



U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, DC 20416

AUDIT REPORT
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To: James Rivera, Associate Administrator,
Office of Financial Assistance

David Frederickson, Associate Administrator,
Office of Field Operations

From: Robert G. Seabrooks,
Assistant Inspector General for Auditing

Subject: Audit of the Guaranty Purchase Process

Attached is a copy of the subject audit report. The report contains two findings and five recommendations addressed to your respective offices. Based on discussions with SBA management officials in Office of Finance Assistance, Office of Field Operations, and Office of General Counsel we changed recommendation 2.A to require the Guaranty Purchase Review teams to obtain lenders loan files on a sample basis. Actions on recommendation 1.A and 1.B are planned or have been taken. Management did not agree with recommendations 2.A, 2.B, and 2.C.

The findings and recommendations in this report are subject to review and implementation of corrective action by your respective offices in accordance with the existing Agency procedures for audit follow-up. Please provide your management response to the recommendations within 30 days of the date of this report using the attached SBA Forms 1824, Recommendation and Action Sheets.

If you or your staff has any questions, please contact Garry Duncan, Director, Credit Programs Group, at 202-205-7732.

Attachment

AUDIT OF
THE GUARANTY PURCHASE PROCESS
AUDIT REPORT NO. 3-15

The findings in this report are the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The findings and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.

**AUDIT OF
THE GUARANTY PURCHASE PROCESS**

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SUMMARY

SBA has taken several actions in recent years to improve the 7(a) guaranteed loan purchase process, including periodic quality assurance reviews and issuance of Policy Notice 5000-831, “7(a) Loan Guaranty Purchase Policy.” While these actions should help shore up the guaranty purchase process, additional measures are needed to strengthen the process and protect the Small Business Administration (SBA) from making erroneous guaranty payments to lenders that originate service, and/or liquidate loans in non-compliance with SBA rules and regulations.

In 1983, SBA began to implement the Preferred Lenders Program (PLP) which allows certain lenders to process, service, and liquidate SBA guaranteed loans with reduced oversight by SBA. Prior to the PLP, SBA reviewed all 7(a) loan purchase requests before approving a guaranty. After the PLP began, the primary control used by SBA to assess lender compliance on PLP loans is the guaranty purchase process, which is generally initiated by the lender after a PLP loan defaults. Since 1983, there has been significant growth in PLP loans. In fiscal years 2001 and 2002, PLP loans represented 55 percent of the total dollars of 7(a) loans approved. Due to the limited oversight of PLP loans, this growth has increased the risk of the 7(a) loan program and the importance of the guaranty purchase process.

This report examines the effectiveness of the guaranty purchase process to offset the increased risk of the delegated authority under the PLP. The objective of the audit was to determine if the guaranty purchase process identified all material lender errors and non-compliances. During the audit, we examined the purchase decisions for 153 loans. The audit showed that the guaranty purchase process in effect at the time did not identify material lender errors and non-compliances in 30 of 153 purchased loans, which we believe should have resulted in some form of corrective action, such as guaranty purchase repairs or denials. As a consequence of not identifying these adverse conditions, SBA made \$7.6 million in erroneous payments when it honored the guaranties on the 30 loans.

Lender deficiencies identified during the audit involved the following areas:

- repayment ability,
- equity injection,
- use of loan proceeds,
- IRS verification,
- credit worthiness,
- collateral, and
- eligibility.

The primary reason these deficiencies were not detected was a lack of adequate guidance and inconsistent interpretation of the guaranty purchase procedures. The purchase procedures in effect at the time of the audit had not been materially revised or updated since 1983. As a

consequence, the purchase process did not incorporate the necessary controls and procedures to offset the increased risk of the delegated lending authority under the PLP.

In FY 2000, SBA implemented the Guaranty Purchase Review (GPR) program as an alternative solution to a 1997 OIG audit recommendation to centralize the guaranty purchase process. The GPR is a quality assurance program designed to examine SBA compliance with existing guaranty purchase review procedures and seek solutions for improving the process. Although the GPR program is a step in the right direction, because it is limited to compliance with existing procedures, it will not identify material non-compliance that can only be discovered by reviewing lenders loan files. Also, the GPR does not use valid statistical sampling techniques to select loans for review. Thus, the results of the GPR are not reliable for evaluating the population of purchased loans or estimating the level of erroneous payments.

One of the President's initiatives for improving the government's financial performance includes reducing erroneous payments to recipients. Office of Management and Budget Circular A-11, Preparation, Submission, and Execution of the Budget, requires agencies to submit an estimate of the extent of erroneous payments made with their budget. The largest amount of erroneous payments made by SBA includes purchase of guaranties for loans where the lender did not comply materially with SBA requirements. SBA's current procedure of using the results of the GPR to estimate erroneous payments is not necessarily representative of the total population of guaranties purchased because the loans reviewed are not selected using valid statistical sampling techniques, and therefore, cannot be relied upon to accurately estimate erroneous payments.

In October 2002, SBA issued Policy Notice 5000-831, "7(a) Loan Guaranty Purchase Policy," to clarify and strengthen the guaranty purchase process. The policy notice was based on feedback from the GPR program, the Office of Financial Assistance (OFA), and the Office of Inspector General (OIG). While implementation of the procedures discussed in the policy notice should help shore up the guaranty purchase process, it can be further strengthened by including a review of the lender's loan files to ensure that all relevant documentation is obtained and reviewed before a guaranty is honored. As demonstrated during the audit, many lender errors and non-compliances were only discovered after reviewing the lenders' loan files. Consequently, including a review of the lenders' loan file in the guaranty purchase review process will help to protect against erroneous guaranty payments.

Finally, during the audit the OIG conducted a survey of SBA's field staff responsible for performing detailed reviews of guaranty purchase requests and individuals approving purchase decision recommendations. The survey revealed a difference in how the field offices interpreted and applied the guaranty purchase process and procedures. Based on the survey, the misinterpretations were generally due to a lack of understanding as to what should be reviewed and questioned. The survey respondents also identified a lack of clear guidance and training as the principle cause of our cited adverse condition. The survey results will be issued in their entirety in an OIG Inspections Report.

To improve the quality of the guaranty purchase process and reduce the incidence of erroneous payments, we recommended that the Agency take the following actions: (i) establish criteria for obtaining the entire lender's loan file to ensure all deficiencies are detected; (ii) establish timeframes for completing the training for all individuals involved with the guaranty purchase process; (iii) employ valid statistical sampling techniques to select loans for GPR review; (iv) obtain lenders loan files, on a sample basis, for review by the GPR teams, and (v) revise the loan selection criteria for GPR reviews by deleting the requirement that loans must be purchased and charged off within a specific time frame. SBA management indicated that it would evaluate benefits of obtaining the lenders loan file and that a timeframe for training field staff responsible for making purchase determinations has been established. Management did not agree to implement the recommendations for improving the GPR process. SBA's comments and evaluations are included in the body of the report and in their entirety in Appendix B.

INTRODUCTION

A. Background

The SBA is authorized under Section 7(a) of the Small Business Act of 1958, as amended, to provide financial assistance to small businesses in the form of government guaranteed loans. SBA guaranties loans that are made by participating lenders under a Guaranty Agreement to originate, service, and liquidate loans in accordance with SBA rules and regulations. In the event of non-compliance, SBA may be released from liability on a loan guaranty.

Upon loan default a participating lender submits a guaranty purchase request to SBA. The purchase request is reviewed and the guaranty is honored, unless it is determined that the lender did not materially comply with program rules and regulations, in which case, SBA may be released from the guaranty, in whole or part, at the discretion of the Agency.

In recent years, the number of loans made under the PLP has increased significantly. PLP lenders are authorized to make credit decisions with little or no oversight by SBA. In fiscal year (FY) 2002, PLP loans comprised 30 percent of the total number of 7(a) loans approved. This represented 55 percent of the total dollar value of loans approved that year, or \$6.7 billion. The increase in PLP loans also increased the importance of the guaranty purchase review process. Other than the annual PLP lender compliance reviews, the only other opportunity SBA has to assess lender underwriting, on a loan-by-loan basis, is when a guaranty purchase request is submitted to the Agency. From FY 1999 through FY 2002, SBA purchased guaranties on PLP loans totaling approximately \$1.5 billion.

