U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

AUDIT REPORT
Issue Date: December 23, 2005
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To: Michael W. Hager
Associate Deputy Administrator for Capital Access

/S/ original signed
From: Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit of SBA's Administration of the Supplemental Terrorist Activity Relief (STAR) Loan Program.

At the request of the SBA Administrator and the Chair of the U.S. Senate Committee on Small Business and Entrepreneurship, the Office of Inspector General reviewed SBA's administration of the STAR loan program. Attached is a copy of the subject audit report. The objectives of the audit were to determine if STAR loan recipients were appropriately qualified to receive STAR loans and if SBA established and implemented proper administrative procedures to verify STAR loan recipient eligibility. The report contains one finding and seven recommendations addressed to you. Based on responses received from SBA officials, minor revisions were made to the report. Your response has been synopsized and included as Appendix D and the response from the former Associate Deputy Administrator for Capital Access and former Associate Administrator for Financial Assistance has been synopsized and included as Appendix E.

The recommendations in this report 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 management decisions for the recommendations to our office within 30 days of the date of this report using the attached SBA Forms 1824, Recommendation Action Sheet.

Should you or your staff have any questions, please contact me at 202-205- [FOIA Ex. 2].

Attachment

AUDIT OF SBA's ADMINISTRATION OF THE SUPPLEMENTAL TERRORIST ACTIVITY RELIEF LOAN PROGRAM

Report Number: 6-09

AUDIT OF SBA's ADMINISTRATION OF THE SUPPLEMENTAL TERRORIST ACTIVITY RELIEF LOAN PROGRAM

Table of Contents

Page

INTRODUCTION 1

BACKGROUND 1

AUDIT OBJECTIVES AND SCOPE 9

RESULTS OF AUDIT 10

Finding and Recommendations

Eligibility of Most STAR Loan Recipients Was Difficult to Determine From Lender Loan Files 10

Appendices

Appendix A: Statistical Sampling Results and Projection Information

Appendix B: Information on Sampled Loans

Appendix C: Sample Loan Justifications

Appendix D: SBA Management's Response

Appendix E: Comments of Former Associate Deputy Administrator for Capital Access & Former Associate Administrator for Financial Assistance

Appendix F: Report Distribution

INTRODUCTION

The terrorist attacks of September 11, 2001 disrupted the economy of the United States. In response to concerns about the impact of these terrorist attacks on small businesses, Congress authorized the Small Business Administration (SBA) to guaranty up to $4.5 billion in loans made by lenders to small businesses "adversely affected" by the terrorist attacks and their aftermath. These loans were designated by SBA as Supplemental Terrorist Activity Relief (STAR) loans.

Several Associated Press articles issued in September 2005 raised concerns whether STAR loans were made to borrowers that were not affected by the September 11 terrorist attacks. The SBA Administrator and the Chair of the U.S. Senate Committee on Small Business and Entrepreneurship subsequently asked the Office of Inspector General (OIG) to perform a review of the STAR loan program. This report presents the results of our review.

BACKGROUND

Overview of Relevant Loan Programs

Under section 7(a) of the Small Business Act (15 U.S.C. § 636(a)), SBA may guaranty up to 85 percent of the amount of a loan made by an authorized lender to a small business. This program is known as the "7(a) program." In 1983, SBA implemented the Preferred Lenders Program (PLP) which allows designated lenders to process, service and liquidate SBA guarantied loans with reduced SBA oversight. Loans made under the 7(a) program that go into default are individually reviewed by SBA to determine whether the lender complied with agency lending requirements. If it is determined that the lender did not comply materially with SBA's regulations, SBA can negotiate a settlement of the guaranty amount or deny payment of the guaranty entirely.

The Small Business Act also permits SBA to make direct loans to victims of declared disasters in 15 U.S.C. § 636(b). Disaster loans, which are available to businesses and to homeowners, can be used to fund repairs of physical damage to homes and businesses, and to provide working capital to disaster-impacted businesses to allow them to pay their bills or otherwise fund operational needs. These latter loans are known as Economic Injury Disaster Loans (EIDLs). In order to make Federal assistance available to more businesses that were impacted by the September 11th terrorist attacks, and not just those located in the declared disaster areas, on October 22, 2001, SBA expanded the EIDL program to assist small businesses located outside the declared disaster areas.

Congressional Authorization of the STAR Loan Program

The STAR loan program was authorized under the Defense Appropriations Act of 2002, Public Law 107-117, January 10, 2002 (The Act). The Act provided that:

> *[T]he [SBA] Administrator shall, in lieu of the fee collected under section 7(a)(23)(A) of the Small Business Act (15 U.S.C. 636(a)(23)(A)), collect an annual fee of 0.25 percent of the outstanding balance of deferred participation*

loans made under section 7(a) to small businesses adversely affected by the September 11, 2001 terrorist attacks and their aftermath, for a period of 1 year following the date of enactment and to the extent the costs of such reduced fees are offset by appropriations provided by this Act.

The Act did not define the term "adversely affected," and we did not discover much relevant legislative history for this particular Act to help discern Congress' intended meaning of this term.[1] SBA managers involved in the implementation of this program have asserted that they participated in numerous discussions with congressional staff, as well as top Agency political and career leadership, as to the appropriate interpretation of the legislative mandate; and that there was a general understanding that the intent was to be more, rather than less, inclusive. Congress appropriated $75 million for the STAR loan program, which allowed SBA to guaranty up to $4.5 billion of STAR loans[2]. Funds were available from January 11, 2002 through January 10, 2003.

SBA Guidance on STAR Loan Program Procedures

SBA issued two procedural notices in January 2002, providing guidance for the STAR loan program: Notice 5000-775 (January 17, 2002) and Notice 5000-779 (January 31, 2002). The notices identified small businesses eligible for STAR loans as follows:

[T]he term "<u>adversely affected small business</u>" means a small business that has suffered economic harm or disruption of its business operations as a direct or indirect result of the terrorist attacks perpetrated against the United States on September 11, 2001. Some examples of economic harm are: difficulty in making loan payments on existing debt; difficulty in paying employees or vendors; difficulty in purchasing materials, supplies, or inventory; difficulty in paying rents, mortgages, or other operating expenses; and, difficulty in securing financing.

The procedural notices made clear that the list of examples was not all inclusive and that the Agency anticipated there would be other circumstances where a business was adversely affected by the terrorist attacks so as to be eligible for a STAR loan. The notices, however, did not provide any examples illustrating what would constitute a "disruption of business operations." Procedural Notice 5000-779 provided the following additional guidance on eligibility:

Agency guidance should not be construed as limiting eligibility to any particular geographic area or to any specific type(s) of business. A loan to a start-up business may qualify for the STAR program if, for example, the business planned

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[1] We note, but have not relied upon, floor statements by various Senators and Congressional Representatives relating to separate legislation which would have revised certain SBA programs, including the 7(a) program, to facilitate provision of financial assistance to small businesses harmed by the September 11th attacks. Although that legislation was pending at the same time that Congress enacted the Defense Appropriations bill establishing the STAR loan program, it was never passed by both Houses of Congress.

[2] Congressional appropriations for the 7(a) program are generally far less than the amount of loans that SBA is authorized to guaranty because appropriations are based upon historical default rates in the program and program costs are offset through fees paid by lenders to obtain an SBA guaranty. Therefore, the amount of money appropriated to fund the STAR loan program was substantially less than the total lending authority for that program.

to commence operations earlier, but its ability to do so was hampered by the terrorist actions and their aftermath.

The SBA Associate Administrator for Financial Assistance (AA/FA) at the time the STAR loan program was in effect explained that her recollection was that "earlier" as used in the above quote applied to businesses that were planned before and after September 11, 2001.

Procedural Notice 5000-775 indicated that responsibility for determining program eligibility would rest with the lenders and provided broad guidance on the documentation that would be needed to show borrower eligibility for a STAR, stating, "Each lender making a reduced fee 7(a) loan under the provisions of the new law is responsible for determining that the loan is being made to a small business that was adversely affected by the terrorist attacks of September 11, 2001. For each such loan, the lender must prepare, place, and keep in its loan file, a short written statement documenting the basis for its conclusion that the loan is eligible for inclusion under this provision." Notice 5000-779, however, imposed additional requirements, stating as follows:

> *SBA believes that a high percentage of businesses finding it necessary to seek SBA-guaranteed financing may be found to have been adversely affected by the terrorist actions. In order to qualify for the reduced fee, however, the lender must: 1) find that the loan applicant was adversely affected by the terrorist events of September 11, 2001; AND, 2) prepare and maintain in its loan file a write up summarizing its analysis and its conclusion that the loan is eligible for the STAR program. A lender will not be found to have met its responsibility for determining that a borrower was adversely affected if the lender statement merely states that conclusion, but does not provide a narrative justification demonstrating the basis for the conclusion.*

Procedural Notice 5000-779, further provided:

> *In order for a loan to qualify as a loan under STAR, the SBA lender must:*
>
> > *Determine that the applicant business was "adversely affected" by the terrorist activity of September 11, 2001, and must document the basis for this conclusion in its loan file. This documentation must be available for review by SBA, but need not be submitted to SBA.*

Lenders were, accordingly, advised that they would not be required to provide their justifications for prior SBA approval.

