs through the chip-n-saw * * **

* * * * * * * * *

Additional Capacity

When the mill was originally designed, it included two log decks, a head rig, timber deck, stack track and a drop sorter. None of these items was completed due to the lack of funds but the layout of the mill did not change. The amount of funds needed to complete the additions is estimated to be approximately $2.4 million. Estimates will be obtained for the majority of the work prior to completion. Due to the subjectivity of estimating, fluctuation in the amount of funding should be considered as all of the additions listed below need to be made in order to operate the mill effectively.

Below is a description of each major addition and the effect on production.

- *Head rig - * * * has the equipment but the computer system and installation must be completed. This will allow the mill to cut the larger (higher-grade) logs that are currently being purchased and accumulating on the yard. In addition, the head rig will cut the logs currently being forced into the chip-n-saw but actually appropriate for the head rig thus increasing the yield on these logs. This will also allow us to have an alternate source for the mill when the chip-n-saw is not running. This is by far the most key operational addition to the mill as we cannot process all of the logs being purchased; however, the other changes are needed to handle the increased production from the head rig as well as the existing operations. We estimate that the head-rig will provide 40,000 feet of production. In addition, the chip-n-saw should produce at least 10,000 feet more of production as only the logs designed for the chip-n-saw will be processed in the chip-n-saw.*

- *Chip-n-saw optimization - The chip-n-saw does not have a working optimization system in place and must be run manually. During construction, a sub-standard system ($20,000) was attempted but was unsuccessful. In order to increase yield and productivity and substantially reduce the re-work lumber being produced, optimization at the chip-n-saw is a necessity. In addition, we will be changing the type of knives at the chip-n-saw as the current knives produce too much re-work lumber*

- *Pre-positioner for gang -The gang does not have a pre-positioner or a lone bar and therefore lumber is wasted on nearly every cant and the amount of cants that can be run through the gang is reduced significantly. This system is new and will partially optimize the gang as well as increase the capacity to accommodate the cants from the head rig. The optimizing will increase the yield at the gang significantly.*

- *Timber line -The timber line will allow * * * to cut timbers (6x6 and larger) and increase production without going through the trimmer/edger system. In addition, timbers will increase the yield as the saw kerf is reduced substantially.*

- *Stack Tack -Currently cants (3½ x6' or 8's) are being hand-stacked on the green chain. This requires additional personnel and reduces the amount of separations for lumber. * * * already owns the equipment but the equipment must be installed. We considered installing a stack track and a timber line stacker but we decided on the drop sorter. Once we discussed the installation with a contractor we determined that the stack track and timer line were only short-term fixes and not the long-term plan. The drop sorter has 37 bays and will be sufficient to stack the cants. timbers and pallet lumber. This will cut down on the number of personnel and ensure the green chain can handle the lumber being produced. Although the cost is approximately $100K higher than the stack track/timber line, we feel the payback is less than one year and therefore the drop sorter should be installed.*

- *Rosser head de-barker will allow larger short logs to be processed while providing an alternative to the current de-barker when it is broken down. In addition, this de-barker will serve as a swell butt reducer. The combination of the second de-barker and the loaders listed below should correct our primary problem of supplying logs to the mill. For one month, the log deck caused 50% of the down time in the mill.*

- *Loaders - Two loaders will be installed to feed into the de-barkers. The current system has been a problem since the beginning and this should cut down our biggest problem with getting logs to the mill.*

- *Edger modifications - The in-feed system to the edger will be modified and a storage chain will be added to allow the bottleneck of the manufacturing system to be relieved. More specifically, the in-feed to the* *edger currently only holds three boards but will be changed to hold six boards. In addition, the storage chain will allow the trimmer to run for a period of time while the edger is down. In addition, to these modifications, we feel a separate optimization system (it currently operates the trimmer system) must be installed for the edger to handle the increased volume. The installation of the optimizer will allow the speed of the trimmer and edger to be increased significantly and the edger will no longer have to be run semi-automatic.*

- *Misc. - The other additions are to correct known problems that are preventing * * * from exceeding 60,000 everyday. If left alone, these problems will increase as the production increases.*