The Office of Inspector General has conducted several audits of purchased loans in recent years and found that the guaranty purchase process did not adequately protect SBA from making erroneous purchase payments. In an audit report on guaranty purchases, issued on September 30, 1997 (Report No. 7-H-5-11-26), the OIG found that 17 of 58 purchase decisions (29 percent) were inappropriate. To address these issues, SBA implemented the GPR process in FY 2000. The purpose of the GPR process was to review a random sample of purchase decisions on a quarterly basis to insure compliance with existing purchase procedures and identify areas in need of improvement. In October 2002, SBA issued Policy Notice 5000-831 that provided general guidance and instructions for processing 7(a) loan guaranty purchases. With the release of the policy notice, SBA hoped to improve the quality, consistency, and timeliness of guaranty purchase decisions.

B. Objective and Scope

The audit objective was to determine if the guaranty purchase process adequately ensures lender compliance with SBA rules and regulations and protects against erroneous guaranty purchase payments.

During the audit, we reviewed the procedures used to evaluate guaranty purchase requests and examined SBA and lender loan files. We also interviewed SBA officials in the Office of

Field Operations (OFO), Office of Financial Assistance (OFA) and various field offices. The audit period covered 7(a) loans purchased between January 1994 through January 2002.

We examined the purchase decisions on 30 of 153 loans that had been identified with material lender errors during this audit and a previous OIG audit. The 30 loans were purchased for \$26.6 million. Survey questionnaires were sent to all field personnel responsible for processing guaranty purchase requests and making purchase decisions. The questionnaires concentrated on individual purchase experience, management support, training, documentation requirements, and workload. The results of the survey will be issued in a separate inspection report.

Fieldwork was performed from January 2002 through July 2002. The audit was performed in accordance with Government Auditing Standards.

C. Prior Audit Resolution

A September 30, 1997 audit report on the guaranty purchase process noted that 29 percent (17 of 58) of the purchase decisions examined were incorrect or unsupported. The statistical sampling techniques used to select the loans examined had a 90 percent confidence level. Based on a projection of the loans examined, we estimated that SBA purchased 826 loans for \$102.9 million without sufficient documentation to make an informed purchase decision. It was further estimated that 389 loans purchased for \$16.2 million resulted in erroneous payments because the loan files contained documentation of lender errors that should have precluded purchase of all or part of the guaranties. The cause for the erroneous payments was attributed to SBA district offices that either made mistakes or were lenient when evaluating documentation on defaulted loans with lender errors.

The two primary recommendations included in the audit report were to (i) centralize the purchase process to insure consistency in purchase decisions and eliminate the conflicting responsibilities of the district offices, and (ii) provide additional guidance on the type of information needed to protect SBA interests. SBA management concurred with the recommendation to provide additional guidance but offered an alternative solution to centralization of the purchase process. The Agency agreed to establish a quality assurance program to review up to 10 percent of all purchase decisions on an annual basis. We agreed to accept this action as an alternative solution to centralization. In FY 2000, the Office of Field Operation established the GPR process to assess compliance with existing purchase procedures and identify areas in need of improvement. The Agency has also proposed centralizing the purchase process within a few districts on a pilot basis during FY 2003.

RESULTS OF AUDIT

The 7(a) guaranty loan purchase process did not always identify material lender non-compliance and adequately protect SBA from making erroneous guaranty purchase payments. This resulted in \$7.6 million of erroneous guaranty payments on 30 of the 153 loans we examined that were purchased by SBA from January 1994 to January 2002. SBA did not have sufficient documentation to support the purchase decision for seven loans with a purchase value of \$2.1 million. Documentation in the lenders' loan files showed that SBA should not have purchased the guaranties totaling \$5.5 million for the remaining 23 loans because the lenders did not comply with SBA policies and procedures. The audit also showed that the GPR program, which was the result of an alternative solution to prior audit recommendations to centralize the guaranty purchase process, needs improvement. After audit field work was completed, SBA issued a policy notice in October 2002, designed to improve the guaranty purchase process. While implementation of the procedures contained in the notice should help shore up the guaranty purchase process, additional actions are needed to reduce the number of erroneous payments.

Finding 1 Purchase Procedures did not Minimize SBA's Risk of Making Erroneous Payments

SBA did not identify several material lender non-compliances with 7(a) loan program regulations on 30 of 153 purchased loans. Lender non-compliances involved loan origination and closing, servicing, and liquidation actions. None of the compliance issues were identified during SBA's guaranty purchase process because the purchase procedures in effect at the time were outdated, vague, and did not include controls for addressing loan origination issues, such as the borrower's ability to repay the loan from the cash flow of the business. As a result, SBA erroneously paid \$7.6 million to purchase the guaranties on 30 loans. (Refer to Appendix A for a list these loans.)

SBA's Loan Guaranty Purchase Process

The guaranty purchase process is the primary control for ensuring lender compliance, on a loan-by-loan basis, with the program rules and regulations and protecting SBA from making erroneous payments. SBA is authorized to purchase the guaranteed portion of a loan at any time or when a lender demands in writing that SBA honor its guaranty upon default by the borrower. In accordance with 13 Code of Federal Regulations (CFR) § 120.524, SBA is released from liability on a loan guaranty, in whole or part, if the lender failed to comply materially with any of the provisions of the regulations, the loan guaranty agreement, or the loan authorization. Further, purchase of the guaranty portion of the loan does not waive any of SBA's rights to recover money paid on a guaranty, based upon the lender's negligence, misconduct, or violation of program rules or regulations.

The guaranty purchase process begins with a purchase request from the lender or SBA's fiscal transfer agent for loans sold on the secondary market. Regardless of the request method, a

written demand for purchase must be submitted to SBA. The following must also be provided: (i) a certified transcript of account, (ii) copies of all loan closing instruments, including the loan guaranty agreement, loan authorization, note, guaranty, and (iii) collateral documentation with evidence of required liens. As applicable, the lender must also provide copies of standby agreements, evidence of equity injection, assignments of life insurance, and other documents as may be required in the loan guaranty agreement and the loan authorization. Once received, the documents are reviewed by an SBA purchase processor to determine SBA's liability on the guaranty.

If it is determined that the lender did not comply with program rules and regulations which will likely cause a loss to the Agency, the purchase reviewer may work with the lender to correct the deficiency or to get the lender to reduce (repair) or withdraw the guaranty. If the lender refuses to withdraw or accept a repair, the reviewer may recommend a partial or full denial of the guaranty. The field offices are authorized to accept withdrawal or take repair actions, but denials must be referred to the SBA's Office of Financial Assistance in Washington, D.C. for a final determination.

The purchase procedures have essentially remained unchanged since 1983. During this time, SBA has delegated loan processing, servicing, and liquidation authority to its best lenders under the Preferred Lender Program (PLP). The number of PLP loans has increased over the years and represented 55 percent of the 7(a) loans (in terms of dollars) approved in FY 2002. Before the PLP program was established, SBA reviewed the credit decisions for all 7(a) loans before approving a loan guaranty. Under the PLP program, that responsibility belongs to the lenders and credit decisions are generally no longer subject to SBA scrutiny, prior to a purchase request. SBA, however, did not implement adequate controls to offset the increased risk from the delegation of lending authority. As a result, several loan guaranties were purchased that should have been denied or repaired due to the lenders' failure to comply with program rules and regulations.

Lender Deficiencies not identified during the Guaranty Purchase Process

The seven most common lender deficiencies found in the 30 purchased loans reviewed involved, repayment ability, equity injection, use of loan proceeds, credit worthiness, IRS verification, eligibility, and collateral. Most of the 30 loans exhibited two or more of these conditions and recovery of the guaranty was usually based on the combined impact of these deficiencies. The following sections provide details on each of the seven conditions.

