



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

Rural Development
Business and Industry
Direct Loan Program
State of Hawaii



Report No.
34601-6-SF
September 2002



UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Washington D.C. 20250



DATE: September 30, 2002

REPLY TO
ATTN OF: 34601-6-SF

SUBJECT: Rural Development – Business and Industry Direct Loan Program
Hawaii State Office

TO: John Rosso
Administrator
Rural Business-Cooperative Service

THROUGH: Sherie Hinton Henry
Director
Financial Management Division

This report presents the results of our audit of Rural Development's Business and Industry Direct Loan Program for the State of Hawaii. Your written response to the draft report is included as exhibit D to the report.

We have accepted your management decision on all recommendations in the report. The Office of the Chief Financial Officer (OCFO), U.S. Department of Agriculture, has responsibility for monitoring and tracking final action on the findings and recommendations. Please note that final action on the findings and recommendations should be completed within 1 year to preclude listing in the Semiannual Report to Congress. Follow your agency's internal procedures for forwarding final action correspondence to OCFO.

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

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

EXECUTIVE SUMMARY

RURAL DEVELOPMENT BUSINESS AND INDUSTRY DIRECT LOAN PROGRAM STATE OF HAWAII

AUDIT REPORT NO. 34601-6-SF

RESULTS IN BRIEF

This report presents the results of our audit of the Rural Development's Business and Industry (B&I) direct loan program, as administered by the State of Hawaii. We performed this review as a part of a Nationwide audit of Rural Business-Cooperative Service's direct loan program. We reviewed all 11 B&I direct loans issued by the State of Hawaii from fiscal year (FY) 1998 through FY 2001.

Under the B&I direct loan program, Rural Development makes and services loans issued to borrowers. The loans are intended to improve private business and employment in rural communities.

The objective of our audit in the State of Hawaii was to evaluate the State's oversight of B&I direct loans. Specifically, we were to determine (1) if the B&I direct loans were properly made and serviced (i.e., if collateral was monitored and if documentation was submitted to the National Office in a timely manner), and (2) if the loan proceeds were used as specified in the application.

Nothing came to our attention indicating that loan proceeds were not used as specified in the loan documents. However, we concluded that the State office was negligent in making and servicing the direct loans. Seven of the State's 11 B&I loans were either in delinquency or bankruptcy at the time of our audit. All 11 loans contained some deficiency.

- The State office did not obtain sufficient collateral to secure nine loans in case the borrowers defaulted. The State office staff did not verify the existence of the assets being pledged. In seven cases, the State was aware the loans were under collateralized at loan approval.
- For three of the 11 loans, the borrower did not have the minimum required equity in their business at the time the loan was made. Another five borrowers did not maintain the minimum equity and we determined that the State office did not monitor these businesses to ensure their financial stability.
- For all 11 loans, the State did not conduct chattel appraisals at the time of

loan approval or during the loan for equipment pledged as collateral.

- For seven of the 11 loans, the State Office did not file a lien search prior to loan fund disbursement. The State office discovered belatedly that one of the seven borrowers had already pledged its assets to another creditor.
- For five of the seven loans classified as start-up ventures, the State office did not require an independent feasibility study. The State office accepted business plans prepared by the borrowers as meeting regulatory requirements. The State office also allowed a consultant to submit a feasibility study even though the office noted the consultant was part owner of the company requesting funding.

Of the 11 loans, we questioned whether 9 loans should have been made because adequate documentation did not exist to support the disbursement of funds at loan closing.

The deficiencies we found occurred because the office staff did not follow the program requirements and did not have the specific training to make or service the direct loans issued. Furthermore, the current State office loan review process was not sufficient enough to identify and prevent any of the reported deficiencies. The staff also relied on loan reviews by the Office of the General Counsel (OGC) to detect loans that were improper. OGC officials noted that the purpose of their loan reviews does not include such detection.

We issued a Management Alert, dated July 13, 2001, documenting our concerns regarding the B&I direct loan program at the Hawaii State Office.

