

AUDIT REPORT
LOAN ORIGINATION AND SERVICING PRACTICES
OF NET 1ST NATIONAL BANK

AUDIT REPORT NUMBER 2-01

October 29, 2001

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA operations. The finding 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.

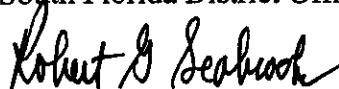


U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
ISSUE DATE: OCTOBER 29, 2001
REPORT NUMBER: 2-01

DATE: October 29, 2001

TO: Francisco Marrero
District Director
South Florida District Office

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

SUBJECT: Audit of Loan Origination and Servicing Practices of Net 1st National Bank

Attached is a copy of the subject audit report. The report contains one finding and eight recommendations. You agreed with the recommendations and your comments have been synopsized in the report.

The findings in this report are the conclusions of the Office of Inspector General's Auditing Division. The findings and recommendations are subject to review and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide your management response to the recommendations within 30 days from the date of this report on the attached Recommendation Action Sheets (SBA Form 1824). The forms should be sent to:

Audit Manager
SBA OIG/Atlanta Field Office, Suite 1803
233 Peachtree Street, NE
Atlanta, Georgia 30303

Any questions you may have regarding this report may be directed to Garry Duncan, Director, Credit Programs Group, at 202-205-7732.

Attachment

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SUMMARY

A review of Net 1st National Bank (Net 1st) was made to determine if 7(a) loans were processed and serviced in accordance with SBA's policies and procedures. In a June 2000 examination report, the Office of the Comptroller of the Currency (OCC) Examination Report identified 12 SBA guaranteed loans that it believed increased the government's risk of loss. The OCC referred this matter to SBA's South Florida District Office who in turn referred the matter to the OIG in July 2000 and stated that the bank was materially mismanaging its 7(a) loan portfolio. A consent order entered into by the OCC and Net 1st subsequent to the start of our audit, required the bank to cease making SBA guaranteed loans until its lending, processing, and servicing procedures improved. The consent order was lifted in November 2000.

Our audit efforts confirmed that, prior to the consent order, Net 1st was not processing and servicing 7(a) loans in accordance with SBA policies and procedures. The bank did not have evidence of a comprehensive written SBA lending policy and did not have competent experienced lending staff. Both the OCC and we identified numerous deficiencies for loans processed prior to execution of the consent order. As a result of the OCC findings, the lender took actions to improve its loan processing and servicing practices. However, we noted that additional improvements were required. Areas still needing improvement included: (i) equity injection documentation; (ii) use of loan proceeds, (iii) packager and loan service provider compensation; and (iv) compensation documentation paid to outside agents.

We recommend that the District Director, South Florida District Office, require that Net 1st make improvements in its lending practices in the areas of equity injection, loan proceeds, and compensation paid to outside agents. The District Director agreed with each recommendation and notified Net 1st of the corrective actions to be taken.

INTRODUCTION

A. Background

Net 1st National Bank, a subsidiary of First Telebank Corporation, is located in Boca Raton, Florida. The bank became an SBA lender in October 1994 making loans as a regular and LowDoc lender in 13 SBA districts (New York, Baltimore, Georgia, North Florida, South Florida, Indiana, Mississippi, Louisiana, Dallas/Fort Worth, Houston, San Antonio, St. Louis, and San Francisco).

On July 6, 2000, the Office of Inspector General received a letter from SBA's South Florida District Office stating that Net 1st was materially mismanaging its 7(a) loan program. The district provided a letter from the OCC dated June 20, 2000, along with excerpts from the most recent OCC examination report referring to 12 SBA guaranteed loans originated by the bank.

The district office said there were problems in the following areas:

- imprudent lending practices,
- loan delinquencies,
- non-compliance with the loan authorization,
- ineligible use of loan proceeds, and
- lack of or misleading documentation.

On September 25, 2000, Net 1st and the OCC entered into a Consent Order agreeing not to process SBA guaranteed loans until specific OCC requirements were met. The loan processing prohibition was lifted in November 2000.

For the period October 1, 1998, to October 31, 2000, the lender approved 83 SBA guaranteed loans valued at \$42.4 million with government guarantees of \$31.1 million. As of October 31, 2000, 11 of these loans were cancelled or paid in full, and 65 were committed or current, and 7 were troubled (past due, delinquent, or in liquidation).

B. Objectives and Scope

The objective of the audit was to determine if Net 1st was processing and servicing 7(a) loans in accordance with SBA policies and procedures. If not, were the deficiencies material, and what was the cause?