➤ Repayment Ability

Fifteen of the 30 loans (50 percent) lacked repayment ability. According to SOP 50 10, the ability to repay the loan from the cash flow of the business is the most important consideration in the loan making process. The SOP further provides that historical earnings and cash flow are the best basis upon which to gauge repayment ability, but realistic projections of future earnings may be used if historical cash flow does not demonstrate repayment ability. The audit showed that

repayment ability was based on poor documentation, faulty cash flow projections, and inadequate working capital. SBA purchased the guaranties on the 15 loans for \$3.4 million.

The following examples illustrate the type of repayment discrepancies that were not detected during the guaranty purchase process.

- *The lender for an SBA guaranteed loan used unsupported information to establish the borrower's repayment ability for a startup business. Projected cash flow was based on \$600,000 in pending purchase orders and a patent for the sole product of the business. Documentation found in the lender's loan file showed that the borrower had only one purchase order for \$25,760 and a letter of intent to purchase the product. The letter of intent did not specify the quantity or amount of the purchase. Furthermore, there was no evidence that the borrower ever obtained the patent for the product. The borrower defaulted within 6 months of the final disbursement after making the equivalent of 1½ payments. SBA purchased the loan guaranty for \$116,772 without noting that the lender based repayment on inaccurate information.*
- *A lender accepted the borrower's projection for the purchase of an on-going business in determining if there would be sufficient cash flow to repay a \$280,000 SBA guaranteed loan. The projections, however, omitted several expenses that were included in the business financial statements provided by the seller. Expenses excluded from the lender's repayment calculation included disposal and environmental fees, worker's compensation insurance, an increase in the lease payment, and owner's salary or withdrawal. The result of these expenses, when included in the lender's repayment analysis, is a negative cash flow. Under SBA regulations, a loan must be declined where there is no evidence of repayment ability. The borrower defaulted on the loan 8 months after disbursement. SBA purchased the loan guaranty for \$191,458.*

➤ **Equity Injection**

Ten of the 30 loans (33 percent) had material discrepancies involving equity injection. The total amount of equity required for the 10 loans was \$1.3 million, but only 50 percent of that amount was supported in the lenders loan files. The remaining 50 percent either did not qualify as equity or was not supported. Pursuant to OMB Circular A-129, "Policies for Federal Credit Programs and Non-Tax Receivables," borrowers who participate in Federal credit programs should have an equity interest in any asset financed with the credit assistance, and business borrowers should have a substantial capital or equity at risk in their business. The loan agreements for all 10 loans required evidence of the equity injections prior to the first disbursement. Standard Operating Procedures (SOP) 50 50 4, provides that lenders must submit evidence of the equity injection with their guaranty purchase request. The guaranty purchase procedures in effect at the time the loans were purchased, however, did not sufficiently define what constituted adequate evidence of equity injection. Thus, determination of adequacy and sufficiency was left up to the discretion of the individual purchase reviewers and/or field office. SBA paid \$3.4 million to purchase the guaranties on the 10 loans.

The following examples illustrate the type of equity injection discrepancies found during the audit.

- *A borrower of a \$450,000 SBA guaranteed loan was required to inject \$255,000 of equity into the business prior to loan disbursement. Eleven days after loan approval, the borrower submitted documentation to the lender showing that over \$447,000 of expenditures for construction, franchising fees, equipment, and other items had been injected into the business. The lender accepted the documentation as evidence and submitted it to SBA with a guaranty purchase request. SBA also accepted the documentation as evidence of equity injection and paid the guaranty. An analysis of the documentation showed that only \$191,000 of the expenses submitted by the borrower qualified as equity, which left an equity injection shortfall of \$64,000 (\$225,000 - \$191,000). Expenditures that did not qualify as equity included an unpaid invoice which was subsequently paid with loan proceeds and fees paid by the borrower's principals that were later reimbursed with loan proceeds. The borrower defaulted after making only three payments, and the guaranty was purchased for \$194,804.*
- *As evidence of a \$70,000 equity injection on a \$280,000 SBA guaranteed loan, the borrower provided the lender with a detailed spreadsheet listing expenditures in excess of \$95,000 as proof of equity injection. The spreadsheet included photocopies of receipts and checks in support of the expenditures. Documentation found in the lender's loan file suggests that the lender did not do a careful review of the equity injection evidence before disbursing the loan. The borrower defaulted six months after the loan was approved and eight months later, the lender noted that most of the expenditures submitted by the borrower did not qualify as equity injection. The lender further noted that the amount that qualified as equity would depend on the interpretation of the District Office.*

After reviewing the lender's purchase request, the District Office asked for additional evidence of the borrower's \$70,000 injection. The lender stated that a substantial amount of evidence for the cash injection was submitted with the purchase request, which included very detailed spreadsheets prepared by the borrower. The lender did not notify SBA that an internal review showed that the majority of the documentation submitted by the borrower might not qualify as evidence of the equity injection. The District Office did not question the lender any further on the equity injection evidence and purchased the loan guaranty for \$191,458.

- *The borrower of a \$1.1 million SBA guaranteed loan was required to pay \$38,000 of the closing costs as equity injection. Prior to the first disbursement, the lender was required to obtain evidence of the borrower's equity injection. The borrower defaulted on the loan after making only ten payments. The lender submitted a purchase request to SBA that included a list of \$39,106 in closing costs that was submitted as evidence of the equity injection. A review of the lender's loan file*

showed that the majority of the closing costs were paid from loan proceeds with the exception of a \$500 escrow deposit and another \$1,000 paid to a packager. As a result, 96 percent of the closing costs claimed as the borrower's equity injection were actually paid with loan proceeds. SBA purchased the loan for \$609,203.

➤ **Use of Loan Proceeds**

Ten of the 30 loans (30 percent) had lender deficiencies involving the use of loan proceeds. SOP 50 50 4, Appendix 26, "Checklist for Purchase Documents," requires lenders to include the loan settlement sheet (SBA Form 1050) with the guaranty purchase request. The settlement sheet shows how the loan was disbursed and serves as certification that it was disbursed in accordance with the loan agreement. In addition, the settlement sheet identifies the approved methods for disbursement, such as the use of joint payee checks to ensure that loan proceeds are used as authorized. The problems identified included missing settlement sheets, failure to use joint payee checks, lack of supporting evidences for expenditures, and unauthorized use of proceeds. SBA paid \$2.5 million to purchase the guaranties on the 11 loans.

The following are examples of improper uses of loan proceeds.

- *The lender of a \$793,000 SBA guaranteed loan did not take appropriate measures to ensure that the loan proceeds were used as authorized in the loan agreement. The lender disbursed \$493,747 to refinance several borrower loans without obtaining sufficient documentation to determine if the debt met refinancing requirements. Among other things, the debt to be refinanced with the SBA loan must be on unreasonable terms and the refinancing must result in an increase in cash flow. The refinanced debt must also be current. The only documentation for the refinanced loans found in the lender's file was a borrower-generated schedule that did not include sufficient information to evaluate the eligibility of the debt. Furthermore, the schedule showed that two of the loans were not current.*

The purchase request submitted by the lender included the settlement sheet (Form 1050) that was attached to a document that showed that the lender issued a \$107,000 joint payee check, as required. A copy of the check found in the lender's loan file, however, showed that the check was made out in the name of the borrower only and deposited into the borrower's bank account. There was no evidence that the intended recipient of the check ever received payment for the balance on a purchase contract for equipment that also served as collateral to secure the loan. SBA noted neither of these lender discrepancies during the guaranty purchase review process. SBA purchased the loan guaranty for \$595,925.

- *According to the settlement sheet for a \$280,000 SBA guaranteed loan, \$16,000 was disbursed directly to the borrower for working capital. The balance of \$264,000 went to third parties via joint payee checks. The closing documents prepared at settlement, however, showed that \$98,664 was disbursed directly to the borrower. Further, there*

was no evidence to support that any of the proceeds disbursed to the borrower were used to purchase inventory, machinery, or equipment as stipulated in the settlement sheet and authorized in the loan agreement. SBA paid \$191,458 on the loan guaranty.

