



CIVIL DIVISION

UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

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JUL 31 1969

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Dear Mr. Sandoval:

The General Accounting Office has recently completed a survey at the Detroit Regional Office of the Small Business Administration (SBA). Our survey, limited to business loans authorized by section 7(a) of the Small Business Act, included inquiry into the reasonableness of the value placed on collateral, the care with which it is managed, and the manner in which it is disposed of when acquired through liquidation. Our review included an examination of 21 loans randomly selected from 118 loans in liquidation as of December 31, 1968, or charged off during the period January 1, 1964, to December 31, 1968. In our review we identified a weakness in the valuation of collateral which we are bringing to your attention for appropriate consideration.

NEED TO ESTIMATE THE LIQUIDATION  
VALUE OF COLLATERAL WHEN LOANS  
ARE PROCESSED FOR APPROVAL

SBA's current practice of not estimating the liquidation values of collateral, in our opinion, does not provide responsible officials with sufficient information on the degree to which a proposed loan is secured.

SBA procedures state that it is important that the collateral offered to secure loans be carefully evaluated, that the loan files contain documentary evidence of the value of collateral, and that loans be secured by collateral of a type, amount and value which, considered with other factors, such as the character and ability of the management and prospective earnings, will afford the required assurance of repayment.

For 14 of the 21 loans we reviewed, we found that values provided by the borrower were used. These values were about 4 times greater than the values subsequently placed on the collateral at the time of liquidation. We believe that at the time of loan application a comparison of the market value with the estimated liquidation value of the collateral should have been made to permit a reasonable assessment of the risks involved in making the loan. The difference between the market value and the estimated liquidation value of the collateral securing one of the loans included in our review is illustrated below.

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A loan of \$15,000 was approved September 9, 1966. At the time the loan was processed for approval, the borrower estimated the collateral -- consisting primarily of equipment for a bowling alley, including lanes and bowling balls cut to three-quarters of regulation size -- had a value of \$22,125. Although such a value appeared to adequately secure the loan, it had no relationship to liquidation value. In December 1968, the collateral was given a liquidation value of only \$661 after the borrower had defaulted on his loan payments. Since the cost of removing equipment from the leased building would have exceeded the value that could have been obtained through a sale, the liquidation officer recommended that SBA abandon it.

For the remaining seven loans, SBA appraisers estimated the value of collateral rather than relying on borrowers' estimates. In five of these instances, both a market and a liquidation value were estimated following procedures in effect prior to April 1964. Liquidation values are generally significantly lower than market values, as illustrated by the five instances below where SBA appraisers had estimated both values:

<u>Amount of loan</u>	<u>Appraised value of collateral</u>	
	<u>Market</u>	<u>Liquidation</u>
\$25,000	\$ 29,940	\$ 12,750
75,000	91,085	47,065
15,000	23,530	10,540
85,000	166,300	108,250
35,000	50,000	37,500

SBA officials have acknowledged that values placed on collateral at the time of loan processing are often in excess of the values that can be expected in liquidation. However, they stated that use of liquidation values in the past resulted in loans being declined on the basis that they were not sound. Accordingly, SBA discontinued the practice of estimating liquidation value of collateral in April 1964. In our opinion, the fact that past use of liquidation values resulted in loan denials is not cause for abandoning what would seem to be a sound management practice. We believe the records should clearly show a realistic estimate of the probable proceeds from any collateral used to secure a loan since such a disclosure would provide responsible officials with a greater awareness of the risks involved and possibly cause them to apply other accepted criteria in making loan approvals. We recognize that based on their judgment of an applicant's loan repayment ability they may approve loans despite inadequate collateral.

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Recommendation

We recommend that SBA establish a procedure for realistically estimating the liquidation value of collateral at the time loans are processed for approval. Also to assure that loans of sound value are not turned down solely for lack of collateral, responsible SBA officials may need additional instructions in applying other acceptable criteria used in the loan approval process.

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We plan no further reporting of this matter at this time. We would appreciate your comments and advice on any action taken on the matter presented in this letter. We appreciate the courtesy and cooperation given to our representatives during this review.

Sincerely yours,

Henry Eschwege

Henry Eschwege  
Associate Director

The Honorable Hilary Sandoval, Jr.  
Administrator, Small Business  
Administration

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