



U.S. Department of Agriculture



Office of Inspector General
Western Region

Audit Report

Rural Development Liquidation of Business and Industry Guaranteed Loans

Report No. 34601-8-SF
SEPTEMBER 2003



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



DATE: September 30, 2003

REPLY TO

ATTN OF: 34601-8-SF

SUBJECT: Rural Development - Liquidation of Business and Industry
Guaranteed Loans

TO: John Rosso
Administrator
Rural Business-Cooperative Service

THROUGH: John M. Purcell
Director
Financial Management Division

This audit report presents the results of our nationwide review of the Liquidation of Business and Industry Guaranteed Loans. Your written response to the draft report is included as exhibit C. Excerpts from your response and our position on the response are incorporated into the relevant sections of the report.

Based on your written response we have accepted your management decision on all of the recommendations except for Recommendation Nos. 4, 5, 8 and 9. To reach management decision on these recommendations please refer to the OIG position following each of these recommendations in the report.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned and the timeframes for implementation of those recommendations for which management decision has not yet been reached. Please note that the regulation requires a management decision to be reached on all recommendations within a maximum of 6 months from report issuance and final actions be taken within 1 year of management decision. Follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

We appreciate the cooperation and assistance provided by your staff during our audit.

\s\
RICHARD D. LONG
Assistant Inspector General
for Audit

Executive Summary

Rural Development - Liquidation of Business and Industry Guaranteed Loans (Audit Report No. 34601-8-SF)

Results in Brief

This report presents the results of our audit of Business and Industry (B&I) loan liquidations. The B&I program is designed to provide Federal guarantees for quality loans that commercial and other authorized lenders make to businesses to enhance employment opportunities in rural areas. When borrowers default on their loans and are not able to return to a current status, the lenders will liquidate collateral in order to minimize losses. For liquidations that are expected to exceed 90 days, the lenders must submit to the Rural Business-Cooperative Service (RBS) estimated loss claims, which stop interest accrual on loan principal. RBS has a process to monitor and control liquidations and to approve loss payments to lenders in accordance with the guarantees.

The objectives of our audit were to determine if (1) liquidations were conducted in accordance with the program's laws, regulations, and instructions; (2) internal controls over the liquidation process provided reasonable assurance that program losses were minimized; and (3) final loss claims were accurate and fully supported. We reviewed 10 judgmentally selected loans at 7 RBS State offices with final loss payments in fiscal year 2001. The total principal for these loans was about \$20 million.

In our review of the sampled loans, nothing came to our attention to indicate material weaknesses in RBS' controls over B&I loan liquidations. However, we concluded that RBS has an opportunity to reduce program costs by revising some of the procedures used in liquidations and by improving its process for reviewing final loss claims. Our audit indicates that such improvements would have reduced total loss payments of \$13,136,348 made to lenders for the 10 sampled loans by as much as \$818,121, or 6.2 percent (see exhibit A).

RBS needs to improve controls to minimize program losses:

- For 4 of the 10 liquidated loans, RBS State offices did not ensure that lenders filed claims for estimated loss payments or filed these claims in a timely manner. Estimated loss payments stop interest accrual on loan principal and, therefore, limit RBS' payments to lenders. Our review disclosed that the RBS National Office had not provided instructions that would ensure that estimated loss claims were filed in a timely manner. Timely estimated loss payments, for the four loans would have reduced the Government's share of final losses by as much as \$581,618.

- For 3 of 10 loans reviewed, RBS State offices authorized protective advances that lenders should not have been eligible to claim. The State offices authorized these advances because RBS program direction did not clearly state that lenders would not be able to claim protective advances after borrowers had voluntarily conveyed loan collateral in full satisfaction of their debts.

RBS may authorize lenders to make protective advances in order to preserve and protect loan collateral. Such advances typically include costs for insurance, taxes, utilities, and security. Protective advances accrue interest at the note rate and must constitute indebtedness of the borrower to the lender. When borrowers convey loan collateral to lenders, their debts are normally cancelled.

We questioned protective advances totaling \$199,428. However, we concluded that these advances would have qualified as liquidation expenses. Since liquidation expenses do not accrue interest, we took exception to \$16,494, the Government's share of the interest on the questioned protective advances.

RBS needs to improve controls over loss payment review:

- State offices approved final loss claims containing erroneous information. This occurred because RBS directives did not require sufficient review of loan payment history documents and because staff did not always follow prescribed review procedures. Undetected errors overstated the Government's share of final losses by \$45,246.
- A State office approved a final loss claim containing unsupported costs. Directives did not require RBS to obtain and review supporting documentation, even for cases with significant liquidation costs. In this case, unsupported protective advances plus associated interest overstated the Government's share of the final loss by \$174,763.

