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AUDIT OF

DECLINED DISASTER LOANS

WASHINGTON, DC

AUDIT REPORT NO. 8-6-F-005-016

June 3, 1998

US SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

Date: June 3, 1998

To: Bernard Kulik, Associate Administrator for Disaster Assistance

From: Peter McClintock, Assistant Inspector General for Auditing

Subject: Audit Report - Audit of Declined Disaster Loans

Attached is a copy of the subject audit report. The report contains one finding with one recommendation directed to your office. At your request, we examined declined disaster loans to determine whether the decline rate was higher than necessary due to improper decline decisions. Decline decisions generally were appropriate. The draft report contained two examples of declined applications that could have been approved, but after obtaining additional information, we deleted one of the examples (sample number 55). Based on the response to the draft report we revised the recommendation to be more specific as to when a summary decline should be issued and reduced the number of applications that we believe should have been summary declined due to lack of repayment ability from seven to six.

The recommendation in this report is subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for audit follow-up. Please provide your management response to the recommendation within 30 days form the date of this report, using the attached SBA Form 1824, Recommendation Action Sheet.

Any questions or discussion of the issues contained in the report should be directed to Garry Duncan at (202)205-7732.

Attachment

AUDIT OF DECLINED DISASTER LOANS

WASHINGTON, D.C.

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SUMMARY

At the request of the Associate Administrator for Disaster Assistance, we audited declined disaster loan applications to determine whether the decline rate was higher than necessary due to inappropriate decline decisions. The audit was based on a review of a random sample of 97 disaster loan applications declined between October 1, 1994, and September 30, 1995.

Decisions to decline loan applications were generally appropriate. We identified only 1 of 97 declined applications that we believe could have been approved. The application was declined because the loan officer decided that available cash was not sufficient to service the additional debt.

The decline rate was higher than necessary, however, because summary decline procedures were not applied consistently to applications that did not meet minimum income and/or repayment ability criteria. Of the 97 declined applications in our sample (see Appendix A), 16 could have been summary declined without processing. If summary decline procedures had been followed consistently, the number of applications accepted for processing would have decreased, thereby reducing the decline rate and increasing the percentage of approved applications.

Because summary decline procedures were not followed, loss verification costs were incurred unnecessarily and processing workload was increased. When an application is summarily declined, the loan officer does not have to evaluate creditworthiness or perform detailed repayment ability analysis. In addition, summary declined applications do not require visits by loss verifiers to determine the extent of property damage. The average cost to verify the loss for an application was about $121.

We recommend that the Associate Administrator for Disaster Assistance institute procedures to ensure summary decline procedures are followed when appropriate.

The Associate Administrator for Disaster Assistance provided a rationale for the actions taken by the loan officers, but generally agreed with the report and indicated that applications will be summary declined when appropriate. Complete management comments are presented in Appendix C.

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendation are subject to review, management decision, and corrective action by your office in accordance with Agency procedures for follow-up and resolution.

INTRODUCTION

A. BACKGROUND

The Associate Administrator for Disaster Assistance requested that we conduct an audit of declined disaster loan applications to determine whether the decline rate was higher than necessary due to inappropriate decline decisions. He asked us to review the quality of the credit decisions made for declined applications.

The SBA Disaster Loan Program is the primary source of Federal assistance for non-farm private sector disaster losses. The Small Business Act, as amended, authorizes SBA to make loans to eligible victims of declared disasters. Loans are made to individuals and non-farm businesses of all sizes to repair or replace damaged real and/or personal property. Economic injury disaster loans are made to small businesses to provide necessary working capital until normal operations resume.

Applications for disaster assistance are received either in person or by mail. If the application is received in person, the applicant is interviewed to determine eligibility and repayment ability. Interviews are not held for applications received by mail. Upon completion of the interview or receipt by mail, the application is screened for completeness and acceptability. Applications accepted for complete processing are "docketed." When applicants are determined to be ineligible or lack repayment ability, the application can be summary declined. Since applications that are summary declined are not docketed, they are not counted as a declined loan.

For fiscal years 1992 to 1995, the Office of Disaster Assistance received a total of 525,377 applications of which 48 percent (250,131) were approved and 52 percent (275,246) were declined. Of the applications that were not approved, 37 percent (191,595) were declined after docketing, 10 percent (54,858) were declined before docketing (summary decline), and 5 percent (28,793) were withdrawn by the applicant.

Declined disaster home loan applicants are referred for assistance to the Individual and Family Grant Program administered by the Federal Emergency Management Agency (FEMA) and the respective State. There are no Federal grant programs for applicants denied disaster assistance for business loans.