Procedural Notice 5000-779 also provided instructions to lenders to reclassify a loan that had either been approved or disbursed after January 11, 2002 from a regular 7(a) program loan to a STAR loan. SBA subsequently issued Procedural Notice 5000-782 on February 21, 2002 to "streamline the process for re-classifying previously approved loans as STAR loans."

None of the procedural notices required that money loaned to a small business under the STAR loan program had to be used to address the adverse effect suffered by the business as a result of the September 11 attacks and their aftermath. According to an SBA internal fact sheet, STAR loan proceeds could be used for all regular 7(a) loan purposes. This was confirmed in an article written by the SBA Associate Deputy Administrator for Capital Access (ADA/CA) at the time in a publication issued in April 2002 by the National Association of Government Guaranteed Lenders, Inc. (NAGGL), a trade association for lenders that participated in the 7(a) Program and other government guarantied lending programs. An SBA regulation (13 C.F.R. § 120.120) permits 7(a) loans to be used for any or all of the following purposes:

(1) Acquire land (by purchase or lease);
(2) Improve a site (e.g., grading, streets, parking lots, landscaping), including up to five percent for community improvements such as curbs and sidewalks;
(3) Purchase one or more existing buildings;
(4) Convert, expand or renovate one or more existing buildings;
(5) Construct one or more new buildings;
(6) Acquire (by purchase or lease) and install fixed assets;
(7) Purchase inventory, supplies and/or raw materials;
(8) Working capital; and
(9) Refinancing certain outstanding debts (certain types of refinancing are prohibited).

Lender Participation in the STAR Loan Program

During the first three months of the program, only two percent of the $4.5 billion program authority had been used. According to SBA officials, certain lenders were reluctant to use the Program due to concerns that the Agency would second guess their justifications used to establish eligibility and possibly deny payment of the guaranties. According to SBA officials, various congressional staff expressed considerable concern about the lenders' apparent lack of interest in the STAR loan program and urged SBA to promote the use of the program among its participating lenders.

SBA responded by promoting the program through articles in trade journals, speeches at lender conferences, and by directing agency district offices throughout the country to contact local lenders to persuade them to use the STAR loan program.

In the April 2002 NAGGL article, discussed above, the ADA/CA at the time voiced SBA's concern about the limited use of the STAR loan program by lenders. The ADA/CA voiced two theories for this based upon discussions with lenders: (1) some lenders hadn't heard about STAR yet; and (2) others who knew about the program either "do not yet know that loans for small businesses in all areas of the country can qualify, or do not fully understand how to determine that a business was adversely affected by the events of September 11." To provide guidance on the latter, the ADA/CA advised:

> *The terrorist actions on September 11, 2001 fundamentally changed the day-to-day lives of all Americans. But small business owners, who in times of economic disruption are more vulnerable than large businesses, were particularly hard hit.*

In many industries, small businesses saw sales plummet as Americans temporarily deserted the marketplace in favor of the comfort afforded by home and family. This dramatic decline in the purchase of goods and services was very apparent in the hospitality and travel industries. But, the disruption of normal business operations was also experienced by small businesses in industries less visibly affected by the events of September 11. Because of this, the SBA believes that a very large percentage of small business borrowers located in areas throughout the country may be eligible for the STAR program.

In guaranteeing a STAR loan, the SBA will rely on the lender's determination that a small business was adversely affected by the terrorist actions. When performing compliance or loan purchase reviews, the SBA will be looking only to verify that the lender documented its evaluation of the small business' eligibility for the STAR program. The SBA has not established any requirements regarding the severity or duration of the adverse impact that the small business suffered.

The ADA/CA also offered the following guidance on eligibility for STAR loans:

Perhaps the best way to illustrate circumstances where loans would likely be found eligible for the STAR program is through examples:

- *For a few days after September 11, a small bakery in Niagara Falls, NY suffers dramatic decline in its business and has difficulty obtaining delivery of its raw materials. Both situations are quickly corrected. Now the bakery comes in seeking a loan to expand its operations. Is this loan request eligible to be processed under STAR? YES. The business was clearly adversely affected by the terrorist act. It does not matter how severe the impact was, or how long it lasted. The lender should find the loan eligible for STAR, and simply summarize how the bakery was adversely impacted by September 11- in this instance, the temporary loss of sales and disruption of supplier deliveries.*

- *Since September 11, a small trucking firm in Peoria, IL, has had increased travel times for its deliveries due to more frequent inspections because of heightened security. These delays have increased the firm's operational costs. Despite this, the business is still operating profitably, and is seeking a loan to finance the purchase of two additional trucks. Is this loan eligible to he processed under STAR? YES. In this case, the adverse affect [SIC] could be considered ongoing, but is not fatal to the business' success. The lender should find the loan eligible, and, again, simply summarize the basis for that conclusion.*

As these examples show, we expect that a very high percentage of 7(a) loan applications are appropriate for STAR processing. We also expect that some loans made through the regular 7(a) program since January 10, 2002 may also *qualify under STAR, and we have established procedures for reclassifying such loans, when appropriate.*

On May 30, 2002, the AA/FA at the time spoke at a conference in Northern California attended by 125 lenders participating in the 7(a) program. According to our interview with the AA/FA, the purpose of the speech was to market the STAR loan program to the lenders and encourage participation. A newsletter that reports on the 7(a) program, Coleman Report, in an issue dated June 1, 2002, quoted extensively from the AA/FA's presentation. The newsletter advised that the AA/FA's presentation was made at a time when lenders participating in the 7(a) program were concerned about SBA's heightened level of scrutiny in reviewing lender requests for payment of loan guaranties resulting in an increasing number of SBA denials of guaranty payments. The newsletter advised that the AA/FA also promised the agency would not second guess lender justifications on Supplemental Terrorist Relief (STAR) 7(a) loan program loans. The newsletter quoted the AA/FA as saying:

"SBA has taken a stand that is very inclusive. We have an expansive definition of economic disadvantage. As a matter of fact, we believe that every business can probably demonstrate some degree of economic disadvantage as a result of the terrorist attacks. We so strongly believe this -- we have a lunch meeting every Tuesday -- we've offered any lender who has a loan that can't find any basis for it to be a STAR loan to e-mail us the facts of the situation and we'll spend our lunch hour looking at it for you."

"I know many of you have not used the program because you are worried about post-lending review by SBA. First of all, I want to tell you that by the terms under which we have implemented the program, we delegate to you, the lender, the authority to determine that a business was adversely affected. It is your determination, not SBA's determination. It is not our intent to substitute our judgment for your judgment in these cases."

"The second factor for PLP reviews and for post-purchase reviews on any loan that defaults is that SBA will only be looking for one thing. They will be looking for a document that you have put in the file where you discuss how the business was adversely affected. It is not enough to say 'This business was adversely affected.' It is enough to say 'This business was adversely affected because…' And we believe that the 'becauses' can be very inclusive. For example, one of our lenders on the East Coast sent in a whole series of examples where they were asking us to make judgments so they could get benchmarks for what was considered eligible for STAR and what wasn't."

"In fact, every single example they sent in we determined would have been eligible for STAR. One example was a bakery in downtown Washington, DC. First of all, the events shut down Washington for about a day, so that effectively the business was out of business for a little bit -- a day, maybe two. Secondly, there were some disruptions to the bakery's ability to deliver products and its ability to get raw materials. For those that weren't in Washington, traffic

patterns in the city were changed immediately and many remain changed. There are a lot of streets that are no longer open to traffic on a daily basis, so there was some disruption of traffic patterns. The borrower wanted to buy his building. On first blush you might say that buying the building has very little to do with anything related to the attacks. It doesn't have to. The business was adversely affected, and because it was adversely affected, it is eligible for STAR no matter what purpose the loan is to be used for."

"There will be lots of examples that will come to mind automatically. The travel agent who not only had a number of cancellations because the planes stopped flying but also had cancellations because people were reluctant to travel. Those things are clear. But you also need to think about the printer who provides the materials for the brochures for the travel agent who doesn't have any business right now."

"One of our lenders actually said he has instructed his staff if he has a loan that is not a STAR loan, the lender has to justify that as well as justify the ones that are STAR loans. I think that's a great practice. We want to encourage these loans to be made, and we want you to understand that we do not intend to play 'gotcha..'"