KEY RECOMMENDATIONS

The Rural Development National office should rescind the Hawaii State office's loan-making and servicing authority for B&I direct loans until the National office is confident the State office is qualified to process and service its direct loan portfolio. At the time of our review, and at the time we issued a Management Alert on July 13, 2001, the Hawaii State office was still in the process of making direct B&I loans. Rural Development responded to the Management Alert and rescinded the Hawaii State office loan-making and servicing authority on July 18, 2001. Subsequently, funding for the B&I direct loan program was terminated in FY 2002 (October 2001).

Additionally, we recommend that RD determine if there is adequate collateral to support the loans and if not, work with the borrower to obtain additional collateral. In addition, we recommend that the National Office determine if the State Office had implemented effective procedures for servicing the loan portfolio before reinstating its loan servicing authority.

AGENCY RESPONSE

In its July 19, 2002, written response to the draft report, RD agreed with our findings. The response included RD's actions taken or planned for each recommendation.

Applicable portions of RD's response are incorporated, along with our position, in the Findings and Recommendations sections of this report.

OIG POSITION

We accepted RD's management decision on each of the recommendations.

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INTRODUCTION

BACKGROUND

The Rural Business-Cooperative Service (RBS), an agency within the United States Department of Agriculture (USDA) Rural Development mission area, operates loan programs that are intended to assist in the business development of the Nation's rural areas and the employment of rural residents. To achieve this mission, the agency guarantees B&I loans made by private lenders and also issues loans directly to borrowers.

The B&I direct loan program is not intended for marginal or substandard loans. These loans are made primarily to finance sound business projects that create or retain jobs for businesses located in rural areas. For direct loans, a borrower can receive a loan for as much as \$10 million. From October 1, 1996, through April 15, 2001, Rural Development funded 192 loans totaling \$77.8 million Nationwide. During the same period, 61 of these loans were either delinquent or liquidated (31.77 percent).

The direct loan program is administered in accordance with the Code of Federal Regulations (CFR), Title 7, part 1980, subpart E for loan making and loan servicing. While the B&I Direct Loan Program was not funded for fiscal years 2002 or 2003, existing loans continue to be administered under the applicable regulations.

The responsibilities of State office staff includes collecting payments, obtaining compliance with covenants and provisions of the loan documents, obtaining and analyzing financial statements, verifying payment of taxes and insurance premiums, obtaining and maintaining liens on collateral, and ensuring sufficient collateral is pledged to secure the entire debt to the Government.

OBJECTIVES

Our overall objective was to evaluate the State office's oversight of B&I direct loans. Specifically, we were to determine (1) if the B&I direct loans were properly made and serviced (i.e., if collateral was monitored and required documentation was submitted to the National Office in a timely manner), and (2) if the loan proceeds were used as specified in the application.

SCOPE

We reviewed all of the B&I direct loans issued and serviced by the Rural Development Hawaii State Office from November 1997 through July 2001. The audit control point (ACP) judgmentally selected for review the State of Hawaii. The ACP requested that we review three delinquent loans and two current loans for this audit. As of April 15, 2001, the Rural Development office in Hawaii had issued 11 direct loans totaling \$6.2 million, to borrowers located in the State of Hawaii and the Western Pacific territories. During our fieldwork, we noted that 7 of the 11 loans were either delinquent or in Chapter 7 bankruptcy proceedings. The State of Hawaii's 11 loans were the most active in the B&I direct loan program in the Western Region.

To address the objectives of our audit, we judgmentally selected for review five of the 11 direct loans. We selected these loans after considering factors such as (a) loan amount, (b) loan status, (c) borrower's location, and (d) State office staff recommendations. In addition, we performed a limited review of the remaining six loan case files to determine whether the State office (a) obtained and maintained sufficient collateral to secure the loans, (b) verified that the borrower's tangible balance sheet equity percentage met minimum requirements, (c) obtained independent feasibility studies, if applicable, and (d) filed applicable Uniform Commercial Code (UCC) liens prior to disbursing loan funds. Our fieldwork was conducted from June 2001 through September 2001.

