

AUDIT OF SIX SBA GUARANTEED LOANS

Report Number: 8-18
Date Issued: September 8, 2008



U.S. Small Business Administration
Office Inspector General

Memorandum

To: Grady Hedgespeth
Director, Office of Financial Assistance
/s/ Original Signed

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of Six SBA Guaranteed Loans
Report No. 8-18

Date: September 8, 2008

This report identifies six loans that we believe warrant immediate attention by the Agency in order to recover approximately \$1.2 million of improper payments. We reviewed these loans as part of our ongoing audit of the liquidation process at the National Guaranty Purchase Center in Herndon, VA. The six loans were part of a statistical sample of loans charged off between October 1, 2005 and July 31, 2007. While many of the loans were older loans that had been purchased by SBA prior to fiscal year (FY) 2005, the identified deficiencies are so egregious that we believe full denial of the guaranties is warranted. We reviewed all origination, servicing and liquidation actions as documented in the SBA loan files. We conducted the audit from June 2007 to March 2008 in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States.

The Small Business Administration (SBA) is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guaranteed loans. SBA loans are made by participating lenders under an agreement (SBA Form 750) to originate, service and liquidate loans in accordance with SBA regulations, policies, and procedures. If a lender fails to comply materially with SBA regulations, the loan agreement, or does not make, close, service, or liquidate a loan in a prudent manner, SBA has exclusive discretion to release itself, in whole, or in part, from liability on the loan guaranty.

The six loans identified in this report were improperly charged off when full denial of the guaranties should have been pursued due to material lender non-compliance with SBA requirements. A subsequent report will be issued to address

the systemic weaknesses and improvements needed in the liquidation process at the Herndon Center.

While all, but one, of the six loans received a complete purchase review and all six received a comprehensive charge-off review, lender deficiencies were not identified or adequately resolved by SBA. These deficiencies included:

- Non-disclosure of contaminated property;
- Inadequate evidence of equity injection;
- Inadequate evidence of IRS tax verifications;
- Inadequate appraisals;
- Questionable repayment ability;
- Inappropriate broker fees;
- Unreported adverse events;
- Unsecured collateral; and
- Unapproved and insufficient offers in compromise

A detailed description of the compliance issues for each loan is provided in appendices to this report.

RECOMMENDATIONS

We recommend the Director, Office of Financial Assistance:

1. Seek recovery of \$339,643, plus interest, from Comerica Bank on the guaranty paid by SBA to [FOIA Ex. 4 and 6].
2. Seek recovery of \$639,717, plus interest, from Small Business Loan Source, Inc. on the guaranty paid by SBA to [FOIA Ex. 4 and 6].
3. Seek recovery of \$133,713, plus interest, from Branch Banking & Trust Co. on the guaranty paid by SBA to [FOIA Ex. 4 and 6].
4. Seek recovery of \$40,000, plus interest, from Banco Popular de Puerto Rico on the guaranty paid by SBA to [FOIA Ex. 4 and 6].
5. Seek recovery of \$41,766, plus interest, from Stearns Bank of Arizona on the guaranty paid by SBA to [FOIA Ex. 4 and 6].
6. Seek recovery of \$21,164, plus interest, from Community Trust Bank, Inc. on the guaranty paid by SBA to [FOIA Ex. 4 and 6].

AGENCY COMMENTS

The Director of the Office of Financial Assistance provided written comments to the report, partially agreeing with recommendation 3, disagreeing with recommendation 5, and neither concurring or nonconcurring with the remaining four recommendations. The full text of management's comments, which are summarized below, can be found in Appendix VII.

Regarding recommendation 3, management commented that it has negotiated the recovery of \$20,000 from the lender based on the liquidation value of the inventory and the lender's involvement with its disposition. Further, management stated that a full recovery of the \$133,713 purchase amount is not justified based on the facts of the case. Regarding recommendation 5, management concluded that because inadequate equity injection does not appear to have been the proximate cause of the business failure, recovery from the lender is not warranted. The Director stated that he will provide a management decision on the remaining four loans when lender responses on those loans have been received.

Management also expressed concern about the Agency's ability to recover additional payments on the six loans because of their age and because recovery has already been negotiated on one of the loans. For three of the six loans, management stated that [FOIA Ex. 5

]. Management also commented that pursuing further payment was not a good use of the Agency's resources as it would divert resources away from current efforts to improve lender performance of loan origination, servicing, and liquidation activities.

Management commented that most of the loans in the report predated the centralization of loan approval, servicing, and liquidation functions at SBA, the reengineering of the guaranty purchase review, and the doubling of staff. Management stated that since November 1, 2007, the Center has maintained a 45-day pledge to reach a purchase decision on all complete packages using a newly designed Tab System. A year ago, the average inventory was 279 days old. Also, the Center is now in immediate contact with lenders when purchase packages are deficient and is able to reach decisions on most of these within 45 days as well. Management stated that the review process has also been reengineered and standardized to bring greater quality and consistency to the Center's purchase decisions. Furthermore, lender training has been provided on deficiency trends that have been identified.

