

AUDIT REPORT
DISASTER HOME LOAN SERVICING CENTERS
AUDIT REPORT NO. 9-15
August 3, 1999

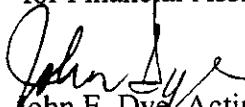
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U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
Issue Date: August 3, 1999
Number: 9-15

To: Jane P. Butler, Associate Administrator
for Financial Assistance

From: 
John E. Dye, Acting Assistant Inspector General
for Auditing

Subject: Audit of Disaster Home Loan Servicing Centers

Attached is a copy of the subject audit report. The report contains two findings and five recommendations concerning collection of past due disaster home loans by servicing centers.

Three of the five recommendations contained in the draft audit report have been modified based on comments in your June 30, 1999 letter and discussions with your staff. As a result of the changes reflected in the final report, it is our understanding that you now agree with each recommendation.

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

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

Attachment

cc: Associate Deputy Administrator for Capital Access

**AUDIT OF
DISASTER HOME LOAN SERVICING CENTERS**

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SUMMARY

We audited the Small Business Administration's (SBA's) disaster home loan servicing operations at the four servicing centers located in Birmingham, El Paso, New York, and Santa Ana. As of September 30, 1997, SBA's portfolio of disaster home loans at the servicing centers consisted of 185,417 loans valued at about \$3 billion, of which 12,843 loans valued at \$179 million were in a past due, delinquent, or in-liquidation status (referred to hereafter as past due loans). We statistically sampled 432 of these loans valued at \$4.8 million to determine whether SBA followed collection procedures or performed liquidation actions intended to minimize losses.

Department of the Treasury guidelines and public policy require that debt collection procedures be designed to maximize the collection of delinquent debts (minimize losses). In line with these guidelines and policies, SBA established standard operating procedures to make maximum use of resources for intensive collection follow-up on delinquent accounts. These procedures require early and predictable contact after loans become delinquent and liquidation action to recover from borrowers who can pay, but will not. If followed, these procedures should minimize SBA's risk of loss by returning delinquent loans to current status or obtaining recovery through liquidation actions.

Collection actions on past due disaster loans were untimely, not done weekly, and continued beyond recommended time limits. Based on a statistical sample, it is estimated that SBA may not have followed procedures to minimize its risk of loss for 6,785 loans either by initiating early and predictable contact or by initiating early liquidation actions. Although specific losses cannot be identified, collection efforts were not maximized for outstanding loan balances totaling \$79.2 million. Management cited insufficient staffing as a roadblock to more effective collection actions. We determined, however, that loan collection guidelines were not always followed.

In February 1998, SBA established a goal to contact all delinquent borrowers weekly in order to improve the timeliness and consistency of collection actions. SBA officials stated that as a result of staffing increases and the contracting of the servicing function for 30 percent of the loan portfolio, this goal was met as of February 1999. As of that date, the reported percentage of past due borrower contacts increased to 100 percent (as opposed to 40 percent for fiscal year 1997) while the currency rate increased by 1.5 percent. Cash collections also increased by about 19 percent from FY 97 to FY 98.

The audit also showed that disaster home loans were charged off without litigation or collection agency referrals. Our review of 165 charged off loans between January 1 and September 30, 1997, disclosed that 28 percent had potential for recovery using litigation tools such as garnishment, real estate liens, judgments, and/or collection agencies. SBA officials stated that litigation referrals were not made because servicing center managers did not believe that the Department of Justice would litigate delinquent loans. The managers also stated that delinquent loans were not referred to collection agencies due to disputes over payment amounts or various complaints from borrowers. SBA now sends these loans to the Department of the

Treasury for possible referral to collection agencies. We estimate that \$4.8 million charged off for 928 loans would have been potentially recoverable if liquidation tools had been used.

We recommend that the Associate Administrator for Financial Assistance improve past due loan collection actions, conduct a staffing requirements study, and use available collection tools to liquidate loans. The Associate Administrator agreed with the recommendations.

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

INTRODUCTION

A. BACKGROUND

In the early to mid-1980s, SBA established servicing centers in Birmingham, El Paso, New York, and Santa Ana to service disaster home loans. Servicing functions were then transferred from SBA district offices to increase effectiveness and improve the loan currency rate. The centers were responsible for:

- processing administrative actions (generally requested by borrowers),
- making collection efforts for past due/delinquent accounts,
- liquidating unsecured loans when collection efforts were unsuccessful, and
- transferring secured loans to district offices for liquidation.

To determine the appropriate collection effort required, SBA classified loans into six status categories.

<i>Current</i>	Payment is current or less than 10 days behind schedule.
<i>Past due/delinquent</i>	Payment is between 10 and 60 days behind schedule.
<i>Default</i>	Payment is 61 or more days behind schedule.
<i>In liquidation</i>	It is necessary to resort to selling collateral or taking other enforcement action to obtain payment.
<i>Deferred</i>	Borrowers have been given permission to suspend making payments for a specific period of time.
<i>Charged off</i>	No reasonable expectation that borrower will repay the loan.