Recommendations In Brief

In order to strengthen controls over B&I loan liquidation and to address final loss overpayments, we recommend that RBS take the following corrective action: (1) Establish a control to ensure that lenders submit estimated loss claims upon agency approval of their liquidation plans, except when the sale of loan collateral is expected within 90 days, or when another date to end interest accrual is in the Government's best interest. (2) Provide clarification to ensure that State office staff do not authorize lenders protective advances when borrowers cannot incur additional debt. (3) Direct staff to recover from lenders \$45,246 for errors on final loss claims. (4) Supplement program direction to require that staff review lenders' records to confirm loan balances when the lenders do not provide documentation to support these balances with their liquidation plans. (5) Issue an Administrative Notice to

instruct State office staff to use the Final Loss Settlement Checklist. (6) Direct State office staff to recover from a lender \$174,763 for unsupported protective advances. (7) Establish dollar thresholds for total claimed liquidation expenses and protective advances, above which staff would obtain and audit supporting documentation.

**Agency
Response**

In its written response to the audit report, RD generally concurred with all findings and recommendations. The complete written response is shown in Exhibit C of the audit report.

OIG Position

We accept RD's management decision for all recommendations in this report except for Recommendation Nos. 4, 5, 8 and 9. In order to reach management decision for Recommendation Nos. 4, 5, and 8, RD must provide OIG with a copy of the Office of General Counsel's (OGC) determination and a copy of the corresponding bill sent to the lender. For Recommendation No. 9, RD has to provide to OIG a timeframe for implementing the recommendation.

Abbreviations Used in This Report

B&I	Business and Industry
OIG	Office of Inspector General
OGC	Office of General Counsel
RD	Rural Development
RBS	Rural Business-Cooperative Service
USDA	U. S. Department of Agriculture

Table of Contents

Executive Summary	i
Abbreviations Used in This Report	iv
Background and Objectives	1
Findings and Recommendations	3
Section 1: Controls Over the Liquidation Process	3
Finding 1 Claims for Estimated Loss Payments Were Not Filed in a Timely Manner	3
Recommendation No. 1	5
Recommendation No. 2	5
Finding 2 RBS Authorized Protective Advances for Which Lenders Were Not Eligible	6
Recommendation No. 3	7
Section 2: Controls Over the Loss Payment Review	8
Finding 3 Final Loss Claims Contained Erroneous and Unsupported Information	8
Recommendation No. 4	10
Recommendation No. 5	11
Recommendation No. 6	11
Recommendation No. 7	12
Recommendation No. 8	12
Recommendation No. 9	12
Scope and Methodology	14
Exhibit A – Summary of Monetary Results	17
Exhibit B – B&I Liquidated Loans Reviewed	18
Exhibit C – RBS Response to Draft Report	19

Background and Objectives

Background

The Rural Business-Cooperative Service (RBS), an agency within the U.S. Department of Agriculture's Rural Development (RD) mission area, operates the B&I Guaranteed Loan Program. The program provides guarantees backed by the full faith and credit of the Federal Government for quality loans that commercial and other authorized lenders make to businesses that enhance employment opportunities in rural areas. This guarantee provision is not intended for marginal or substandard loans or for relief of lenders having such loans. Proceeds from B&I loans may be used for working capital, machinery and equipment, buildings, real estate, and certain debt refinancing. The maximum loan that can be guaranteed under the B&I program is \$25 million.

In order to obtain the Government guarantee, which is usually between 70 and 80 percent of loan principal plus accrued interest, lenders must ensure that borrowers provide sufficient collateral to secure the loan and have the resources and ability to operate their businesses and make scheduled payments on their debt. Lenders are also responsible for all servicing actions to ensure that borrowers continue to make proper use of loan funds and maintain liens on loan collateral. Loan servicing responsibilities also require lenders to take prompt action in case of default to help borrowers return to a current status. Lenders must notify RBS of any delinquency that exceeds 30 days. If borrowers cannot or will not cure their default, lenders or RBS must liquidate the loan.

Once a lender makes the decision to liquidate, it must submit a detailed liquidation plan, which includes a current appraisal of loan collateral, to RBS. Upon receiving RBS' approval of the plan, the lender must conduct liquidation in a manner that will ensure the best return in order to minimize loss. For liquidations that are expected to exceed 90 days, RBS must process an estimated loss payment for the lender, which will stop further interest accrual on loan principal. Until the lender files an estimated loss claim, the interest the borrower owes on the debt continues to accrue, adding to the amount of the debt and consequently the amount the RBS guarantee will have to cover.

Once liquidation is completed, the lender will submit to RBS a final loss claim, which will consider loan principal plus accrued interest, authorized liquidation expenses and other outlays to preserve collateral (i.e., protective advances), and proceeds from the sale of collateral. RBS confirms the Government's share of final loss, in terms of the loan guarantee percentage. The lender will receive that amount exceeding previously made estimated loss payments.

Objectives

The objectives of our review were to determine if (1) liquidations were conducted in accordance with the program's laws, regulations, and instructions; (2) internal controls over the liquidation process provided reasonable assurance that program losses were minimized; and (3) final loss claims were accurate and fully supported. Our audit was limited to a review of RBS' liquidation process for B&I loans and did not consider the adequacy of lender loan making or servicing.