On June 24, 2002, the SBA issued Information Notice 5000-805 to its field offices entitled "Lenders Determine Borrowers Eligibility for 7(a) STAR Loans." The notice advised as follows:

The Office of Financial Assistance reminds all SBA employees that the responsibility for making the final determination regarding whether a borrower qualifies for a 7(a) STAR Loan has been delegated to the participant. When the program was announced, the following was stated in Notice 5000-775.

Each lender making a reduced fee 7(a) loan under the provisions of the new law is responsible for determining that the loan is being made to a small business that was adversely affected by the terrorist attacks of September 11, 2001. For each such loan, the lender must prepare, place, and keep in its loan file, a short written statement documenting the basis for its conclusion that the loan is eligible for inclusion under this provision.

Information Notice 5000-805 did not contain the language in Procedural Notice 5000-779 that stated that a "lender will not be found to have met its responsibility for determining that a borrower was adversely affected if the lender statement merely states that conclusion, but does not provide a narrative justification demonstrating the basis for the conclusion."

Subsequent to these actions, there was a significant increase in STAR loan approvals and reclassifications. From July 1, 2002 through September 30, 2002, a total of 3,191 STAR loans were approved or reclassified, totaling approximately $1.3 billion which is more than 14 times greater than the lenders' use of the program during the first three months.

On October 1, 2002, SBA issued Procedural Notice 5000-828, stating that the maximum loan size for regular 7(a) loans was capped at $500,000 due to restrictions that Congress had imposed on spending under the program in a continuing budget resolution. The Notice advised that the cap on loan size did not apply to the STAR loan program, and that the maximum loan that could be made under that program was $2 million. After October 1, 2002, there was a significant increase in the percentage of STAR loan approvals exceeding $500,000. Prior to the 7(a) loan cap, 27 percent of the STAR loans were greater than $500,000. After the cap, 44 percent of the STAR loans were greater than $500,000.

There was also a significant increase in program activity immediately prior to expiration of the STAR loan program on January 10, 2003. Eight percent of all STAR loans disbursed were approved during the last four days of the program (577/7058). Ultimately, there were 8,201 STAR loans approved totaling approximately $3.7 billion, but only 7,058 were disbursed. Of the 7,058 disbursed loans, 1,262 loans were reclassified from the 7(a) program to the STAR loan program.

When the STAR loan program expired on January 10, 2003, funds remained in the appropriations for that program. After the STAR loan program expired, Congress authorized 37 percent of the $75 million budgetary authority for making STAR loans to be transferred to the appropriations for the 7(a) program.

AUDIT OBJECTIVES AND SCOPE

As requested by the Chair of the U.S. Senate Committee on Small Business and Entrepreneurship, the objectives of the audit were to determine if STAR loan recipients were appropriately qualified to receive STAR loans and if SBA established and implemented proper administrative procedures to verify STAR loan recipient eligibility. To answer the audit objectives, we selected a statistical sample of 59 STAR loans from the universe of 7,058 disbursed STAR loans approved between January 11, 2002 and January 10, 2003. We used the Defense Contract Audit Agency's 'E-Z-Quant' statistical sampling program to compute the sample size at a 95 percent confidence level. See Appendix A for the statistical sample loan results and projection information and Appendix B for information about the loans included in our sample.

Our review for the first objective was limited to an examination of the documentation maintained in the lenders' loan files to support their eligibility determinations and interviews with as many of the 59 borrowers as we were able to contact. Therefore, to the extent that lenders did not adequately document the eligibility of loan recipients, it could not be determined whether those borrowers were appropriately qualified for the STAR loan program.

During the audit, we (i) examined loan files maintained by the lenders, (ii) interviewed SBA officials from the Office of Financial Assistance, the Office of General Counsel, the Office of Congressional and Legislative Affairs, the Office of the Chief Financial Officer, and the Office of Lender Oversight, (iii) interviewed selected lender officials, and (iv) contacted certain small businesses that obtained STAR loans. While we made repeated attempts to contact all 59 STAR loan recipients in our sample, we did not have current contact information for 2 of the borrowers, and 15 others did not respond to our inquiries. As a result, we interviewed only 42 of the 59 loan recipients in our sample. We did not verify the accuracy of the borrowers' statements.

There were 27 lenders included in our sample. We made site visits to six of the lenders that made 30 of the 59 sampled loans, and 3,934 (56 percent) of the total population of 7,058 disbursed STAR loans, to review loan files and interview lender officials. These lenders were located in Dallas, TX; Phoenix, AZ; Minneapolis, MN; San Diego, CA; Kimberly, WI; and Livingston, NJ. The other 21 lenders for the remaining 29 loans shipped the files to our audit offices for review. The audit was conducted during September and October 2005, in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Finding - Eligibility of Most STAR Loan Recipients Was Difficult to Determine From Lender Loan Files

Most lender files did not contain sufficient information to demonstrate that borrowers were adversely affected by the September 11th terrorist attacks and their aftermath. As a result, eligibility could not be determined for 85 percent of STAR loans reviewed. While SBA initially established broad criteria for determining how borrowers were adversely affected, lenders were required to document in their loan files a "write up summarizing its analysis and conclusion" that the loan was eligible for the STAR loan program. A conclusion absent a narrative justification demonstrating the basis for the conclusion was not acceptable.

Due to initial limited lender participation in originating STAR loans, SBA undertook efforts to promote the program by advising lenders that virtually any small business qualified and assuring them that SBA would not second guess their justifications. Although SBA established criteria for documenting STAR loan eligibility, it did not establish specific requirements to review or verify lenders' STAR justifications. Despite the documentation requirements, we found that lenders did not include sufficient justifications showing impact on borrowers and STAR loans may have gone to businesses that were not adversely impacted by the terrorist attacks of September 11th or their aftermath. As a result, funds appropriated for guaranties on loans made to small businesses adversely affected by the terrorist attacks may not have been used for that purpose. Nevertheless, it appears that qualified borrowers were not precluded from receiving STAR loans due to a lack of funds because there was a surplus of budget authority available when the program expired.

STAR Loan Criteria

Pursuant to SBA Procedural Notice 5000-779, in order to qualify for a STAR loan, lenders were required to:

> " **…***(1) find that the loan applicant was adversely affected by the terrorist events of September 11, 2001; AND, (2) prepare and maintain in its loan file a write up summarizing its analysis and its conclusion that the loan is eligible for the STAR program. A lender will not be found to have met its responsibility for determining that a borrower was adversely affected if the lender statement merely states that conclusion, but does not provide a narrative justification demonstrating the basis for the conclusion."*

Questionable Eligibility

Nine (15 percent) of the 59 borrowers in our statistical sample appeared to have been appropriately qualified to receive STAR loans based on a review of the lenders' loan files and discussions with available borrowers. Eligibility for the remaining 50 (85 percent) STAR loans could not be determined because the required justifications were either missing, related to the seller of an existing business rather than the "loan applicant" and SBA procedures did not specify whether such loans could qualify, contrary to documentation in the lender's loan files or borrower statements, or ambiguous. The justifications for the 50 loans can be grouped as follows:

- **Justification was missing (5 loans).**

- **Justification was merely a conclusion with no support (4 loans).**

  Three of the four loans had this justification: "*This customer has been adversely affected by the terrorist attacks of September 11, 2001 in the following manner: Borrower has experienced a business disruption" (Appendix C, Nos. 13, 14 & 15)*

- **Justification was based on the adverse effects suffered by the business being purchased with a STAR loan rather than the "loan applicant" and SBA procedures did not specify whether such loans could qualify (11 loans).**

  While Procedural Notice 5000-779 was clear that existing and start-up businesses could qualify for STAR loans, it did not specify whether a borrower purchasing an existing business could qualify. Procedural Notice 5000-779 required lenders to find that the "loan applicant" was adversely affected by the terrorist events of September 11, 2001. It is our interpretation that a justification based on the business being purchased rather than the "loan applicant" did not qualify for the STAR loan program. We recognize, however, that there may be other interpretations of this requirement, and therefore, have concluded that eligibility could not be determined for the loans in this category.