OFFICE OF INSPECTOR GENERAL RESPONSE

Management's proposed actions to recommendations 3 and 5 were not fully responsive. Accordingly, we will pursue resolution of these recommendations through the audit resolution process. Management did not provide a response to recommendations 1, 2, 4, and 6 because it was not able to obtain lender responses for these four loans. Management stated that the current market environment has resulted in high workloads, which made the requests for lender responses especially burdensome. The draft report, however, was issued on May 22, 2008 and Management was given over 2 months to obtain the lender's responses. Nevertheless, we are providing Management another 30 days from the issuance of this report to submit a response on these four loans. If a response is not received by then, we will pursue a management decision on the four recommendations through the audit resolution process.

In response to proposed actions on recommendation 3, we recognize that SBA negotiated a \$20,000 recovery, using SBA's 20-percent recovery rate for the liquidation value of the borrower's inventory. However, the borrower was a furniture retailer and there was evidence in the loan file that the liquidation value of the furniture inventory was higher than the liquidation value of most other types of inventory. Therefore, using a recovery amount of 20-percent of the liquidation value of the borrower's inventory was not reasonable. The higher value of the furniture inventory also elevated the importance of the lender's monitoring of the borrower's liquidation actions and its inventorying and assessment of the loan collateral. However, since the lender relied exclusively on the borrower's claim that the loan would be repaid in full, we maintain that the lender should be held accountable for the entire \$133,713 SBA loss on this loan.

Regarding recommendation 5, the borrower was having cash flow difficulties within 15 months of final loan disbursement, which caused the lender to defer principal payments on the loan. Loan repayment problems also continued after the deferment. Therefore, the loan clearly fit the Agency's definition of an early-problem loan, and an additional \$40,750 of equity could have mitigated the payment problems. SBA's policy states that if there is an early-problem loan, a direct link between the business failure and lack of injection should be assumed and a full denial of liability may be appropriate. Therefore, we continue to support our position that the lender should be held accountable for the \$41,766 SBA loss.

We commend SBA on efforts it made after commencement of the audit to reengineer the guaranty purchase process at the Center. We also recognize that the Agency has made significant investments in staffing, training, and technology to systematically improve the quality of lender purchase packages as well as their

underwriting, closing, and servicing policies. We look forward to evaluating the effectiveness of the reengineered purchase process in future audits.

While these actions will presumably improve the quality of future purchase reviews performed at the center, they bear no relevance to decisions the Center reached on recently charged-off loans nor do they absolve lenders from their responsibility to abide by the Agency's policies. The audit evaluated the appropriateness of charge-off decisions rendered on loans that had been purchased. Many of these loans did not receive a charge-off review until they had accumulated into a fairly large backlog several years later. Our purpose was to determine whether SBA was acting responsibly to recover improper payments made to lenders who did not comply with Agency requirements.

We agree that many of the loans are old because the Agency had not reviewed them timely. However, the age of the loans does not negate the importance of holding lenders accountable for material noncompliance and recovering Government funds that should not have been disbursed. Under the Improper Payments Information Act, agencies are required to identify and recover improper payments, including guarantees on Federal loans. [FOIA Ex. 5

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ACTIONS REQUIRED

We are requesting that the Director, Office of Financial Assistance provide a proposed management decision on recommendations 1, 2, 4, and 6 within 30 days of the issuance of this report.

We appreciate the courtesies and cooperation of the Small Business Administration during this audit. If you have any questions concerning this report, please call me at (202) 205-[FOIA Ex. 2].

APPENDIX I. [FOIA Ex. 4 and 6]

The deficiencies on this loan resulted in a \$339,643 improper payment that should be recovered. During our ongoing audit of the liquidation and charge-off processes at the National Guaranty Purchase Center, we identified a problematic loan (number [FOIA Ex. 2]) made by Imperial Bank (lender) to [FOIA Ex. 4 and 6] (borrowers).

Background

Imperial Bank was authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, Imperial Bank was permitted to process, close, service and liquidate SBA loans with limited documentation and review by SBA. In November 2000, Comerica Bank acquired Imperial Bank and became responsible for all decisions regarding SBA loans made by Imperial Bank.

On September 27, 2000, using PLP procedures, the lender approved a \$1,000,000 loan to the borrowers to purchase the land and improvements of an existing gas station business located at [FOIA Ex. 4 and 6]. The loan was closed and fully disbursed on January 22, 2001. The borrowers defaulted only 7 months later, on July 22, 2001. Thus, this loan is considered an early default loan in accordance with SBA policy. On December 20, 2001, SBA purchased the guaranty for \$749,702. After purchase, proceeds from the sale of collateral and a repair against the lender reduced SBA's share of the loan balance to \$339,643. On August 8, 2006, SBA charged off its guaranteed share of \$339,643.