We reviewed 10 B&I loans liquidated in fiscal year 2001 with total guarantees of about \$20 million. The loans had been made and serviced by lenders in seven States. See the Scope and Methodology section at the end of this report for complete details.

Findings and Recommendations

Section 1: Controls Over the Liquidation Process

We identified two areas where RBS can reduce program losses during the liquidation process. Specifically, RBS needs better controls to ensure that lenders file claims for estimated loss payments in a timely manner and that lenders are authorized only those protective advances for which they are eligible. Strengthening these controls could reduce the amount of interest in lenders' final loss claims. For the loans we reviewed, we concluded that the controls were not working because RBS State offices had misconstrued RD direction.

Finding 1

Claims for Estimated Loss Payments Were Not Filed in a Timely Manner

RBS State offices did not ensure that lenders filed claims for estimated loss payments in a timely manner or that these claims were filed at all. This occurred because some State office staff believed estimated loss claims were not mandatory and that they could not require lenders to file them. In other cases, the staff had expected expeditious liquidations that would not have required loss estimates. Until an estimated loss claim is filed, interest continues to accrue on the loan principal and is added to the amount guaranteed by RBS. Estimated loss payments stop interest accrual and can result in significant savings on final losses—especially with extensive liquidation periods. We found that changes to written direction and the Lender's Agreement would be needed to ensure timely filing of estimated loss claims. The Government had incurred as much as \$581,618 in excess interest costs on the loans in question (see exhibit A).

A lender can file an estimated loss claim after it provides RBS with a complete liquidation plan. RD Instruction 4287-B, § 4287.157 (g)¹ states that a lender “will file an estimated loss claim once a decision to liquidate has been made if the liquidation will exceed 90 days.” On the other hand, RBS' Lender's Agreement (April 1997) does not appear to make the filing of the estimated loss claim mandatory. It states that a lender “may request a tentative loss estimate,” but does not require the lender to do so.

¹ The primary criterion for the audit was RD Instruction 4287-B (December 1996), “Servicing Business and Industry Guaranteed Loans,” which restated 7 CFR, Part 4287-B with some additional program direction.

For 4 of the 10 liquidated loans, we determined that lenders had not filed estimated loss claims or had done so only after long delays. For three of the four liquidated loans, we stopped interest accrual 30 days after RBS had approved the lenders' liquidation plans. We then compared the lesser amount of interest that would have been included in the final losses with the interest that was actually claimed. For the remaining loan, the lender, with RBS' concurrence, had allowed the borrower to sell the collateral. The sale occurred very early in the liquidation process, and an estimated loss payment normally would not have been needed. After the sale, a disagreement developed regarding the lien position on part of the collateral, which took about a year to resolve. For this case, we allowed interest to accrue for 30 days after the sale had been completed. For all four cases, we considered 30 days as a reasonable amount of time to process payments for estimated loss claims.

Table 1 summarizes our analysis. For each loan, it shows the number of days that estimated loss payments were delayed, actual interest accruals, audit adjusted interest based on timely estimated loss payments, and the added cost to the Government due to delayed payments. Variable interest rates on the four loans ranged from 8.75 percent to 10.5 percent:

Table 1 – Excess Interest Accruals on Sample Liquidated Loans

Loan	Principal Range ²	Days Delayed	Actual Interest	Adjusted Interest	Difference	Guar. %	Added Cost
3A	\$396,327-\$353,112	443	\$83,570	\$35,774	\$47,796	80	\$38,237
5	\$1,488,001-\$660,890	1,130	\$240,408	\$11,389	\$229,019	80	\$183,215
7	\$2,331,659	234	\$220,613	\$82,342	\$138,271	90	\$124,444
8A	\$5,459,655	221	\$684,251	\$347,506	\$336,745	70	\$235,722
Totals		2,028	\$1,228,842	\$477,011	\$751,831		\$581,618

RBS needs to establish a control to ensure that lenders submit estimated loss claims upon agency approval of liquidation plans, except when the sale of loan collateral is expected within 90 days, or when another date to end interest accrual is in the Government's best interest. Note that RD Instruction 4287-B, § 4287.157 (c) requires submission of the liquidation plan "within 30 days after a decision to liquidate." In addition, RBS should change language in the Lender's Agreement to conform to RD Instruction 4287-B, § 4287.157 (g).

² For some loans, business activity during liquidation caused principal balances to change.

Recommendation No. 1

Establish a control to ensure that lenders submit estimated loss claims upon agency approval of liquidation plans, except when the sale of loan collateral is expected within 90 days, or when another date to end interest accrual is in the Government's best interest.

Agency Response.

In its written response dated September 12, 2003, RD agreed to amend RD Instruction 4287-B and RD 4279-4 and publish a proposed rule by September 30, 2004.

OIG Position.

We accept RD's management decision. For final action, please provide documentation to the Office of the Chief Financial Officer (OCFO) to indicate that the agreed upon actions have been taken.

