SECURING COLLATERAL FOR DISASTER LOAN DISBURSEMENTS

Report Number: 07-22

Date Issued: May 9, 2007

U.S. Small Business Administration
Office Inspector General

Memorandum

To: Herbert L. Mitchell, Associate Administrator
Office of Disaster Assistance

Date: May 9, 2007

[Exemption 6]

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Report on Securing Collateral for Disaster Loan Disbursements
Report No. 07-22

This is the second in a series of reports resulting from our audit of SBA's efforts to expedite loan disbursements during its *90-in-45 Campaign* at its Loan Processing Center in Fort Worth, Texas. The campaign was started in the fall of 2006 to resolve a backlog of more than 90,000 loans approved for Hurricanes Katrina, Rita, and Wilma within 45 days. We initiated the audit in response to an employee complaint that loans processed during the campaign were being disbursed contrary to borrowers' wishes and without obtaining all of the documents required to disburse the loan proceeds. The complainant also alleged that mortgage documents were being destroyed, limiting SBA's ability to record a lien on the property, and that SBA was not using staff and resources cost effectively.

This report addresses whether SBA (1) obtained all of the documents required to protect its interest in collateral on secured loans prior to disbursing loan proceeds, and (2) maintained original mortgage documents needed to record a lien on property serving as collateral on secured loans. We focused our initial efforts on determining whether collateral had been secured because at the time of our audit the center had a backlog of 4,970[1] unprocessed checks from borrowers for collateral recording and filing fees. Work is continuing to determine whether other required documents were secured prior to making loan disbursements, and findings related to this portion of the work will be reported separately.

---

[1] This represents the number of unprocessed checks related to Gulf Coast hurricanes at the Loan Processing Center in Fort Worth, Texas that was observed on January 18, 2007. There was actually a backlog of 5,656 unprocessed checks that day; however, 686 were not related to the Gulf Coast hurricanes.

We reviewed loan files in the Disaster Credit Management System (DCMS) associated with 80[2] of the 4,970 unprocessed checks observed at the center on January 18, 2007, which required collateral to determine whether SBA disbursed loans prior to perfecting liens on property used to secure the loans. The combined value of the 80 loans sampled totaled approximately $9.5 million.[3] We also determined whether the recording of mortgages and Uniform Commercial Code (UCC) filings on personal property were made timely after receipt of the filing fees from borrowers. Because the processing center did not date-stamp checks when they were received, we assessed the age of the checks based on the dates that checks were written.

To determine if mortgage documents were being destroyed, we performed a walk-through of the warehouse used by the center for storing archived scanned documents. We also interviewed loan officers and managers at the processing center and asked center staff to produce copies of mortgages on 21 randomly selected loans.

We conducted this portion of the audit from January to February 2007 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States. A more detailed description of our audit scope and methodology is provided in Appendix I.

BACKGROUND

The Small Business Administration (SBA) provides direct disaster loans to help homeowners, renters, businesses and nonprofit organizations return to pre-disaster condition. SBA disaster loans are the primary form of Federal assistance for non-farm, private sector disaster losses and are the only form of SBA assistance not limited to small businesses.

Physical disaster loans over $10,000 and economic injury loans over $5,000 must be secured with collateral. According to SBA officials, for physical disaster loans with disbursements of $50,000 or less, SBA requires an executed mortgage (signed and notarized, but not recorded) and a check from the borrower for filing fees.[4] For loans between $50,000 and $250,000, loan closing attorneys are instructed to obtain either a recorded mortgage, deed of trust, a deed to secure debt, or proof of recording, and a title search report. For loans exceeding $250,000, SBA also requires proof of title insurance unless it waives this requirement. Loans approved for personal property require the filing of a UCC with the Secretary of State or county.

---

[2] The 80 loans were statistically sampled to allow for projections to be made with a 95-percent confidence level.

[3] The $9.5 million represents the approved amount of the loans and is rounded up from $9,462,850.

[4] It is expected that SBA will record the mortgage immediately after disbursement.

SBA's Loan Processing and Disbursement Center in Fort Worth, Texas is responsible for approving and disbursing disaster loans. The Fort Worth center currently employs a title desk to facilitate the recording of collateral documents with title companies. Borrowers submit executed collateral documents and title fees via check or money order. A copy of the check is made and the check itself is separated from collateral documents in the mailroom, subsequently entered in the field cashiering system, and retained by the collateral cashier for safekeeping. The collateral documents are forwarded to the case manager/closer who becomes the initial reviewer of the collateral documents for legal sufficiency. The case manager/closer then forwards the documents to the title desk, where they are again reviewed for legal sufficiency.

Once approved by the title desk, the check is retrieved from the cashier to be matched with the collateral documents and sent to the title company for recording. Alternatively, borrowers may file the collateral documents directly with the state, county or parish.

RESULTS IN BRIEF

As a result of the *90-in-45 Campaign* SBA disbursed over $858 million on 25,732 loans by November 4, 2006, significantly reducing the backlog of undisbursed loans from 90,000 to less than 45,000. Given the size of SBA's loan backlog prior to the campaign, this was a significant accomplishment, which helped to get needed funds into the hands Gulf Coast disaster victims faster.