➤ **Internal Revenue Service (IRS) Verification**

Seven of the 30 loans (23 percent) did not have adequate evidence that the lender obtained IRS verification of the borrowers' financial information. SOP 50 10 (4) and several SBA Policy Notices require IRS verification of financial information for all loans to on-going business, including the verification of the borrowing principals and the sellers' financial information when there is a change of ownership. Ten percent of the purchase processors that responded to the survey indicated that they do consider the IRS verification requirement during the guaranty purchase review. SBA purchased the guaranties on the seven loans for \$1.2 million.

The following example demonstrates the type of problems that can occur when IRS verification is not obtained.

- *The lender of an SBA guaranteed loan permitted the purchaser of a restaurant to assume the SBA loan with a balance of \$140,128. SOP 50 10 4 provides that loan assumptions must be evaluated in the same manner as a new SBA guaranteed loan application. According to 13 CFR 120.150, the character of the applicant and the ability to repay the loan from the earnings of the business must be considered during the credit analysis. One of the things to be considerer is the applicant's willingness to abide by the law. The individual that assumed the loan submitted several financial documents to the lender, including a Wage and Tax Statement (Form W-2), a Federal tax return, and an income statement. All three documents were clearly altered in order to assume an SBA guarnatied loan. The lender, however, did not obtain IRS verification as required by SBA regulations, which would have disclosed the applicant's false statements. Moreover, SBA did not hold the lender accountable for failing to obtain the IRS verification during the guaranty purchase review process. SBA paid \$93,689 to purchase the loan guaranty.*

➤ **Credit Worthiness**

Six of the 30 loans (20 percent) had discrepancies involving credit issues. According to 13 CFR 120.150, the applicant for an SBA guaranteed loan must be credit worthy and loans must be so sound as to reasonably assure repayment. A key consideration during a credit analysis is the character, reputation, and credit history of the applicant, its associates and guarantors. Another key consideration is the willingness and ability of the principals to pay their debts. SBA paid \$838,000 when it honored the guaranties on the six loans.

Examples of lender deficiencies involving credit decisions follow.

- *The borrower of an SBA guaranteed loan had \$47,000 of unpaid taxes when the loan application was submitted to the lender. According to the borrowing business' financial*

statements found in the lender's loan file, the business owed \$74,000 of Federal payroll taxes of which \$47,000 was sixty days in arrears. There was no evidence that the lender questioned the borrower about the delinquent taxes or took measures to verify payment of the taxes prior to disbursement of the SBA loan. SBA purchased the loan guaranty for \$177,166, 8 months after it was disbursed without considering the implication of the lender's failure to recognize the financial difficulty facing the business as a result of the delinquent taxes and its reflection on the character of the borrower.

- *The financial statements for a borrower of an SBA guaranteed loan showed that accounts payable of \$13,200 was 90 days or more past due. The past due accounts did not include delinquent sales taxes owed to the state. SBA guaranteed loan proceeds were used to pay off the borrower's past due accounts, with the exception of the delinquent taxes, but there was no explanation in the lender's loan file to indicate the reason the account was delinquent. The state filed a tax lien for unpaid sales taxes one month after the loan was disbursed and the borrower made no payments on the loan before defaulting. SBA paid \$70,105 on the guaranty without questioning the lender's failure to consider the character implications of not paying state sales taxes.*

➤ **Collateral**

Four of the 30 loans (13 percent) had missing collateral or were not fully secured with all available collateral. Pursuant to SOP 50 10 (4), paragraph 41.h.1, SBA loans must be secured as fully as possible with whatever worthwhile assets are available. Worthwhile assets include those belonging to the applicant business and its principals. SBA paid \$2 million to purchase the four loans.

- *The lender secured a \$333,000 guaranteed loan with collateral valued at \$259,000. Based on the principal's personal financial statements, additional collateral was available in the form of a motel and a condominium with a liquidation value of \$83,200. If the collateral was taken to secure the loan as required, the loss to SBA might have been reduced by \$62,400 (0.75 x \$83,200). SBA purchased the guaranty for \$245,981.*

➤ **Eligibility**

Two of the 30 loans (7 percent) went to borrowers that did not qualify for Federal financing. The discrepancies found during the audit involved a borrower who did not meet the residency requirement and a borrower who had previously defaulted on several Federal loans. SBA paid over \$1 million to purchase the guaranties on the two loans.

The following examples are purchased loans that did not meet SBA eligibility requirements.

- *The lender made a \$522,000 SBA guaranteed loan to a borrower whose principal did not have the proper resident status at the time the loan was approved. According to SOP 50 10(4), a lender must verify the resident alien status of an applicant to ensure that the*

principal is authorized to remain in the United States for at least half of the maturity of the approved loan. The principal clearly indicated on SBA Form 912, Statement of Personal History, that he was not a citizen and provided a copy of an employment authorization card, which authorized the borrower to remain in the United States for only two months after the loan approval date. The term of the loan was 22 years. SBA purchased the loan for \$404,468 after the borrower made only seven payments.

- *The lender approved a \$1.1 million SBA guaranteed loan to a borrower whose affiliated business had seven delinquent Federal loans. Pursuant to 31 CFR §285.13 and USC 3720B, individual with outstanding delinquent Federal debts are ineligible to receive additional Federal financial assistance. SBA regulations at 13 CFR 120.110 (q) further specify that applicants are ineligible for an SBA business loan if the applicant or an affiliated business previously defaulted on a Federal loan that resulted in a loss. Prior to receiving the SBA guaranteed loan, the affiliated business had received seven loans from the U.S. Department of Agriculture totaling \$279,379; all of which were delinquent when the SBA loan was disbursed. Although the borrower did not disclose the existence of the affiliated business and associated loans in the loan application, the affiliated business was noted in the principals' Federal income tax returns submitted to the lender with the loan applications. As a result of the delinquent Federal debt, the borrower was not qualified to receive additional Federal financial assistance in the form of an SBA guaranteed loan. SBA purchased the loan guaranty for \$609,203 without noting that the borrower was ineligible for the loan.*

The Cause of the Incorrect Guaranty Purchase Decisions

One of the main reasons so many material lender errors and non-compliances were not detected by the guaranty purchase review process was the lack of adequate guidance provided by SBA and inconsistent interpretation of that guidance by the field offices. Another cause for the errors was the lack of a formal training program.

- **Inadequate Guidance**

The guaranty purchase procedures in affect at the time of the audit had not been significantly revised since 1983, while at the same time the number of PLP loans being made by lenders authorized to make credit decisions without SBA oversight was increasing. The procedures applied by SBA for evaluating credit decisions and repayment ability for non-PLP loans, however, were not incorporated into the guaranty purchase process, even though SBA considers repayment ability to be the most important aspect of the loan making process. Consequently, the risks involved with the delegation of lending authority were not offset by compensating controls in the guaranty purchase process.

Most of the lender credit decisions for the 30 loans we questioned were accepted by SBA. This apparent practice to not second-guess lender credit decisions is reflected in the survey of loan processors conducted during the audit. Over 43 percent of those that responded said

they do not consider creditworthiness or repayment ability during the guaranty purchase reviews. One respondent noted, “*SBA cannot question lender decisions or underwriting on PLP loans.*” Another noted, “*our review has nothing to do with the lender approval of the loan.*” The responses reflect an environment where purchase processors do not scrutinize lender compliance with arguably the most important aspects of the loan making process--- loan origination and repayment ability.

Also, the purchase procedures provided little guidance on how to evaluate equity injection. Thus, determination of lender compliance with the equity injection requirement was left to the discretion of the individual purchase processors and/or each field office. One respondent to the survey indicated that the degree of evidence needed for equity injection depended on “*who you ask*” while another stated, “*it depends on what the injection was required for.*” Many of the respondents believed that paid invoices or cancelled checks were adequate evidence of equity injection while others believed that financial statements and the settlement sheets were sufficient. Clearly, there were a wide variety of opinions among the guaranty purchase processors as to what is acceptable evidence for equity injection.