Servicing center collection action starts when loan payments are 10 days late. Loan information is then entered into SBA's Delinquent Loan Collection System so action can be initiated to return the loan to current status. After all collection efforts are completed, past due loans should be transferred to liquidation. The focus of servicing actions should then be to maximize recovery through sale of collateral or other approved actions. After all SBA collection actions are completed, the loans are sent to the Department of the Treasury (Treasury) for referral to collection agencies, Federal Salary and Administrative Offset, and/or Internal Revenue Service Offset.

Servicing and liquidation procedures are contained in Title 13, Code of Federal Regulations, OMB Circular A-129, the U.S. Treasury's Managing Federal Receivables Manual, and SBA SOPs 50 52 and 50 50 3. Both the Treasury and SBA procedures indicate that action should be taken quickly to resolve delinquencies. In those instances when an account cannot be restored to a current status, liquidation actions should maximize financial recovery on the loan.

As of September 30, 1997, SBA had 185,417 disaster home loans located at the four disaster servicing centers. The status of the loans follows:

LOAN STATUS	PERCENTAGE	SUB TOTAL
Current	93.00	\$2.8 billion
Delinquent	5.90	\$177 million
Deferred	.90	\$25 million
In liquidation	.08	\$2 million
Total (rounded)	100.00	\$3 billion

B. AUDIT OBJECTIVES AND SCOPE

The overall audit objectives were to determine whether SBA followed collection procedures and used available liquidation tools to minimize loan losses. To accomplish our objectives, two statistical samples were selected. The first was for 267 of 16,031 past due loans with outstanding balances of \$3.4 and \$198.6 million, respectively. Each loan was examined to ascertain collection actions taken after the next payment due date to September 30, 1997. A second sample of 165 loans from a total of 3,327 loans with outstanding balances of \$1.5 and \$30.6 million, respectively, evaluated actions taken to maximize financial recovery when loans could not be returned to a current status. Appendix A describes the sampling methodology.

Loan files, SBA's management information systems, and non-government data were reviewed. Personnel from the four servicing centers, SBA headquarters, other Federal agencies, private lenders, and collection agencies were interviewed. Field work was performed between May 1997 and January 1999. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Collection procedures established to minimize losses on past due disaster home loans were not always followed by SBA. The procedures included contacting borrowers as soon as their loan becomes past due with contact continuing each week the loan remains in that status. Collection efforts should cease after loans are past due for no more than 150 days and liquidation activity should begin. Some loans were then charged off without using all available collection tools.

FINDING 1 Actions to Collect Payments on Past Due Loans Needed Improvement

Collection actions on past due disaster loans were untimely, not done weekly, and continued beyond recommended time limits. Based on a statistical sample, it is estimated that SBA could have minimized its losses for 6,785 loans either by initiating contact to return them to current status or starting liquidation action earlier. Although specific losses cannot be identified, outstanding loan balances totaling \$79.2 million were at an increased financial risk. SBA management cited insufficient staffing as a roadblock to more effective collection actions. We determined, however, that loan collection guidelines were not always followed. To improve the timeliness and consistency of borrower contacts, SBA established a goal during the audit to consistently contact borrowers of past due loans.

Past due borrowers should be identified and contacted

After a disaster home loan becomes 10 days past due, a form letter is automatically generated by the Denver Finance Center (Finance Center) and sent to the borrower. The Finance Center also generates an automated weekly listing that identifies such loans. The loans are aged by days past due and distributed to the servicing centers. The servicing center staffs are responsible for contacting borrowers, either by telephone or letter, on a continuing basis. A record of all contacts is recorded in SBA's automated chronological record file.

SBA's SOP 50 52 reiterates U.S. Treasury policy that the primary use of servicing resources will be for the collection of past due loans at the earliest stages of delinquency. Only one of the service centers, however, used its resources in this manner. The priorities of two other centers were to accomplish administrative actions related to real estate and collection efforts for loans past due for 180 days or more. The priorities of the fourth center were not determined because the current manager was unaware of how resources had been used in the past.

Collection actions for borrowers of past due loans could be improved

Attempts to contact borrowers of past due loans were not made early or weekly. To evaluate the timeliness of collection efforts, we determined the number of borrower collection contacts for each sampled loan at intervals of 30, 60, 120, 180, and over 180 days. For audit purposes, we decided that any verbal or written contact attempt by the servicing or finance