While the Agency's efforts to reduce the backlog succeeded in expediting loan disbursements, in its haste, SBA did not properly secure its interest in collateral on many of the disbursed loans. Our audit disclosed that SBA disbursed approximately $7.3 million[5] on 61, or about 76 percent, of the 80 loans without properly securing all of the loan collateral. According to records maintained in DCMS, 36 of the 61 loans had missing documents for one or more pieces of collateral prior to disbursement. For 19 of the 61 loans, collateral perfection was not required prior to disbursement as the total amount disbursed was $50,000 or less. However, SBA was still required to obtain collateral documents prior to disbursement and perfect the collateral immediately afterwards. Despite this requirement, as of January 30, 2007, SBA disbursed the 19 loans before obtaining all executed mortgages or recordable UCCs and had not taken actions to perfect all collateral on the loans.

[5] The $7.3 million is rounded up from $7,281,750.

Premature disbursement; however, was not just a problem during the campaign, but also occurred prior to the Agency's disbursement initiative. Of the 61 loans, 35 were disbursed prior to the *90-in-45 Campaign.* Projecting the sample results to the universe of loans disbursed, we estimate that SBA released $368 million in loan proceeds on about 3,113 secured loans without perfecting liens on property used as collateral or completing UCC filings.

While our review was limited to unprocessed checks on hand as of January 18, 2007, we believe that improperly securing collateral is a systemic issue that extends beyond those loans examined in our audit as many of the underlying reasons for the problems relate to how the center processes loan disbursements. For example, in some instances case managers/closers disbursed loans before the collateral documents had been properly reviewed for legal sufficiency by the title desk. Consequently, the documents had to be corrected and returned to the borrowers for execution, which in some cases took up to 6 months, delaying SBA from perfecting the collateral. In other instances, collateral documents and associated checks for filing fees had been separated in the mailroom and could not be re-matched together once the documentation had been reviewed and was ready to be filed.

Finally, the center could not process many of the checks either because they were too old to be accepted by the title company or had incorrect information. In these instances the checks had to be returned to the borrower and replacement checks issued before the collateral could be secured. For example, approximately 52 percent of the backlog (2,949 checks) were over 90 days old and had to be replaced by the borrowers. We also found instances where borrowers' checks were either written for the wrong amount or to the wrong payee. When checks were incorrect, loan closers did not always timely follow-up with borrowers to obtain replacement checks, which created further delays in securing the collateral.

As of February 21, 2007, the center had significantly reduced the backlog to 3,699. However, the center continues to get large volumes of checks daily for fees associated with securing loan collateral, preventing it from eliminating the backlog entirely. Consequently, we believe that SBA needs to pursue a different process for securing payment for the mortgage and UCC fees that does not rely on paper checks submitted by borrowers. One option may be to deduct the mortgage and UCC filing fees directly from the loan proceeds so that borrowers do not have to remit checks.

Finally, we could not substantiate the allegation that mortgage documents had been destroyed. While case managers told us they believed mortgage documents were being shredded, they were unable to provide us examples that we could validate. We also attempted to locate the original mortgage documents for 21 loan files for which liens had been perfected. The center was able to locate 17 of the collateral files, which we verified contained original mortgage documents. The other four files had been transferred to servicing.

On March 22, 2007, we provided SBA with the draft report for comment. On April 17, 2007, SBA provided us with its formal response, which is contained in its entirety in Appendix IV. SBA generally concurred with the audit findings and recommendations and provided comments on the funds it considers to be "at risk" on loans involving relocation property purchases. SBA believes that because some of these loans have been partially collateralized, the funds "at risk" should be based on only that portion which has not been collateralized.

We disagree with SBA's position because Agency procedures require that *all collateral* be secured before certain levels of disbursements can be made, and SBA cannot be certain that the collateral already recorded will be of sufficient value to cover the full amount of loan proceeds when the loan defaults. SBA also indicated that many of the loan files began to show that collateral was recorded during February and March 2007 and that the timing of our review impacted our assessment of the files. While loans may have been collateralized subsequent to our audit, the fact remains that SBA is required to, but did not, secure all collateral before disbursing funds on the loans we reviewed. In some cases SBA had fully disbursed the loans. This practice jeopardized SBA's lien holder position for the loan assets and eroded SBA's leverage in getting borrowers to execute collateral documents. A summary of SBA's comments and our response can be found on pages 10 through 13 of this report.

RESULTS

SBA Did Not Perfect Collateral for $368 Million in Loan Disbursements

We statistically sampled 99 loans from a universe of 4,970 loans associated with checks backlogged at the title desk. For approximately 80 of the sampled loans, loan officers were required to secure collateral before loan disbursement. We found that the center disbursed approximately $7.3 million on 61, or 76 percent, of the 80 secured loans without perfecting all of the collateral. According to the records maintained in DCMS, 36 of the 61 loans had missing documents for one or more pieces of collateral prior to disbursement. For 19 of the 61 loans, collateral perfection was not required prior to disbursement as the total amount disbursed was $50,000 or less. However, SBA was still required to obtain collateral documents prior to disbursement and perfect the collateral immediately afterwards.