The audit was conducted in accordance with generally accepted government auditing standards.

METHODOLOGY

To accomplish the overall objectives of the audit, we performed the following procedures: At the Rural Development Hawaii State Office, we (1) interviewed State office personnel to obtain an understanding of the B&I direct loan program and the State office's responsibilities for making and servicing the direct loans; and (2) reviewed 11 (five complete and six limited) borrower case files to determine if the loans were made in accordance with program rules and regulations.

We visited with the five borrowers selected to (1) verify the existence of collateral pledged to secure the loan; (2) evaluate the State office's oversight of the loan; (3) obtain an understanding of the business ventures; and (4) determine if the loan proceeds were used as specified.

FINDING AND RECOMMENDATIONS

CHAPTER 1	STATE OFFICE WAS NEGLIGENT IN MAKING AND SERVICING DIRECT LOANS
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FINDING NO. 1

STAFF WAS NOT TRAINED TO ISSUE LOANS

The Rural Development Hawaii State Office was negligent in administering the B&I direct loan program. The State office did not obtain sufficient collateral to secure the loans, did not obtain chattel appraisals, and did not ensure that borrowers met minimum equity requirements.

The State office also did not file lien verifications prior to disbursing loan funds, and did not obtain independent feasibility studies for all start-up businesses. This occurred because State office personnel were not always aware of program requirements and lacked effective training to adequately service and monitor the loans issued. The current State office review process was not sufficient enough to identify and prevent any of the reported deficiencies. The staff also relied on loan reviews by the OGC to detect loans that were improper. We questioned whether the State office should have made 9 of the 11 direct loans because of equity or collateral deficiencies evident before loan closing. The loan amount for the nine borrowers was \$5,355,000.

Regulations¹ state;

The lender is responsible for seeing that proper and adequate collateral is obtained and maintained in existence and of record to protect the interest of the lender, the holder, and [Rural Development].

We found deficiencies in the monitoring and servicing of all 11 loans issued by the State office. (See exhibit B.) In each case, we concluded that the office staff either did not know program regulations or did not understand lending principles sufficiently.

The State office had developed a checklist to ensure they received the required documentation necessary to assess and approve the loan. However, the checklist only verified that a document was received. The

¹ 7 CFR Ch. XVIII (1-1-97 Edition) 1980.443 (a) (1)

checklist did not require a reviewer to document that loan documents were reviewed for accuracy or make a determination that the loan documents were completed in accordance with program requirements. This included collateral and chattel appraisals, equity requirements, lien searches, and feasibility studies.

Insufficient collateral. The State office did not ensure the B&I direct loans had sufficient collateral prior to loan closing. Our review of the State office files disclosed that 9 of the 11 loans did not have sufficient collateral. The State office prepared a summary of credit request for each loan. This report was designed by the State office to justify the issuance of each loan. A line item within this report was to document the value of the collateral used by the borrower to secure each loan. This report disclosed that 7 of 11 loans had insufficient collateral at loan closing. In addition, our review disclosed that the State office used questionable collateral to secure another 2 loans. The State office issued the loans even though the regulations required the loan to be secured prior to loan closing.

An applicant is required to submit RD Form 449-2, Statement of Collateral. The form requires that an appraiser certify that he has personally inspected the collateral as listed in this report and has estimated the value of the property to be acquired. Furthermore, the appraiser is required to verify that the market values in the report are fair and reasonable. The State office accepted this form as proof of collateral even though information such as an appraiser's signature and collateral listings were missing. In 5 loan files, we did not find any evidence that the form existed and in another 5 cases the appraiser did not sign the form or the required collateral listing was either missing or inadequate. The lack of a review of the collateral by an independent party prior to loan closing jeopardizes the Government's interest. The loan amount for the nine borrowers with insufficient collateral was \$5,355,000.