- *Parts - As part of the additions, a parts inventory of between $50,000 and $75,000 will need to be maintained to reduce the amount of down time incurred each day. This will significantly enhance production.*

EXHIBIT D – COLLATERAL ITEMS NOT ACCOUNTED FOR AT LIQUIDATION

Item	Appraised Value At Loan Closing 3/2/99
Dodge Gear Box Serial #246151-SK	$2,000
Falk Gear Box model 2100YB2-L	9,500
Western Ratio Bear Box #3015	5,500
Falk Gear Box SN B-873909	2,500
Falk Gear Box SN B-873908	2,500
Falk Gear Box model 2115J-25 Shaft Mount	1,500
Western Ration Gearbox #3037	4,500
Falk Gear Box Model 102-5EX2-06A9	4,500
Western Ratio Bear Box #8208 Serial #3039	4,500
Western Ratio Bear Box #8208 Serial #3038	5,500
Falk Gear Box Model 4EZ-06A	2,000
Falk Gear Box Model 7.52-4EZ2-06A	2,000
Falk Gear Box Model 4EZ2-06A	500
Falk Gear Box Model 7-139721-09	1,100
Falk Gear Box Model 102-5EZ2-06A9	2,500
Falk Gear Box Model 7.52-4EZ2-06A9	2,000
Falk Gear Box Model 4EZ-06A	2,500
Falk Gear Box Model 12-4E2-06AS	250
Falk Gear Box Model 102-5EZ2-06A9	2,500
Falk Gear Box Model 102-5EZ2-06A9	2,500
Radicon Gear Box #R10056/80	250
Morse Gear Box 1750 RPM	4,500
230 Volt 3 phase gear head (3 units)	2,100
10/HP 1800/RPM	1,500
2 HP 1725 RPM Gear Head	500
Browning 3 # P 1725 RPM Gear Head	600
C Face Motor W/Gear Box and Brake	1,500
Radicon Gear Box Small	300
Falk Model 102-5EZ06A9 10/hp Serial #B-873904	2,500
Western Gear Box 24.5 Ratio SN# 3037	5,000
Falk Model 2215-3	2,000
Reliance 2/HP Ratio 70	500
Browning 5/HP Ratio 40/1	300
48/1 Ratio 1.5/HP	200
Churchhill 6.4 Ratio 33.24/1	300
Churchhill 6.4 Ratio 33.24/1	300
Churchhill 6.4 Ratio 33.24/1	300
Perfection American 40/1	500
Reliance GB 2/HP Ratio 70	300
Reliance GB 2/HP Ratio 70	300
Dayton Motor and Gear	300
Perfection 2/HP 1735/RPM	$300

Item	Appraised Value At Loan Closing 3/2/99
American Standard Air Compressor	$20,000
Unscrambler 6 Strand 81 Chain Tall with even end	12,000
Cox 10" Water Gun Worthington Pump	12,000
Stowell 8' Band Mill & second 8' B and Mill for Parts	30,000
42' Roller Bed, 17 Roller 7' Long 8" Diameter with	8,000
28" White Concabe Chip Belt Roller Bed 55' Long	10,000
Infeed and Outfeed for Albany Band Saw	40,000
Bay LSI Drop Sorter	250,000
Fifteen (15) units of Tulsa Winches for Decks	30,000
Yates American A-20 Rebuild Planer	80,000
40 HP Sunstran Hydraulic System for Yates Planer	10,000
Total	**$586,700**

EXHIBIT E – RURAL DEVELOPMENT'S RESPONSE TO THE DRAFT REPORT

USDA

United States
Department of
Agriculture

Rural Development

Operations and
Management

Washington, DC
20250

DEC 12 2002

SUBJECT: Rural Development
Lender Servicing of Business and Industry
Guaranteed Loans in Georgia
(Audit No. 34601-004-AT)

TO: Richard D. Long
Assistant Inspector General
for Audit
Office of Inspector General

Attached for your review is the Rural Business-Cooperative Service's response to the official draft for the subject audit.

This response is being submitted for inclusion in the final report and your consideration to reach management decision on the recommendations.

If you have any questions, you may contact La'Shonda DeBrew of my staff at 692-0086.