Non-Disclosure of Contaminated Property

The lender did not minimize the risk of an adverse environmental finding or disclose the results to SBA as required and therefore, exposed SBA to an unacceptable risk of loss in making this loan. The loan authorization required the lender not to disburse any loan proceeds until it (1) completed a review for potential environmental contamination on each business real property site that was acquired or improved with proceeds from the loan, and (2) sufficiently minimized the risk from any adverse environmental findings. Furthermore, Standard Operating Procedure (SOP) 50 10 (4) required the lender to disclose the results of its review to SBA.

An October 9, 2000, environmental site assessment report disclosed that the gas station site had been impaired by an unauthorized release from four underground diesel storage tanks formerly present at the site, and recommended further subsurface investigation to ascertain the vertical and lateral extent of soil

contamination associated with the release. The lender, however, disbursed the loan proceeds on January 22, 2001, without disclosing these results to SBA or performing the recommended additional testing. The contamination of the property significantly decreased the value from its original \$1,450,000 appraised amount. Therefore, as 67 percent of the \$1,498,602 in project funds was provided by the SBA-guaranteed loan, the contamination exposed SBA to a significant risk of loss. The lender did not sufficiently minimize the risk of the adverse environmental findings as required, and SBA clearly would not have approved disbursement of the loan if it had been properly notified of the contamination.

Inadequate Evidence of Equity Injection

The lender also should not have disbursed the loan since there was evidence the cash injection came from borrowed funds. SOP 50 10 (4) stipulates that funds borrowed through the use of personal credit for injection into the business should normally be treated as debt financing, not equity injection. The lender was also required to disclose any loan made to an individual for the equity injection and, in its loan analysis, to address the sources of repayment and the impact on the personal and business balance sheets. The SOP required the lender to obtain formal standby agreements of payment of the principal and interest until the SBA loan was paid in full.

There was evidence the borrowers did not have the personal resources to inject the required \$230,000 into the business. The borrowers' personal financial statement, dated August 31, 2000, showed that \$250,000 would be derived from the sale of two existing businesses and used as equity injection. The borrowers' tax returns for 1997 and 1999;¹ however, showed gross business income of \$16,740 and \$24,986, and net profit of only \$7,849 and \$13,434, respectively. Additionally, the tax returns indicated the businesses had minimal assets. Therefore, the projected sales price of \$250,000 for these businesses was highly questionable. Nevertheless, the lender accepted an August 21, 2000 letter from an attorney, allegedly confirming possession of \$240,000 to be used as a down payment by the borrower, as proof of equity injection. This letter is suspicious as the borrowers' businesses had not been sold as of this date and there was no other mention of \$240,000 in assets on the borrowers' personal financial statement. The lender, however, did not question a \$76,000 check written from the attorney to the settlement agent as equity injection. There was no evidence in SBA's loan file that the borrowers ever sold the businesses and used the proceeds as equity injection. Additionally, the \$76,000 may have constituted a loan as an offer in compromise proposal prepared after loan default indicated the borrower received a loan for an escrow down payment.

¹ The borrower's 1998 tax return was not in the file.

The lender also did not verify the validity of other sources of equity injection. The lender accepted a \$140,000 injection wired from Namco Capital, which may have been a personal loan. Furthermore, an additional \$29,700 in checks provided as support for equity injection was remitted to the settlement agent by individuals other than the borrowers. The SBA loan file did not contain standby agreements or an analysis of how any of these potential loans would be repaid.

Inadequate Evidence of IRS Tax Verifications

The lender also did not obtain verification of the Federal tax returns of the sellers to verify the accuracy of their financial information as required in a change of ownership transaction. As a result, the lender's repayment analysis may have been based on inaccurate information. The borrowers defaulted after making only five loan payments, indicating the borrowers did not have sufficient repayment ability.

While SBA repaired the loan based on the environmental contamination and recovered \$206,611 from the lender, the repair was insufficient as it did not consider the other deficiencies discussed above in determining the level of recovery needed to compensate the Agency for its loss. An SBA loan specialist originally recommended denial of liability in September 2003, citing the lender's failure to obtain IRS verification of the seller's tax returns and disclose the contamination prior to loan disbursement. After the loan was transferred to Herndon in February 2004, however, the denial was never pursued. The loan was finally reviewed for charge-off in June 2006. Even though SBA had determined that the environmental contamination should have precluded the loan from being made under its guaranty loan program, it accepted the inadequate repair amount previously offered by the lender due to the significant lapse in time. Therefore, we believe full recovery of SBA's \$339,643 remaining loss is warranted.

APPENDIX II. [FOIA Ex. 4 and 6]

The deficiencies on this loan resulted in a \$639,717 improper payment that should be recovered. During our ongoing audit of the liquidation and charge-off processes at the National Guaranty Purchase Center, we identified a problematic loan (number [FOIA Ex. 2]) made by Small Business Loan Source, Inc. (lender) to [FOIA Ex. 4 and 6] (borrower).