Regulations² require the State Director "to assure that the collateral values...are fully reviewed, analyzed and the loan file documented as to the facts and reasons for decisions reached."

To secure the B&I loans, the State office used a "blanket" financing statement which described the collateral in general terms, but did not obtain and document what specific collateral existed and was pledged to secure the direct loans. For example, one borrower, borrower E, was allowed to pledge as collateral its future business accounts receivable. No one could predict what these accounts would be and how much they would be worth at any point in time. At loan closing, they were worth

² 7 CFR Ch. XVIII (1-1-97 Edition) 1980.443, Administrative B. Par (b)

nothing. This \$500,000 loan is currently delinquent.

In another instance, the State office accepted collateral that was of questionable value to secure a loan. Generally, collateral must be discounted in value before it is secured. Real property is valued at 80 percent of its book value, while other assets are valued at 60 percent. In the State office's analysis of borrower H's application for a \$2 million loan, the State accepted \$3 million of assets at the discounted value of \$1.8 million. However, the State office allowed the borrower to include, as part of the \$3 million, purchase orders of \$1.6 million. We concluded that purchase orders are goods ordered but not earned or received by the borrower. Consequently, the loan was under-collateralized by approximately \$1 million.

Exhibit C summarizes the status of collateral for all 11 direct loans made by the Hawaii State office. In two cases, we determined based on the information in the file that the collateral pledged was sufficient to secure the loan.

Chattel appraisals. The State staff did not require appraisals on the property taken as collateral for its loans. Regulations³ state, "Appraisal reports prepared by independent qualified fee appraisers will be required on all property that will serve as collateral...The lender will be responsible for assuring that appropriate appraisals are made." Also, the *Appraisals* subpart of a Rural Development Administrative Notice (AN)⁴ states that the borrowers are responsible for providing chattel appraisals that are completed in accordance with generally accepted methods of determining value.

None of the 11 borrowers provided the State office with independent chattel appraisals of the assets pledged as collateral. Only two case files contained equipment listings, but these listings were not adequate to identify the assets pledged and the value of the assets. State office staff indicated they were unaware of the requirement to obtain chattel appraisals to verify the assets pledged.

One of borrowers that had listed equipment was borrower D. Although this borrower's listing showed that its total collateral was valued at \$90,000 less than the loan amount, the State office did not verify the existence of the equipment either by obtaining chattel appraisals or by performing collateral inspections during the term of the loan. Regulations⁵ regarding field visits to borrowers state, "As a guide, visits to newly established borrowers...should be scheduled monthly. Collateral [should

³ 7 CFR Ch. XVIII (1-1-97 Edition) 1980.444 (a)

⁴ Rural Development AN No. 3343 (1980-E) dated June 23, 1997

⁵ 7 CFR Ch. XVIII (1-1-97 Edition) 1980.469-Administrative (C) (2-3)

be] observed and its condition, maintenance, protection, and utilization by the borrower [should appear] satisfactory.”

On July 26, 2001, the borrower, in an interview with the Office of Inspector General (OIG) staff, stated that he disposed of the machinery and equipment pledged to secure the loan approximately one year after he received the loan. The borrower stated that he allowed farmers in the area to use the machinery and equipment and that they had damaged it beyond repair. We referred this borrower for investigation to determine whether he illegally disposed of the assets securing the direct loan.

Equity requirements and lien searches. The State office did not always verify the ownership of pledged assets. For eight loans, the State staff did not adequately compute or monitor the borrowers’ equity in their assets. Three of these borrowers did not meet the minimum requirements for equity. The State staff also did not file lien searches on seven borrowers. One of the seven borrowers had already pledged his assets to another creditor.

Regulations⁶ establish equity requirements based on tangible balance sheet equity.⁷ The regulations require “a minimum of 10 percent tangible balance sheet equity...for insured loans at loan closing.” For new businesses that do not have a history of proven operations, the regulations require 20-25 percent equity.