From the 72 committed, current, and troubled loans in the lender's portfolio at October 31, 2000, we selected for review 9 loans, 8 of which were cited by the OCC and 1 additional loan based on its troubled status. To verify that the lender had corrected deficiencies cited by the OCC, we reviewed three of six new loans disbursed during the period November 2000 to March 2001.

Audit fieldwork consisted of reviewing SBA and lender loan files and obtaining information from loan packagers and vendors. We interviewed personnel from the SBA, OCC, lender, service providers, vendors, and the borrowers. Fieldwork was performed

from November 2000 through June 29, 2001. The audit was performed in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

FINDING 1 - Net 1st National Bank's Loan Processing Practices

Net 1st was not processing and servicing 7(a) loans in accordance with SBA policies and procedures. The OCC identified, and our audit confirmed, deficiencies in the bank's loan processing and deficiencies applicable to specific loans processed prior to the lifting of an OCC consent order in November 2000. The bank took actions subsequent to this date to improve loan processing and servicing practices. However, we noted that improvements were still required. Areas needing improvement included documentation of: (i) equity injections; (ii) use of loan proceeds, (iii) packagers and loan service provider use, and (iv) fee compensation paid to outside agents.

a. Lending Practices Prior to the OCC Consent Order

Net 1st Bank's lending practices, prior to the OCC Consent Order, did not adhere to SBA regulations and procedures because of the bank's inadequate internal controls.

Problems Identified by the OCC

An OCC examination of lending practices disclosed that the bank's underwriting, ongoing supervision, and administration of its portfolio were highly deficient. The lender, in the interest of compliance and cooperation with the OCC, signed a Consent Order to improve its lending procedures. Because of an OCC prohibition on release of information, we were not able to review the examination report in its entirety. However, the consent order required the following actions be taken to correct the lender's deficiencies.

- Develop a comprehensive written SBA lending policy and program requiring:
 - loans be underwritten by bank personnel,
 - supporting documentation be obtained and reviewed prior to loan approval,
 - the bank to conduct an independent verification and analysis of borrower credit, financial, and other information,
 - appraisals be prepared by bank approved appraisers,
 - the bank to use an independent appraisal and review system.
 - bank personnel to make lending commitments and approve loans, and
 - loan closing agents and attorneys be approved by the bank.
- Establish a management information system to accurately track loan transactions such as payments, status, covenant compliance, or periodic financial statements.
- Ensure that it has a competent, experienced senior lending officer or sufficient lending staff for its SBA loans.
- All loans prepared by third party loan packagers are pursuant to a written contract specifying all conditions, terms, and prohibitions.

Based on excerpts from their report, the OCC took exception to the way at least 12 of the SBA guaranteed loans were processed or serviced. The comments can be categorized as follows:

- Insufficient information in loan files to determine debt service coverage.
- Insufficient justification in credit analysis to support the proformas.
- In appropriate classification of debt.
- Insufficient equity injections.
- Uncleared liens.
- Failure to use loan proceeds as authorized.
- Cash flow problems.
- Failure to obtain updated financial statements.

Additional Non-compliances Identified by the OIG Audit

A review of 8 of the 12 loans referred by the OCC and another pre-consent order loan confirmed the problems cited in the examination report plus the following additional non-compliances:

- IRS verification of financial data.
- Lack of credit reports on principals and existing businesses.
- Documentation of senior debt.

Our audit confirmed that the lender had corrected the problems identified by both the OCC examination and our review.

b. Lending Practices Subsequent to the Lifting of the OCC Consent Order

We then reviewed Net 1st lending practices for three of six loans processed after the lifting of the Consent Order through March 31, 2001. In accordance with the consent order, the bank had adopted a formal written lending policy manual and established procedures to monitor, maintain, and improve bank oversight of the SBA loan portfolio. We found, however, that improvements were still needed for lending practices in four areas--equity injection documentation, use of loan proceeds, packager and loan service provider use, and documentation of compensation paid to outside agents.

○ *Inadequate support for cash injections*

The lender had not ensured that the borrowers had injected appropriate cash into the business as required by loan authorization agreements for two loans requiring injections of [Ex. 4] One loan file had a "Cash-Injection Affidavit" certifying that the borrower had met the injection requirements supported by copies of checks drawn on the borrower's personal account. However, neither loan file had cancelled checks, receipts, original "stamped" paid invoices, or similar documentation evidencing the required

injections were put into the business. Title 13 of the Code Federal Regulations, part 120.150(f) states that SBA will consider (as part of an applicant's credit worthiness) sufficient invested equity to operate on a sound financial basis.