Despite this requirement, as of January 30, 2007, SBA disbursed the 19 loans before obtaining all executed mortgages or recordable UCCs and had not taken action to perfect all collateral on the loans. As shown in the table below, the majority of the unsecured collateral involved unrecorded mortgages. Projecting the sample results to the universe, we estimate that about $368 million on 3,113 loans were disbursed without proper collateralization.

Table: Status of Collateral Processing for 99 Sampled Loans

Status	Category	Number
Collateral not Perfected as Required	UCC not filed (5 were missing documents)*	8
	Mortgage not recorded (31 were missing documents)*	46
	Mortgage not recorded timely	4
	UCC and mortgage not perfected	3
	Total	**61**
Collateral Perfected Prior to Disbursement	UCC filed	3
	Mortgage recorded**	16
	Total	**19**
	Total loans requiring collateral before disbursement	**80**
	Collateral not required	19
Collateral Not Required	***Total Loans Reviewed***	***99***

*For 19 of these loans (5 required UCC and 14 required mortgage filings), collateral perfection was not required prior to disbursement as the total amount disbursed was $50,000 or less.

**Three mortgages were recorded after disbursement, but met SBA requirements because the loans did not exceed $50,000.

During our review of the sampled loan files, we found 10 instances where collateral documents were still being reviewed for legal sufficiency well after the loans were disbursed. Specifically:

- Collateral documents for 3 loans were returned to borrowers for execution more than 6 months after disbursement;
- Collateral documents for 6 loans were received from the borrower more than 2 months after disbursement; and
- The borrower was unwilling to execute corrected documents on one loan after the disbursement was made.

Not perfecting liens in a timely manner increases the Agency's risk of losing its lien position to other creditors. For example, in Louisiana, the lien holder's position is established on a first-come, first-served basis. Therefore, delays in filing or recording liens could result in a subsequent creditor obtaining a higher lien holder position than SBA. Due to the projected high volume of loans we identified that were disbursed without securing the proper collateral, SBA should review all loans associated with the backlog of checks to ensure the loans have been properly collateralized.

Further, while our review was limited to unprocessed checks on hand as of January 18, 2007, we believe that improperly securing collateral is a systemic issue that extends beyond those loans examined in our audit as many of the underlying reasons for the problems relate to how the center processes loan disbursements.

Collateral Could Not Be Secured Because Documents Were Not Legally Sufficient and Borrower Checks Could Not Be Processed

Based on interviews of staff at the center and data in DCMS, a variety of problems led to the occurrence of under-collateralized loans. These included:

- Case managers/closers thought they had the needed collateral documents, but the documents were subsequently determined to be legally insufficient;
- Documents had been separated from checks for filing fees and could not be re-matched once documents were ready for filing; and
- Checks were too old to process or had incorrect information.

Case Managers/Closers Disbursed Loans Based on Documents that Were Not Legally Sufficient

While center staff attempted to provide the needed loans as expeditiously as possible, according to entries in DCMS, collateral documents were not legally sufficient to execute on 11 of the 61 loans that were disbursed without first securing all of the collateral. Specifically, we found that:

- 4 mortgages needed to be reprinted;
- 4 collateral documents were unsigned, had not been notarized or were returned to the borrowers for execution;
- 1 mortgage needed to be replaced;
- 1 escrow document needed correcting; and
- 1 amended security agreement was needed.

These problems occurred because the collateral documents did not undergo a legal review prior to disbursement, which is normally performed by the title desk.

Documents Could Not Be Matched with Checks for Filing Fees

Staff at the center stated that a primary reason why collateral had not been perfected was because collateral documents could not be matched with borrowers' checks for filing fees when it came time to file the collateral documents. They explained that mailroom staff at the center separated checks for filing fees from the executed documents for safekeeping while the documents were scanned into DCMS and reviewed for completeness. After documents were scanned they were sometimes erroneously archived instead of being returned to the title desk for a legal review and mailing to the title company.

During the audit we observed employees searching through boxes of archived files to locate some of the missing collateral documents. Moreover, documents were difficult to retrieve from archives because they were filed chronologically by the date they were scanned into DCMS. Therefore, to retrieve the documents, center staff had to determine the date the documents were scanned and search through all of the boxes of documents scanned that day.

SBA's inability to match documents with checks resulted in some collateral documents being sent to title companies for recording as late as 6 months after disbursement. For example, the disbursing center issued a letter to one borrower 4 months after disbursement, stating that it misplaced the mortgage documents and requesting the borrower to sign, notarize, and resubmit the documents. The letter also requested the borrower to issue a replacement check since the original check was over 6-months old. (A copy of the letter is provided in Appendix II.)

We also attempted to determine whether collateral documents had been inappropriately destroyed as alleged by a center employee, which could explain why some documents were missing. Several case managers told us they believed mortgage documents were being shredded; however, they were unable to provide us examples that we could validate. We also requested 21 loan files for which liens had been perfected to determine whether the center maintained the original collateral documents. We were able to verify that 17 had the original collateral documents. We did not review the other four files because the center had transferred them to servicing. Therefore, we were unable to substantiate the employee's claim.

Checks Were Too Old To Process or Had Incorrect Information

As of January 18, 2007, the processing center had a backlog of 4,970 unprocessed checks from borrowers to cover fees associated with recording mortgages and making UCC filings on loans resulting from the Gulf Coast hurricanes. While we could not determine when the center received the checks because they were not date-stamped upon receipt, 2,949 or 52 percent were over 90 days old, of which 2 percent were 1- to 3-years old.