  A loan to a dry cleaner illustrates this type of justification: *"Borrower has advised that subject business had closed down for the day on September 11 and September 12, due to the tragic events of 9/11/01. We will therefore designate this as a STAR."*

  The adverse impact was under the previous ownership and therefore, the justification did not apply to the applicant borrower. (Appendix C, No. 24)

- **Justification was contrary to documentation in the lender's loan file or borrower statements (21 loans).**

  The following example illustrates this type of justification: *"[Borrower] experienced a considerable drop-off in revenue after the terrorists attacks in September. It took a significant toll on the cash flow of the business. With sales* *down, overhead costs diminished the working capital of the business. [Principal] did an excellent job utilizing all his resources to fulfill all his obligations and pay his suppliers and creditors in a timely manner. With the proposed SBA loan, [Principal] will be able to consolidate his entire corporate debt into a low interest note, benefiting cash flow immediately. Since January, sales are back on track and [Borrower] is on target to meet all their projections for 2002."*

The information that contradicted this justification was found in the lender's credit memorandum which stated, *"In 2001, [Principal] took a break from working at the shop and being on site at all times. The result was a drop off in quality control and efficiency, ultimately leading to a fall off in sales from $575,564 in 2000 to $438,880 for the 12-months ending 12/31/01. This was disappointing to [Principal], who then decided he wanted full ownership back." (Appendix C, No. 30)*

- **Justification was vague and neither contrary to nor supported by documentation in the lender's loan file or borrower statements (9 loans).**

An example of this type of justification is the following statement: *"[Borrower] has been planning to expand their business by adding on to their existing facility and upgrading their equipment. Because this business is closely tied to the new construction industry the borrower has been reluctant to expand his business due to the impact 9/11 had on the economy."*

There was no evidence in the lender's loan file to support or contradict that the borrower was reluctant to expand his business. The borrower's financial statements indicated a strong growth in income from 1999 through 2003 with no significant increase in costs. The borrower did not respond to our inquiries. (Appendix C, No. 58.)

The statistical projection of these groupings to the entire disbursed STAR loan portfolio of 7,058 loans is shown at Appendix A.

It is not our position that the recipients of the 50 loans were unqualified for the STAR loan program. We only conclude that eligibility could not be determined for these recipients due to the lack of adequate STAR justifications and supporting documentation in the lenders' loan files.

Many Borrowers Were Unaware They Had Received STAR Loans

We interviewed 42 of the 59 STAR loan recipients in our sample to determine if they knew they had a STAR loan and had discussed the impact of the terrorist attacks with the lender. The remaining 17 borrowers could not be reached during the audit. The results of the interviews are listed below.

- Only two of the 42 borrowers were aware they had obtained a STAR loan.

- Thirty-six of the 42 borrowers said they were not asked or could not recall if they were asked about the impact of the attacks on their businesses.

- Of the nine borrowers who appear to have been adversely affected, eight confirmed they were adversely affected by the attacks. (The ninth did not respond to our inquiries.)

- Twenty-five of the 34 borrowers we interviewed, where eligibility could not be established, stated they were not adversely affected by the terrorist attacks.

- The other nine said they were adversly impacted, but provided different justifications than what was documented in the lender files or provided explanations of how the sellers were impacted rather than themselves.

- After repeated attempts, we were unable to reach the other 16 borrowers whose loans were not properly justified and therefore, we relied solely on the justifications and documentation in the lenders' files in categorizing these loans.

Lack of Adequate Controls and Oversight

SBA did not implement adequate internal controls and oversight of the STAR loan program to ensure that only eligible borrowers obtained STAR loans. SBA delegated to its lenders the responsibility for the final determination of an applicant's qualification for a STAR loan without any oversight by SBA. Although SBA was responsible for determining if the borrowers met eligibility and credit requirements for regular 7(a) loans, SBA loan officers were directed not to question the lenders' justifications for regular 7(a) STAR loans. Further, in an effort to promote the STAR loan program and encourage lender participation, senior SBA officials made several public statements that broadened the scope of eligibility for the program and provided assurances that lender eligibility justifications would not be second guessed.

Public statements made by the then ADA/CA and the AA/FA conveyed SBA's expansive interpretation of the term "adversely affected" and that SBA believed that virtually every small business had suffered some direct or indirect adverse impact and could likely qualify for a STAR loan. In an April 2002 NAGGL article, the ADA/CA at the time offered the following guidance on eligibility for STAR loans:

> *Perhaps the best way to illustrate circumstances where loans would likely be found eligible for the STAR program is through examples:*
>
> > *• For a few days after September 11, a small bakery in Niagara Falls, NY suffers dramatic decline in its business and has difficulty obtaining delivery of its raw materials. Both situations are quickly corrected. Now the bakery comes in seeking a loan to expand its operations. Is this loan request eligible to be processed under STAR? YES. The business was clearly adversely affected by the terrorist act. It does not matter how severe the impact was, or how long it lasted. The lender should find the loan eligible for STAR, and simply summarize how the bakery was adversely impacted by September 11-*

in this instance, the temporary loss of sales and disruption of supplier deliveries.

• Since September 11, a small trucking firm in Peoria, IL, has had increased travel times for its deliveries due to more frequent inspections because of heightened security. These delays have increased the firm's operational costs. Despite this, the business is still operating profitably, and is seeking a loan to finance the purchase of two additional trucks. Is this loan eligible to be processed under STAR? YES. In this case, the adverse affect [SIC] could be considered ongoing, but is not fatal to the business' success. The lender should find the loan eligible, and, again, simply summarize the basis for that conclusion.

As these examples show, we expect that a very high percentage of 7(a) loan applications are appropriate for STAR processing. We also expect that some loans made through the regular 7(a) program since January 10, 2002 may also qualify under STAR, and we have established procedures for reclassifying such loans, when appropriate.

The AA/FA at the time was quoted in the June 1, 2002 <u>Coleman Report</u> as saying:

"SBA has taken a stand that is very inclusive. We have an expansive definition of economic disadvantage. As a matter of fact, we believe that every business can probably demonstrate some degree of economic disadvantage as a result of the terrorist attacks. We so strongly believe this – we have a lunch meeting every Tuesday – we've offered any lender who has a loan that can't find any basis for it to be a STAR loan to e-mail us the facts of the situation and we'll spend our lunch hour looking at it for you.."

Furthermore, statements by the ADA/CA and the AA/FA advised lenders that although STAR justifications would be required during compliance and purchase reviews, SBA would not substitute its judgment for the lenders' judgment as to the substance of those justifications. The ADA/CA wrote:

When performing compliance or loan purchase reviews, the SBA will be looking only to verify that the lender documented its evaluation of the small business' eligibility for the STAR program.

The AA/FA further advised, as quoted in the <u>Coleman Report</u>:

"I know many of you have not used the program because you are worried about post-lending review by SBA. First of all, I want to tell you that by the terms under which we have implemented the program, we delegate to you, the lender, the authority to determine that a business was adversely affected. It is your determination, not SBA's determination. It is not our intent to substitute our judgment for your judgment in these cases. The second factor for PLP reviews and for post-purchase reviews on any loan that defaults is that SBA will only be

looking for one thing. They will be looking for a document that you have put in the file where you discuss how the business was adversely affected."

Lenders, however, were not required to submit STAR loan justifications with their guaranty purchase requests to SBA, and SBA loan officers were not required to evaluate the justifications during the purchase review process. Furthermore, although officials in the Office of Lender Oversight stated that STAR loan eligibility was examined during PLP lender reviews and any problems would have been noted as either an ineligible business or an ineligible use of proceeds citation, there were no such citations made in the PLP lender reviews that we examined which included 5 STAR loans with inadequate justifications.

Lenders' Understanding of STAR Loan Program Requirements

According to several lenders, participation in the STAR loan program was low when the program was introduced due to unclear and poorly defined requirements. After a vigorous marketing campaign by SBA, lender participation in the STAR loan program increased. Statements by the ADA/CA and AA/FA were interpreted by certain lenders we interviewed to mean that every small business could claim it was somehow impacted by the attacks, and therefore, eligible to receive a STAR loan. While several lenders stated they were aware of the program requirements and limitations set out in the governing procedural notices, they stated that they relied on the public statements made by senior SBA officials. For example, one lender claimed that SBA approved a list of boiler-plate STAR loan justifications used by their loan officers, although SBA officials could not recall approving such a list. Such boiler-plate justifications, however, were not in compliance with the requirements of Procedural Notice 5000-779 that lenders document their analysis supporting eligibility. Thus, it appears that certain lenders believed that abbreviated justification statements were acceptable.

STAR Loan Program Compared to SBA's Disaster Loan Program

Prior to implementing the STAR loan program, SBA expanded the Economic Injury Disaster Loan (EIDL) program to assist small businesses located outside the declared disaster areas and the contiguous geographic areas that suffered substantial economic injury as a direct result of the terrorist attacks and their aftermath. The expanded EIDL program consists of direct loans approved by the SBA Office of Disaster Assistance. Regulations were published in the Code of Federal Regulations and memos were written describing loan processing procedures and specific eligibility criteria with sample questions and answers for the loan officers to refer to in determining eligibility.

Under Expanded EIDL, the applicant was required to establish how it suffered substantial economic injury as a direct result of the terrorist attacks and had to provide monthly sales figures for the 3 years prior to the disaster and up to the most recent month before loan application. SBA then performed and documented an analysis before approving the loan.

The STAR loan program was comparable to the Expanded EIDL program in that both were designed to assist victims of the September 11th terrorist attacks and their aftermath. Unlike Expanded EIDL applicants, however, loan applicants under the STAR loan program were not required to demonstrate that they had been injured by the terrorist attacks or provide supporting documentation.