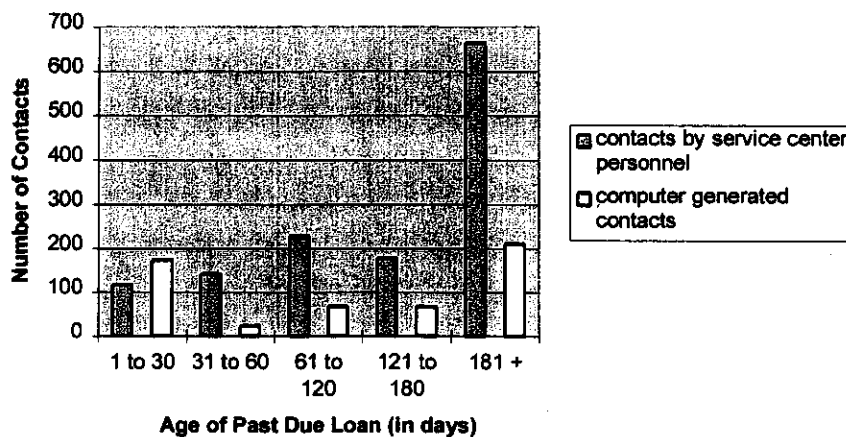
centers would be considered a collection "contact." SBA's automated chronological file was used to identify the number of attempted contacts for each loan.

a. Servicing center collection efforts should be made earlier

Standard Operating Procedure 50 52 requires that collection efforts should be promptly initiated during the earliest stages of delinquency. The SOP, however, does not define "earliest stages of delinquency." Also, the U.S. Treasury's Managing Federal Receivables Manual states that because ability to collect debt decreases with age, Federal agencies are encouraged to resolve all loan delinquencies as quickly as possible. Both SBA and Treasury guidance provide that collection contacts should be personal; i.e., telephone calls or non-form letters.

As shown below, when early contact (within 30 days of a missed loan payment) was attempted, the majority of collection efforts were made by Finance Center computer-generated letter instead of personal servicing center actions. Also, most contact attempts occurred after loan payments were more than 180 days past due. See the following chart.

Analysis of Contact Attempts With Borrowers



b. Weekly borrower loan collection contacts were needed

SOP 50 52 states that predictable contact with borrowers is one of the goals of SBA's collection system. The SOP further states that a weekly listing of all delinquent loans will be supplied to each service center for use in contacting each borrower. Also, one of the productivity measures used by SBA management is weekly contact with borrowers. We concluded, therefore, that predictable contact can be defined as weekly contact.

For 250 of the 267 loans reviewed, borrower contact was attempted at least once while in a past due status. Collectively, the 250 loans were in past due status for about 14,000 weeks; therefore, the number of collection attempts should have equaled an equivalent number of weeks. Using the SBA automated chronological file, we could only identify about 1,800 weekly

contact attempts. The per loan percentage ranged from 0 to 80 percent with an average contact rate of only 12 percent.

c. SBA established a collection goal for past due loans

During our audit, the Associate Deputy Administrator for Capital Access established a goal of consistently contacting borrowers of past due loans on a weekly basis. An attachment to the memo showed that as of the memo date (February 9, 1998), the contact goal had not been met. Subsequent reports showed significant increases in the contact rate and that the goals had been substantially achieved. Program managers claim they were able to achieve the goals by increasing staffing by 22 percent and by contracting the servicing effort for 30 percent of the portfolio. The following chart shows the reported positive changes that occurred for significant performance categories.

Category	FY 97	February 1999	Difference
Weekly Borrower Contacts	40 %	99.9 %	+ 59.9 %
Currency Rate of Home Loan Portfolio	92.1 %	93.6 %	+ 1.5 %
Delinquency Rate of Home Loan Portfolio	4.5 %	1.5 %	- 3.0 %
Cash Receipt Collection Level	13.2 %	15.7 %	+ 2.5 %
Staffing Level	94	116	+ 22
Home Loan Portfolio Size	185,417	124,305	- 61,112

SBA computes the overall percentage of borrower contacts based on information received from each of the disaster home loan service centers. This information, obtained from Delinquent Loan Collection System inputs, was used to prepare a monthly report for SBA management officials.

We could not verify the accuracy of the reported weekly contact data because prior LCAW 27 (Loan Collection Accounting Weekly) reports showing past due loans assigned to service centers and the LCAW 31 report showing the performance statistics by service center were not retained. Based on limited testing of current data, however, nothing came to our attention that would indicate the reported data were inaccurate.

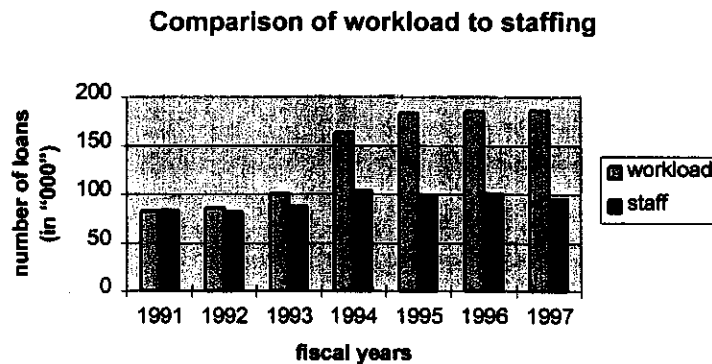
Earlier transfer of past due loans to liquidation should be accomplished

Collection actions were continued beyond the time period recommended by the Treasury. Appendix 4 of Treasury's Asset Management Manual recommends loans past due for more than 75 days be transferred to liquidation status. As of September 30, 1997, 124 (46 percent) of the loans reviewed were in a past due status for more than 75 days. Ten of these were subsequently paid in full or returned to current status and 47 were transferred to liquidation status or charged off. Servicing personnel were still attempting to return the remaining 67 loans (54 percent) to current status through collection contacts. SBA had not established a time requirement for transferring delinquent loans to liquidation status. By continuing collection efforts on older past

due loans, servicing center staff had fewer resources to expend on collection efforts on loans that recently became past due.