○ *Monitoring of loan proceeds not documented*

The lender had not obtained appropriate documentation regarding the use of loan proceeds for the previously mentioned loans. The two loans were disbursed for [Ex. 4] respectively. The lender's documentation did not properly evidence that the disbursed loan funds had, in fact, been used as required by the loan authorization. SBA Form 1050, Settlement Sheet, requires the disclosure of the purpose of the loan proceeds and the name of applicable payees in an effort to monitor the disbursement of loan funds. SBA procedures are intended to reduce risk and assure that loan proceeds are used for eligible purposes.

○ *Improper Use of Packagers and Lender Service Providers*

Agents were improperly serving as both packagers and lender service providers (LSP) on the same loan transactions on 8 of 12 loans reviewed. This relationship is barred by Title 13 of the Code of Federal Regulations and SOP 50 10 (4)(B), Subpart A, except under very specific circumstances. The lender contracted with two LSPs during the period, January 1999 through April 2001. The initial LSP, [Ex. 4] [Ex. 4] served as both packager and LSP on the same loan transactions from January 1999 through November 1999. A second LSP, [Ex. 4] was employed from December 1999 through April 2001. We confirmed that packaging fees totaling \$14,350 and LSP payments totaling \$204,824 were paid to the agents operating in this dual capacity during the review period.

The agents had executed agreements with the lender that clearly state that the agents were lender or bank service providers and which identified lender functions to be performed by the agents and the compensation to be provided. In a letter to the OIG, dated February 9, 2001, the bank's former president confirmed that the agreements between the lender and its agents gave the agents authority to operate as a third-party service provider for the bank and to conduct activities on-behalf of the bank.

While the lender and LSP agents confirmed that fees had been paid, both entities contend that the agents were actually serving in the capacity as "referral agents" and not as "LSPs" for the loans in question. In accordance with 13 CFR, part 103.1, a referral agent is a person or entity who simply identifies and refers an applicant to a lender or a lender to an applicant. It defines a LSP as an agent who carries out lender functions in originating, disbursing, servicing, or liquidating a specific SBA business loan. It also

requires lenders to have written agreements with LSPs governing the compensation charged and the services to be rendered. The agreements between the agents and Net 1st and the agents' actions met the definition of an LSP.

In addition to the lender's contention that the agents were not serving as LSPs, this condition occurred because the South Florida District Office did not use information provided to it to identify the condition. The district was aware of the two agents acting as LSPs and, for one, obtained copies of the LSP agreements for each loan. The SBA Form 4, submitted with each loan application, disclosed the packaging fees received by the agents. The district merely had to compare the LSP agreements to the SBA Form 4 to know that the agents were acting contrary to SBA regulations.

o *Lack of Approved Compensation Agreements*

The lender did not disclose compensation agreements as required by Title 13 of the CFR. Our review of five loan files disclosed four that had 13 instances for which compensation agreements were not submitted for services totaling \$15,420. The services not disclosed to SBA included real estate appraisals, legal services, environmental inspections, broker fees, and packaging services. Additionally, in two instances when compensation agreements were provided, they did not provide proper itemization to support \$7,100 in fees. Each of these agreements was for legal services, but was missing the itemization of the specific services and the dates and time charged. Without this information, SBA was prevented from making an assessment of whether all fees related to SBA financial assistance were reasonable.

Title 13 of the CFR, Part 103.5(a) requires any applicant, agent, or packager to execute and provide to SBA a Compensation Agreement, SBA Form 159. Further, the Compensation Agreement requires that each charge exceeding \$1,000 be itemized on a separate schedule, reflecting the date, time, and description of services rendered. Part 103.5(b) of the CFR authorizes SBA to reduce the charge or refund any amounts charged where SBA deems the compensation unreasonable.

The deficiencies identified by the OCC and the SBA OIG prior to the Consent Order occurred because Net 1st had not established adequate internal controls to ensure proper loan origination and servicing. Net 1st did not have an internal loan processing and servicing function, could not provide evidence of formal written loan origination and servicing policies and procedures, did not have internal personnel experienced with SBA policies and procedures, and did not adequately review loan packages received from agents for compliance with SBA policies and procedures. Without these controls, Net 1st had no way of determining if the efforts of the lender service providers met SBA's standards.