- **Lack of a Training Program**

SBA had no formal program for training personnel responsible for processing guaranty purchase requests and ensuring against erroneous purchase payments. Over 81 percent of the respondents to the survey questionnaire stated that they did not have any formal training. One respondent commented, “*I wish courses were offered and made available*” and another stated, “*it might be very helpful to have a class.*” One purchase processor stated that “*they learned by doing and making mistakes so you eventually establish your own criteria.*” One respondent went so far as to say, “*I beg for training.*”

New Guidance on Guaranty Purchase Processing

During the audit, SBA issued Policy Notice 5000-831, “7(a) Loan Guaranty Purchase Policy,” which took effect on October 2, 2002. The new policy was developed based on information obtained through the GPR and other sources, including the on-going audit of the guaranty purchase process. The new policy strengthened many of the areas in the purchase process that allowed material lender errors to go unchecked. An example of one improvement is the requirement that all PLP lenders submit the Statement of Personal History (Form 912) on early default loans, the credit memorandum with all supporting documentation, and a complete copy of the borrower’s loan application when a PLP loan defaults or experiences payment problems within the first 18 months after disbursement.

The Guaranty Purchase Review Program FY 2001 Final Summary Report, issued May 2002, by the Office of Field Operations (OFO) noted that it was critical that individuals who process guaranty purchase requests be adequately trained so that field staff can purchase loans consistently, accurately, and efficiently. Thus, OFO recommended that all purchase review staff be required to attend updated training. During the audit, OFO entered into a contract for the

development of a training course to be given to all field personnel responsible for processing guaranty purchase requests. Although a schedule for the training had not been established, development of the course is scheduled for completion by March 31, 2003.

According to OFO, improved purchase guidance and training will lead to a reduction of erroneous payments on 7(a) loan guaranties.

The Purchase Review Process can be Strengthened by Lender Loan File Reviews

The guidance provided in the new guaranty purchase policy and the development of a formal training program should enhance the purchase review process and improve the consistency in purchase decisions among the various field offices. The new policy does not go far enough, however, to ensure full lender compliance with SBA rules and regulations. For instance, under the new policy for verifying a cash equity injection, the lender is required to obtain copies of the checks and the borrower's bank statement to evidence the source and destination of the funds. These documents alone are not sufficient to determine if the cash came from borrower equity or a loan, which would require a stand-by agreement to qualify as equity. The best way to ensure that all pertinent documents are considered during the purchase review process is to obtain and review the lender's loan files.

The following examples illustrate the benefits of reviewing the lender's files.

- *The lender of a purchased PLP loan accepted copies of 74 cancelled checks and 22 receipts as evidence for a \$43,000 equity injection. The checks, however, were drawn on the same bank where the borrower had seven commercial loans and the timing of the checks paralleled the timing of the loans. All seven loans were refinanced with the SBA loan. Although the evidence used to develop this finding (i.e., various checks, bank statements, and a lender developed schedule of loans to be refinanced) was found in the lenders loan file, it would not necessarily be provided to SBA under the new guaranty purchase policy.*
- *The lender of another PLP loan obtained what was believed to be evidence of \$70,000 in equity injection, but an internal audit conducted by the lender showed that only \$20,000 of the documentation qualified as evidence of the equity injection. In spite of the finding, the lender submitted the voluminous equity injection documentation to SBA with its guaranty purchase request. When SBA questioned the lender about the evidence, the lender claimed that the documents submitted were more than sufficient to support the full amount of the required equity injection. The loan was purchased without further review of the evidence.*

The Policy Notice also does not require lenders to submit the documentation needed to identify other types of lender non-compliances as shown in the following examples:

- *The lender of a \$100,000 LowDoc loan stated in the loan officer's report that projected sales would increase by 900 percent based solely on two distribution agreements negotiated by the borrower. There was no evidence that either agreement was ever executed which was only determined after examining the entire lender loan file. The borrower defaulted after making 17 payments, ten of which were interest only.*
- *On another PLP loan, the president, who owned 40 percent of the borrowing business, answered yes to the criminal history question on the Form 912 that was found in the lender's loan file. This should have made the loan ineligible for processing under PLP procedures, but instead of providing additional information on the criminal activity and submitting the loan to SBA for approval, the president sold all his shares in the business to the secretary to avoid the requirement to submit a 912. The requirement still existed in this case, however, because the transaction occurred within six months of applying for a loan. The lender did not submit the Form 912 with the guaranty purchase request, so SBA was unaware of its existence. This is another example of a material problem that was discovered by reviewing the lender's loan file.*

It is uncertain if the lender non-compliances described in the preceding examples would be identified under the new guaranty purchase policy because the documentation needed is not required. The only way to insure that these conditions are identified is by performing a thorough review of the lender's loan file. One approach to accomplish this would be to use a two-stage process. The first stage would consist of a desk review of the lender's loan file to search for indications of material lender errors or non-compliances that might impact the guaranty. If potential problems were discovered during the desk review, the second stage would consist of a thorough examination of the lender's loan file to determine if there is sufficient evidence to warrant corrective action on the guaranty. If there were no indications of problems found during the during the desk review, the purchase request would be processed under standard purchase procedures.

RECOMMENDATIONS

We recommend that the Associate Administrator for Financial Assistance take the following action:

- 1.A Strengthen the guaranty purchase process by establishing risk-based criteria for obtaining the entire lender's loan files, e.g., for all early default loans. Loans considered to be high risk should be subject to a more detailed review, such as the "two-stage" approach discussed in the audit report.

We recommend that the Associate Administrator for Field Operations take the following action:

- 1.B Establish a time frame for completing the training of all individuals involved with guaranty purchase processing.

Management Response

The Assistant Administrator for the Office of Financial Assistance (AA/OFA) and the Associate Administrator for the Office of Field Operations (AA/OFO) indicated that they had not had the opportunity to review the audit results and, therefore, could not agree or disagree with the findings at this time. SBA officials also took exception with several issues presented in the body of the audit report as follows:

- The 30 problematic purchased loans identified in the audit are only potential deficiencies and may merely lack documentation support rather than being an actual lender deficiency.
- Most of the loans were made by the same lender that is no longer in the program.
- The OIG \$7.6 million erroneous payment estimate will likely result in a much lesser loss once liquidations are complete.
- A 1997 OIG audit report identified 17 loans with potential material deficiencies. Documentation found subsequent to the audit supported the purchase decisions. Consequently, the 1997 audit figures likely substantially inflated the estimated losses.

Notwithstanding the above issues, SBA management agreed to study recommendation 1.A and reported that it has already developed a time frame for completing training for SBA personnel as recommended in recommendation 1.B.

OIG Response

Minor adjustments to the draft report have been made based on discussions with officials from the Office of Field Operations, the Office of Financial Assistance, and the Office of General Counsel.

The purchase decisions on the 30 problematic loans cited in the report comprise 20 loans that were examined during a recent audit of a single lender and 10 that were analyzed during this audit. The fact that 20 loans were made by a single lender that no longer participates in the SBA 7(a) loan program has no bearing on the quality of the guaranty purchase decisions made at the 12 different field offices involved with these purchase decisions. To date, the OIG has issued audit reports on 9 of the 20 loans which have resulted in over \$1.9 million in guaranty payment recoveries. Two of the nine reports with combined recommended recoveries totaling \$178,600 are under appeal. The remaining 11 loans have a potential recovery of \$1.5 million. Based on the success of the first nine audit reports (involving seven field offices), we believe there is a high probability of recovering all or a major portion of the guaranties paid to purchase the 11 loans. Furthermore, since the auditors obtained both the SBA and lender files all supporting documentation has been considered.

Regarding the questionable purchase decisions for the ten loans examined during this audit, seven were identified as problematic by the GPR teams and after obtaining additional documentation, the SBA determined that the original purchase decisions were supportable for six

loans and requested repayment of the guaranty for one loan. The remaining three purchase decisions, however, are being evaluated by the OIG and may result in recommended recoveries totaling approximately \$1.5 million. Regarding management's comments that the estimated \$7.6 million in erroneous payments on the 30 loans will likely result in a much lesser loss once the liquidations are completed, SBA records show that 20 of the 30 loans have already been liquidated and charged off.