Staffing cited as a problem

SBA managers cited staffing as a major roadblock to more effective servicing. We were told that the disaster loan servicing workload had grown without a corresponding increase in staff. Our analysis, as shown in the following chart, confirms that workload and staffing had not increased proportionately.



While it is true that workload increased in greater proportion than staffing, the audit disclosed that prior staffing studies were of questionable use in determining appropriate staffing levels. The SBA conducted three such studies between June 1990 and November 1996. These studies contained one or more of the following deficiencies:

- projected servicing center workload not considered,
- the composition of the workload (secured versus unsecured loans) not considered, and/or
- time and motion studies not performed (one report recognized that a comprehensive analysis would require such a study).

Any future staffing studies to determine home loan service center requirements should eliminate the above mentioned deficiencies. Also, changes in recent laws and directives, including the following, should be considered:

Congressional initiative Public Law 104-208 directs SBA to conduct a demonstration program for outsourcing the servicing of 30 percent of the disaster home loan portfolio. To this end, a contract was awarded in April 1998. Although this requirement did not reduce the number of servicing personnel (due to possible understaffing), it did reduce the number of loans serviced by each servicing center.

FY 1998 Appropriations Act requirements The FY 1998 Appropriations Act mandated SBA to sell its portfolio of defaulted guaranteed and direct loans beginning in FY 1998. The sale of the disaster loan portfolio is scheduled to continue through year-end FY2000. We believe the size of the portfolio will be significantly reduced when this action has been fully implemented.

Debt Collection Improvement Act of 1996 The Act requires referral to the Treasury of debt delinquent for more than 180 days and not in litigation or liquidation. As previously stated, many past due disaster home loans did not receive adequate collection action until they were past due for 180 days or more. Therefore, delinquent loans not serviced under contract may be eligible for transfer to the Treasury. Adherence to this Act will also decrease the size of the home loan portfolio. In FY 98, SBA began forwarding unsecured disaster home loans that were 180 days delinquent to Treasury for collection.

Recommendations

We recommend that the Associate Administrator for Financial Assistance take the following actions relative to disaster home loans:

- 1A. Incorporate into SOP 50 53 the following procedures:
 - contact borrowers by telephone as soon as their loan becomes past due, and
 - contact all past due borrowers weekly.
- 1B. Discontinue routine collection efforts (telephone calls and letters) and transfer loans to liquidation status after 120 to 150 days in a past due status.
- 1C. Determine service center staffing requirements by conducting a study considering factors such as
 - projected and historical workload,
 - workload composition,
 - time and motion analysis, and
 - changes in recent laws and directives.

Management Response

The Associate Administrator for Financial Assistance agreed with the recommendations and stated that:

- Recommendation 1A. has been implemented with the change to be included in the next SOP update.

- Routine collection actions will be discontinued after a loan is in past due status from 120 to 150 days as suggested in recommendation 1B. Depending on the workout status, the loan will be transferred to liquidation.
- Implementation of recommendation 1C. will be delayed until funding is received and factors affecting loan administration have stabilized. Funding for the study will be included in an upcoming budget request.

Evaluation of Management's Comments

Based on discussions with personnel in the Office of Financial Assistance, draft report recommendations 1B. and 1C. were modified. The Associate Administrator agreed with recommendation 1A. and now verbally agrees with revised recommendations 1B. and 1C.

FINDING 2 Collection Tools were not Always used to Recover Loan Losses

Disaster home loans were routinely charged off without litigation referral. Our review of 165 loans charged off between January 1 and September 30, 1997, disclosed that 28 percent had potential for recovery using litigation collection tools such as real estate liens, garnishments, judgments, or collection agencies. Litigation referrals were not made because servicing center managers did not believe that the Department of Justice (Justice) would litigate delinquent loans. In addition, management officials claimed that collection agency referrals were not made due to disputes over payment amounts or various complaints from borrowers. We estimate that \$4.8 million charged off for 928 loans was potentially recoverable if all available collection tools had been employed.