Recommendation No. 2

Change language in the Lender's Agreement to conform to RD Instruction 4287-B, § 4287.157 (g).

Agency Response.

In its written response dated September 12, 2003, RD agreed to amend the language in the Lenders Agreement so that it will be in conformance with RD Instruction 4287-B, § 4287.157 (g) by September 30, 2004.

OIG Position.

We accept RD's management decision. For final action, please provide documentation to OCFO to indicate that the agreed upon actions have been taken.

Finding 2**RBS Authorized Protective Advances for Which Lenders Were Not Eligible**

For 3 of 10 loans reviewed, RBS State offices authorized lenders to make protective advances that they should not have been eligible to claim. The State offices authorized these advances because RBS program direction did not clearly state that lenders would not be able to claim protective advances after borrowers had voluntarily conveyed loan collateral in full satisfaction of their debts. As a result, RBS authorized \$199,428 of ineligible protective advances, which overstated the Government's share of final loss payments by \$16,494 (see exhibit A).

Lenders make protective advances to preserve and protect loan collateral when borrowers fail to do so. Such advances typically include costs for insurance, taxes, utilities, and security. RD Instruction 4287-B, § 4287.156 provides the following:

Protective advances and interest thereon at the note rate will be guaranteed at the same percentage of loss as provided in the Loan Note Guarantee. Protective advances must constitute an indebtedness of the borrower to the lender.... Agency written authorization is required when cumulative protective advances exceed \$5,000.

For three loans, RBS authorized lenders to make protective advances after borrowers had conveyed collateral in full satisfaction of their debts. Since these advances no longer constituted indebtedness of the borrowers to the lenders, they were not eligible for the final loss claims.

Table 2 shows total protective advances (including eligible advances made before conveyance of collateral), ineligible advances, and interest accruing on ineligible advances. Since these advances would otherwise qualify as liquidation expenses, which do not accrue interest, the table shows the Government's share on the final loss claim for the interest only.

Table 2 – Additional Cost to Government for Ineligible Protective Advances

Loan	Total P.A.	P.A. Interest	Ineligible P.A.	Ineligible Interest	Guar. %	Govt. Share
8A	\$56,024	\$3,722	\$29,748	\$1,200	70	\$840
8C	\$178,705	\$33,884	\$140,456	\$19,125	80	\$15,300
9	\$246,406	\$25,415	\$29,224	\$443	80	\$354
Totals	\$481,135	\$63,021	\$199,428	\$20,768		\$16,494

During the exit conference on July 8, 2003, RBS officials and staff agreed that protective advances must become debt of the borrower. They advised

that there are two other circumstances besides conveyance of collateral when borrowers could not incur additional debt—after discharge from bankruptcy and after the lender has made demand for the full amount of obligation for which the borrower is responsible. RBS needs to provide clarification to ensure State office staff do not authorize lenders protective advances when borrowers cannot incur additional debt.

Recommendation No. 3

Provide clarification to ensure State Office staff do not authorize lenders protective advances when borrowers cannot incur additional debt.

Agency Response.

In its written response dated September 12, 2003, RD agreed to amend instruction 4287-B and Form 4279-4 (Lender's Agreement) accordingly, and publish a proposed rule by September 30, 2004.

OIG Position.

We accept RD's management decision. For final action, please provide documentation to OCFO to indicate that the agreed upon actions have been taken.

Section 2: Controls Over the Loss Payment Review

Finding 3

Final Loss Claims Contained Erroneous and Unsupported Information

For 2 of 10 loans, RBS approved final loss claims that contained errors and unsupported costs. This occurred because RBS directives did not always require sufficient review of documentation supporting the lenders' claims and because staff did not always follow prescribed review procedures. As a result, the Government's final loss payments were overstated by \$45,246 for erroneous information reported for two loans and by \$174,763 for unsupported protective advances with accrued interest for the second of the two loans (see exhibit A).

Errors on Final Loss Claims

After reviewing liquidation documentation for one loan (loan 5 in exhibit B) at the RBS State office and the lender's office, we noted numerous errors that affected the final loss claim. Most of these errors appeared to have been related to record keeping problems that arose after the bank that completed liquidation acquired the bank that had originally made the loan and started the liquidation. The successor bank did not have the original loan ledgers, and the summary information it presented to RBS had numerous inaccuracies, which in the aggregate overstated the final loss:

- Principal distributions from other loans. The borrower had two other loans from the lender, which RBS had not guaranteed. The lender overstated principal distributions for the guaranteed loan by \$213,260 when it included funds for the non-guaranteed loans in the final loss calculation.
- Principal distributions for the guaranteed loan. On the other hand, the lender understated distributions for the guaranteed loan by \$75,451.
- Interest reserve differences. The loan provided construction funding to develop a residential subdivision. In recognition of this, the lender budgeted \$129,000 of principal to make interest payments during construction. We found that the lender understated these interest reserve distributions by \$10,865. Further, the lender did not accrue interest on these distributions, which were, in fact, distributions of principal.
- Legal expenses. The final loss claim included \$1,069 of ineligible legal expenses. State office staff mistakenly allowed these expenses, which documentation revealed the lender had incurred prior to liquidation. On

the other hand, the lender had not submitted a claim for \$7,220 of eligible legal expenses. The lender's final loss claim, therefore, understated legal expenses by a net amount of \$6,151.