Background

Small Business Loan Source, Inc. was authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, Small Business Loan Source, Inc. was permitted to process, close, service and liquidate SBA loans with limited documentation and review by SBA.

On December 15, 1999, using PLP procedures, the lender approved a \$1,000,000 loan to the borrower to purchase the land and improvements of an existing gas station business located at [FOIA Ex. 4 and 6]. The loan was closed and fully disbursed on March 10, 2000. The borrower defaulted in less than 6 months. Thus, this loan is considered an early default loan in accordance with SBA policy. On January 24, 2001, SBA purchased the guaranty from the secondary market for \$749,412. After purchase, proceeds from the sale of collateral reduced SBA's share of the loan balance to \$639,717.

The servicing of this loan was transferred from the Houston District Office to the Herndon Center in March 2004, and Center loan officers noted that a post purchase review had not yet been conducted. This loan, however, remained at the Center for more than 3 years without a post purchase review. In 2007, Headquarters officials directed the Center to forego post purchase reviews on loans that had been purchased 6 or more years previously because they inappropriately believed a 6-year statute of limitations prevented the Agency from seeking recovery on these loans. As a result, the subject loan never received a post purchase review. On July 16, 2007, the Center completed a charge-off review for this loan and concluded that the lender's servicing and liquidation was adequate. SBA's guaranteed share of \$639,717 was charged off.

Inadequate Appraisal

The real property purchased with loan proceeds did not appraise for the value required by the loan authorization and appeared to be significantly overstated. The loan authorization required the lender to obtain a real estate appraisal on the real property, showing a fair market value of at least \$1,650,000. The lender

obtained an appraisal that provided an as-is market value of \$1,750,000. Because \$265,000 of this amount was attributable to the going concern value, only \$1,485,000 was attributable to the real property. Therefore, the appraisal did not meet the requirements of the loan authorization. Furthermore, the property sold for only \$925,000 approximately 2 years after the appraisal was made, indicating that the appraisal was significantly overstated.

Questionable Repayment Ability

SOP 50 10 (4) states that historical earnings and cash flow are the most reliable bases for determining repayment ability. The repayment ability must include the company's revenues and expenses and consider owner withdrawals and annual fixed obligations including the proposed loan payments. The SOP further provides that the loan application must be denied if the borrower cannot repay the loan from the cash flow of its operations.

However, an analysis of the borrower's repayment ability was not present in SBA's loan file. For example, there was no evidence in the loan file that the lender compared the seller's tax transcripts with the income tax returns and/or other financial information as required by SOP 50 10 (4). The file did not contain copies of IRS tax transcripts, tax returns or financial information for the seller, or other documentation supporting the borrower's repayment ability. As a result, we could not determine whether or how the lender calculated the borrower's repayment ability.

The absence of a repayment analysis may have contributed to the borrower's early default. The borrower defaulted after making 4 loan payments, of which \$784 was applied to principal. Since this loan was an early default loan, the seller's and borrower's financial information were material to SBA's purchase decision. However, since SBA never completed a post purchase review prior to charge-off, the missing documentation was never requested for review and the lender's financial analysis was not questioned.

SOP 50 51 (2) states that a full denial of liability would generally be warranted if there is an early default or early loan problems, and the lender fails to provide evidence of required verification of financial information or a credible explanation for its absence.

Inadequate Evidence of Equity Injection

The lender did not obtain evidence that at least \$250,000 had been injected into the business prior to disbursement as required by the loan authorization. The lender's support for \$152,500 of the equity injection consisted of 4 cashier's

checks that were issued after loan disbursement. The lender also provided a letter from Metro Bank showing that the borrower had \$52,442 in its bank account the day before the loan was disbursed. The validity of the letter is questionable as it appears to have been altered. It appears the body of an existing Metro Bank letter was eliminated and replaced with false account information, which included different font sizes and misalignments. Furthermore, it is questionable why a letter was provided rather than a bank statement, which is the usual evidence provided to document an account balance. Considering that Metro Bank provided financing to the seller on the purchase of the same business approximately 1 year earlier, the bank's letterhead would have been available for the parties involved to falsify the existence of the remaining required equity injection amount the day before loan disbursement. Therefore, it is doubtful the borrower had the funds to make the equity injection.

The remaining \$45,058 of equity injection was evidenced by a \$50,000 cashier's check from the borrower to Global Managers & Consulting, Inc, which acted as a broker for this loan. The seller, IMAK Enterprises, requested that the buyer reimburse the broker the \$50,000 allegedly paid to the seller for the extension of their closing of [FOIA Ex. 4 and 6]. There was no explanation of why the borrower was responsible for the closing extension fee and it should not have been accepted as equity injection for this loan. SOP 50 10 (4) prohibits lenders or their associates from charging an applicant any commitment, bonus, broker, commission, referral or similar fees. The broker was an associate of the lender and it appears the lender allowed the borrower to pay the broker a fee and disguised it as a reimbursement to the seller.