Recovery opportunities for charged off loans were lost

SOP 50 52 required service center personnel to review each loan for the borrower's ability to pay. If a determination was made that the borrower had the ability but was unwilling to pay, step-by-step instructions were provided on how to package and send the loans to the U.S. Attorney for litigation action. The litigation action to be taken by the U.S. Attorney includes garnishment of wages, and judgments against real and personal property. Also, SOP 50 50 3 required an identification of those assets against which a judgment might be enforceable and an estimate of potential recovery. The Debt Collection Act of 1996 further provided Federal agencies the authority to use collection tools for delinquent debt. The Act addressed existing tools such as judgments against borrowers and liens on borrower assets and added a new tool, garnishment of wages. Also, OMB Circular A-129 supports the authority of agencies to litigate against borrowers.

Loan officers classified borrowers for 91 (55 percent) past due loans in our sample as able but unwilling to pay based solely on their knowledge of the loans. Rather than pursuing the borrowers for repayment, the loan was charged off using SBA Form 327 that contained the statement, *"The loan is uncollectible and collection costs, administrative or litigation, would*

exceed any estimated recovery." We found no estimate of potential recovery to support this statement nor could SBA personnel provide documentation that the estimates were made. SBA considered loan officers experienced enough to selectively judge whether the loan warranted further collection action.

Of the 91 loans classified as unwilling to repay, we identified 46 (51 percent) with charged off balances totaling \$239,829 that had potential for recovery (see Appendix B). Recovery could be accomplished using collection tools such as real estate liens, garnishment of borrower wages, or miscellaneous litigation action. The following paragraphs discuss how these tools might have been used.

Real Estate Liens We identified 15 loans with charged off balances of \$117,636 for borrowers who had attachable real property assets. The disaster application and a commercial database or mortgagor interview were used to verify borrower-owned real property when the loans were charged off as shown by the following examples.

- A loan (*sample number 76*) disbursed in [*] for \$20,000 was charged off in August 1997 with an outstanding balance of \$18,762. The loan was collateralized by personal property consisting primarily of household goods. By using a commercial database, we found that the borrowers had purchased a single-family residence in 1996. The property, which was assessed for \$125,000, was still owned by the borrowers at the time of charge off.
- Another loan (*sample number 125*) disbursed in [*] for \$20,000 was charged off in February 1997 with an outstanding balance of \$19,716. The loan was collateralized by personal property consisting of household goods. By using a commercial database, we found that the borrowers had purchased a single-family residence in January 1993. The property, which was assessed for \$72,548, was still owned by the borrowers at the time of charge off.

Garnishment Actions Garnishment of borrower wages may have been possible for 29 loans with total outstanding balances of \$102,317. Our review of disaster loan applications or credit bureau reports identified borrower employment. The following examples indicate that garnishment could have been used as a collection tool.

- A loan (*sample number 7*) was disbursed in [*] for \$10,000. The loan balance of \$7,724 was charged off in April 1997. The employer for one of the two borrowers confirmed employment for the last 17 years.
- A loan (*sample number 104*) was disbursed in [*] for \$10,000. The loan balance of \$8,533 was charged off in March 1997. The employer for one of the two borrowers confirmed employment for the last 10 years.

* FOIA EX. 6

Miscellaneous Litigation Actions Other litigation action may have been possible for two loans with charged off balances totaling \$19,875. The borrowers had other assets that SBA could pursue (corporate stock) or held corporate positions indicating potential income was available for loan repayment.

- A loan (sample number 60) disbursed in [*] for \$10,000, was charged off in August 1997 with an outstanding balance of \$10,141. The loan application and confirmation by the borrowers showed Social Security payments as the only source of income. Real estate owned by the borrowers at the time of the disaster application was subsequently transferred to another party. A commercial database, however, disclosed that each of the borrowers has held or currently holds officer positions in one or more for-profit corporations located in Mississippi and Virginia.
- Another loan (sample number 109) disbursed for \$10,000 [*] was charged off in June 1997 for \$9,734. A commercial database showed the borrowers were operating three for-profit corporations from the same address as the residence listed in the disaster loan application. A Dun & Bradstreet credit report verified the existence of one of the businesses.

Also, loan officers classified borrowers for nine additional loans as unable to repay their debt without support for this classification. Collection action was not pursued against the estates for loans to six deceased borrowers or for three borrowers whose real property foreclosures resulted in deficiency judgments. Collection tools, therefore, may have been appropriately applied to some or all of these loans.

Litigation referrals to Department of Justice

SBA officials stated that loans were not referred to Justice because litigation would not be pursued for SBA's small dollar unsecured loans. We noted that Justice has had a \$600 minimum loan limit since 1993. Only 10 loans in our sample, however, had a balance of \$600 or less. The Justice Director for Debt Collection Management stated that SBA's beliefs might be based on experiences with referrals made prior to the establishment of the private counsel program in the early 1990s. The Director believes that referral to private counsel is the most cost beneficial means of collecting cases because SBA would pay only for those accounts for which collections are received.