B. AUDIT OBJECTIVES

The overall objective of the audit was to determine whether the decline rate of loan applications was higher than necessary. In this regard, we assessed whether (i) applications for applicants with sufficient cash flow were declined; (ii) alternatives, such as refinancing existing debt, were considered; and (iii) summary decline procedures were followed.

C. SCOPE OF AUDIT

The audit was based on a random sample of declined loan applications. From a universe of 48,064 applications declined between October 1, 1994, to September 30, 1995, we randomly selected 97 for detailed analysis. A list of the declined loan applications in our sample is included in Appendix A.

The auditors reviewed file documentation for each declined application, analyzed data contained in the files, discussed selected declined applications with district personnel, and visited two SBA Recovery Centers and Disaster Field Offices to observe interviewing, screening, and loan processing operations. Audit field work was performed between April 22, 1996, and October 31, 1996. The audit was conducted in accordance with Government Auditing Standards.

D. FOLLOW-UP ON PRIOR AUDITS

This was the first audit of declined disaster loan applications.

RESULTS OF AUDIT

Decisions to decline loan applications generally were appropriate. The review of 97 declined applications identified only 1 for which the declination was questionable. The application was declined because the loan officer concluded the applicant had insufficient cash flow to meet living expenses. We consider a one percent error rate for declination decisions acceptable, given the conditions under which disaster loans are made. Oftentimes, disaster loan officers are temporary employees who have relative short timeframes to approve a loan and who are not thoroughly familiar with SBA policies and procedures. Details of the inappropriate declination are presented in Appendix A.

The decline rate and loss verification costs, however, could have been reduced if greater use had been made of summary decline procedures. By summarily declining more applications, the number of declined docketed applications would have been reduced, and this reduction would have caused a corresponding increase in the percentage of approved applications.

FINDING Consistent use of Summary Decline Procedures would have reduced the decline rate

The decline rate for disaster applications for fiscal year 1995 was higher than necessary because summary decline procedures were not followed consistently. In our sample, summary decline procedures were not used for 16 of 97 applications that did not meet minimum household income levels or repayment criteria. The use of summary decline procedures would have resulted in a reduction of verification costs of a minimum of $121 per application and a reduction in loan officer workload.

Applicants did not meet the minimum income level

On ten applications, the applicants' household incomes did not meet SBA's minimum household income levels. SOP 50 30 3, paragraph 59.g. (SOP in effect at the time the applications were processed) states that applicants whose household incomes are below the minimum income levels are classified as a "decline-automatic" and referred directly to the Individual and Family Grant Program, thus bypassing SBA processing. Even though the household incomes for the 10 applications ranged from 2.6 to 100 percent below SBA's minimum income levels, they were not declined immediately. Instead, they were processed for repayment ability, creditworthiness, and loss verification, and then declined.

Fixed Debt Method calculations showed applicants lacked repayment ability

An additional six applications for home loans that lacked repayment ability were not declined prior to docketing. When an application for a home loan indicates the applicant meets SBA's minimum household income levels, the loan officer should use the Fixed Debt Method to determine if the applicant has sufficient cash flow to repay the disaster loan. This method assumes that there is a certain maximum level of debt (expressed as a percentage of gross income) that one can afford. If the amount required to repay the loan would cause an applicant to exceed the maximum level of fixed debt, then the application should be summary declined.

Officials from two disaster area offices stated that because applications were accepted without the necessary supporting documentation, such as W-2 forms or tax returns, loan officers were uncertain that the financial information was accurate and were reluctant to decline the applications at this point. Instead, applications were docketed and received full loan processing, including creditworthiness analysis and loss verification before being declined. According to SOP 50 30 3, paragraph 69.d., a summary decline should be issued if the screener, after reviewing the application and exhibits, determines an applicant obviously lacks repayment ability.

Unnecessary processing increased workload and loss verification costs

By processing loans that could be summary declined, loss verifier and loan officer workloads were increased, unnecessary loss verification costs were incurred, and applicants were unnecessarily delayed in applying for grant assistance. The 16 applications that should have been summary declined averaged 14.4 days (244 total days) between screening and the date of recommendation to decline. Time spent during this period processing the applications could have been used to review other applications or could have resulted in a reduction in the number of loan officers needed. Because verifications are done after loans are docketed, greater use of summary declines would have resulted in fewer applications requiring loss verification. This also could reduce the number of loss verifiers needed.

According to 1996 data developed by the Office of Disaster Assistance, the average cost to verify disaster losses per loan application was at least $121. Losses are verified for all docketed applications. Because loss verification was done for each of the 16 applications reviewed, loss verification costs were incurred unnecessarily. By using summary decline procedures as prescribed in SOP 50 30 3, the Office of Disaster Assistance could reduce loss verification costs significantly in the future. Although calculations were not done, we believe additional savings could have been realized in the reduction of loss verifier and loan officer workloads. Details of the 16 applications that did not meet SBA's minimum household income levels or have sufficient cash flow to repay a loan and were not summary declined are provided in Appendix B.