Center staff stated that if checks are not processed within 90 days, the title companies will generally not accept them, putting SBA in the position of having to request a replacement check from the borrower. Not processing these checks timely potentially puts the Agency at risk of losing its lien position in the event the borrower defaults on the loan. For example, in Louisiana, the lien holder's position is established on a first-come, first-served basis. Consequently, delays in filing or recording liens could result in a subsequent creditor obtaining a higher lien holder position than SBA.

We also found instances where borrowers' checks were either written for the wrong amount or to the wrong payee. For example, of the 61 loans files we reviewed, we found 6 instances where the center had to request a replacement check because the borrower remitted a check for an incorrect amount. According to center staff, checks were made out for incorrect amounts because employees were not always aware of various state and title company fees and would misinform borrowers. When checks were incorrect, loan closers did not always timely follow-up with borrowers to obtain replacement checks. Additionally, we identified three instances where a borrower made his/her check payable to the wrong payee rather than to the title company.

SBA Took Actions to Correct Deficiencies in the Processing of Collateral Documents

During the audit, SBA made efforts to correct many of the deficiencies we identified. For example, to ensure that executed documents are legally sufficient before loan disbursement, the center now ensures that the title desk reviews collateral documents before they are sent to the borrower for execution. As of February 21, 2007, SBA had also reduced the backlog of checks to 3,699 by realigning staff and improving disbursement procedures. Further, to prevent borrowers from having to submit replacement checks when the payee information is incorrect, SBA now signs the check over to the title companies.

While these actions are commendable, SBA needs to reevaluate its process for collecting recording and filing fees from the borrowers. The center continues to have a backlog of unprocessed checks because the check volumes have been large. The process becomes especially cumbersome when checks have to be returned to borrowers because they are too old or inaccurate. The Agency is likely to continue to experience delays in processing checks for recording and filing fees unless an automated solution is pursued. One option would be to deduct closing fees directly from loan proceeds, which would not only expedite the filing of collateral documents, but would eliminate errors in the amount of check fees and require less center resources to process disbursements.

RECOMMENDATIONS

We recommend that the Associate Administrator for Disaster Assistance:

1. Direct the Loan Processing Disbursement Center to perfect collateral on the 61 loans identified during the audit that had not been perfected.

2. Review all loans associated with the backlog of checks to ensure collateral on these loans was perfected.

3. Ensure that legal sufficiency reviews of appropriate security instruments and other closing documents are conducted prior to disbursements in excess of $10,000, as required.

4. Pursue an automated means of securing borrower payment for mortgage recording and UCC filing fees, such as deducting these fees directly from loan proceeds.

AGENCY COMMENTS

On March 22, 2007, we provided SBA with a draft of the report for comment. On April 17, 2007, SBA submitted its formal response, which is contained in its entirety in Appendix IV. SBA generally concurred with the audit findings and recommendations, but commented on several issues raised in the report.

SBA agreed to perfect the collateral on the 61 loans we identified that were not fully secured. However, SBA noted that a disproportionate number of loans (43) in our overall sample were loans that were closed in escrow for relocation property purchases. SBA believes that because some of the loans associated with the relocation purchases have been partially collateralized, the funds "at risk" should be limited to only the amount that would have been collateralized had the proper documents been recorded. SBA requested that we clarify our methodology for estimating the amount of disbursements "at risk," and indicated it would take issue with our conclusion that the full $368 million is "at risk" if this amount includes loans that were partially collateralized.

Further, SBA commented that it is critical the OIG recognize the nature, need and procedures related to escrow closings for these loans. SBA states that in no case is all collateral in place at the time of disbursement as the in trust agent holds all SBA funds until the conditions in the in trust agreement are met and the executed documents are in hand. SBA further stated that a review of the loan files on one specific day will fail to disclose the true status of the file, and that since the audit consisted of files where a title services check had been received it is reasonable to assume that the closing had occurred. SBA also stated that neglecting to acquire collateral on the old property is a process violation, but would generally add little risk to the government.

SBA agreed to review all loans associated with the backlog of checks, but stated they had already identified and substantially reduced the backlog of checks when the OIG audit began. SBA also agreed to ensure that legal sufficiency reviews are conducted prior to disbursements in excess of $10,000 as required, and noted that in February 2007 it made changes to the disbursement procedures to address this issue. Finally, SBA agreed to identify another means of securing borrower payment for mortgage recording and UCC filing fees, noting that it is currently researching and exploring a way to pay title service fees directly from the loan proceeds.

OFFICE OF INSPECTOR GENERAL RESPONSE

While we believe that SBA's proposed actions are responsive to our recommendations, we do not agree with management's comments related to collateral requirements for relocation property purchases and the sufficiency of its actions to reduce the backlog of checks for title services. SBA is correct in noting that a significant number of the 61 loans reviewed involved relocation properties. Based on the sample of 61 loans, we estimated that $368 million on 3,113 loans had not been fully collateralized.