Finally, the estimated amounts cited in the 1997 guaranty purchase audit report were based on 17 purchase decisions that were unsupported at the time SBA decided to honor the guaranty. A review of the SBA purchase files for ten of the loans showed that they contained insufficient documentations for rendering proper purchase decisions. The purchase files for the other 7 loans contained evidence that the lender failed to comply with SBA rules and regulations. Consequently, none of the purchase decisions were supportable at the time of purchase. This placed the Agency at risk of making erroneous payments for a projected amount of \$102.9 million at the time of purchase. This is the point of the finding; that purchase decisions were made without supporting documentation, not whether the documentation was obtained subsequent to the guaranty purchases.

Accordingly, we continue to advocate that SBA take the corrective actions specified in recommendations 1.A and 1.B.

Finding 2 The Guaranty Purchase Review Process can be Strengthened

The GPR process was established in FY 2000 as an alternative solution to an OIG audit recommendation to centralize the purchase process. The primary purpose of the GPR program is to assess the accuracy of prior purchase decisions and identify areas for improvement. Each quarter, a sample of purchased loans is selected for review by GPR teams. During FY 2001, the GPR teams reviewed 300 purchased loans from 77 different field offices. The OIG audit found that due to the limitation discussed below, the GPR process did not identify all inappropriate purchase decisions. Also, the method used to select the sample of loans is not statistically valid. Consequently, the results of the GPR may not be reliable for projection or reporting the erroneous payments as required in OMB Circular No. A-11.

The GPR did not include a Review Lenders' Loan File

The GPR procedures do not require a review of the lenders' loan files in assessing the quality and accuracy of the original purchase decision. This is because the GPR is designed to test SBA compliance with existing guaranty purchase procedures, which do not require a review of the lenders' loan files and are primarily limited to reviewing the documentation assembled during the original purchase decision. As a result, inappropriate purchase decisions that can only be discovered by reviewing the lender's loan files will not be identified.

For example, an OIG review of a lender's loan file for a PLP loan purchased by SBA showed that one of the two principals had a criminal history, but the lender's purchase request did not include this information. The original loan application submitted to the lender included a Statement of Personal History (Form 912) for each principal that showed one principle had a criminal history. Under Federal Regulations, business associates with a criminal history may not be eligible for an SBA business loan and the Office of Inspector General must clear applicants that answer 'yes' to a criminal history on the Form 912 before processing. The definition of an associate includes individuals who own more than 20 percent of the equity. According to SBA regulations, an associate relationship commences six months before the date of the loan application and continues as long as the loan is outstanding. Also, loans to principals with criminal history are not eligible for processing under the PLP. The lender, however, elected to permit the principal with the criminal history to sell his shares in the business to the other principal and submit a revised application rather than submitting the original loan application to SBA for approval.

The second application did not include a Form 912 for the principal with the criminal history and, upon default by the borrower; the lender application that was submitted with its guaranty purchase request. Consequently, without the lender's loan files, SBA had no way of knowing about the lender's questionable practice and the principle's criminal history. Moreover, it is unlikely that the quarterly GPRs would identify the inappropriate decision to purchase this loan because GPRs are limited to examining compliance with existing procedures and documentation obtained at the time of the purchase review. (Refer to finding 1 for more examples.)

GPR Sampling Methodology is too Restrictive

Prior to each GPR, a sample of purchased loans is judgmentally selected, i.e. one loan from each SBA field office. Prior to FY 2002, loan selection was restricted to those charged off within 6 months of the purchase date. In FY 2002, that period was extended to 12 months. The reason for the charge off requirement is found in the FY 2001 GPR summary report, that noted "liquidation practices are among the most common bases for denial of purchase" and, therefore, the liquidation process should be completed before the loan is subject to review.

We found that not all purchased loans are liquidated within 12 months of purchase. An OIG audit of a purchased loan showed that a SBA guaranteed loan purchased for \$595,925 in December 1999 was not charged off for 2 1/2 years. The audit also found that the lender did not materially comply with SBA regulations, which resulted in recovery of \$450,559 of the guaranty as recommended in the audit report. This loan would not be eligible for review under the GPR process, however, because it was not charged off within 12 months of purchase. Consequently, the GPR process would not have detected the erroneous purchase. As of September 30, 2002, a total of 3,896 loans purchased for over \$675 million did not meet the 12-month selection requirement. Under current policy, none of these loans will be subject to the GPR quality assurance process.

RECOMMENDATIONS

We recommend that the Associate Administrator for Field Operations take the following actions:

- 2.A On a sample basis, obtain the lender's loan files for loans reviewed under the GPR to ensure the quality of the purchase decision.
- 2.B Employ valid statistical sampling techniques to select purchased loans for GPR team reviews so that results are comparable from year to year and can be used to track progress in reducing erroneous payments.
- 2.C Revise the criteria for selecting loans for purchase decision review by deleting the requirement that a loan be purchased and charged off within a specific timeframe. We recommend that the 12-month criteria be eliminated and that loans be selected based on purchase or charge off date.

Management Response

According to SBA management, the GPR program has had substantial impact on the guaranty purchase process and the number of field office guaranty repairs has increased since the initiation of the GPR. Furthermore, the management document that instituted the GPR in FY 2000 provided that SBA would perform "an arm's length review" of loan processing. This means that the GPR teams must only review the same materials reviewed in the field offices in making purchase decisions. Thus, including a review of the lenders' files would not be consistent with the current process. Management also stated that including the lenders' loan file in the GPR process would impact the workload and significantly increase the costs to SBA and the lenders.

SBA management stated that it uses a random sampling methodology for selecting loans for each GPR. The population of purchased loans from which a sample is selected includes all business loans purchased and charged-off in the prior fiscal year. This ensures that that current purchase practices are reviewed and SBA will not be seeking recovery on loans purchased many years ago, with possible statute of limitations issues. The charge-off criterion ensures that the reviews cover one key basis for denial of liability set forth in 13 C.F.R. Section 120.254. SBA has found through experience that deficiencies in liquidation practices are a common reason for repair actions and therefore, should be examined in the GPR review. The criterion to review loans that were charged off within 12 months of the purchase date is in line with SBA data, which shows that the average time from purchase to charge-off is 9 months.

Another criterion of the GPR process is to select loans from each purchasing field office. SBA believes this is critical for purposes of identifying purchase issues at each field office. According to SBA management, prior OIG reviews included a relatively small number of SBA's

77 field offices and the results were then extrapolated to the entire loan portfolio. While this may be sufficient for OIG projections, SBA seeks to go further with program management. Reviewing a few loans from each field office provides SBA management much greater accuracy and accountability for loan processing.

OIG Response

We do not agree with management's position that the GPR is prohibited from obtaining and reviewing the lender files. It is our position, however, as noted in finding 1, that lender file reviews should be an integral part of the guaranty purchase reviews performed in the field offices. This does not mean that the GPR would need to review lender files for all selected loans. A sample review of a few lender files during each GPR is necessary for quality assurance purposes. Recommendation 2.A was modified based in part, on management's response and our position described herein.

We also do not agree that the GPR sampling methodology is reliable for accurately assessing the condition of the population of purchased loans. The restrictive criteria placed on the GPR sample, i.e., one loan from each district office and loans purchased and charged off within the same 12-month period; limit the sample to a point where it is not representative of the population as a whole. To achieve valid statistical results that reflect the population, it is necessary to use an unrestricted random sample selection method that allows each purchased loan an equal opportunity of being selected. While the sampling methodology used by the GPR may be acceptable for internal oversight purposes, it is not reliable for projecting to the population of purchased loans or reporting the projected level of erroneous guaranty purchase payments. If the Agency plans to use the results of the GPR for these purposes, then the sampling methodology and its limitations must be fully disclosed.

One of the most significant limitations of the GPR sampling methodology is the restriction to loans purchased and charged off within the same 12-month period. In the response, SBA management stated that the average loan is charged-off within 9 months of purchase. Management further stated that the 12-month criteria eliminated problems that would be created if GPR began to examine and question loans purchased several years earlier. Our analysis of the SBA loan data base showed that 40 percent of the loans purchased during FY 2000 and FY 2001 exceeded the 12-month criterion and therefore, would be eliminated from the GPR sample pool. The excluded loans represented \$528.5 million or 66 percent of the total gross guaranties purchased in FY 2000 and FY 2001. Clearly, it appears that the sampling method employed by the GPR excludes a significant portion of the purchased loans from the quality assurance process. Also, regarding the concern of reviewing purchases several years old, the statute of limitations for purchased loans is 6 years from the date of discovery. We question any decision not to pursue recovery on a bad purchase that is within the 6 year period. Consequently, we continue to question the use of the GPR sampling methodology as viable tool for ensuring the overall quality of the guaranty purchase process and protecting SBA against erroneous payments.