[FOIA Ex. 7(A)].

Unreported Adverse Event

SBA SOP 50 51 (2) required the lender to notify SBA of an adverse event, such as abandonment of collateral by the borrower. The lender, however, neglected to notify SBA of the business closure in a timely manner. According to the Houston District Director, the lender closed and boarded the business on December 1, 2000, without notice to SBA. The Houston District office independently discovered this closure in mid-January 2001.

Due to this and other examples of the lender's failure to report the status of problem loans, the District Director recommended that the lender's PLP status be rescinded in February 2001. The District Director expressed concerns regarding (1) repairs or denials of liability on the lender's loans that were brokered by an individual under a major investigation by the Federal Bureau of Investigations,

and (2) the lender's continued concentration on financing gas station/convenience stores, which are high-risk loans.

Due to the significance of the identified deficiencies, SBA should recover the full amount of the \$639,717 guaranty paid to the lender.

APPENDIX III. [FOIA Ex. 4 and 6]

The deficiency on this loan resulted in a \$133,713 improper payment that should be recovered. During our ongoing audit of the liquidation and charge-off processes at the National Guaranty Purchase Center, we identified a problematic loan (number [FOIA Ex. 2]) made by Branch Banking & Trust Co. (lender) to [FOIA Ex. 4 and 6] (borrower).

Background

On March 27 2001, SBA approved a \$250,000 loan to the borrower, an existing furniture retailer, to purchase inventory, equipment and provide working capital. The loan was processed using regular 7(a) loan procedures, and therefore, SBA was responsible for determining the eligibility and credit risk of the borrower. The lender was required to service and liquidate the loan in accordance with SBA regulations, policies, and procedures. The loan was closed and fully disbursed on October 9, 2001 and the borrower defaulted on October 16, 2003. On September 20, 2004, SBA conducted the purchase review and purchased the guaranty for \$133,714. The purchase review did not identify any material deficiencies with the lender's servicing or liquidation actions. On February 17, 2006, SBA charged off its guaranteed share of \$133,714.

Unsecured Collateral

The lender did not properly secure \$222,126 in collateral when the loan defaulted, and allowed the borrower to self liquidate the collateral without monitoring the liquidation actions of the borrower. The lender relied on the borrower's claim that the liquidation of the inventory through a "going out-of-business sale" would be sufficient to repay the loan in full, and believed the borrower had the professional experience to determine the amount of inventory needed to repay the loan. The lender, however, never performed an analysis to validate the borrower's claim. Furthermore, while the lender claimed site visits were conducted throughout the life of the loan, it was unable to provide evidence of site visits or that it had inventoried and assessed the condition of the collateral upon loan default as required by SOP 50 51 (2).

Although the borrower stated liquidation would be complete by December 2003, and the loan balance of \$194,581 would be paid in full, only \$16,267 had been received as of the beginning of January 2004. Shortly thereafter, the borrower retained a lawyer who advised him to move his deposits to another bank. Even with these red flags, the lender relied on false promises that the loan would be paid in full and did not take appropriate action to inventory and secure the collateral.

In late February 2004, the borrower informed the lender that all inventory had been sold, but no additional proceeds were submitted. In August 2004, the lender learned the borrower had left town and could not be located. Consequently, the lender did not ensure that the collateral had been liquidated and that all of the liquidation proceeds had been obtained.

SBA Policy Notice 5000-831 identifies that if there is reason to believe that collateral is missing or devalued as a result of a lender's failure to conduct a timely site visit or obtain a meaningful collateral inspection, a repair or partial denial is generally warranted. Due to the significance of the identified deficiency, SBA should recover the full amount of the \$133,713 guaranty paid to the lender.

APPENDIX IV. [FOIA Ex. 4 and 6]

The deficiency on this loan resulted in a \$40,000 improper payment that should be recovered. During our ongoing audit of the liquidation and charge-off processes at the National Guaranty Purchase Center, we identified a problematic loan (number [FOIA Ex. 2]) made by Banco Popular de Puerto Rico (lender) to [FOIA Ex. 4 and 6]. The loan was processed under SBA LowDoc procedures, and therefore, SBA was responsible for determining the eligibility and credit risk of the borrower. Banco Popular de Puerto Rico was required to service and liquidate the loan in accordance with SBA regulations, policies, and procedures.

Background

On November 14, 1996, SBA approved a \$50,000 loan to the borrower to purchase equipment, inventory and leasehold improvements and provide working capital for a start-up auto repair business. The loan was closed and fully disbursed on October 1, 1997. The borrower made one interest-only payment on October 29, 1997, and defaulted. Thus, this loan is considered an early default loan in accordance with SBA policy. The lender did not request that SBA purchase the guaranty until July 17, 2001, nearly 4 years after loan default. SBA's San Juan District Office completed a purchase review and purchased the loan for \$40,000 on July 24, 2001.