State office staff did not provide adequate documentation supporting their conclusions regarding any equity calculations. For example, when the State office processed a loan on November 5, 1997, it computed an equity position of 27.8 percent. Our review disclosed that the State office did not maintain the documentation to support their determination.

The loan agreements⁸ also state, “The borrower shall at all times maintain a tangible net worth equal to at least 10% [or 20%] of total assets.” Five borrowers failed to keep their equity above the minimum. The State office staff said they were unaware of this requirement and noted it was not in the 1980-E regulations. We concurred but pointed out that by signing the loan agreement, the borrower agreed, as a condition of the loan, to maintain the specified equity position at all times.

Finally, the regulations⁹ require the State office to “ascertain that no claim or liens of... suppliers of machinery and equipment or other parties are

⁶ 7 CFR Ch. XVIII (1-1-97 Edition) 1980.441 (a)

⁷Tangible balance sheet equity refers to equity in material assets, such as machinery, and excludes assets that are immaterial, such as goodwill.

⁸ Loan Agreement(s) section 4(G)

⁹ 7 CFR Ch. XVIII (1-1-97 Edition) 1980.443(c) (1)

against the collateral of the borrower...that would adversely affect the collateral of the borrower when the security instruments are filed.” To fulfill this requirement, the State office should file a Uniform Commercial Code (UCC-3),¹⁰ or lien search. Without a lien verification, the State office is unable to ascertain whether other creditors hold a higher lien position.

For seven of the 11 loans, the State office did not file a UCC-3 prior to disbursing loan funds. In one case, that of borrower B, the State office’s running record indicated that an “oversight” occurred because the State office “assumed” it had second position on the collateral pledged. When the lien search was completed the State office discovered that two other creditors possessed higher lien positions on the business assets of borrower B. The State office recomputed the collateral pledged after being placed in third position and determined that only 85 percent of the loan amount was secured.

Feasibility studies. The State office did not require an independent feasibility study for five start-up venture loans. Regulations¹¹ state, “A feasibility study by a recognized independent consultant will be required for all loans...The loan approval official may make an exception to the requirement of feasibility study for loans to existing businesses...”

For four of the loans, the State office believed that the business plans prepared by the borrowers were sufficient to meet regulatory requirements. For the other loan, the State office allowed a feasibility study to be submitted even though it noted the consultant was part owner of the company requesting funding. Without independent feasibility studies, the State office could not perform an adequate analysis of the viability of the start-up business.

In an OIG Management Alert dated July 13, 2001, we brought to the attention of the Rural Development National office our concerns regarding the direct loan program in Hawaii. In the Management Alert, we concluded the Rural Development Hawaii State office did not obtain sufficient collateral to secure the direct loans issued. We recommended and the National office agreed in their response dated July 20, 2001, to rescind the State office’s loan making and servicing authority for the B&I direct loan program. In addition, the National office agreed to provide training to State office staff relating to loan making and require the State office to review each of the 11 active direct loans to determine the adequacy of the collateral and develop collateral listings. The current review process in place was not sufficient to identify and prevent any of the weaknesses that we identified. We discussed the deficiencies with the State office, which generally concurred with the issues

¹⁰ A UCC-3 is an instrument used to determine whether any other creditors or parties have perfected a lien on the assets pledged as collateral.

¹¹ 7 CFR Ch. XVIII (1-1-97 Edition) 1980.442

noted.

During the exit conference, State office staff stated that OGC reviewed the loan packet to ensure that it had been properly completed. Rural Development National office personnel also stated that they believed OGC was reviewing the direct loan applications and documents to determine if the loan should be made.

We found that OGC does not review the loan file to determine if the loan meets program requirements, but only if the loan documentation submitted includes sufficient legal language to adequately protect the Government. The OGC attorney responsible for reviewing the Hawaii State office's direct loan dockets stated that OGC is only responsible for reviewing submitted loan documentation to make recommendations to the State office on language changes. OGC does not analyze supporting documentation to determine whether the loan should be made.