Past due loan referrals to private collection agencies

No past due loans were referred by the servicing centers to private collection agencies during FY 96 and 97. For the 6 prior years, \$1.7 billion in disbursed loans were referred to collection agencies that generated recoveries of about \$7.2 million. Disaster officials stated that referrals were no longer made because

- SBA believed borrower payments for some loans transferred to collection agencies were due to SBA collection efforts, not the collection agency,

* FOIA Ex. G

- loan files were not returned to SBA in a timely manner, and
- complaints were received from borrowers and SBA field offices concerning the collection agencies.

Officials at the three private collection agencies under contract during our audit stated that they were aware of some problems but nothing that would warrant SBA's stopping loan referrals.

The Debt Collection Act of 1996 authorizes Treasury to award contracts to collect delinquent debt. As a result, SBA will no longer send delinquent loans directly to private collection agencies, but will send the accounts to Treasury. Treasury will determine if the use of a private collection contractor is warranted. Treasury's Managing Federal Receivables Manual, Appendix 4, recommends that delinquent unsecured consumer debt be referred to private collection agencies around the 75th day of delinquency. Delays in sending loans to Treasury could reduce the account's collectibility.

Recommendation

We recommend the Associate Administrator for Financial Assistance take the following actions:

- 2A. Where appropriate, refer unsecured loans to the Department of Justice for litigation against the borrowers and guarantors.
- 2B. Where appropriate, refer secured loans to the Department of Justice for litigation against the borrowers and guarantors when collateral is liquidated and full recovery is not achieved.

Management's Response

The Associate Administrator verbally agreed with the recommendations and stated that loans in liquidation status will be transferred to district offices or the loan liquidation center with a recommendation for transfer to the Department of Justice, if appropriate.

Evaluation of Management's Response

Based on discussions with personnel in the Office of Financial Assistance, draft report recommendations 2A. and 2B. were modified. The Associate Administrator now verbally agrees with the revised recommendations.

Statistical Sampling Techniques and Results

We reviewed data from a statistical sample of past due loans and a statistical sample of charged off loans to develop our estimates of population values. These estimates have measurable precision or sampling errors. The precision is a measure of the expected difference between the values found in the samples and the values of the same characteristic that would have been found if 100 percent reviews had been made using the same techniques.

Sampling precision is indicated by ranges or confidence intervals that have upper and lower limits and a certain level of confidence. Calculating at a 90-percent confidence level means the chances are 9 out of 10 that if we reviewed all of the past due and charged off loans in the populations, the resulting values would be between the lower and upper limits, with the population mid-point estimates being the most likely amounts of past due loans needing improved collection efforts and charged off loans that had potential for additional recovery.

The following population estimates and lower and upper limits were calculated using the U.S. General Accounting Office 'SRO-STATS' program at a 90-percent confidence level. We used the population mid-point estimates as the statistical projections for this report. These projections are applicable solely to the past due and charged off loans in the period of our review.

	Point Estimate Amount	Lower Limit	Upper Limit	Point Estimate Number	Lower Limit	Upper Limit
Past due loans	\$79,210,910	\$64,372,140	\$96,265,520	6,785	5,957	7,613
Charged off loans	\$ 4,817,661	\$ 3,147,329	\$ 6,788,654	928	730	1,126

LOANS WITH COLLECTION POTENTIAL

NO. COUNT	SAMPLE NO.	LOAN NUMBER	CURRENT OFFICE	CHARGE OFF AMOUNT	WAGE GARNISH	REAL ESTATE	OTHER SOURCES
1	123			\$ 2,798.84	X		
2	28			592.71	X		
3	117			4,171.30	X		
4	6			934.19	X		
5	8			820.49	X		
6	51			4,744.07		X	
7	52			5,487.58		X	
8	60			10,140.88			X
9	61			6,962.86	X		
10	62			1,700.73		X	
11	76			18,762.18		X	
12	79			3,992.39	X		
13	99			2,720.37	X		
14	101			1,725.35		X	
15	115			903.16		X	
16	116			3,191.71	X		
17	125	*	*	20,016.28		X	
18	136			7,157.39		X	
19	150			1,893.92		X	
20	154			2,061.18	X		
21	159			9,976.60	X		
22	160			2,777.23		X	
23	24			9,837.49	X		
24	7			7,274.01	X		
25	16			4,236.61	X		
26	17			1,042.55	X		
27	21			4,588.47	X		
28	48			394.46	X		
29	55			343.99	X		
30	59			6,957.45	X		
31	73			4,887.46	X		
32	75			1,962.50	X		
33	80			1,529.97		X	
34	89			6,100.48		X	
35	91			2,109.30	X		
36	98			4,028.99	X		
37	104			8,532.83	X		
38	109			9,734.40			X
39	119			722.77		X	
40	120			2,024.84	X		
41	121			1,926.69	X		
42	132			2,910.75	X		
43	158			665.53	X		
44	134			370.13	X		
45	38			42,901.78		X	
46	58			1,213.75		X	
TOTALS				\$239,828.61	29	15	2

* FOIA Ex. 6



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

DATE: June 30, 1999

TO: Garry L. Duncan
 Acting Assistant Inspector General
 For Auditing

FROM: Jane Palsgrove Butler *Jane Palsgrove Butler*
 Associate Administrator
 For Financial Assistance

SUBJECT: Draft Audit Report - Audit of Disaster Home loan Servicing Centers

The Office of Financial Assistance (OFA) has reviewed the subject draft audit report on Disaster home Loan Servicing Centers. We appreciate the opportunity to comment on this audit report in draft form.