These errors overstated the final loss claim for loan 5 by \$52,107. Considering the 80-percent guarantee, RBS overpaid the lender by \$41,686.³

RD Instruction 4287-B, § 4287.157 (d) (1) requires that a lender's liquidation plan includes "a copy of the payment ledger if available which reflects the current loan balance and accrued interest to date and the method of computing the interest." It is silent about action the State office should take if such documentation is not available. RBS needs to supplement this instruction to require that State office staff review lenders' records to confirm loan balances when the lenders do not provide supporting documentation with their liquidation plans.

The lender for the second loan (loan 7 in exhibit B) claimed the liquidation appraisal fee of \$8,900 as a liquidation expense. Since this loan had a 90-percent guarantee, the cost to the Government was \$8,010. RD Instruction 4287-B, § 4287.157 (d), however, prescribes that liquidation appraisal fees "will be shared equally by the Agency and the lender." These fees should not be included in final loss claims. Consequently, the Government's share would have been \$4,450 (\$8,900 X 50 percent). Since the Government actually paid \$8,010, the lender received an overpayment of \$3,560.

We believe State office staff would have identified this error if they had completed the Final Loss Settlement Checklist (Appendix B to RD Instruction 4287-B), which asks whether liquidation appraisal fees were shared equally between the lender and RBS. The Final Loss Settlement Checklist, if used, is an effective control. RBS needs to issue an Administrative Notice to instruct State office staff to do so in order to help ensure accurate liquidation loss payments.

Unsupported Costs on Final Loss Claim

For loan 7, RBS authorized \$301,713 of protective advances, which the lender later included in its final loss claim. The lender told us that supporting documentation for these advances would be at the bank's headquarters office in another State. However, numerous requests to that office failed to produce any documentation. We were able to obtain support for \$127,099 of the protective advances from the lender's attorney who had retained some documents in his files. Therefore, \$174,614 of protective advances were not supported. With accrued interest of \$19,568, these

³ This total reflects corrections to numerous transactions, which affected interest accrual for up to 6½ years. Corrections for each of the first three categories considered independently do not equal the total. The correction for legal expenses is a liquidation adjustment that does not affect interest accrual.

unsupported advances contributed \$194,182 to the final loss claim, resulting in an overpayment of \$174,763 after RBS honored the 90-percent guarantee.

RBS State office staff required that the lender request approval for each protective advance, but did not review related invoices or other supporting documentation. The staff expressed surprise that the lender did not have supporting invoices, since the lender's attorney had provided timely and complete information throughout liquidation. The staff members added that they would consider requesting invoices for future liquidations.

RD Instruction 4287-B, § 4287.158 (c) provides the following direction for lenders and RBS with respect to final loss claims:

Before approval by the Agency of any final loss report, the lender must account for all funds during the period of liquidation, disposition of the collateral, all costs incurred, and any other information necessary for the successful completion of liquidation. Upon receipt of the final accounting report of loss, the Agency may audit all applicable documentation to determine the final loss. The lender will make its records available and otherwise assist the Agency in making any investigation.

This directive places the responsibility on the lender to ensure the accuracy of final loss claims. It states that RBS staff may confirm supporting documentation, but does not require them to do so—even for liquidated loans with significant costs, which may include liquidation expenses and protective advances. RBS should establish dollar thresholds for claimed costs, above which State office staff would obtain and review supporting documentation.

Recommendation No. 4

Direct State office staff to recover \$41,686 from the lender for loan 5 in exhibit B for errors on the final loss claim.

Agency Response.

In its written response dated September 12, 2003, RD stated that it would consult with OGC to determine if there is a legal basis for seeking recovery of the specified amount. If OGC determines that there is a legal basis, RD will make every effort to make the specified collection by December 31, 2003.

OIG Position.

We cannot accept management decision until RD provides us with a copy of OGC's determination and if collection is appropriate, a copy of the collection notice sent to the lender.

Recommendation No. 5

Direct State office staff to recover \$3,560 from the lender for loan 7 in exhibit B for an error on the final loss claim.

Agency Response.

In its written response dated September 12, 2003, RD stated that it would consult with OGC to determine if there is a legal basis for seeking recovery of the specified amount. If OGC determines that there is a legal basis, RD will make every effort to make the specified collection by December 31, 2003.

OIG Position.

We cannot accept management decision until RD provides us with a copy of OGC's determination and if collection is appropriate, a copy of the collection notice sent to the lender.

Recommendation No. 6

Supplement RD Instruction 4287-B, § 4287.157 (d) (1) to require that State office staff review lenders' records to confirm loan balances when the lenders do not provide documentation to support these balances with their liquidation plans.