Program instructions¹² support this understanding. The instructions state that OGC "should review the submitted material to determine whether all legal requirements have been met" and that "OGC's review of [Rural Development's] standard forms will be only for proper execution thereof, unless the State Director brings specific questions or deviations to the attention of OGC."

¹² FmHA Instruction 1942-A, 1942.8(g), revised 11/02/1994

OGC's role in the loan making process occurs largely at loan closing. Regulations require OGC to provide the State office closing instructions¹³ that contain any actions required by the applicant, architect, attorney, and other representatives prior to loan closing.

RECOMMENDATION NO. 1

Rescind the Hawaii State office's loan making and servicing authority for B&I direct loans.

Rural Development Response

In response to our Management Alert dated July 13, 2001, the RD National Office rescinded the Hawaii RD State Office loan-making and servicing authority for Business and Industry direct loans on July 18, 2001.

OIG Position

We agree with RD's correction action. For Final Action, please provide documentation to OCFO that Hawaii's servicing authority has been rescinded.

RECOMMENDATION NO. 2

Determine if there is adequate collateral to support the questioned loans in exhibit B. If possible, obtain additional collateral to meet any collateral deficiencies.

Rural Development Response

In its written response, dated July 19, 2002, RD stated that they would have a full inventory of all collateral and the most recent values within 30 days of issuance of the final audit report. RD also stated that for loans determined to be under-collateralized, the Agency would work with borrowers to attempt to obtain adequate collateral, if available.

OIG Position

¹³ FmHA Instruction 1942-A, (2-6-1985), 1942.6(a) instructs the State office to transmit information required by OGC, and to request loan closing instructions.

We accept RD's management decision on this recommendation. For Final Action, please provide documentation to OCFO that the agreed upon actions have been taken.

RECOMMENDATION NO. 3

Establish controls to ensure that the State office has developed and implemented effective procedures for servicing the State's loan portfolio prior to re-instating their loan servicing authority.

Rural Development Response

In its written response, dated July 19, 2002, RD stated that the National Office is working with the State Office to determine appropriate servicing actions for individual B&I Direct Loan Program borrowers. RD stated that they will continue to work with the State on every action, treating this as hands-on training, until RD feels the appropriate State Office staff (Program Director and two loan specialists) have gained the needed competence to work on their own. RD also stated that in addition to completion of the National Training Conference in July 2002, and prior to restoration of their servicing authority, RD will require six servicing actions be submitted to the National Office to determine adequacy of the State's knowledge of program regulations and responsibilities.

RD also stated that in addition to their normal supervision, RD will specifically monitor the Hawaii Problem/Delinquent Loan Reports submitted on a quarterly basis. These reports will be discussed with State Office staff, deadlines for accomplishing certain activities will be established, and follow up will be provided as needed. After servicing authority is restored, the National Office will continue to monitor their activities via post reviews of all servicing actions for at least 6 months.

OIG Position

We accept RD's management decision to review the servicing actions for six loans, prior to reinstating Hawaii's servicing authority. For Final Action, please provide to OCFO the results of the reviews that verify the State has adequate knowledge of program regulations and responsibilities.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

Recommendation Number	Description	Amount	Category
2	Loans not adequately secured at loan closing.	\$5,355,000	*Unsupported Loans, No Recovery

* Unsupported loans are those in which adequate documentation was not available to support the disbursement of loan funds.

EXHIBIT B – SUMMARY OF DEFICIENCIES

Hawaii State Office Direct Loans

No.	Borrower	Location	Loan Amount	Status	Unsupported Loans	Deficiencies
1	A	Kealahou	\$275,000	1	\$275,000	A, B, C, D, E, F
2	B	Hilo	\$170,000	2	\$170,000	A, C, D, E, G, H
3	C	Kihei	\$50,000	3	\$50,000	A, C, D, E, F
4	D	Hilo	\$450,000	3	\$450,000	A, B, C, D, E
5	E	Kailua-Kona	\$500,000	3	\$500,000	A, B, C, D, E, F, H
6	F	Kaunakakai	\$110,000	3	\$110,000	A, C, E, G, H
7	G	Guam	\$500,000	2	\$500,000	A, C, D, E, F, G, H
8	H	Ookala	\$2,000,000	3	\$2,000,000	A, B, C, E, F, H
9	I	Hilo	\$1,300,000	1	\$1,300,000	A, B, C, D, E, F
10	J	Waiailua	\$495,000	1	\$0	A, D, E, I
11	K	Guam	\$350,000	1	\$0	A, D, E
Totals			\$6,200,000		\$5,355,000	