OFA does not dispute the facts of the audit. The audit indicates that the Home Loan Centers may have missed some opportunities in collection efforts during the early stages of the period subject to the audit. The report indicates, correctly, that during this period certain centers subordinated collection activity to other important Agency priorities. These priorities included providing credit assistance to thousands of disaster victims needing to restructure home financing after the Northridge Earthquake, the most devastating disaster in recent U.S. history. Counseling assistance was also given to thousands of borrowers new to SBA loan accounting, servicing and administrative procedures. And, collection forbearance was provided to thousands of new borrowers who communicated their legitimate needs for deferments and reductions in payments after suffering severe financial distress caused by disaster. The priorities used at OFA centers were developed by center managers after thorough analysis of the needs of disaster victims, the restraints of extremely limited resources and the impacts of exceedingly heavy workload. They were clearly communicated to and approved by OFA.

I am pleased that the audit report confirms the very substantial improvements in Home Loan Center operations and collection results that have occurred since the audit was initiated in 1997. The audit confirms the outstanding progress that OFA has made to minimize the effect of staffing constraints through management initiative and outsourcing activity.

The audit confirms that SBA's home loan portfolio in centers grew from approximately 100,000 loans in the fall of 1993 to over 185,000 home loans in the fall of 1997. It also confirms the significant fact that Home Loan Center staffing was virtually unchanged during that period. Although delinquencies in the portfolio grew dramatically, critical loan administration services were consistently provided to disaster victims. During the same period, as confirmed by the report, OFA established focused collection goals including weekly collection contacts and early liquidation action. We achieved these goals, in part, by installing sophisticated, national automated calling services. Finally, to achieve these goals, we were able to make our staffing more congruent with our workload by contracting for private sector administration of 30% of the portfolio. The private sector contact was mandated by Congress and relieved our overworked staff of approximately 65,000 loans to service. As a result, dramatic improvements in early contact, collections and currency have been made – also as reported by the draft audit report.

OFA comments on the Findings and Recommendations of the Report are as follows:

Finding 1. "Actions to Collect Payments on Past Due Loans Needed Improvement".
We concur and have made appropriate improvements.

Recommendations:

1A. Incorporate into SOP 50-53 the following procedures:

- Contact borrowers by telephone as soon as their loan becomes past due and
- Contact all past due borrowers weekly.

Response: We concur. This recommendation has been implemented. A written change will be included at the next SOP update.

1B. Discontinue collection efforts and transfer loans to liquidation status after 75 days in a past due status.

Response: We concur in part. Borrowers who clearly can pay but will not should be transferred. However, immediately transferring all cases to liquidation after 75 days is not appropriate.

- 1) Immediately following a disaster HLCs are routinely overwhelmed by large numbers of new loans many of which become delinquent at virtually the same time. Time is needed to contact borrowers to preclude wasteful administration and loan transfer costs and to enable cooperative borrowers to make up delinquent payments.
- 2) Districts, and the LLC in California, do not have the resources to absorb large numbers of newly delinquent transfers over a short period following a disaster.
- 3) Home disaster loans frequently are made to disaster borrowers who have limited experience with credit. Educating many borrowers regarding repayment practices is more time consuming than conventional consumer loans.
- 4) Borrowers have experienced both the disaster and the traumatic effects that disaster victims must deal with including diminished financial capacity. SBA's loan making and servicing programs encourage maximum flexibility in collections. Early liquidation of most home loans is inappropriate and not consistent with disaster loan making policy considering the circumstances in which they are made.
- 5) Center experience indicates that 75% or more of accounts 60-90 days delinquent become current before further delinquency. Transferring and shipping all cases to liquidation locations at 75 days would result in massive transfers and mailing of files and would separate accounts from collectors familiar with the cases.

1C. Determine service center staffing requirements by conducting a study considering factors such as:

- Projected and historical workload,

- **Workload composition,**
- **Time and motion analysis, and**
- **Changes in recent laws and directives.**

Response: We concur. But, given current budget constraints, we are unable to authorize the recommended study at this time. When funding becomes available and workload amounts, composition and other factors affecting loan administration have stabilized, we will pursue implementation of this recommendation.

Finding 2. Collection Tools were not Always used to Recover Loan Losses.

Response: We concur. However, analysis is required in the choice of collection tool to assure collection activity is cost effective. The use of collection tools results from the credit judgement and experience of our center staff as well as the success they have had with particular collection tools. Wage garnishment will soon be available and will prove to be a significant collection tool for unsecured or undersecured small dollar loans. More experienced utilization of the "Auto Dial" phone collection system has proven a highly effective tool in accelerating collection receipts and keeping borrowers from drifting too far into delinquent status. Another effective collection tool implemented since the audit, is the referral for Treasury Offset at 180 days, unless coded "Do Not Refer". Additionally, monthly transfers of loans charged off are made to Treasury for servicing.