Agency Response.

In its written response dated September 12, 2003, RD agreed to supplement RD Instruction 4287-B, § 4287.157 (d) (1) to incorporate the recommended changes by September 30, 2004.

OIG Position.

We accept RD's management decision. For final action, please provide documentation to OCFO to indicate that the agreed upon actions have been taken.

Recommendation No. 7

Issue an Administrative Notice to instruct State office staff to use the Final Loss Settlement Checklist (Appendix B to RD Instruction 4287-B).

Agency Response.

In its written response dated September 12, 2003, RD agreed to issue an Administrative Notice by December 31, 2003, to advise the State Office staff of the clarification.

OIG Position.

We accept RD's management decision. For final action, please provide documentation to OCFO to indicate that the agreed upon actions have been taken.

Recommendation No. 8

Direct State office staff to recover \$174,763 of unsupported protective advances for loan 7 in exhibit B.

Agency Response.

In its written response dated September 12, 2003, RD stated that it would consult with OGC to determine if there is a legal basis for seeking recovery of the specified amount. If OGC determines that there is a legal basis, RD will make every effort to make the specified collection by December 31, 2003.

OIG Position.

We cannot accept management decision until RD provides us with a copy of OGC's determination and if collection is appropriate, a copy of the collection notice sent to the lender.

Recommendation No. 9

Establish dollar thresholds for total claimed liquidation expenses and protective advances, above which State office staff would obtain and review supporting documentation.

Agency Response.

In its written response dated September 12, 2003, RD stated that in consultation with OGC, it will determine if an AN will be sufficient to clarify the existing provisions of RD Instruction 4287-B in this regard. If OGC determines an AN is not sufficient to clarify this concern, RD will amend its instructions to incorporate the suggested changes.

OIG Position.

We cannot accept RD's management decision. In order for us to accept management decision, RD will need to provide a date when the agreed upon action will be implemented.

Scope and Methodology

Our audit addressed the liquidation of guaranteed B&I loans. Accordingly, we assessed actions taken during the liquidation process and evaluated the extent to which they minimized the final loss. The audit did not consider the adequacy of lender servicing or RBS actions prior to the decision to liquidate.

From the RBS guaranteed loan database, we identified all final loss claims paid between October 1, 2000, and September 30, 2001. Such claims had been paid for loans totaling \$48,228,029 to 35 borrowers in 19 States. Two of these borrowers each had two guaranteed loans. We combined the loans for these borrowers and considered them as single loans for audit purposes. The total final loss for the 35 borrowers' loans was \$25,518,000. From these loans, we selected those with final losses over \$600,000 and included any other loans in the same States with final losses over \$200,000. This provided a sample of 15 loans in 9 States.

We conducted audit fieldwork from January through June 2002 for 10 loans within 7 States. At this point, we determined we had sufficient information and decided not to complete the five remaining loans in our sample. At the conclusion of fieldwork at each State office, we briefed State Office staff on the results for that State. Our overall results were discussed at an exit conference with the National Office. See exhibit B for information regarding the 10 borrowers whose loans were included in audit fieldwork.

The audit included evaluation of controls over the following activities:

- Loan Monitoring and Decision to Liquidate. We reviewed the extent to which RBS monitored loan status and, when necessary, worked with lenders to reach a decision to liquidate, in conformance with RD Instruction 4287-B, §'s 4287.145 and 4287.157.
- Approving Liquidation Plans. We determined the extent to which RBS required lenders to file comprehensive plans in accordance with RD Instruction 4287-B, § 4287.157.
- Authorizing Estimated Loss Claims. We assessed the timeliness of processing such claims, in accordance with RD Instruction 4287-B, § 4287.157 (g) and the extent to which the claims limited interest accrual and, thus, the final loss total.
- Executing Liquidation Procedures. Lenders conducted liquidations for all of the loans reviewed. We evaluated the extent to which RBS

monitored and assisted lenders to maximize liquidation proceeds and minimize the final loss, in accordance with RD Instruction 4287-B, § 4287.157.

- Reviewing Loss Claims and Authorizing Final Payment. We evaluated RBS' procedures to review and approve final loss claims in accordance with RD Instruction 4287-B, § 4287.158. This included accounting for principal releases, interest accrual, proceeds from collateral sales, collection of personal and corporate guarantees, estimated loss payments, liquidation expenses, and protective advances. We also assessed the timeliness of processing claims and making final loss payments.
- Collecting the Government's Share of Future Recoveries. We reviewed procedures to ensure that the Government received its share of collections made after the final loss payment, in accordance with RD Instruction 4287-B, § 4287.169.

We conducted this audit in accordance with generally accepted government auditing standards. To accomplish the audit's objectives, we conducted fieldwork at the RBS National Office, at 7 RBS State offices, and at the lenders' offices for each of the 10 loans we reviewed.