Walter Wright for
SHERIE HINTON HENRY
Director
Financial Management Division

Attachment

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12/10/02

USDA

United States Department of Agriculture
Rural Development

Rural Business–Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

DEC - 5 2002

SUBJECT: Rural Development Lender Servicing of Business and Industry Guaranteed Loans in Georgia
Audit Report No. 34601-4-At

TO: Sherie Hinton Henry
Deputy Administrator for
Operations and Management

This is in response to the official draft findings and recommendations of the above-captioned Office of Inspector General (OIG) audit.

Recommendation No. 1:
In consultation with the Office of the General Counsel (OGC), rescind the Loan Note Guarantee or substantially reduce the $3,706, 908 loss payment due to the lender's failure to exercise due diligence in ensuring that the construction of the sawmill was properly planned, designed, and equipped, with available funding to produce the quantities of lumber sufficient to meet debt service.

Agency Response
We have met with the National Office OGC and have been advised that the Loan Note Guarantee cannot be determined unenforceable due to negligent servicing by the lender. Furthermore, the lender's lack of due diligence during the processing of the loan may be used to deny the Loan Note Guarantee or reduce the guaranteed loan loss payment only when such action, or lack thereof, can be linked to either a material noncompliance with the governing regulation or terms of loan approval as provided in the Conditional Commitment for Guarantee and/or fraud or misrepresentation of which the lender had knowledge, condoned, and participated in. However, the Rural Business-Cooperative Service (RBS) National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to determine to what extent the loss payment can be reduced due to the lack of due diligence during loanmaking and negligent servicing by the lender. Upon such determination, the State Office is to notify the lender of the finding and proceed to reduce/recover the amount of the loss, if any, occasioned by the lender's negligent servicing. Notification to the lender on action regarding this recommendation will be completed not later than May 31, 2003. A management decision is requested.

received
12/6/02

Recommendation No. 2:
Establish controls to ensure future projects involving new development be designed and the cost be estimated by an independent professional (i.e., engineer) using accepted engineering and design practices.

Agency Response
RD Instruction 4279-B, section 4279.156(a), provides for all project facilities to be designed utilizing accepted architectural and engineering practices and conforming to applicable Federal, State, and local codes and requirements. The Agency will consult with OGC to determine if this instruction provides the latitude to develop an Administrative Notice (AN) to clarify that such architectural and engineering practices include cost estimates by an independent professional. If this option is utilized, the AN will be developed and issued by March 31, 2003. In the event an AN is not feasible, then the agency will revise RD Instruction 4279-B, section 4279.156(a), to incorporate the recommendation of the OIG. If this option is utilized, the Rural Development instruction will be developed as a proposed rule to be published in the Federal Register by December 31, 2003. A management decision is requested.

Recommendation No. 3:
Implement controls to ensure that lenders have construction progress inspections made by a qualified inspector prior to making progress payments in the future.

Agency Response
RD Instruction 4279-B, section 4279.156(b)(1), provides that the Agency will normally expect the lender to have inspections made by a qualified individual prior to any progress payment. The Agency will consult with OGC to determine if this instruction provides the latitude to develop an AN to clarify that the lender is directed to comply with this provision. If this option is utilized, the AN will be developed and issued by March 31, 2003. In the event an AN is not feasible, then the Agency will revise RD Instruction 4279-B, section 4279.156(b), to incorporate the recommendation of the OIG. If this option is utilized, the Rural Development instruction will be developed as a proposed rule to be published in the Federal Register by December 31, 2003. A management decision is requested.

Recommendation No. 4:
To the extent that the loss payment is not recovered in Recommendation No. 1, recover it due to the lender's failure to obtain security of sufficient value to cover loss.

Agency Response
The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to determine to what extent the loss payment can be reduced based on the lender's failure to obtain security of sufficient value to cover the loss. Upon such

determination, the State Office is to notify the lender of the finding and proceed to reduce/recover the amount of the loss, if any, occasioned by the lender's failure to obtain sufficient collateral to cover the loss. Notification to the lender in regard to this recommendation will be completed not later than May 31, 2003. A management decision is requested.