Applications reviewed for completeness in lieu of summary declines

Our observations of operations at two disaster field offices showed that disaster loan officers were reviewing applications for completeness and docketing those determined to have all the necessary information. We questioned personnel in both offices as to why summary declines were not done. We were told that there was an insufficient number of experienced loan officers to make summary decline decisions and, for that reason, loan officers were only required to determine if the application was complete before docketing.

Our review of the six applications that we believe should have been summary declined due to lack of repayment ability showed that the applicants correctly reported income and fixed debts on their applications. After applying the fixed debt method calculation, all six applications had negative repayment ability. These applicants obviously lacked the ability to repay a disaster loan and should have been summary declined.

Recommendation

1. We recommend that the Associate Administrator for Disaster Assistance summary decline home loan applications when applicants do not meet the minimum income test or have a negative repayment ability.

SBA Management Response

The Associate Administrator for Disaster Assistance agreed to apply the minimum income test as part of the screening process and summary decline loans whenever household income was below the minimum level.

He will also remind area offices to issue summary declines as part of the screening process when it is obvious that the fixed debt method shows the applicant lacks repayment ability. Loan officers who screen applications, however, do not and cannot be expected to perform a fixed debt method calculation to determine if the applicant has sufficient cash flow to repay a disaster loan. The screeners do not know all of the facts needed to make a determination of repayment ability, such as the potential amount of the loan, possible refinancing, relocation of victims homes, or if a partial loan is appropriate. Because of these reasons, it is impractical to expect that a fixed debt method calculation is feasible or practical at screening.

Evaluation of SBA Management Response

The Associate Administrator's response meets the intent of our recommendation regarding SBA's minimum income test requirements.

Although the Associate Administrator states that it is not possible for loan officers during screening to perform a fixed debt method calculation, he states that there may be instances where it is obvious at screening that the fixed debt method will result in a summary decline.

SOP 50 30 3 requires cash flow to be used as the basis for establishing repayment ability for any disaster loan. Paragraph 69.d., of the SOP, provides that home loan applications should be declined during the screening process whenever the screener determines that the victim obviously lacks repayment ability after reviewing the Disaster Home Loan Application. For home loans, the applicant's ability to repay is determined using the fixed debt method as described in Appendix 26.

The six home loan applications we discuss in the report are considered to be "obvious instances" where the fixed debt method would result in a summary declined. Each application had a negative repayment ability based on furnished information from the applicant. Our review showed that the applicants correctly reported income and fixed debts.

In our opinion, an applicant with a negative repayment ability would be considered an "obvious instance" where a summary decline should be made. If the screeners had performed the fixed debt calculation, about 6 percent of the home loan applications in our sample that were declined for lack of repayment ability after docketing, could have been summary declined. Such a summary decline would reduce processing costs by a minimum of $121 per application because loss verification would not have to be performed. Also, summary declines would have provided these disaster victims assistance quicker because the applicant would have been referred to the Individual and Family Grant Program sooner.

Loan Inappropriately Declined

For disaster home loan applications, a specific formula is used in determining if the applicant has sufficient cash available to service the SBA debt. This formula, called the Fixed Debt Method, considers all of the applicant's income, debt, and expenses when determining available cash. Therefore, the cash available represents discretionary income. SBA prefers to limit the SBA debt repayment to no more than one-third of this discretionary income. A home loan application (sample number 30) for a verified loss of $7,720 was declined because the loan officer determined that the applicant's $151 monthly cash available was insufficient to service additional debt and to sustain the applicant's family of two. The loan officer did not compute the monthly SBA payment, which we determined to be $38. After making the disaster loan payment the applicant would have had $113 per month to spend on non-essential living expenses. The loan officer did not consider that computations of cash flow for home loan applications include necessary living expenses and that any excess cash flow is for discretionary spending.