Regular 7(a) Loans Capped at $500,000

On October 1, 2002, SBA issued Procedural Notice 5000-828, stating that the maximum loan size for regular 7(a) loans was capped at $500,000 due to restrictions that Congress had imposed on spending under the program in a continuing budget resolution. The Notice advised that the cap on loan size did not apply to the STAR loan program, and that the maximum loan that could be made under that program was $2 million. After October 1, 2002, there was a significant increase in the percentage of STAR loan approvals exceeding $500,000. Prior to the 7(a) loan cap, 27 percent of the STAR loans were greater than $500,000. After the cap, 44 percent of the STAR loans were greater than $500,000. The cap provided an incentive for the liberal use of STAR loans to get around the $500,000 7(a) cap and may have been a contributing factor towards the increased use of the STAR loan program.

STAR Loan Program Performance and Funds Availability

While STAR loan eligibility could not be ascertained from most lender files, it does not appear that any eligible business concern would have been prevented from receiving a STAR loan due to a lack of funds. When the STAR loan program expired, there was a surplus of funds available and more than $27 million (37 percent) of the $75 million STAR loan budgetary authority was transferred to the 7(a) program. Further, the default rate for STAR loans is not excessive when compared to similar SBA guarantied loans. As of September 30, 2005, only 8 percent of disbursed STAR loans approved between January 11, 2002 and January 10, 2003 had been transferred to liquidation status, while 10 percent of the 7(a) loans approved during the same time period had been transferred to liquidation status.

RECOMMENDATIONS

If SBA enacts another special program where 7(a) loans are to be used for Nation-wide disaster relief, we recommend the Office of Capital Access take the following actions:

1. Require loan applicants to justify how the business was harmed by the disaster.

2. Require lenders to obtain supporting documentation to verify applicant claims of injury and provide detailed justifications showing applicant eligibility.

3. Implement effective internal controls and program oversight to ensure borrower eligibility and lender compliance.

In relation to the STAR loan program, we recommend the Office of Capital Access take the following actions:

4. Implement procedures to require lenders to submit STAR loan justifications when seeking SBA's purchase of a STAR loan guaranty.

5. Establish criteria, in consultation with the Office of General Counsel, to provide more definitive guidance and examples for purchase reviewers to use in determining what constitutes an inadequate justification for STAR eligibility.

6. For future purchase requests, determine, in consultation with the Office of General Counsel, whether STAR loans that contain inadequate justifications can be reclassified as 7(a) loans (if budget authority remains available) or whether SBA can deny lender requests for purchase of the guaranties under SBA regulation 13 C.F.R. 120.524.

7. Review guaranties the agency has already paid under the STAR loan program, obtaining additional records from lenders as necessary, to determine whether lenders were paid despite the absence of adequate borrower eligibility justifications. If lenders had inadequate justifications, determine, in consultation with the Office of General Counsel, whether SBA should reclassify the loans as 7(a) loans (if budget authority remains available) or seek recovery of the guaranties from the lenders.

SBA Management's Response

SBA management generally concurred with the audit recommendations, but expressed concerns with the extent of audit work performed and several OIG conclusions in the audit report.

The Associate Deputy Administrator for Capital Access (ADA/CA) and the former ADA/CA and former Assistant Administrator for Financial Assistance (AA/FA), believe that the OIG report failed to reflect a full understanding of the purpose of the STAR loan program. The more significant comments from the two responses are presented below.

- Most, if not all, STAR loan program borrowers were eligible for the STAR loan program, but more rigorous controls are needed for the guaranty review process for STAR loans.
- The report is deficient because it does not provide any historical context for the authorization and implementation of the STAR program.
- The SBA officials emphasized the different purposes of the STAR loan program and the disaster loan program, suggesting that the OIG has an overly narrow definition of which borrowers were eligible for STAR loans.
- The former ADA/CA and AA/FA suggested that the STAR loan program was intended as a general economic stimulus program.
- Guidance provided to lenders regarding eligibility and documentation requirements through the speech and article detailed in the report were clear and consistent with the earlier Agency procedural notice.
- The ADA/CA stated that lenders were aware that loans would be reviewed during the guaranty purchase process and had no basis to believe a purchase request would not be evaluated for STAR loan program eligibility.
- In a May 2002 speech, the AA/FA at the time specifically stated that during PLP and post purchase reviews, SBA would be looking for documents in the lender's files that discussed how the businesses were adversely affected, but would not play "gotcha" to deny a guaranty or otherwise penalize lenders.
- The former ADA/CA and AA/FA believe that the OIG is now engaged in second guessing STAR loan program justifications, including those that appear to meet the broad program eligibility guidelines.

It was recommended that the OIG consider extending its audit work and interview other individuals involved in creating and implementing the STAR loan program. In particular, it was suggested that the OIG interview staff on the congressional committees at the time the program was created as well as the former ADA for Management and Administration, the former Counselor to the Administrator, the former ADA/CA, the former Acting ADA/CA and other current and former SBA employees directly and indirectly related to the implementation of this program. The former ADA/CA and AA/FA believe the information gained from these interviews would allow a more complete and comprehensive OIG audit report. (Copies of the actual responses from the ADA/CA and the former ADA/CA and AA/FF are at Appendices D and E, respectively.)

OIG Evaluation of SBA Management's Response

SBA Management generally agreed with all OIG recommendations and did not disagree with the audit finding that eligibility of most STAR loan recipients in the loans reviewed was difficult to determine from lender files. Nevertheless, SBA officials raised concerns with several of the OIG conclusions in the report. The more significant concerns are addressed below.

With regard to our understanding of the STAR loan program, the OIG believes that when Congress established the program to assist small businesses that were "adversely affected" by the September 11th attacks and their aftermath, the intent was that loan applicants would be required to demonstrate that they had actually been directly or indirectly harmed in some discernible manner to obtain a STAR loan. As set forth in the report, in the vast majority of cases, the lender files did not contain sufficient documentation to support such a determination. Additionally, rather than passing legislation to benefit small businesses adversely impacted by the attacks and their aftermath, Congress could have increased the level of appropriations for the regular 7(a) program if congressional intent was limited to stimulating the economy.

The OIG does not agree that guidance provided through the speech and article was always consistent with the procedural notice. In the procedural notice, which the OIG reviewed and concurred with, the Agency offered a non-exhaustive list of examples of discernible economic harm that a business might have suffered to be eligible for a STAR loan (e.g., "difficulty in making loan payments on existing debt; difficulty in paying employees or vendors; difficulty in purchasing materials, supplies, or inventory; difficulty in paying rents, mortgages, or other operating expenses; and, difficulty in securing financing"). The article and speech by the former loan program officials, however, offered examples of businesses that had shut down for a day or two due to the September 11th attacks as being eligible for a STAR loan. In our opinion, these communications appear to have broadened the scope of eligible applicant businesses.

Further, the Agency notice advised that a lender making a STAR loan needed to prepare "a write up summarizing its analysis and its conclusion that the loan is eligible for the STAR program," and that merely stating a conclusion of eligibility without a "narrative justification demonstrating the basis for the conclusion" would be insufficient. The guidance offered by the former ADA/CA and AA/FA, although reiterating that lenders were required to document their justifications, also advised that SBA would only "verify that the lender documented its evaluation of the small business' eligibility" and that SBA would not "substitute [its] judgment for [a lender's] judgment" as to eligibility. We believe these communications were intended to, and did, send a message to lenders that the Agency would not question lender eligibility determinations. As the former ADA/CA and AA/FA stated, "[i]n order to encourage lenders to make STAR loans, we needed to give them some level of comfort that we would not later 'play gotcha' to deny guaranty liability or otherwise penalize lenders." Our interviews with several lenders that made a significant number of STAR loans confirmed that some lenders believed that SBA only required very minimal documentation of borrower eligibility. In effect, the guidance by the former loan program officials suggested that SBA delegated broad, if not, complete discretion to lenders to determine applicant eligibility.

Indeed, this implication finds support in the fact that, although the Agency required lenders to document STAR eligibility justifications, it did not require lenders to provide these justifications when requesting SBA to purchase a guaranty on a defaulted STAR loan. Typically, however, the Agency requires lenders to provide documentation showing borrower eligibility when seeking purchase. In contrast, under the STAR loan program, the Agency did not implement any control either at loan inception or after a loan default to determine whether lenders were adequately documenting whether STAR loan recipients were adversely affected by the September 11th attacks or their aftermath. The Agency now acknowledges that "more rigorous controls over the purchase review process can be put in place prior to approving purchases of STAR loans to confirm eligibility" and recently issued a notice implementing this requirement.