Status:

- 1 - Current on principal and interest and/or interest only payments
- 2 - Borrower filed for Chapter 7 Bankruptcy protection (Delinquent)
- 3 - Borrower delinquent on loan payments

Deficiencies:

- A - Terms and Conditions in Denial of Credit letters not specified
- B - Tangible balance sheet equity minimum requirements not maintained during term of loan
- C - Collateral pledged at loan closing not adequate to secure the entire loan amount
- D - Case file did not contain equipment listings of pledged assets
- E - No equipment chattel appraisals conducted
- F - No UCC-3 liens filed with the Bureau of Conveyances
- G - Minimum tangible balance sheet equity requirement not met at loan closing
- H - No independent feasibility study completed
- I - UCC-3 lien not filed prior to loan fund disbursement

EXHIBIT C – STATUS OF COLLATERAL FOR ALL 11 DIRECT LOANS MADE BY THE HAWAII STATE OFFICE

Loan Amounts vs. Collateral Values Shown on the Summary of Credit Request

Borrower	Loan Amount	Status	Summary of Credit Request Collateral Pledged	Exceptions
A	\$275,000	Current	\$205,000	Insufficient Collateral
B	\$170,000	Bankruptcy	\$113,745	Insufficient Collateral
C	\$50,000	Delinquent	\$31,200 (A)	Insufficient Collateral
D	\$450,000	Delinquent	\$362,803	Insufficient Collateral
E	\$500,000	Delinquent	\$155,030 (C)	Insufficient Collateral
F	\$110,000	Delinquent	\$108,000	Insufficient Collateral
G	\$500,000	Bankruptcy	\$374,000	Insufficient Collateral
H	\$2,000,000	Delinquent	undeterminable	Questioned Collateral – OIG (B)
I	\$1,300,000	Current	undeterminable	Questioned Collateral – OIG (B)
J	\$495,000	Current		Sufficient Collateral
K	\$350,000	Current		Sufficient Collateral
Totals	\$6,200,000			

Notes:

- A** - Computation by State office incorrect. Total discounted collateral pledged was \$9,000.
- B** - OIG questioned pledged balance sheet assets; therefore, reduced total collateral pledged.
- C** - Credit Request indicated "accounts receivable to be generated" as collateral. No dollar value noted. Equity section of the Credit Request noted \$155,030 of cash available for project.

EXHIBIT D – RD's WRITTEN RESPONSE TO THE DRAFT REPORT

Exhibit D – Page 1 of 4





	
<small>United States Department of Agriculture</small>	AUG 01 2002
<small>Rural Development Operations and Management Washington, DC 20250</small>	SUBJECT: Office of Inspector General (OIG) Exit Teleconference - Business and Industry Direct Loan Program - State of Hawaii (Audit Number 34601-006-SF)
	TO: Richard D. Long Assistant Inspector General for Audit Office of Inspector General, USDA
<p>Attached is a memorandum dated July 19, 2002, from the Administrator, Rural Business Cooperative Service, responding to recommendations 1, 2, and 3 in the above subject audit.</p> <p>This response is being submitted for your consideration to reach management decision.</p> <p>If you have any questions, please contact Rochelle Diamond of my staff at 692-0077.</p>	
	SHERIE HANTON HENRY Director Financial Management Division Attachment
<small>Rural Development is an Equal Opportunity Lender. Comments of disapproval should be sent to: Secretary of Agriculture, Washington, DC 20250</small>	
	