Recommendation No. 5:
In consultation with OGC, evaluate options and implement an appraisal process for realistically valuing a startup manufacturing business with specialized machinery and equipment. Options may include deep discounting of going concern appraisals or reduced guarantee percentages for such appraisals.

Agency Response
The Agency agrees with this recommendation. Revisions to RD Instruction 4279-B will be published as a proposed rule in the Federal Register to address this recommendation by December 31, 2003. A management decision is requested.

Recommendation No. 6:
To the extent that the loss payment is not recovered in Recommendation No. 1, reduce the guaranteed amount paid to Lender A by the $601,501 of collateral not accounted for at liquidation.

Agency Response
The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC to develop a notification to the lender to reduce the loss payment by $601,501, based on the lender's failure to account for collateral equal to that amount during liquidation to the extent that the loss payment is not recovered in Recommendation No. 1. Notification to the lender regarding this recommendation will be completed not later than May 31, 2003. A management decision is requested.

Recommendation No. 7:
Establish controls to ensure that lenders keep an inventory accounting of all collateral items and reconcile the inventory of equipment items with those sold during liquidation.

Agency Response
RD Instruction 4287-B, section 4287.157(c), requires the lender to submit a written liquidation plan to the Agency prior to initiating liquidation of a borrower's loan. RD Instruction 4287-B, section 4287.157(d)(2), provides that the lender's liquidation plan is to include a full and complete list of all collateral including any personal and corporate guarantees. The Agency will consult with OGC to develop an AN to clarify and/or reiterate that the lender is to comply with

this provision. The AN will be developed and issued by March 31, 2003. A management decision is requested.

Recommendation No. 8:
To the extent that the estimated loss payment is not recovered in Recommendation No. 1, recover from Lender A 80 percent ($60,000) of the $75,000 that was advanced to the borrower prior to the issuance of the Conditional Commitment.

Agency Response
The RBS National Office will advise the Georgia Rural Development State Office to consult with the Atlanta Regional OGC in the development of a notification to the lender to reduce the loss payment by $60,000, based on the lender's advance of $75,000 to the borrower prior to issuance of the Conditional Commitment, to the extent that the loss payment is not recovered in Recommendation No. 1. Notification to the lender regarding this recommendation will be completed not later than May 31, 2003. A management decision is requested.

Recommendation No. 9:
Require all lenders whose annual reports are overdue to submit them within 60 days or provide sufficient evidence to support that they have exhausted full faith efforts in attempting to obtain them from the borrowers. Those lenders that do not comply should be put on notice that failure to provide copies of borrowers' annual reports is considered negligent servicing and could cause the loan guarantee to be unenforceable.

Agency Response
We have met with the National Office OGC and have been advised that the Loan Note Guarantee cannot be made unenforceable due to negligent servicing by the lender. RD Instruction 4287-B, section 4287.107(d), requires the lender to obtain and forward to the Agency the financial statements required by the Loan Agreement within 120 days of the end of the borrower's fiscal year. The Agency will consult with OGC to develop an AN to clarify and/or reiterate that the lender is to comply with this provision. Furthermore, the Agency will include direction that the lender is to either submit any overdue borrower financial reports within 60 days of the date of notification or provide sufficient evidence to support that they have exhausted all full faith efforts in attempting to obtain them from the borrower. Lenders who do not comply will be notified that they may be negligent in servicing the borrower's loan, and that any loss occasioned by such negligent servicing will result in a reduction of any loss payment request. The AN will be developed and issued by March 31, 2003. A management decision is requested.

Recommendation No. 10:
Establish a control mechanism to ensure annual lender visits are made and documented.

Agency Response
The Agency's Rural Development Application Processing Tracking System contains a field for tracking the requirement of RD Instruction 4287-B, section 4287.107(c), for annual Agency conferences with the lender on the condition of the borrower's loan. The Agency will develop an AN to Rural Development State Offices, not later than May 31, 2003, reiterating this requirement and monitor compliance at least semiannually on June 30 and December 31 each year. A management decision is requested.

If you have any questions or concerns, please contact Dwight Cannon, Director, Special Projects/Programs Oversight Division, (202) 690-4100.

John Rosso

JOHN ROSSO
Administrator