With regard to extending our audit work, the objective of our audit was to determine, based on established law, if STAR loan recipients were appropriately qualified and if SBA established and implemented proper administrative procedures to verify STAR loan recipient eligibility. Our objective was not to determine how the enabling law was established. Accordingly, the OIG does not believe it was necessary to interview all individuals involved in creating and implementing the STAR loan program to accomplish our objective.
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Statistical Sampling Results and Projection Information

From the population universe of 7,058 disbursed STAR loans, we randomly selected a statistical sample of 59 to compute our estimate of population values. In statistical sampling, the estimate of attributes in the population universe has a measurable precision or sampling error. The precision is a measure of the expected difference between the value found in the sample and the value of the same characteristics that would have been found if a 100 percent review had been completed using the same techniques.

Sampling precision is indicated by ranges, or confidence intervals, that have upper and lower limits and a certain confidence level. Calculating at a 95 percent confidence level means the chances are 9.5 out of 10 that, if we reviewed all of the loans in the total population, the resulting values would be between the lower and upper limits, with the population point estimates being the most likely amounts.

We calculated the following population point estimates and the related lower and upper limits for the selected attributes using the Defense Contract Audit Agency's 'E-Z-Quant' software program at a 95 percent confidence level. Accordingly, 50 of 59 loans or 85 percent did not contain adequate justifications and/or supporting documentation.

Value	Occurrences in Sample of 59 Loans	Population Point Estimate	Lower Limit	Upper Limit
Lender file did not contain an adequate justification and/or supporting documentation.	50	5,981	5,152	6,549
Justification missing or merely a conclusion.	9	1,076	511	1,905
Justification related to the seller rather than applicant borrower.	11	1,315	684	2,180
Justification contrary to documentation in file.	21	2,511	1,665	3,465
Justification vague and neither contrary to nor supported by documentation in file.	9	1,076	511	1,905

Appendix B

Information on Sampled Loans

#	Approval Date	Gross Loan Amount	SBA Guaranty Amount	Business Type	Business Location	Primary Use of Proceeds	Lender Justif-ication	Borrower Response
1	8/2/02	$988,900	$741,675	Restaurant	FL	L, Imp	A	U
2	12/18/02	$520,000	$390,000	Construction	CA	L, Imp, WC	A	Y
3	11/15/02	$622,000	$466,500	Dentist	AZ	L, Imp, R	A	Y
4	7/31/02	$589,500	$442,125	Measuring / Testing Equip.	AZ	L, Imp, R	A	Y
5	8/6/02	$866,200	$649,650	Machine Shop	KS	D,E	A	Y
6	11/27/02	$160,000	$120,000	Day Care	FL	L, Imp	A	Y
7	9/12/02	$50,000	$25,000	Radiator	AZ	WC	VS	Y
8	7/31/02	$25,000	$12,500	Electrical	WI	WC	VS	Y
9	11/27/02	$205,000	$153,750	Moving/Storage	MD	BO, WC	VS	Y
10	6/4/02	$450,000	$337,500	Drycleaner	TX	A, WC	N	U
11	7/2/02	$725,000	$543,750	Restaurant	FL	L, Imp, R	N	N
12	9/9/02	$25,000	$12,500	Dentist	CO	WC	N	U
13	4/26/02	$72,000	$36,000	Electrical	KY	WC	N	Y
14	4/15/02	$25,000	$12,500	Carpenter	CO	WC	N	N
15	1/7/03	$510,800	$383,100	Apparel	OH	BO, WC	N	U
16	11/26/02	$136,000	$102,000	Bar and Grill	OH	L, Imp	N	N
17	8/22/02	$650,000	$487,500	Limo Service	CT	D, WC	N	Y
18	8/23/02	$100,000	$50,000	Oil Company	CT	WC	N	U
19	6/12/02	$640,000	$480,000	Golf Course	TX	L, Imp, E	S	N
20	10/4/02	$541,600	$406,200	Auto Accessories	TX	L, Imp, WC	S	U
21	9/10/02	$860,000	$645,000	Gas station and convenience store	TX	L, I	S	U
22	12/5/02	$1,079,000	$809,250	Liquor Store	GA	L, Imp, A, WC	S	N
23	6/4/02	$1,000,000	$750,000	Machine Shop	FL	A, WC	S	N
24	3/26/02	$420,000	$315,000	Drycleaner	FL	E, A, WC, I	S	N
25	10/29/02	$200,000	$150,000	Cleaning Supply Wholesaler	NC	A, WC	S	Y
26	3/7/02	$412,000	$309,000	Restaurant	TX	A, WC	S	U
27	11/15/02	$770,000	$577,500	Gas station and food mart	NJ	L, Imp, A	S	Y
28	12/6/02	$976,000	$732,000	Gas Station/ Mini Market	CA	A, L, Imp	S	N
29	12/27/02	$73,000	$54,750	Printing	WI	L, Imp	S	Y
30	5/16/02	$115,000	$97,750	Auto Repair	CA	D	C	U
31	10/9/02	$825,000	$618,750	Dr. Office	NC	L, Imp,	C	U

#	Approval Date	Gross Loan Amount	SBA Guaranty Amount	Business Type	Business Location	Primary Use of Proceeds	Lender Justif-ication	Borrower Response
						WC		
32	12/5/02	$770,000	$577,500	Restaurant	NJ	L, Imp	C	N
33	9/12/02	$175,000	$131,250	Beauty Salon	TX	LHI, D, FF, WC	C	N
34	8/8/02	$459,000	$344,250	Electronics Store	CA	L, Imp	C	N
35	6/5/02	$877,500	$658,125	Home Heath Care	OH	L, Imp	C	N
36	4/26/02	$371,500	$278,625	Appraiser	OR	L, Imp	C	N
37	3/14/02	$168,000	$126,000	Convenience Store	LA	D, WC	C	U
38	12/5/02	$290,000	$217,500	Chiropractor	TX	D, R, WC	C	U
39	1/9/03	$772,700	$579,525	Pharmacy	PA	L, Imp, A, WC	C	N
40	9/27/02	$624,700	$468,525	Furniture Store	FL	C, D	C	N
41	10/4/02	$78,000	$66,300	Janitorial Services	CO	A, WC	C	N
42	4/12/02	$160,000	$120,000	Chemical Product Wholesaler	MN	E, LHI, WC	C	Y
43	9/19/02	$55,500	$47,175	Communications Equip. Wholesaler	TX	I,D	C	Y
44	4/26/02	$1,395,000	$922,932	Medical Clinic	TX	L, Imp, R	C	N
45	1/9/03	$1,957,500	$999,988	Dr. Office	WA	L, Imp	C	N
46	8/29/02	$212,400	$106,200	Apparel	CO	R/E	C	Y
47	9/23/02	$1,600,000	$1,000,000	Computer Repair	IL	A	C	N
48	1/18/02	$62,370	$53,014	Orthodontist	WI	E, LHI	C	N
49	7/10/02	$51,900	$44,115	Chiropractor	TX	WC, E, I	C	N
50	12/3/02	$583,500	$437,625	Tanning Salon	NV	E, Imp, WC, FF, D	C	N
51	1/8/03	$930,000	$697,500	Clothing Wholesaler	CA	L, Imp	VN	Y
52	2/25/02	$237,000	$177,750	Restaurant	TX	E, LHI, WC	VN	U
53	7/26/02	$147,400	$125,290	Printing	AZ	WC, E, I	VN	N
54	6/18/02	$154,100	$115,575	Painting Contractor	AZ	D, WC	VN	U
55	9/4/02	$25,000	$21,250	Candy Store	IL	WC	VN	N
56	11/12/02	$10,000	$5,000	Machine Shop	WI	WC	VN	U
57	12/27/02	$1,460,000	$897,900	Gas Station and Convenience store	CA	L, Imp	VN	N
58	11/1/02	$1,100,000	$825,000	Painting Contractor	MN	D, C, E, WC	VN	U
59	8/26/02	$240,000	$180,000	Chiropractor	IA	A, WC	VN	U

Table Legends

Primary Use of Proceeds:

L – Land purchase
Imp – Improvements purchase
WC – Working Capital
R – Renovations
D – Debt Refinance
E – Equipment Purchase
BO – Buyout of partner
A – Acquisition of Business
LHI – Leasehold Improvements
FF – Furniture and Fixtures purchase
C – Construction
R/E – Real Estate Purchase
I – Inventory Purchase

Lender Justification:

A – STAR loan recipient appeared to be appropriately qualified
VS – STAR justification was vague, but was supported by documentation in the lender's loan file and borrower statements
N – STAR justification was missing or merely stated a conclusion with no support
S – STAR justification was related to the seller rather than the applicant borrower
C – STAR justification was contrary to documentation in the lender's loan file or borrower statements
VN – STAR justification was vague and neither contrary to nor supported by documentation in the lender's loan file or borrower statements

Borrower Response:

U – Auditor was unable to get in touch with the borrower
Y – Borrower stated they were adversely affected by the terrorist attacks of September 11th
N – Borrower stated they were not adversely affected by the terrorist attacks of September 11th

Sample Loan Justifications

The justifications as presented in the various categories in this appendix are verbatim from the STAR loan justifications documented in the lenders' loan files. In categorizing these justifications, we relied on additional supporting or contradictory information located in the lenders' files or that we obtained from statements made by the borrowers we interviewed. We determined that the recipients of loans in categories A and VS appeared to be qualified to receive STAR loans based on a review of the lenders' loan files and discussions with available borrowers. It is not our position that the recipients of the loans listed in categories N, S, C, and VN were unqualified for the STAR loan program. We only concluded that eligibility could not be determined for these recipients due to the lack of adequate STAR justifications and supporting documentation in the lenders' loan files or non-specific SBA procedures. Our audit was limited to reviews of the loan files maintained by the lenders and interviews with the borrowers we were able to contact.