While some collateral may have been recorded on these loans, it is uncertain what the value of the collateral will be at the time of loan default. For this reason, SBA's operating procedures require that *all collateral* be secured before certain levels of disbursements can be made. Therefore, management's suggestion that only the amount disbursed without proper collateralization is "at risk" is misleading because SBA does not know whether the collateral already recorded will be of sufficient value to cover the full amount of the funds disbursed when the loan defaults. Also, as SBA indicated in its response, collateral on many of the loan properties is best available, which means that even with all collateral in place, the loan may not be fully secured by real property. This provides an additional reason to collateralize all available property and assets before disbursement.

Further, SBA's suggestion that it is acceptable to disburse loans that are only partially secured is contrary to its own operating procedures and guidance. SBA's operating procedures require full collateralization of the loan assets. For example, if disbursements exceed $50,000, loan closing attorneys are instructed to obtain a recorded mortgage, deed of trust, a deed to secure debt, or proof of recording, and a title search report. For loans exceeding $250,000, SBA also requires proof of title insurance. Additionally, while SBA states that neglecting to acquire collateral on the old property adds little risk to the government, SOP 50 30 5 states that the damaged property from which the victim is relocating may have significant value. The guidance requires both the damaged property <u>and</u> the relocation property be used as collateral. Of the 38 loans that involved relocations, 10 did not have executed documents for both the new and damaged properties, 6 did not have executed documents for the new property, and 8 did not have executed documents for the damaged property.

SBA also mentioned that the OIG needed to understand the procedures related to escrow closings for these loans, and that many of the loan files began to show collateral filed or recorded during SBA's review conducted subsequent to our audit (from February 28 to March 7, 2007), indicating that timing is critical to making a full assessment of these files. While loans may have began to show that collateral was filed in February and March, what SBA needs to recognize is that the collateral had not been recorded before the loans were disbursed, as required by SBA regulations and guidance. Not perfecting liens in a timely manner increases the agency's risk of losing the lien position to other creditors. For example, in Louisiana, the lien holder's position is established on a first-come, first-served basis. Therefore, delays in filing or recording liens could result in a subsequent creditor obtaining a higher lien holder position than SBA. The fact that we identified over 5,000 uncashed checks at the center on January 18, 2007, many of which were several years old, indicates that the title companies were not provided the fees needed to record property titles; and therefore would not have filed even if they had the documents. We also found that in a number of cases, the documents had not been sent to the title companies on the relocated properties.

It is also essential that SBA obtain the appropriate documents prior to disbursement, because it may not be successful in obtaining them after the borrower has already received the loan proceeds. For example, on October 22, 2006, SBA fully disbursed $107,600 on one loan without receiving the appropriate documents from the borrower. When we reviewed the file 3 months later, the documents still had not been received as the borrower was unwilling to execute the corrected documents.

Regarding the check backlog, we agree that SBA had identified the backlog at the time of our audit, and noted in our report that SBA had reduced the backlog from the 5,656 checks we observed on January 18, 2006, to 3,699 checks by February 21, 2007, or by 26 percent. However, while the Agency has devoted resources to reduce the backlog, it has not addressed the process changes needed to prevent a recurrence of the backlog in the future. We remain concerned that unless SBA pursues an automated means of securing borrower payment for mortgage and UCC filings, the backlog could easily reach unmanageable levels again. Despite SBA's comments, it agreed to explore a means to pay title service fees directly from the loan proceeds.

We believe that overall SBA's proposed actions are responsive to our audit findings and recommendations, and commend the Agency for promptly addressing issues raised by the audit. SBA indicated that it has fully resolved recommendation 3, and is making progress on recommendations 1, 2, and 4. However, SBA's response did not provide target dates for full implementation of the three recommendations that are in progress. Therefore, we cannot consider management's comments to be fully responsive and are requesting further actions by the Agency.

ACTIONS REQUIRED

Because SBA provided no target dates for completing proposed actions for all recommendations, we are requesting that target dates for implementing recommendations 1, 2, and 4 be provided by May 23, 2007. We also request that management provide support showing that it has already implemented recommendation 3 so that we may consider this recommendation closed.

We appreciate the courtesies and cooperation of the Office of Disaster Assistance representatives during this audit. If you have any questions concerning this report, please call me at (202) 205-[Ex 2] or Susan Bader, Director, Disaster Programs Group, at (202) 205-[Exemption 2]

APPENDIX I. SCOPE AND METHODOLOGY

To determine whether collateral was properly and timely perfected, we selected a statistical sample of 99 loans from a universe of 4,970 loans associated with the checks backlogged at the title desk that we observed on January 18, 2007. The sample size was based on a 95 percent confidence level with a precision rate of $\pm$9.3. (A listing of the 99 loans is provided in Appendix III).

The original universe of backlogged checks was provided by the title desk in an Excel spreadsheet and contained 5,656 checks, 686 of which we statistically determined included loans for disasters outside the Gulf Coast hurricanes, which were excluded from our review. To determine the accuracy of the universe of backlogged checks provided by the title desk, we tested the existence of 20 randomly selected checks. We were able to verify the existence of the original check and were assured of the completeness of the data contained in the Excel spreadsheet. We also examined documentation contained in the Disaster Credit Management System to assess the adequacy of the disbursing center's collateral recording process.