SBA's purchase review concluded that there were no deficiencies that would result in a loss to the Agency. On September 28, 2005, 4 years after guaranty purchase, the Herndon Center conducted the comprehensive charge-off review, concluding that servicing and liquidation were adequate and that the liquidation plan had been followed. There were no recoveries through liquidation and SBA charged off the entire guaranty amount of \$40,000.

Unsecured Collateral

The lender did not timely transfer the loan into liquidation status and take appropriate action to maximize recovery on this loan. The borrower used the loan proceeds and equity injection to purchase \$52,400 of equipment that was secured by a \$50,000 chattel mortgage as required by the SBA note. The borrower and his wife also personally guaranteed the loan. In March 1998, when the borrower sold the business to a third party for \$2,700, exclusive of the equipment, the third party was allowed to retain the equipment collateral for safekeeping and was authorized to negotiate with the lender for the purchase of the equipment. There was no evidence the lender performed a site visit, as required, or took action to inventory and secure the collateral. If the lender had properly and timely secured the

collateral, it would have been involved in the sale of the business and could have pursued the guarantors and new business owner for payment on the loan.

The lender did not transfer the loan into liquidation status and inform SBA of the sale of the business until June 2000. The lender also did not properly pursue collection from the third party owner who had possession of the collateral. In May 1998 and again in June 2000, the new owner offered the lender \$15,000 for three pieces of equipment originally valued at \$21,249. The funds, however, were never collected by the lender and the third party retained possession of the equipment until finally selling it sometime before July 2001. There was no evidence that the lender questioned the whereabouts of the remaining \$31,151 of equipment that was purchased with loan proceeds or attempted to recover it.

Due to the lender's mismanagement of the liquidation, there was no recovery on this loan. SBA SOP 50 51 (2) required the lender to maximize recovery in the minimum amount of time, perform a site visit within 60 days of default, and notify SBA of any adverse event. A lender's failure to act in a timely manner to safeguard and liquidate loan collateral must be considered in evaluating a purchase request. If the lender permits a substantial decline in the value of collateral to occur because of unnecessary delays or mismanagement of the liquidation process, a repair or partial/full denial of liability should be considered. If the lender had taken the appropriate actions on this very early default loan, it is possible that full recovery may have been achieved through the sale of collateral and pursuit of the guarantors. As a result, full denial of the \$40,000 SBA guaranty is warranted.

APPENDIX V. [FOIA Ex. 4 and 6]

The deficiency on this loan resulted in a \$41,776 improper payment that should be recovered. During our ongoing audit of the liquidation and charge-off processes at the National Guaranty Purchase Center, we identified a problematic loan (number [FOIA Ex. 2]) made by Stearns Bank of Arizona (lender) to [FOIA Ex. 4 and 6] (borrower). The loan was processed using LowDoc procedures, and therefore, SBA was responsible for determining the eligibility and credit risk of the borrower. Stearns Bank of Arizona was required to service and liquidate the loan in accordance with SBA regulations, policies, and procedures.

Background

On October 6, 2000, SBA approved a \$130,000 loan to the borrower to fund leasehold improvements, equipment purchases and working capital for a start-up [FOIA Ex. 4 and 6] franchise. The loan was disbursed between January 2, 2001, and July 12, 2001. Due to delays in obtaining permits for the improvements, the lender extended the original 6-month principal deferment period by 3 months before the loan was even fully disbursed. Approximately 15 months after the final disbursement, another 6 month deferment of principal was approved because the borrower was having cash flow difficulties. After continuous repayment issues, the borrower finally defaulted on April 24, 2004. This loan is considered an early problem loan under SBA policy.

On April 26, 2005, SBA completed the purchase review for the subject loan concluding that there were no deficiencies that would result in a loss to the Agency. On January 9, 2006, SBA completed its comprehensive charge-off review and charged off its guaranteed share of \$41,776.

In June 2006, SBA's Office of Credit Risk Management (OCRM) performed a lender site visit to Stearns Bank. During the site visit the subject loan was reviewed for compliance with SBA regulations. The results of the review noted that only \$21,000 of the borrower's equity injection was verifiable. Based on OCRM's results, this loan was referred to SBA's Office of Financial Assistance for review and potential denial. The Office of Financial Assistance is still in the process of reviewing this loan and a repair or denial of liability has not yet been pursued.

Inadequate Evidence of Equity Injection

The lender did not verify \$40,750 of the required equity injection. The original loan authorization required \$46,650 of equity injection, but prior to disbursement

the lender obtained SBA's approval to increase the required injection to \$61,750. As a result, the lender was required to ensure \$61,750 was injected into the business prior to the first disbursement. The lender; however, provided support for only \$21,000 of the \$61,750 required injection.