At the National Office we interviewed officials and staff about their concerns regarding B&I liquidations and obtained and analyzed related program documentation. We also identified databases containing final loss payment information, which we used to establish our audit universe and to select a judgmental sample for field review.

We visited RBS State offices in Louisiana, Michigan, Oklahoma, New Jersey, Arkansas, North Dakota, and Maine. These State offices had overseen liquidation for our 10 sample loans. At each of the State offices, we performed audit work which included the following:

- Interviewed staff about general issues regarding the B&I liquidation process and about specific issues pertaining to sample loan liquidations.
- Obtained and reviewed promissory notes, security documents, loan note guarantees, correspondence with lenders, liquidation plans, appraisals, and other pertinent documents contained in sample loan files.
- Ascertained the extent to which State offices processed estimated loss payments to lenders in order to minimize interest accrual over extensive liquidation periods. For this analysis, we computed the loss that could have been avoided through timely processing of such payments. We did not include the Government's cost of capital, which we recognize would

have at least partially offset any advantage from early processing of estimated loss payments.

- Reviewed and evaluated final loss claim documents submitted to the State office.

We visited lenders for each of the 10 sample liquidated loans and performed audit work which included the following:

- Interviewed lenders about general issues regarding the B&I liquidation process and about specific issues pertaining to sample loan liquidations.
- Reviewed files and correspondence for sample liquidated loans. Obtained loan collateral, appraisal, and insurance documents. Assessed the extent to which liquidation procedures maximized the return from the sale of collateral and minimized the final loss.
- Reviewed documentation for final loss claims not previously obtained at the State offices. Ascertained the extent to which amounts paid to lenders were proper.

Exhibit A – Summary of Monetary Results

Exhibit A – Page 1 of 1

Recommendation No.	Description	Amount	Category
1	Estimated loss payments not processed in a timely manner.	\$581,618	FTBPTBU ⁴ : Savings from management improvement
3	Ineligible protective advances were allowed.	\$16,494	FTBPTBU: Savings from management improvement
4	Final loss claims contained errors.	\$41,686	Questioned costs – recovery recommended
5	Final loss claims contained errors.	\$3,560	Questioned costs – recovery recommended
8	Final loss claims contained unsupported costs.	\$174,763	Unsupported costs – recovery recommended
	Total	\$818,121	

⁴ Funds To Be Put To Better Use

Exhibit B – B&I Liquidated Loans Reviewed

Exhibit B – Page 1 of 1

Key	Business	State Office	Loan Total	Loss Paid
1	Health and Fitness Center	LA	\$1,290,000	\$622,377
3A	Pharmaceutical Container Manufacturer	MI	\$527,000	\$349,099
3B	Ski Resort	MI	\$2,750,000	\$944,704
4	Modular Home Manufacturer	OK	\$1,200,000	\$719,774
5	Residential Developer	NJ	\$1,562,500	\$767,645
7	Shoe Manufacturer	AR	\$2,500,000	\$2,203,160
8A	Pasta Manufacturer	ND	\$5,575,000	\$3,845,422
8B	Waste Management Systems	ND	\$304,800	\$216,784
8C	Refinery Catalyst Waste Recycling	ND	\$3,497,550	\$2,856,262
9	Retail Craft Sales	ME	\$950,000	\$611,121
TOTALS			\$20,156,850	\$13,136,348

Exhibit C – RBS Response to Draft Report

Exhibit C – Page 1 of 5



United States
Department of
Agriculture

Rural Development

Operations and
Management

Washington, DC
20250

SEP 12 2003

SUBJECT: Liquidation of Business and Industry
Guaranteed Loans
(Audit Number 34601-008-SF)

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 Rochelle Diamond of my staff at (202) 692-0077.

A handwritten signature in cursive script, appearing to read "Betty S. Longhini".

for JOHN M. PURCELL
Director
Financial Management Division

Attachment

Rural Development is an Equal Opportunity Lender. Complaints of
discrimination should be sent to: Secretary of Agriculture,
Washington, DC 20250





United States Department of Agriculture
Rural Development

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

SEP 11 2003

SUBJECT: Rural Development Lender Servicing of Business and Industry
Business and Industry Loan Program
Audit Report No. 34601-008-SF

TO: John M. Purcell
Director
Financial Management Division

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

We request that the report clarify the entrance and exit protocols for each unit (State Office) for this type of audit. Some of the State Program Directors had neither an exit nor an entrance conference and no idea of the findings. One State said that an auditor appeared, removed files and this report was their first information on the findings. Two States had received verbal reports and were given the opportunity to respond.

Regarding your Finding Number 3, "Final Loss Claims Contained Erroneous and Unsupported Information," at least three program directors vigorously differ. They contend that the final loss calculations were, in fact, appropriate, defensible, and documented at the time they were computed. One person noted that while there were not always receipts in the file, the attorney had a detailed list and description and could defend every penny spent, and therefore, the allegation of lack of documentation was unfounded. Another commented that because of various bank transfers, the records were difficult to untangle, but given what was available at the time, that State had reached a reasonable and conservative understanding of the claims. He also noted that information available to auditors 2 years hence, was not available to State staff at the time of the liquidation. The program directors were unanimous in observing that after the passage of 2 years and countless hands having been in the loan files, it would not be cost effective to now undertake the research to make a point-by-point rebuttal. In addition, one program director has documented the facts about one lender who acted prudently in every way and vigorously protected and defended the government's interests. In fact, that lender saved the government almost \$15,000.