Of the 99 loans we identified, 80 loans met SBA's disbursement thresholds for a secured loan. We reviewed each of these 80 loan files in DCMS for assurance of required collateral perfection during the period January 30 to February 5, 2007. We also interviewed management officials from various departments within the disbursing center, such as, the collateral division, title desk, warehousing, and administration to gain an understanding of the loan process from receipt of application to disbursement.

To determine the validity of the allegations regarding the shredding of mortgage documents, we toured the facilities, including the warehouses where the archived scanned documents were stored. We interviewed center managers and reviewed the contract and associated invoices for offsite shredding services. We also interviewed loan officers and managers at the processing center and asked center staff to produce copies of mortgages on randomly selected loans.

The audit was conducted from January 4, 2007, to February 12, 2007 in accordance with *Government Auditing Standards* as prescribed by the Comptroller General of the United States, and included such tests as we considered necessary to provide reasonable assurance of detecting abuse or illegal acts.

APPENDIX II. LETTER TO BORROWER

12/21/06
MUF

SBA

U.S. Small Business Administration

U.S. SMALL BUSINESS ADMINISTRATION
DISASTER ASSISTANCE
14925 Kingsport Road
Fort Worth, Texas 76155-2243

(817) 868-2300
(800) 366-6303
Hearing Impaired
TDD (817) 267-4688

Date: 12-21-06

[redacted]

RE: SBA Application No. [Exemption 2]

Dear Borrower(s):

Regrettably, the signed and notarized Multiple Indebtedness Mortgage, along with the Request for Notice of Seizure you previously submitted to secure your loan cannot be located. Since your loan has been fully disbursed, SBA must have an original recorded mortgage to prevent your loan from defaulting. Please complete the enclosed forms, sign before a notary, and return to the SBA with a cover letter stating: [redacted]

Per our conversation, we also need a new check payable to Title Services USA for $195 to record the Mortgage and Request for Notice of Seizure, as the first check is greater than six (6) months old. Upon receipt of the new check, and the signed and notarized Multiple Indebtedness Mortgages, SBA will return your check #2071 for $220, dated 6-16-06.

Thank you very much for your prompt assistance in this matter. Should you have any questions, please do not hesitate to contact me. I hope you and your family enjoy a very Merry Christmas!

Sincerely,

[redacted]
U.S. Small Business Administration
Disaster Processing and Disbursement Center

APPENDIX III. LOANS SAMPLED

Collateral Not Perfected			
Account #	Approved Amount	Amount Disbursed	Status of Recording
[Exemption 2]	$10,000	$10,000	UCC not filed
[Exemption 2]	$53,200	$15,400	UCC not filed
[Exemption 2]	$34,600	$34,600	UCC not filed
[Exemption 2]	$38,800	$38,800	UCC not filed
[Exemption 2]	$98,000	$98,000	UCC not filed
[Exemption 2]	$202,000	$202,000	UCC not filed
[Exemption 2]	$59,300	$59,300	UCC not filed
[Exemption 2]	$15,800	$15,800	UCC not filed
[Exemption 2]	$84,700	$50,000	Mortgage not recorded
[Exemption 2]	$51,700	$51,700	Mortgage not recorded
[Exemption 2]	$222,800	$222,800	Mortgage not recorded
[Exemption 2]	$194,100	$194,100	Mortgage not recorded
[Exemption 2]	$229,800	$229,800	Mortgage not recorded
[Exemption 2]	$47,000	$47,000	Mortgage not recorded
[Exemption 2]	$79,000	$79,000	Mortgage not recorded
[Exemption 2]	$33,200	$33,200	Mortgage not recorded
[Exemption 2]	$183,600	$183,600	Mortgage not recorded
[Exemption 2]	$21,200	$21,200	Mortgage not recorded
[Exemption 2]	$22,200	$22,200	Mortgage not recorded
[Exemption 2]	$24,300	$24,300	Mortgage not recorded
[Exemption 2]	$38,100	$38,100	Mortgage not recorded
[Exemption 2]	$104,500	$104,500	Mortgage not recorded
[Exemption 2]	$39,500	$39,500	Mortgage not recorded
[Exemption 2]	$33,800	$33,800	Mortgage not recorded
[Exemption 2]	$134,400	$134,400	Mortgage not recorded
[Exemption 2]	$110,800	$110,800	Mortgage not recorded
[Exemption 2]	$31,300	$31,300	Mortgage not recorded
[Exemption 2]	$240,000	$210,000	Mortgage not recorded
[Exemption 2]	$55,000	$50,000	Mortgage not recorded