EXHIBIT D – RD’s WRITTEN RESPONSE TO THE DRAFT REPORT

Exhibit D – Page 2 of 4

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United States Department of Agriculture
Rural Development
Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

JUL 19 2002

SUBJECT: Audit Report No. 34601-6-SF

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

THROUGH: Sherie Hinton Henry *Sherie Hinton Henry*
Director *7/29/02*
Financial Management Division

This is our response to the official draft report for the subject audit. We are requesting management decision on all three recommendations:

- **Recommendation No. 1:** Rescind the Hawaii State Office’s loanmaking and servicing authority for Business and Industry (B&I) Direct Loans.
Agency Response: We rescinded the Hawaii State Office’s loanmaking and loan servicing authority for the B&I Direct Loan program on July 18, 2001. A copy of that letter is attached. It should be noted that there is no appropriation for the B&I Direct Loan program for FY 2002.
- **Recommendation No. 2:** Determine for the 11 loans if there is adequate collateral to support the disbursement of loan funds. If possible, obtain additional collateral to meet any collateral deficiencies.
Agency Response: We will have a full inventory of all collateral and the most recent values within 30 days of issuance of the final audit report. For loans determined to be under-collateralized, the Agency will work with borrowers to attempt to obtain adequate collateral, if available.
- **Recommendation No. 3:** Establish controls to ensure that the State Office has developed and implemented effective procedures for servicing the State’s loan portfolio prior to re-instating their loan servicing authority.

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

received
7/26/02 DC

EXHIBIT D – RD’s WRITTEN RESPONSE TO THE DRAFT REPORT

Audit Report No. 34601-6-SF

2

Agency Response: The National Office is working with the State Office to determine appropriate servicing actions for individual B&I Direct Loan Program borrowers. We will continue to work with the State on every action, treating this as hands-on training, until we feel the appropriate State Office staff (Program Director and two loan specialists) have gained the needed competence to work on their own. In addition to completion of the National Training Conference in July 2002, and prior to restoration of their servicing authority, we will require six servicing actions be submitted to the National Office to determine adequacy of the State’s knowledge of program regulations and responsibilities.

In addition to our normal supervision, we will specifically monitor the Hawaii Problem/Delinquent Loan Reports submitted on a quarterly basis. These reports will be discussed with State Office staff, deadlines for accomplishing certain activities will be established, and follow up will be provided as needed. After servicing authority is restored, the National Office will continue to monitor their activities via post reviews of all servicing actions for at least 6 months.



JOHN ROSSO
Administrator
Rural Business-Cooperative Service

Attachment

EXHIBIT D – RD’s WRITTEN RESPONSE TO THE DRAFT REPORT

Exhibit D – Page 4 of 4

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USDA

United States
Department of
Agriculture

Rural Business-
Cooperative Service
Washington, DC
20250

JUL 18 2001

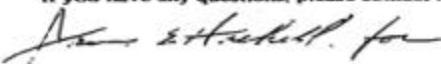
SUBJECT: Business and Industry Direct Loan Program
Loanmaking and Loan Servicing Authority

TO: State Director, Rural Development
Hilo, Hawaii

In response to a July 13, 2001, Management Alert issued by the Office of Inspector General, the loanmaking and loan servicing authority for the Business and Industry (B&I) Direct Loan Program in the Hawaii Rural Development State Office is hereby rescinded effective immediately.

Any B&I Direct loanmaking and loan servicing request should be processed to the point of approval, including State Loan Committee action, and forwarded to the B&I Division for review and concurrence. National Office concurrence must be received prior to your taking any action related to B&I Direct loanmaking or loan servicing.

If you have any questions, please contact me directly, (202) 720-7287.


WILLIAM F. HAGY III
Acting Administrator
Rural Business-Cooperative Service

The Rural Business - Cooperative Service replaces the Rural Development

Informational copies of this report have been distributed to:

General Accounting Office (1)

Office of the Chief Financial Officer

Director, Planning and Accountability Division (1)