When analyzing equity injection, SBA accepted inadequate evidence of a \$20,000 payment for a franchise fee, accepted a \$1,433 payment for a sign deposit that was reimbursed to the borrower with SBA loan proceeds, and did not question the unsupported remaining balance noting that the increase in equity injection never materialized. Furthermore, SBA incorrectly noted that equity injection was not materially deficient because the loan was not an early default or early problem loan. In actuality, this loan was an early problem loan as defined by SBA since the lender deferred two or more consecutive payments within 18 months of final disbursement.

SOP 50 51 (2) states that if there is an early default or early loan problems and a significant cash injection is not properly documented, a direct link between business failure and the lack of injection should be assumed, and a full denial of liability may be appropriate. As evidenced by the cash flow difficulties experienced by the borrower, the required equity injection was clearly material to the loan and this deficiency supported full denial of SBA's \$41,766 guaranty.

APPENDIX VI. [FOIA Ex. 4 and 6]

The deficiency on this loan resulted in a \$21,164 improper payment that should be recovered. During our ongoing audit of the liquidation and charge-off processes at the National Guaranty Purchase Center, we identified a problematic loan (number [FOIA Ex. 2]) made by Community Trust Bank, Inc. (lender) to [FOIA Ex. 4 and 6] (borrower). The loan was processed under SBA LowDoc procedures, and therefore, SBA was responsible for determining the eligibility and credit risk of the borrower. Community Trust Bank, Inc. was required to service and liquidate the loan in accordance with SBA regulations, policies, and procedures.

Background

On July 30, 2001, SBA approved a \$70,000 loan to the borrower to pay off existing debt, purchase inventory and provide working capital for an existing automobile repair business. The loan was closed and fully disbursed on October 3, 2001. The borrowers made two payments and defaulted on November 22, 2001. Thus, this loan is considered an early default loan in accordance with SBA policy.

On March 12, 2004, SBA completed the purchase review for the subject loan and concluded that there were no deficiencies that would result in a loss to the Agency. On July 12, 2006, SBA completed its comprehensive charge-off review. The charge-off review disclosed that the lender accepted an offer in compromise from a guarantor without SBA approval. SBA did not question the amount of the offer in compromise, but simply ensured that any proceeds had been submitted to SBA and charged off its guaranteed share of \$23,086. Offer in compromise payments of \$2,250 were also applied to the loan after charge-off, bringing SBA's outstanding loss to \$21,164.

Unapproved and Insufficient Offer in Compromise

The lender accepted an insufficient offer in compromise without adequately determining the financial condition of the offeror and without SBA approval. SBA Procedural Notice 5000-917 identifies that the compromise with any obligor for less than the full outstanding principal loan balance is an action for which lenders must obtain prior written approval by SBA. Additionally, for each offer in compromise, SOP 50 51 (2) requires a balance sheet and statement of income and expenses which covers the most current year and an evaluation of the assets of the obligor(s). This information, combined with the prognosis of the obligors' earning power, forms the basis for determining the adequacy of the offer.

On July 9, 2004, the lender requested SBA's approval of a \$7,800 offer in compromise with one of the loan guarantors. At the time of the request, the outstanding balance of the loan was \$34,933. SBA responded to the lender and requested further financial analysis and justification for the compromise that was not submitted with the lender's original request. On August 20, 2004, SBA placed this action into an inactive status due to the lender's failure to provide the information requested within 30 days. Without SBA's approval, the lender began collecting payments under the \$7,800 compromise agreement in October 2004. To date, the offeror has paid \$6,000 of the \$7,800 compromise amount.

Information within the SBA loan file supported that the offeror had the ability to pay the loan in full, and therefore the \$7,800 should not have been accepted. Specifically, the June 27, 2001, personal financial statement of the offeror reported a net worth of \$257,882. The statement supported that the offeror owned real estate of \$210,000 with equity of \$80,000 and had liquid assets of over \$30,000. Additionally, there is evidence that the guarantor making the offer was upset that he would be responsible for the entire debt of the two other guarantors who had declared bankruptcy.

Therefore, while it appears that the offeror had the ability to pay the loan in full, he was only willing to pay \$7,800 to settle the debt. If this amount was not accepted, he indicated he would attempt to re-open and operate the business. It appears the lender accepted the offer to resolve this issue and closed the loan without consideration of SBA's requirement to maximize recovery. The lender's non-compliance with SBA requirements is material and full recovery of SBA's \$21,164 loss is warranted.

APPENDIX VII. AGENCY COMMENTS



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

DATE: August 8, 2008
TO: Debra S. Ritt, Assistant Inspector General for Auditing
FROM: Grady Hedgespeth, Director, Office of Financial Assistance
SUBJECT: Draft Report on the Audit of Six Guaranteed Loans, Project No. 7016

We appreciate the opportunity to provide our preliminary comments on your draft report on the purchases of the six loans in question. We will provide additional comments when lender responses have been received and evaluated for four of the six cases. We consider the remaining two cases to be fully resolved. [FOIA Ex. 5

] Additionally, based on our follow up review of two of the six cases, we found that the improper payment total cited in your report was overstated. These findings are described in greater detail below.