APPENDIX III. LOANS SAMPLED

Collateral Not Perfected			
Account #	Approved Amount	Amount Disbursed	Status of Recording
[Exemption 2]	$180,900	$180,900	Mortgage not recorded
[Exemption 2]	$122,600	$122,600	Mortgage not recorded
[Exemption 2]	$189,100	$189,100	Mortgage not recorded
[Exemption 2]	$133,500	$133,500	Mortgage not recorded
[Exemption 2]	$100,000	$100,000	Mortgage not recorded
[Exemption 2]	$205,900	$205,900	Mortgage not recorded
[Exemption 2]	$134,700	$134,700	Mortgage not recorded
[Exemption 2]	$338,400	$338,400	Mortgage not recorded
[Exemption 2]	$126,400	$126,400	Mortgage not recorded
[Exemption 2]	$222,800	$222,800	Mortgage not recorded
[Exemption 2]	$209,100	$209,100	Mortgage not recorded
[Exemption 2]	$186,600	$186,600	Mortgage not recorded
[Exemption 2]	$153,600	$50,000	Mortgage not recorded
[Exemption 2]	$162,100	$162,100	Mortgage not recorded
[Exemption 2]	$107,600	$107,600	Mortgage not recorded
[Exemption 2]	$245,200	$245,200	Mortgage not recorded
[Exemption 2]	$233,600	$233,600	Mortgage not recorded
[Exemption 2]	$139,900	$139,900	Mortgage not recorded
[Exemption 2]	$38,750	$38,750	Mortgage not recorded
[Exemption 2]	$31,100	$31,100	Mortgage not recorded
[Exemption 2]	$123,400	$123,400	Mortgage not recorded
[Exemption 2]	$240,000	$240,000	Mortgage not recorded
[Exemption 2]	$160,300	$160,300	Mortgage not recorded
[Exemption 2]	$114,800	$60,000	Mortgage not recorded
[Exemption 2]	$140,200	$140,200	Mortgage not recorded
[Exemption 2]	$130,000	$130,000	UCC and mortgage not perfected
[Exemption 2]	$109,000	$109,000	UCC and mortgage not perfected
[Exemption 2]	$97,600	$87,600	UCC and mortgage not perfected
[Exemption 2]	$223,200	$223,200	Mortgage recorded but untimely
[Exemption 2]	$105,000	$92,500	Mortgage recorded but untimely
[Exemption 2]	$182,900	$182,900	Mortgage recorded but untimely
[Exemption 2]	$189,200	$189,200	Mortgage recorded but untimely
		Subtotal: $7,281,750	

APPENDIX III. LOANS SAMPLED

Collateral Perfected Timely			
Account#	Approved Amount	Amount Disbursed	Status of Recording
[Exemption 2]	$61,800	$61,800	UCC filed
[Exemption 2]	$6,500	$1,500	UCC filed
[Exemption 2]	$86,500	$86,500	UCC filed
[Exemption 2]	$166,100	$166,100	Mortgage recorded
[Exemption 2]	$181,000	$131,000	Mortgage recorded
[Exemption 2]	$119,200	$119,200	Mortgage recorded
[Exemption 2]	$126,700	$126,700	Mortgage recorded
[Exemption 2]	$60,800	$50,000	Mortgage recorded
[Exemption 2]	$104,300	$104,300	Mortgage recorded
[Exemption 2]	$148,400	$148,400	Mortgage recorded
[Exemption 2]	$80,400	$50,000	Mortgage recorded
[Exemption 2]	$56,000	$20,000	Mortgage recorded
[Exemption 2]	$298,000	$50,000	Mortgage recorded
[Exemption 2]	$37,600	$37,600	Mortgage recorded
[Exemption 2]	$26,500	$26,500	Mortgage recorded
[Exemption 2]	$50,000	$50,000	Mortgage recorded
[Exemption 2]	$84,500	$84,500	Mortgage recorded
[Exemption 2]	$142,400	$142,400	Mortgage recorded
[Exemption 2]	$51,000	$51,000	Mortgage recorded
		Subtotal: $1,507,500	

APPENDIX III. LOANS SAMPLED

Collateral Threshold Not Met			
Account#	Approved Amount	Amount Disbursed	Status of Recording
[Exemption2]	$130,400	$0	Collateral threshold not met
[Exemption2]	$10,000	$10,000	Collateral threshold not met
[Exemption2]	$36,000	$10,000	Collateral threshold not met
[Exemption2]	$155,000	$0	Collateral threshold not met
[Exemption2]	$323,000	$10,000	Collateral threshold not met
[Exemption2]	$15,000	$15,000	Collateral threshold not met
[Exemption2]	$132,300	$10,000	Collateral threshold not met
[Exemption2]	$10,000	$10,000	Collateral threshold not met
[Exemption2]	$23,500	$10,000	Collateral threshold not met
[Exemption2]	$17,900	$10,000	Collateral threshold not met
[Exemption2]	$53,900	$15,000	Collateral threshold not met
[Exemption2]	$60,300	$10,000	Collateral threshold not met
[Exemption2]	$30,400	$5,000	Collateral threshold not met
[Exemption2]	$40,000	$10,000	Collateral threshold not met
[Exemption2]	$227,800	$10,000	Collateral threshold not met
[Exemption2]	$183,200	$10,000	Collateral threshold not met
[Exemption2]	$170,500	$10,000	Collateral threshold not met
[Exemption2]	$25,000	$0	Collateral threshold not met
[Exemption2]	$42,100	$10,000	Collateral threshold not met
		Subtotal: $165,000	
	Grand Total of All Loans:	$8,954,250	

APPENDIX III. LOANS SAMPLED

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Date: April 17, 2007

To: Debra S. Ritt
Assistant Inspector General for Auditing

From: Herbert L. Mitchell
Associate Administrator
For Disaster Assistance

Subject: OIG Draft Report – Securing Collateral for Disaster Loan Disbursements
(Project No. 7406)

We have reviewed the draft audit report on Securing Collateral for Disaster Loan Disbursements prepared by your office. We generally agree with the recommendations made in the report. The issues identified in this draft report are representative of challenges presented throughout our response to the Gulf Coast hurricanes. Some of the issues came to light during of the Accelerated Disaster Response Initiative (incorporating the 90 in 45 Campaign and other sub-initiatives) beginning in August, 2006. For example, SBA had already identified the check backlog and had substantially reduced it when the OIG's investigation commenced.