We interviewed 34 of the 50 borrowers in categories N, S, C, and VN. Twenty-five claimed they were not affected by September 11, while the other nine claimed they were adversely impacted for reasons other than those documented in the lender files (see number 46 as an example). These nine borrowers may have been considered to be eligible if the lenders had prepared a more appropriate justification. After repeated attempts, we were unable to reach 16 of the borrowers of loans in categories N, S, C, and VN; therefore, we relied solely on the justifications and documentation in the lenders' file in categorizing these loans. We did not verify the accuracy of the borrowers' statements.

Category "A"
STAR Loan Recipient Appeared to be Appropriately Qualified

No.	Justification Provided by Lender	Additional Info obtained from lender file or borrower statements
1	"The SBA loan is being submitted under the STAR Program due to the adverse effects the OC experienced directly linked to the events of September 11. The applicants Attorney/CPA (name withheld) was located at One World Trade Center Drive, 89th floor. A great deal of the principal's legal and financial documents were located in the office of (name withheld). All of the documents were destroyed in the tragic events of September 11, along with the loss of the life of (name withheld). The borrower has spent a great deal of time and cost of reconstructing the documents including obtaining copies of his personal tax returns directly from the I.R.S. Based on this information, the loan qualifies for the STAR Program."	Justification supported by documentation in the lender's loan file.
2	"The results of the 9-11 occurrence resulted in extreme financial hardships which effected our business operations. Our existing government contracts were slowed because of governmental priorities. Release of new contracts was also affected. New contracts were no longer awarded on a timely basis, but extended to a period of 60-120 days. This action resulted in employee layoffs, because of the inability to provide employment to our workers."	Support in the lender's loan file consisted of an aging schedule of account receivables showing past due accounts from various federal agencies.
3	"The OC was indirectly affected by the far reaching short term and long term economic malaise that was a direct results of the events of 9/11. The OC is located in a fly-in destination, Phoenix, a town which relies heavily upon tourism and hospitality as a vital part of the economic engine that drives its local economy. Hospitality and the construction industry were both greatly impacted after the terrorist attacks, which resulted in the loss of jobs and/or a reduction of wages, which many times led to the loss of benefits. Local residents were therefore not buying goods and services that could be put off. Most dental procedures are considered non-urgent or are cosmetic. Borrower reports that some patients canceled routine cleaning or minor cosmetic procedures as a result of loss of benefits or reduced discretionary income. Therefore, the OC is eligible for an SBA "STAR" loan."	Justification supported by documentation in the lender's loan file. Borrower corroborated the justification.
4	"Borrower's financial performance as evidenced by the six month interim statement reflects the economic impact of the events of 9/11. The borrower provides selection and design of laboratory and in-situ testing apparatus and software for a variety of industries including construction related businesses as well as many public works and educational entities across the country and around the world." "Much of the testing equipment is used on soils, rocks, pavement and construction materials. As the construction industry was impacted throughout the country indirectly as a result of 9/11, the need for testing of this type for new projects was reduced." "The construction industry suffered directly and indirectly as a result in the downturn of in the economy. Layoffs in the construction, tourist, and airline industries (to name a few) and major educational facilities all felt the impact of the increased demand on public monies as a result of the 9/11 attacks." "Additionally, the company exports many of its services and products internationally. Interruption of major transportation channels after 9/11 further impacted the business operations of the company."	Justification supported by documentation in the lender's loan file.
5	"After several years of economic expansion, the major economies of the United States and Europe began to slow in 2001. The industry downturn in the wake of the terrorist attacks on September 11, 2001, was immediate, serious and widespread. Air travel to, from and within the United States was halted for a period of days. Airlines cutback their routes, and frequencies, to deal with the fall off in traffic. The major U.S. airlines reported significant financial losses in the fourth quarter and profits for European and Asian airlines declined. Recent trends indicate that, absent an event similar to that occurring on September 11, 2001, air travel growth and airline revenue will gradually return to pre-September 11 levels. As this happens, airlines are expected to slowly expand their routes and frequencies and return to profitability." "[Borrower]'s weak operating performance in 2001 and 2002 is a direct result of 9/11 that resulted in a sharp decline in commercial airline traffic and cancellation of new aircraft orders from the major airlines. This obviously has a trickle-down affect on all subcontractors that support the commercial aircraft manufactures. The company is starting to see an increase in tooling volume that generally proceed an increase in parts volume."	Justification supported by documentation in the lender's loan file.
6	"The applicant's business has experienced a slight slow down from the affects of September 11. With the economic slow down following September 11, many people were laid off and subsequently did not need daycare. As the economy has begun to return to normal level, daycare services have begun to return to a normal level."	The annualized 2001 financial statement (FS) shows that revenue decreased 1.24%.and the annualized interim 2002 FS shows that revenue increased by 21%. The borrower stated that the day care industry was probably hurt somewhat and she did see a decline in her business that she had just acquired in March 2001.

Category "VS"
STAR Justification was Vague, but Supported by Documentation in the Lender's File and Borrower Statements.

No.	Justification Provided by Lender	Additional Info obtained from lender file or borrower statements
7	"The OC was adversely affected by the events of 9/11/01 as shown by the slight sales dip in 2001. However, management is confident that the subject transaction is prudent and is a good time to expand and acquire this business/customer."	While the justification is vague, financial statements show a slight dip in 2001 and the borrower corroborated the statement.
8	"The applicant is requesting assistance through SBA's STAR (Supplemental Terrorist Activity Relief) program as a result of the economic downturn following the terrorist attacks on September 11, 2001. The business has experienced some difficulty in one or more of the following areas: making loan payments of existing debt; paying employees or vendors; purchasing materials, supplies or inventory; paying rents, mortgages or other operating expenses; or securing financing."	While the justification was vague, the lender's credit memorandum supported that the business experienced a decrease in revenue for FY ending 6/30/2002 as a result of 9/11. The borrower stated that he was affected by the overall slow down in the economy.
9	"The subject performs moving and storage for military personnel and was adversely affected by the September 11th tragedies. Prior to 2001, revenue and cash flow were trending higher and this trend has continued after 2001."	While the justification is vague, financial information in the lender's file showed that sales dipped in 2001. The borrower stated his business experienced a downturn after 9/11

Category "N"
STAR Justification was Missing or Merely Stated a Conclusion with No Support

No.	Justification Provided by Lender	Additional Info obtained from lender file or borrower statements
10	No justification in loan file	
11	No Justification in loan file.	
12	"STAR: How was your business impacted by 9/11? Slowed down"	
13	"This customer has been adversely affected by the terrorist attacks of September 11, 2001 in the following manner: Borrower has experienced a business disruption."	Merely a conclusion with no support.
14	"This customer has been adversely affected by the terrorist attacks of September 11, 2001 in the following manner: Borrower has experienced a business disruption."	Merely a conclusion with no support.
15	"This customer has been adversely affected by the terrorist attacks of September 11, 2001 in the following manner: Borrower has experienced a business disruption."	Merely a conclusion with no support
16	No justification in loan file.	
17	No justification in loan file.	
18	No justification in loan file.	Statement by lender in credit analysis alluding to warm weather as cause for business downturn.