It should be noted that most of these loans predate the centralization of the loan approval, servicing and liquidation functions at SBA. Also, all of them were reviewed before the significant investments in staffing, training and technology the agency made in the past year while reengineering the guaranty purchase submission and review processes at the National Guaranty Purchase Center (NGPC). In that time the staff working on the purchase review and liquidation of NGPC's inventory has more than doubled. Some of this staffing addition was specifically focused on eliminating the backlog of the older loans where SBA acknowledges its lack of sufficient attention and resource allocation in the past. However, the age of these cases has made the remedies proposed by this audit not the most cost effective use of our resources, especially given the efforts we are making to proactively drive the lending industry to better loan closing, documentation, servicing and liquidation practices.

SBA is current on reviewing all new purchase packages coming into the center. Focusing on these old loans provides the appearance that allowing loans to sit idle for years is the current environment in the center and in the guaranty purchase process at SBA. That is hardly the case. In the past year, SBA has taken incremental steps to reduce the time between purchase and review. SBA now

requires a purchase package on secondary market loans such as these within 45 days of a purchase.

Since November 1, 2007, the NGPC has maintained a 45-day pledge to reach a decision regarding purchase demand for all complete packages using the Tab System we designed last year. A year ago the average inventory was 279 days old. Even when lenders submit deficient purchase packages such as the ones in this audit, the center is now in immediate contact with the lender while the documentation and lender personnel associated with the case are still readily available. As a result, decisions are reached on most of these incomplete packages within 45 days as well. In addition, the purchase demand is subject to a review process that has been reengineered and standardized to bring greater quality and consistency to judging the critical factors that need to be considered to substantiate a purchase. Trends in deficiencies have been aggregated and analyzed, especially for our largest lenders. Training on these deficiencies and the new process has been delivered in hundreds of sessions around the country. Tailored training and remediation efforts have been delivered to many of our largest lenders at their locations by our National Customer Service Manager using specially coordinated teams of center and district office personnel. In addition, the most common deficiencies that lead to repairs are being shared with the Office of Credit Risk Management. OCRM is using them to help focus their lender reviews on the areas of most frequent defects. All these efforts are systematically improving the quality of lender purchase packages, as well as their underwriting, closing policies, servicing and documentation.

All of this is still very much a work in progress, but the results can already be seen in the significant improvement of package quality and the increase in voluntary withdrawals and cancellations, as lenders become used to the higher expectations of the reengineered NGPC and the consistent approach of our processes. This audit encourages SBA to focus significant recovery efforts on a very limited number of old cases where many of the lenders believed any obligation they had to SBA had been satisfied. It provides little new information to inform or change the proactive direction in which SBA is already moving – a direction that is already having a significant affect on the entire industry.

In preparing our response, we solicited comments and additional documentation from each of the lenders involved. Most of them expressed frustration about going back to review loans that were over six years old, as we are at the same time asking them to change their practices and to submit purchase packages within days for new secondary market defaults. Given the current market environment, bank operation staff are facing high workloads making these requests especially burdensome. Since all of these purchases took place a number of years ago, it is not surprising that we have not yet been able to obtain lender responses on all of

the cases. In this regard, we note that three of the purchases were handled by SBA district offices over six years ago. Depending on the specific facts and circumstances, this means that the statute of limitations may bar recovery were SBA to seek to pursue legal action to collect funds disbursed for the purchases.

An additional complication associated with [FOIA Ex. 4 and 6] (**Appendix I**) is that the National Guaranty Purchase Center already negotiated a repair to address shortcomings in the purchase of this loan by the district office. Part of the justification for the amount of the repair was the old purchase date – December 20, 2001. The NGPC used its best judgment in assessing the facts of this case to reach what it considered to be a fair and reasonable resolution in light of the circumstances. Not surprisingly, the lender is concerned because it presumed that the purchase issues were fully addressed by its partial repayment of the purchase disbursement. However, the lender has indicated that it will submit an additional response. This response will be evaluated before OFA reaches a final decision on the case.

With respect to [FOIA Ex. 4 and 6] (**Appendix II**), The lender is attempting to locate files and provide a response.

For [FOIA Ex. 4 and 6] (**Appendix III**), we've negotiated recovering \$20,000 from the lender based on the liquidation value of the inventory and the lender's involvement with its disposition. The lender has agreed to this amount. A full recovery of the purchase amount of \$133,713 is not justified based on the facts of the case and we consider it resolved.

For [FOIA Ex. 4 and 6] (**Appendix IV**), we are awaiting a response from the lender.

On [FOIA Ex. 4 and 6] (**Appendix V**), we have concluded that, based on all the facts, the possible lack of the full amount of the equity injection does not appear to have been the proximate cause of the business failure. Accordingly, recovery from the lender is not warranted and we consider this case resolved.

For [FOIA Ex. 4 and 6] (**Appendix VI**), we are awaiting a response from the lender.

We will submit the 1824's with the final audit report.