We recommend that the District Director, South Florida District Office, take the following actions:

- 1.A. Require evidence from Net 1st that borrower financial information has been verified with the IRS for all SBA loans approved during the first 6 months of Fiscal Year 2002.
- 1.B. Require Net 1st to document that the equity injections for loan numbers [EX. 4] were placed into the businesses, and to provide documentation supporting required equity injections for all loans made during the first 6 months of Fiscal Year 2002.
- 1.C. Require Net 1st to verify the use of loan proceeds for loan numbers [EX. 4] [EX. 4] and to provide evidence that it verified the use of loans proceeds for all loans made during the first 6 months of Fiscal Year 2002.
- 1.D. Ensure the applicable loan files and the automated management information system are annotated with the applicable deficiency in the event the lender cannot verify the financial information, cannot document that the equity injections were placed into the business, or that the loan proceeds were used as authorized.
- 1.E. Notify lenders of the prohibition against having agents compensated as packagers and LSPs for the same loan transaction.
- 1.F. Compare lender service provider agreements to information in loan applications to determine if agents served as both loan packager and LSP on the same transaction. Decline to review loan applications for which this situation occurs.
- 1.G. Request that the Administrator suspend the privileges of any agents violating the ethical codes contained in CFR, part 103 regarding agents conducting business with SBA.
- 1.H. Require Net 1st to submit SBA Form 159 in accordance with SBA requirements.

Management Comments

The District Director, South Florida District Office, agreed with the recommendations. We attached the District Director's letter, dated October 2, 2001, to the lender requiring it to implement the recommendations.

Evaluation of Management Comments

Management's comments and actions are acceptable.

F21A EX. 4

Lender Comments

A copy of the report was provided to the lender and a response was requested. As of the report issue date no response was received.

Appendix A

LOAN FILES REVIEWED

	BORROWER	DISTRICT OFFICE	LOAN NUMBER	DISBURSE. DATE	GROSS LOAN AMOUNT	LOAN STATUS (3/31/01)
1.	FOIA EX. 4+6					Liquidation
2.						Liquidation
3.						Liquidation
4.						Past Due
5.						Past Due
6.						Current
7.						Current
8.						Current
9.						Current
10.						Current
11.						Current
12.						Current
	TOTAL				\$8,153,700	

FOIA EX.
4+6



**U.S. SMALL BUSINESS ADMINISTRATION
SOUTH FLORIDA DISTRICT OFFICE
100 SOUTH BISCAYNE BOULEVARD, 7TH FLOOR
MIAMI, FLORIDA 33131-2011
TELEPHONE (305) 536-5521 FAX (305) 536-5058**

APPENDIX B

October 2, 2001

Jackie J. Roesser, Acting President
Net 1st National Bank
5295 Town Center Road
Boca Raton, FL 33486

Re: Audit Report – Office of the Inspector General

Dear Ms. Roesser,

I have been provided with a copy of the audit report of the banks SBA loans that were reviewed by the staff of the Office of the Inspector General (OIG). This report recommends that District personnel take several remedial actions to ensure compliance with SBA policy and regulations. Below please find a summation of the recommendations, some of which require your timely reply and others will be requirements implemented for a certain period of time.

1. During the first six (6) months of this fiscal year (10/1/01 to 3/31/02) all applications submitted to the District Office and to the LowDoc Center must be accompanied by IRS transcripts which were received pursuant to requests via IRS Form 4506. Loans presented without these transcripts will not be processed.
2. Please provide to this office the necessary documentation to support equity injections for loans [ex. 4] During the first six (6) months of this fiscal year (10/1/01 to 3/31/02) it will be required that the bank provide documentation demonstrating equity injections, both on loans processed in the District and at the LowDoc Center.
3. Please provide the necessary documentation for SBA to verify the use of loan proceeds on loan numbers [ex. 4] During the first six (6) months of this fiscal year (10/1/01 to 3/31/02) it will be required that the bank provide documentation (based on policy, acceptable to SBA) of use of proceeds for all loans approved in the District or in the LowDoc Center. This documentation must be submitted with SBA Form 2004 after the loan has closed.

FIA ex 4

4. All loan service providers must provide the District office with a copy of their written agreements with the bank. This will enable SBA to determine if any agents have served as Loan Service Providers and Packagers on the same transaction. We will decline to review loan applications for which this situation occurs. The District will request that the Administrator of the SBA suspend privileges of any agents violating the ethical codes contained in CFR, part 103 regarding agents conducting business with the SBA.
5. SBA Form 159, Compensation Agreement must be provided for every loan processed in the District of in the LowDoc Center. This form must be presented with the application.

The documentation required in items 1, 2 & 3 is above and beyond the normal items for a LowDoc loan. Should the processing center indicate to you that this constitutes a more complex situation than they are equipped to handle, they may suspend your LowDoc privileges at their option.

We have been directed to document those two specific loans (noted above) and would appreciate you prompt attention to those items.

Please feel free to call me or John Dunn, Chief, Finance Division, if you have any questions in this matter.

Sincerely


Francisco A. Marrero,
District Director

Cc: Fred Hanus, Center Manager, LowDoc Processing Center
Robert G. Seabrooks, Assistant Inspector General
Jane P. Butler, Associate Administrator, OFA

APPENDIX C

AUDIT REPORT DISTRIBUTION

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