Finally, SBA questioned the estimates presented in the 1997 audit report on the guaranty purchase process and the limited number of field offices examined. The sampling methodology used during that audit was based on valid statistical sampling techniques. The sample was based on a 90 percent confidence level, which measures the precision of the sample. Precision is a measure of the expected difference between the values found in the sample and the values of the same characteristics that would be expected to be found if a 100 percent of the units under examination were reviewed. Thus, due to the 90 percent confidence level of the sampling method used during the 1997 audit, the estimated amounts presented in the audit report are most likely representative of the purchased loan population examined during that audit.

Regarding the limited number of field offices examined, during the audit we conducted a survey of personnel in all SBA field offices that make purchase decisions. The results of the survey, which will be issued in a separate OIG Inspection report show that the problems cited in this and prior audit reports are pervasive throughout the SBA field offices.

SCHEDULE OF LOANS REVIEWED

Loan Number	Loan Type	Amount		Purchase Amount	Non-Compliance Type (See Note)
		Disbursed	Purchased	Questioned	
[FOIA	PLP	\$1,000,000	\$640,325	\$640,325	7
EX. 4]	PLP	\$900,000	\$613,530	\$613,530	3
	LowDoc	\$75,000	\$39,856	\$39,856	3
	PLP	\$100,000	\$83,576	\$83,576	2, 4
	PLP	\$140,000	\$96,360	\$96,360	2
	PLP	\$150,000	\$93,689	\$93,689	5, 6
	PLP	\$1,100,00	\$609,203	\$609,203	1, 2, 3
	PLP	\$233,250	\$177,058	\$177,058	2, 6
	PLP	\$150,796	\$116,722	\$116,722	2, 4, 5
	PLP	\$1,250,000	\$542,668	\$542,968	2
	PLP	\$523,700	\$142,549	\$142,549	2, 3, 5
	PLP	\$522,000	\$404,468	\$404,468	1
	PLP	\$200,000	\$152,044	\$152,044	3, 4
	PLP	\$793,000	\$595,925	\$450,559	4
	PLP	\$400,000	\$309,049	\$309,049	2, 4, 5
	PLP	\$846,000	\$653,455	\$653,455	3, 4
	PLP	\$550,000	\$427,079	\$427,079	6, 7
	PLP	\$1,400,000	\$777,516	\$777,516	2, 3, 7
	LowDoc	\$100,000	\$84,911	\$84,911	2, 4
	PLP	\$91,000	\$64,975	\$64,975	2, 3, 6
	LowDoc	\$100,000	\$74,989	\$74,989	2
	LowDoc	\$75,000	\$45,307	\$45,307	2, 3, 5
	CLP	\$450,000	\$194,804	\$63,497	3
	PLP	\$333,000	\$245,981	\$62,402	7
	CLP	\$263,657	\$162,661	\$162,661	3
	PLP	\$234,000	\$177,1668	\$177,166	5,6
	PLP	\$280,000	\$197,752	\$197,752	2, 3, 4, 6
	Regular 7(a)	\$250,000	\$129,802	\$129,802	4
	PLP	\$120,800	\$70,106	\$70,106	4, 6
	PLP	\$220,000	\$168,916	\$168,916	2
Totals		\$12,851,203	\$8,092,439	\$7,632,489	


Note:

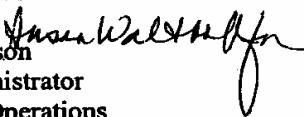
Type of Non-compliance

1. Eligibility
2. Repayment Ability
3. Equity Injection
4. Use of Proceeds
5. Character
6. IRS Verification
7. Collateral (missing or not all available collateral taken)

MEMORANDUM

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing
Office of Inspector General

FROM: James E. Rivera
Associate Administrator
Office of Financial Assistance 

David Frederickson
Associate Administrator
Office of Field Operations 

DATE: February 28, 2003

RE: Audit of Guaranty Purchase Process

We thank you for the opportunity to review and provide written preliminary comments to the draft *Audit of the Guaranty Purchase Process*. Obtaining "better controls over ... [SBA's] business loan purchase process" is currently the Office of Inspector General's (OIG's) Management Challenge Number Five. As stated in OIG's FY 2003 Agency Management Challenge Report (Report Number: 3-04), SBA has made "impressive progress" on Management Challenge Number Five. We appreciate OIG's recognition of the agency's progress in improving the guaranty purchase process, given the great amount of work that has been devoted to this effort.

AGENCY'S ACCOMPLISHMENTS

1. SBA Policy Notice 5000-831, 7(a) Loan Guaranty Purchase Policy

In October of 2002, SBA issued SBA Policy Notice 5000-831, entitled *7(a) Loan Guaranty Purchase Policy*, providing field staff with critical guidance and instructions on guaranty purchase reviews. The guidance was based largely on feedback obtained from the Guaranty Purchase Review (GPR) program. The Offices of Field Operations (OFO), Financial Assistance (OFA) and General Counsel (OGC) worked in consultation with OIG to develop the necessary guidance. We agree with the report's conclusion that this guidance should "help shore up" SBA's purchase process.

2. Uniform Purchase Document Checklist (October 2002)

In October of 2002, SBA issued as an attachment to SBA Policy Notice 5000-831, a guaranty purchase checklist to be used in purchase processing. Field offices are required to use the checklist in the guaranty purchase process, and to attach all supporting

documentation. The checklist should lead to greater consistency in purchase decisions across the country and reduce turnaround time.

3. GPR Program

In FY 2000, SBA instituted the GPR to improve the quality and consistency of SBA's loan purchase decisions. Under the GPR, SBA annually conducts uniform reviews of loan purchase decisions of each of SBA's 77 loan purchasing field offices. SBA has reviewed 605 loan purchase decisions under the GPR. These reviews are intensive and are conducted by a team of senior field loan officers and attorneys. Of the 605 loans examined, GPR reviewers preliminarily identified potential deficiencies in 102 loans. In most cases the deficiencies arose from the need for additional documentation to support the purchase, which OFA then obtained. As a result, OFA's final determinations have so far resulted in a non-concurrence rate of approximately 6% overall (in numbers of loans). Through the GPR, SBA identified over 23 purchase issues that required further Headquarters guidance and clarification. SBA addressed those issues in SBA Policy Notice 5000-831. The GPR process has resulted so far in the recovery from lenders of over \$300,000 in erroneous government payments.

4. Guaranty Purchase Training

OFA, with assistance from OGC and OFO, has developed, and is in the process of finalizing, guaranty purchase training materials. These materials will be converted into an electronic training module and placed on the SBA Intranet. SBA plans to roll out the mandatory training module before the end of FY 2003.

5. Attorney Training

In November of 2002, SBA conducted intensive guaranty purchase training for over 100 field counsel at the national attorney training conference, and training materials were sent to each office. This training highlighted the new guidance contained in the October 2002 policy notice on guaranty purchases (and also the purchase checklist). The training helped ensure that a key reviewer involved in the purchase process at each field office is knowledgeable on the new purchase guidance and procedures.

PURCHASE CONTROLS OVERVIEW

The GPR accomplishments outlined above should shore up the purchase process. They are five of at least eight agency initiatives that should improve the quality of SBA purchases. The remaining three initiatives are also very important. They are:

1. Office of Lender Oversight (OLO) Reviews

During OLO reviews, SBA examines a lender's regulatory compliance with 7(a) program policy and procedures. As part of these reviews, SBA obtains lender loan files and usually reviews them onsite. During the review, weaknesses in the lender's operations may be identified and communicated to the lender. In addition, reviewers may identify issues involving individual loans. These reviews should positively affect the quality of the participant's 7(a) lending activity and compliance with SBA rules and regulations. Improvements resulting from OLO reviews should reduce the number of

loans which SBA cannot purchase. Therefore, OLO reviews serve as an additional purchase control.