Our review indicates that a disproportionate number of relocation files are included in the overall sample. Of the 61 files identified as having adverse findings, 43 are loans closed in escrow for relocation property purchases. Before you issue your report we would like to understand the methodology used in determining that 3,113 loans with an estimated value of $368 million were disbursed without proper collateral being acquired or recorded. It is not clear whether these numbers represent the amount disbursed (the actual amount at risk) or the total approved amount of the loans. Also, we would take issue with any conclusion that suggested that $368 million was at risk, if this amount includes the majority of the relocation loans that were collateralized (with the new property). Neglecting to acquire collateral on the old property is a process violation, but generally would add little risk to the government. The "at risk" amount should be only the amount that would have been collateralized had the proper documents been recorded. Most of the files had evidence of at least one piece of collateral properly being recorded. Therefore, the risk is only the equity the second piece of collateral would have added to the loan. It is also important to understand that collateral on many of these properties is best available. This means that with all collateral in place the loan is not fully secured by real property. We calculate that $967,100 of the $8,328,100 disbursed is at risk. Based on the corrective actions now being taken, the "at risk" will be reduced to zero.

Since an overwhelming number of adverse findings relate to relocations, it is critical that the OIG recognize the nature, need and procedures related to the escrow closings of these loans. In an escrow closing, funds are disbursed to an intermediary and held until a set of conditions are met during the closing on a property or mobile home. Upon receipt of an "In Trust Agreement" letter signed by the title company, attorney or escrow agent handling the closing, the funds are ordered and disbursed to the appropriate intermediary handling the closing. The agent agrees to hold all SBA funds until the listed conditions, executed documents or specified requirements are met and in hand. Accordingly, in no case is <u>all</u> collateral in place at the time of disbursement. This type of disbursement is within our policy and is

APPENDIX III. LOANS SAMPLED

fully justified absent a mistake of fact or law. Subsequent to the closing and release of SBA funds, the agent sends SBA the documents resulting from the closing, often not all once but as they are processed and completed. Recorded documents can take several days to several months to be returned. Title policy certificates may be issued at closing or may take several weeks. The escrow agent has an ongoing obligation to provide the documents and requirement of the in-trust agreement, and issues and problems will be sent back through the agent for resolution or correction.

A review of the relocation files on one specific day will fail to disclose the true status of the file, the closing and the collateral. It is important to determine whether the closing has occurred, what documents have been received, what was still pending filing or issuance, what items have been returned to the agent for correction or action. All of these are contributing factors as to whether or not the auditors would have or expect to see the proof of mortgage or recording of the lien. The fact that the audit consisted of files where a "title services" check had been received would lead to a reasonable assumption that the closing had occurred. In any event, many of these files began to show collateral filed or recorded during our review conducted from February 28 to March 7, 2007, indicating that timing is critical to making a full assessment of these files.

Comments on the Recommendations:

Recommendations #1: Direct the Loan Processing and Disbursement Center to perfect collateral on the 61 loans identified during the audit that had not been perfected.

ODA Response: We concur and have already resolved 28 of the 61 files. Of the 43 relocation escrow files, 17 have been fully resolved. We are continuing to work on the remaining 33 files of which 26 are relocation escrow closings, of which 21 have one of multiple collateral liens in place, leaving the damaged property to be secured in most cases.

Recommendation #2: Review all loans associated with the backlog of checks to ensure collateral on these loans are perfected.

ODA Response: We concur and have continuously reviewed the files associated with the check backlogs. The backlog of checks has been reduced to 1,820 of which 600 are considered to be current work in progress.

Recommendation #3: Ensure that legal sufficiency reviews of inappropriate security instruments and other closing documents are conducted prior to disbursements in excess of $10,000 as required.

ODA Response: We concur and in February 2007 made changes to the disbursement procedures to address this issue. We have instituted an additional review by the team leader before the document and check disposition forms are sent to the title desk. Further, we now require a review and clearance of the documents and check by the title desk, as well. If accurate and complete the documents and check are forwarded for filing. Upon notification by the title desk that the documents and check have been forwarded for filing, the case manager is notified that a disbursement up to $50,000 may be made. On the other hand if the documents are not sufficient and/or the check is not accurate the case manager will be notified that a disbursement cannot be made until the necessary corrections are made and resubmitted to the Title Desk for review.

APPENDIX III. LOANS SAMPLED

Recommendation #4: Pursue an automated means of securing borrower payment for mortgage recording and UCC filing fees, such as deducting these fees directly from loan proceeds.

ODA Response: We concur and as a part of our continued process improvement efforts the "Disbursement Team" is currently researching and exploring the policies and procedures to pay title service fees directly from the loan proceeds.

Thank you for the opportunity to comment on this draft report and if you have any questions on this response please feel free to contact me or James Rivera.

[Exemption 6]

Herbert L. Mitchell
Associate Administrator
for Disaster Assistance