Appendix B

Applications not Meeting Minimum Income Requirement or Lacking Repayment Ability using Fixed Debt Method Calculations

SAMPLE NUMBER	DOCKET NUMBER	HOUSE HOLD SIZE	MINIMUM INCOME LEVEL	INCOME PER APPLICATION	COMPUTED REPAYMENT ABILITY[a]
8		1	$11,040	$26,555	($1,739)
20		1	$11,040	$75,312	($1,456)
22		5	$21,600	$0	n/a
23		3	$15,400	$15,000	n/a
26		5	$21,600	$50,000	($ 1,012)
39		2	$12,300	$12,722	($177)
40	FOIA Ex. 6	1	$11,040	$0	n/a
45		1	$11,040	$ 7,800	n/a
47		5	$21,600	$22,750	($357)
48		4	$18,500	$13,312	n/a
51		2	$12,300	$10,152	n/a
72		4	$18,500	$20,549	($247)
89		1	$11,400	$9,600	n/a
92		2	$12,300	$5,676	n/a
94		3	$15,400	$12,000	n/a
95		4	$18,500	$6,000	n/a

[a] The sample numbers with n/a in the computed repayment ability column represent applicants where the household income was below SBA's minimum income level.

Appendix C

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

Date: MAY 20 ...

To: Peter L. McClintock
Assistant Inspector General for Auditing

From: Associate Administrator
for Disaster Assistance

Subject: Audit Report - Audit of Declined Disaster Loans

I have reviewed the revised copy of the subject audit report and there have been further discussions between our offices at the staff level. As a result, it is our understanding that **Sample Number 55** will be deleted and the report adjusted accordingly.

I commend the effort and the work put into this report by your staff. It represents a really cooperative response to our request for assistance in helping make the disaster assistance program more efficient and effective. We appreciate the time you took to become familiar with our method of operation.

I have the following specific comments:

- On page 1 of the audit, first paragraph under the "Background" heading, the second sentence seems to give a negative approach to the subject, one which I certainly did not intend. If the sentence is amended to read "He asked us to review the quality..." rather than "He expressed concern about the quality...", I believe it will better cover the tenor of my request and remove the negative connotation.

- **Sample Number 30,** page 3. While technically the audit is correct in the application of the fixed debt method to this instance, I believe the auditors did not give sufficient weight to the circumstances of the case and the scope of the loan officer's discretion set forth in the SOP as follows:

  "The FDM calculation is a guideline to help LOs determine whether repayment ability exists, and if so, what the appropriate repayment terms should be. To successfully implement the FDM, LOs must exercise their credit analysis skills and discretion and evaluate all pertinent facts in the loan case file. The informed decision to approve a disaster loan must be justified by good credit and ability to repay. Only a reasoned and thorough analysis of all relevant facts can maintain the balance between prudent lending of subsidized funds and sympathetic consideration of the needs of disaster victims." (SOP 50-30-3, App. 26, Para.3i)

This is a case of two retired applicants (each in their 70s) [FOIA EX. 6] each of whom has income of $550 per month from Social Security. The only fixed debt the application indicates is monthly rent of $238. The application shows no assets, liabilities or outstanding credit. The damage is to personal property, with an estimated repair or replacement cost of $7,728. Under these circumstances, we do not believe the LO abused his discretion in determining that approval of the loan would create an undue hardship for these applicants and that a decline and referral to the Individual and Family Grant Program was appropriate.

- Your audit found 10 applications that did not meet the Minimum Income Test (MIT), but were not summarily declined during the screening process. Although the basic responsibility for applying the MIT rests with FEMA during the course of teleregistration, it is entirely possible that the teleregistrar may miss this point or that the person calling teleregistration on behalf of the victims is not that knowledgeable about the family income. Your recommendation that we apply the MIT as part of the screening process is a good one and will be implemented.

- Your audit found "An additional seven applications [which] should have been identified as lacking repayment ability and declined prior to docketing." Loan officers who do the screening do not, and cannot be expected to, perform a fixed debt method calculation to determine if the applicant has sufficient cash flow to repay the disaster loan. Their function is to determine if the application is sufficiently complete to permit processing. Many times the screening is being done in the field under conditions that are not conducive to loan and credit processing and analysis. And in no case are they in possession of many crucial facts needed to make such a determination. For example, before the verification is performed, the amount of the possible loan is unknown and repayment ability cannot be determined. Also, at screening, before docketing, the IRS information has not been pulled and income verified. The effect of complicating factors, such as possible refinancing, relocation, partial loans and cash flow in the case of sole proprietors or those with rental income cannot be determined at screening with the information then at hand. For these reasons, it is impractical to expect that an FDM calculation is feasible or practical at screening.

  There may be some instances, however, where it is obvious at screening that the FDM will definitely result in a decline. While we have not reviewed the seven cases in question, we will remind the Area Offices to have the screeners keep that possibility in mind when performing their duties.

As a result of the above comments, we believe the possible reduction of costs set forth in the Audit may be overstated. However, again I want to commend your office for their effort and for bringing to our attention matters wherein the operation of the program can be improved.

Bernard Kulik

Appendix D

OFFICE OF INSPECTOR GENERAL
AUDITING DIVISION

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