2. OIG Lender Audits

OIG examines SBA lender files using comprehensive reviews. OIG personnel are trained to spot fraud and lending irregularities that would not normally be identifiable during routine review processes. In addition, the OIG is a referral point for fraud and other irregularities. SBA officials, as well as members of the public, can refer purchase issues to OIG. Consequently, OIG lender audits are also an important purchase control.

3. Guaranty Repair Tracking System (GRTS)

Through the GRTS, SBA field offices can, during the life of a loan, "tag" loans involving problems to highlight potential purchase issues for purchase processors. Such loan tagging is a nationwide purchase control.

AUDIT RESULTS

Though we have reviewed the OIG draft audit of the guaranty purchase process, we have not yet had an opportunity to review the particular audit results and, therefore, cannot concur or disagree with them. The audit identified 30 of 153 guaranty loan purchases with potential material deficiencies. However, they are only potential deficiencies because some of the identified loans may merely have lacked documentation support rather than having an actual lending deficiency. Several of those loans were already identified through SBA's purchase controls. Most of the other loans relate to a previous OIG audit of a single SBA lender which is no longer making SBA loans. OIG's \$8 million erroneous payment estimate in the draft audit was based on the aggregate guaranty purchase amount. It is likely that actual losses will be much less once loan liquidations are completed and a dollar loss is determined.

The draft audit report highlights results of a separate 1997 audit. In that audit, OIG reported that 17 of 58 loan purchases reviewed possessed potential material deficiencies. Following the 1997 audit report, OIG obtained additional documentation on some of the 17 loans and found that the documentation supported purchase on 6 of the loans. OFA and OGC obtained additional documentation on the remaining 11 loans and then OGC reviewed the legal issues. Ultimately, the Associate General Counsel for Litigation determined, based on the information available, that there were no legal grounds to bring suit against the lender on any of the 11 loans. We note that the 2003 OIG draft report highlights the initial findings on the 17 loans, reporting erroneous payments at the full guaranty purchase amount for the 17, and then projecting losses to the entire portfolio based on the 17 loans. Consequently, the 1997 audit figures likely substantially inflated estimated loan losses.

PRELIMINARY RESPONSES TO REPORT FINDINGS AND RECOMMENDATIONS

SBA has reviewed the draft OIG draft report findings and recommendations and provides the following preliminary responses.

Finding 1: Purchase Procedures did not Minimize SBA's Risk of Making Erroneous Payments

As previously noted, in October of 2002, SBA issued Policy Notice 5000-831 providing 13 pages of critical guidance and instructions to SBA field staff on guaranty purchase reviews. In addition, a document purchase checklist was attached to facilitate these reviews. The guidance and checklist were based largely on feedback obtained from the GPR. OFO, OFA, and OGC worked in consultation with OIG to develop the necessary guidance in the notice. Almost all issues listed by OIG under this draft audit finding were addressed in the notice.

Recommendation 1A: Strengthen the guaranty purchase process by establishing risk-based criteria for obtaining the entire lender's loan files, e.g., for all early default loans. Loans considered to be high risk should be subject to a more detailed review, such as the "two-stage" approach discussed in the audit report.

SBA will study this recommendation. SBA will review, along with other issues, i) SBA cost estimates, ii) recovery and other benefit estimates; iii) human resource availability; iv) lender cost estimates; v) overlap with OLO and IG functions; and v) any legal issues that may arise from implementing this recommendation.

Recommendation 1B: Establish a time frame for completing the training of all individuals involved with guaranty purchase processing.

SBA has developed a timeframe for guaranty purchase field training. SBA plans to develop an electronic training module by May 31, 2003. Before the end of FY 2003, SBA will roll out the on-line training module with all purchase processors required to complete the training within a specified time period.

Finding 2: The Guaranty Purchase Review Process needs Improvement

The audit report cited only two areas that needed improvement in the GPR process. The GPR was an important step toward instituting better 7(a) purchase controls. It is because of the GPR, and the joint efforts of OFO, OFA and OGC, in consultation with OIG, that SBA has substantially increased guidance to the field on guaranty purchases (the guaranty purchase notice, the purchase checklist and purchase training). The GPR reviewed approximately 605 loans. The GPR developed a comprehensive purchase review checklist. The program has developed electronic capabilities to facilitate detailed analyses. The GPR itself has improved field focus on purchase decisions. We believe that field offices will take greater care in purchase reviews as a result. To that end, Headquarters reports an increase in the number of field office guaranty "repairs" since the GPR's initiation. In addition, through the GPR, SBA will be able to pinpoint for field offices and lenders, those purchase issues in which they need guidance.

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***Recommendation 2A:** Obtain and review the Lenders' loan files for each loan subject to the GPR process to ensure that the Lender provided all the necessary documentation to evaluate Lender compliances with SBA rules and regulations.*

The management document that instituted the GPR in FY 2000 provided that SBA would perform "an arm's length review" of loan purchases. Arm's length review mandates that a review be performed on an equal footing: this means that the GPR teams review the same materials (field office loan files) that field staff review when making purchase determinations. Review of lender files would not be consistent with this process, and lender file review is more properly a function of OLO.

From a logistical and workload perspective, lender file review during the GPR is impracticable given the volume of loans that SBA reviews. In addition, lender file reviews during the GPR would increase significantly the GPR and lender costs.

***Recommendation 2B:** Employ valid statistical sampling techniques to select purchased loans for GPR team review so that results are comparable from year to year and can be used to track progress in reducing erroneous payments.*

The GPR utilizes a random sampling methodology for its selection of business loan purchases. The GPR established sampling criteria for each review. The pool criteria include: i) all loans purchased and charged-off in the prior fiscal year, and ii) approximately three loans from each field office performing purchases. These criteria have yielded a pool of loans that has provided SBA with valuable feedback on field office purchases.

Requiring that the loans have been purchased in the prior fiscal year ensures that current purchase practices are reviewed and that SBA will not be seeking recovery on loans purchased many years earlier, with possible statute of limitations issues. The charge-off criterion ensures that the reviews cover one key basis for denial of liability set forth in 13 C.F.R. Section 120.524. These regulations address a lender's failure to make, close, service and liquidate loans prudently. SBA has also found through experience that deficiencies in liquidation practices are a common reason for repair actions and, therefore, should be examined in each GPR review.

SBA reviews loans with a purchase to charge-off time period of 12 months or less. A 12 month purchase to charge-off window is in line with OCIO data showing that the average time from purchase to charge-off is 9 months.

Under the second criteria, SBA requires that the sample include loans from each of the purchasing field offices. This is critical for purposes of identifying the purchase issues of each and every field office. Previous to this, OIG had reviewed loans from a relatively small number of SBA's 77 field offices processing purchases and extrapolated those results to the entire loan portfolio. While this may be sufficient for OIG projections, SBA seeks to go further with program management. Review of loans from

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each of the 77 purchasing field offices provides SBA management much greater accuracy and accountability for loan purchases.

As evidenced above, much thought has gone into the GPR and its sampling methodology. That said, SBA is, and has always been, open to fine-tuning the process. We are, therefore, planning to review further purchase portfolio statistics to determine if we can adjust the sampling methodology without sacrificing the breadth and usefulness of the review data. We will work with OIG on this suggestion and thank them for their thoughts on this matter.

Recommendation 2C: Revise the criteria for selecting loans for purchase decision review by deleting the requirement that a loan be purchased and charged off within a specific timeframe.

Again, the criteria noted above for sample selection ensure that SBA is reviewing current loan practices. We reiterate that we will review the purchase portfolio statistics to determine if we can fine-tune the GPR sampling methodology without sacrificing the breadth and usefulness of the review data.

In conclusion, we thank OIG for the opportunity to provide preliminary comments on the draft report. We appreciate OIG's constructive feedback as SBA has been tightening purchase controls. Based on the audit and management challenges reports, which acknowledge the progress that SBA has made in the guaranty purchase review process, we anticipate that guaranty purchases will soon be removed from the Agency's Top Ten Management Challenges.

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