Rural Development is an Equal Opportunity Lender
Complaints of discrimination should be sent to:
Secretary of Agriculture, Washington, DC 20250

received
9/12/03 JH

Audit Report No. 34601-008-SF

2

Our responses to each recommendation follows:

Recommendation No. 1:

Establish a control to ensure that lenders submit estimated loss claims upon agency approval of liquidation plans, except when the sale of loan collateral is expected within 90 days, or when another date to end interest accrual is in the Government's best interest.

Agency Response:

The Agency agrees with the recommendation. RD Instruction 4287-B and Form RD 4279-4, "Lenders Agreement" will be amended accordingly. A proposed rule will be published in the Federal Register by September 30, 2004. A management decision is requested.

Recommendation No. 2:

Change language in the Lender's Agreement to conform to RD Instruction 4287-B, section 4287.157(g).

Agency Response:

The Agency agrees with the recommendation. Form RD 4279-4, "Lenders Agreement," will be amended to conform with RD Instruction 4287-B, section 4287.157(g) by September 30, 2004. A management decision is requested.

Recommendation No. 3:

Provide clarification to ensure State Office staff does not authorize lenders protective advances when borrowers cannot incur additional debt.

Agency Response:

The Agency agrees with the recommendation. RD Instruction 4287-B and Form RD 4279-4, "Lenders Agreement," will be amended accordingly. A proposed rule will be published in the Federal Register by September 30, 2004. A management decision is requested.

Recommendation No. 4:

Direct State Office staff to recover \$41,686 from the lender for loan 5 in exhibit B for errors on the final loss claim.

Agency Response:

In consultation with the Regional Office of the General Counsel (OGC), the Agency will determine if there is a legal basis for recovery of the specified amount. If so, the Agency will make every effort to make the specified collection by December 31, 2003. A management decision is requested.

Audit Report No. 34601-008-SF

3

Recommendation No. 5:

Direct State Office staff to recover \$3,560 from the lender for loan 7 in exhibit B for an error on the final loss claim.

Agency Response:

In consultation with the Regional OGC, the Agency will determine if there is a legal basis for recovery of the specified amount. If so, the Agency will make every effort to make the specified collection by December 31, 2003. A management decision is requested.

Recommendation No. 6:

Supplement RD Instruction 4287-B, section 4287.157(d)(1) to require that State Office staff review lenders' records to confirm loan balances when the lenders do not provide documentation to support these balances with their liquidation plans.

Agency Response:

The Agency agrees with the recommendation and will amend RD Instruction 4287-B, section 4287.157(d)(1) to incorporate the recommended changes by September 30, 2004. A management decision is requested.

Recommendation No. 7:

Issue an Administrative Notice to instruct State Office staff to use the Final Loss Settlement Checklist (Appendix B to RD Instruction 4287-B).

Agency Response:

The Agency agrees with the recommendation. An Administrative Notice (AN) will be issued to advise the State Office staff of the suggested clarification by December 31, 2003. A management decision is requested.

Recommendation No. 8:

Direct State Office staff to recover \$174,763 of unsupported protective advances for loan 7 in exhibit B.

Agency Response:

In consultation with the Regional OGC, the Agency will determine if there is a legal basis for recovery of the specified amount. If so, the Agency will make every effort to make the specified collection by December 31, 2003. A management decision is requested.

Audit Report No. 34601-008-SF

4

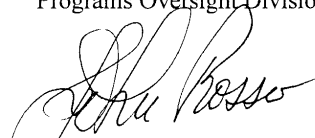
Recommendation No. 9:

Establish dollar thresholds for total claimed liquidation expenses and protective advances above which the State Office staff would obtain and review supporting documentation.

Agency Response:

In consultation with OGC, the Agency will determine if an AN will be sufficient to clarify the existing provisions of RD Instruction 4287-B in this regard. If OGC determines an AN is not sufficient to clarify this concern, then the Agency will amend its instructions to incorporate the suggested changes. A management decision is requested.

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



JOHN ROSSO
Administrator

Informational copies of this report have been distributed to:

Administrator, RBS	
THROUGH: Agency Liaison Officer	(4)
General Accounting Office	(2)
Office of the Chief Financial Officer	
Planning and Accountability Division	
Director	(1)

OIG:ARD&NRD:Bkarson:720-5481:9/30/03

Filename: F:/users/bakarson/:Folder:rbs/subfolder:Liquidation audit SF/subfolder:May 2003 report forward/File:FINAL FINAL 9 30 03

AUTHOR _____ DD _____ DAIG _____