Recommendations:

2A. Refer unsecured loans to the Department of Justice for litigation against the borrowers and guarantors.

2B. Refer secured loans to the Department of Justice for litigation against the borrowers and guarantors when collateral is liquidated and full recovery is not achieved.

Response: We concur in part. It is OFA policy to refer all appropriate cases to District Offices and the Santa Ana Loan Liquidation Center for possible referral to Offices of the U.S. Attorney.

1. OFA will review Home Loan Center charge off activity, during the first quarter of FY 2000, to assure that appropriate cases are being referred to District Offices or the Santa Ana Loan Liquidation Center for subsequent possible referral to U.S. Attorney Offices.
2. It is important to note additional issues related to recommendations 2A and 2B.
 - a. Home Loan Center decisions to refer cases are strongly influenced by feedback from District Offices (and the LLC) regarding District Office credit policies and the effectiveness of litigating small loans through the local U.S. Attorney. Field experience indicates that referral to the U.S. Attorney is frequently not effective for small loans at U.S. Attorney offices in large cities. Many cases cannot be worked aggressively due to U.S. Attorney backlogs. Litigation, when accomplished, frequently results in arrangements that are insufficient to recover

SBA and U.S. Attorney administrative and accounting costs. Further, referrals to private attorneys by the U.S. Attorney frequently have been pending for unacceptably long periods without significant collection results. Finally, working relationships with some U.S. Attorney offices could be jeopardized by referral of high volumes of small loans. U.S. Attorney focuses on larger, more important SBA disaster and regular loan litigation could be jeopardized.

- b. As a result of the Northridge Earthquake, a large percentage of SBA's real estate secured home loans are secured by deeds of trust on California real estate. Non-judicial foreclosure action by SBA on these loans precludes further collection through litigation due to the state's anti-deficiency statutes. Alternatively, judicial foreclosure can be considered, but its availability must be weighed against the time it takes to conclude a judicial foreclosure action in that state (approximately two years, if uncontested; three, if contested) and the debtor's right to redeem the property for up to one year.
- c. Wage garnishment though litigation can be a burdensome collection alternative. It is a time-consuming procedure that requires substantial documentation and nets few returns. In many jurisdictions, to obtain wage garnishment, SBA must file a lawsuit and enforce the judgment, and then conduct a renewal procedure several times during the course of the garnishment. And, if the debtor changes employment, the entire process has to be repeated.

The Debt Collection Improvement Act of 1996 (DCIA) offers a non-litigation alternative to wage garnishment. We understand that the Treasury Department is in the process of implementing it as part of its Treasury Offset Program. OFA supports developing regulations to allow the Agency to implement its own administrative wage garnishment program, based on the DCIA. We look forward to the availability of administrative wage garnishment as an alternative to wage garnishment through litigation.

- d. As noted in the audit, the Debt Collection Improvement Act of 1996 requires referral of delinquent debt (over 180 days) to the U.S. Treasury. The Debt Collection Act provided for substantial new penalties for delinquent debtors. Accordingly, SBA is transferring all appropriate charged off accounts to the U.S. Treasury for further collection activity. Therefore, although accounts may be charged off, increasingly effective collection activity continues. In addition, non charged off accounts over 180 days delinquent will be referred to Treasury for offset which can occur while SBA is still working the accounts.
- e. Recent changes in liquidation processes encourage referral of cases to the U.S. Attorney for litigation where it is appropriate. Paragraph 8 of Chapter 18 in SOP 50-51-2, effective December 1, 1997, allows for loans to be removed from liquidation status and placed into a litigation-only status - if the only available means of collection is through legal action. Since the Agency's present PMQD tracking system doesn't have a loan status category identifiable as litigation-only (the current system identifies loan as being in approval, regular servicing, liquidation, or charge off status), many offices have adopted the policy of placing such loans in charge off status and coding them under 37 (litigation - do not refer). Such loans are then placed in litigation status immediately after charge off,

and then become the primary responsibility of the field counsel. Many of these loans are then referred to the U.S. Attorney for collection-based litigation. This policy allows the Center to better focus on accounts requiring non-litigation collection activity while U.S. Attorney efforts to obtain judgments and judgment liens are proceeding. This also means that some loans that are designated as charged off may be in litigation status for collection-based litigation (loans coded 37). Further, the Lexis-Nexis program, newly available in FY 99 via the Office of General Counsel, has increased SBA asset search capabilities substantially at the field office level.

Again, thank you for the opportunity to comment on your "Draft Audit Report – Audit of Disaster Home Loan Servicing Centers". We appreciate your input, but must note that the DHLSCs have made great strides towards maximizing collection activities, since the initial period of the audit, during the past several years.

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