Category "S"
STAR Justification was Related to the Seller Rather than the Applicant Borrower

No.	Justification Provided by Lender	Additional Info obtained from lender file or borrower statement
19	"From 1999 to 2000 revenues reflected a 24% increase to $494,644. Revenues reflected a 7% decline to $460,283 in fiscal 2001. The seller stated the majority of the decline in revenues was realized immediately after the September 11, terrorist attack. He stated that during this period, people were more interested in staying home and watching the coverage of the attack on television than playing golf."	Impact was under previous ownership and therefore, the justification did not apply to the applicant borrower.
20	"This loan was approved and submitted under the "STAR" Program. This business was actually shut down due to decreases in sales and losses pursuant to September 11, 2001."	The shut down occurred under the previous ownership and therefore, the justification did not apply to the applicant borrower.
21	"The business was negatively impacted by the events of September 11, 2001 because of the decrease in commercial and tourist travel on U.S. Highway 259."	Impact was under previous ownership and therefore, the justification did not apply to the applicant borrower.
22	"The applicant company was adversely affected as a result of the terrorist attacks of September 11, 2001. The effects on the company include: A loss of sales volume; sales dipped about 2% from 2000 to 2001 due to the sluggish economic environment after 9/11/2001. Holiday sales were down slightly."	The negative effects on company were under previous ownership and therefore, the justification did not apply to the applicant borrower.
23	"The applicant company was adversely affected as a result of the terrorist attacks of September 11, 2001. The effects on the company include: closed for the day."	Impact was under previous ownership and therefore, the justification did not apply to the applicant borrower.
24	"Borrower has advised that subject business had closed down for the day on September 11 and September 12, due to the tragic events of 9/11/01. We will therefore designate this as a STAR."	Impact was under previous ownership and therefore, the justification did not apply to the applicant borrower.
25	"The applicant company was adversely affected as a result of the terrorist attacks of September 11, 2001. The effects on the company include: delays receiving inventory & supplies from various vendors due to the terrorist attacks."	Adverse affects occurred under previous ownership and therefore, the justification did not apply to the applicant borrower.
26	"The applicant company was adversely affected as a result of the terrorist attacks of September 11, 2001. The effects on the company include, a slight decline was noticed in September, 2001, but recovered to normal levels by October 2001."	The effects on the company were under previous ownership and therefore, the justification did not apply to the applicant borrower.
27	"The current seller has suffered economic hardship in his attempts to upgrade the facility and install a convenience store. He has invested over $250,000 in renovation and legal expenses to renovate and install the food mart. The station had been closed for 4 months due to renovations. Subsequent to his re-opening in late August of 2001 he was dealt another set back due to the terrorist acts of September 11, 2001. The subject property is located approximately 50 miles from "ground zero" in NY city. Traffic volume decreased by as much as 40% in the area affecting the seller's ability to consistently meet his financial obligations. As a result of this impact, the borrower is applying under the SBA STAR Program."	The adverse affects all occurred under previous ownership and therefore, the justification did not apply to the applicant borrower.
28	"The borrower is seeking SBA loan proceeds because he does not have enough available capital injection to pursue conventional financing. The lack of injection is due to losses sustain in investments which were the result of the economic downturn that was further exasperated by events of 9/11." "The seller's business suffered from the events of 9/11 as well. Although financials would indicate growth, the seller expected to see higher revenues during 2001 (the first full year of the subject business's operations)."	The first part of the justification applies to the impact on the principal's personal investments, rather than an adverse affect on a small business as required by SBA procedures. Therefore, this justification is not relevant. The second part of the justification relates to the adverse affect of 9/11 on the previous owner and therefore, did not apply to the applicant borrower.
29	"The applicant is requesting assistance through SBA's STAR (Supplemental Terrorist Activity Relief) program as a result of the economic downturn following the terrorist attacks on September 11, 2001. The business has experienced some difficulty in one or more of the following areas: making loan payments of existing debt; paying employees or vendors; purchasing materials, supplies or inventory; paying rents, mortgages or other operating expenses; or securing financing."	The lender's credit memorandum showed that the adverse affect was a loss in sales attributed to the events of 9/11 and the subsequent down turn in the economy. This occurred under the previous ownership and therefore, the justification did not apply to the applicant. The applicant did not purchase the business until 12/02.

Category "C"
STAR Justification was Contrary to Documentation in the Lender's Loan File or Borrower Statements

No.	Justification Provided by Lender	Contradictory Information obtained from the lender file or borrower statement
30	"[Borrower] experienced a considerable drop-off in revenue after the terrorists attacks in September. It took a significant toll on the cash flow of the business. With sales down, overhead costs diminished the working capital of the business. [Principal] did an excellent job utilizing all his resources to fulfill all his obligations and pay his suppliers and creditors in a timely manner. With the proposed SBA loan, [Principal] will be able to consolidate his entire corporate debt into a low interest note, benefiting cash flow immediately. Since January, sales are back on track and [Borrower] is on target to meet all their projections for 2002."	The lender's credit memorandum stated: In 2001, [Principal] took a break from working at the shop and being on site at all times. The result was a drop off in quality control and efficiency, ultimately leading to a fall off in sales from $575,564 in 2000 to $438,880 for the 12-months ending 12/31/01. This was disappointing to [Principal], who then decided he wanted full ownership back.
31	"This loan qualifies for financing through the STAR Loan Program. Borrower's negotiations on the real estate were hampered by the events of 9/11. The borrower was trying to purchase the real estate prior to 9/11. The sellers were hesitant to sell after the instability of the economy brought on by the events of 9/11. The doctor continued to pursue the real estate as it was exactly what she needed for her practice, completely furnished and only 3 miles away. There were no other properties in the immediate area that met this criteria."	In our opinion, the justification is illogical and does not explain why the seller would be reluctant to sell. It appears the sale would have benefited the seller during an unstable economy. In discussions with a lender official, they could not explain the justification and indicated it did not make sense.
32	"Revenues for the existing location have risen in each of the years presented, and are on pace to eclipse the $200M mark for the first time since the business started. This mark would have been met in 2002, however, the borrowers experienced a drop in sales due to their proximity to New York City and the terrorist attacks of 9/11/01. The business is located less than a ½ mile from the Hudson River, and is directly across the river from the site where the World Trace Center once stood."	The lender's credit memorandum and tax returns showed that sales increased each year from 1999 to 2002. There was no monthly breakdown of sales to show whether or not sales decreased after 9/11/01. The borrower indicated they were slightly affected during the month of the attacks, but that it did not adversely affect the business over the long term. The SBA loan was used to purchase a second location for the business.
33	"The current owner purchased the business in June 2001. Last year end financial statement reflected 2% decrease in Gross Revenue due to the slow trend in economic after the 9/11 event in the forth quarter."	In its credit memorandum, the lender compared the borrower's gross revenue in 2001 to the previous owner's gross revenue in 2000. There was no analysis linking the 2% decline in sales to 9/11. The borrower stated he did not believe his business suffered economic harm as a result of 9/11.
34	"The request is submitted under the Defense Appropriations Act of 1/10/02. The subject business has been adversely affected through economic harm or disruption of business by the Sept. 11, 2001 terrorist attacks, and their aftermath through the following: General slowdown in revenues"	In general, the business was in an upward sales and net income trend shown in the three prior years' financial history and interim period through 5/31/2002. The loan was used to purchase land and improvements.
35	"This request is submitted under the Defense Appropriations Act of 1/10/02. The subject business has been adversely affected through economic harm or disruption of business by the 9/11/01 terrorist attacks, and their aftermath. The client indicated that as a result of the events of 9/11/01, the business has experienced the following: General slowdown in revenues and/or business activity Difficulty in purchasing material, supplies, or inventory Difficulty in securing financing"	The credit memorandum did not include specific information on how 9/11 affected this business. In general, the business was in an upward sales and net income trend shown in the three prior years' financial history and interim period through 3/31/2002. The business (including affiliates) had a 68% increase in revenue in 2001. There was no evidence that the borrower had difficulty in obtaining financing as a result of 9/11. The loan was used to purchase land and improvements.
36	"The request is submitted under the Defense Appropriations Act of 1/10/02. The subject business has been adversely affected through economic harm or disruption of business by September 11, 2001 terrorist attacks, and their aftermath through the following: Slow down in the economy had a temporary negative affect on the business as fewer borrower's applied for real estate loans and projects were cancelled."	The financial reports and loan review showed a growing business and an 87% increase in revenues. In addition, there was no indication there had been a decline in the number of real estate loans submitted and approved. The borrower stated he was not adversely affected by 9/11. The loan was used to purchase land and improvements.
37	"This customer has been adversely affected by the terrorist attacks of September 11, 2001 in the following manner: Borrower has suffered loss in annual business volume. Borrower has experienced unusual increase in cost of goods sold/services/operational expenses. Borrower has experienced difficulty purchasing raw materials, supplies or inventory."	Financial statements indicate the borrower's sales increased from 2000 to 2001. No evidence in file supported that the borrower suffered loss in volume, had difficulty purchasing inventory or experienced an increase in cost of goods sold. In fact, the financials showed that cost of goods sold was 65% of sales for the year 2001 but only 64% of sales for the month of December 2001.

No.	Justification Provided by Lender	Contradictory Information obtained from the lender file or borrower statement
38	"This customer has been adversely affected by the terrorist attacks of September 11, 2001 in the following manner: Borrower requires economic relief in maintaining current status on fixed debt obligations."	A review of the tax returns and financial statements for the 4 year period 1999 - 2002 reveal that the business was experiencing growth in revenue over this time frame. From 1999 - 2000, the business had a 13% growth in gross revenue. From 2000 to 2001, the business experienced a growth in gross revenue of 24% and when annualized, the growth from 2001 to 2002 was a 23% increase. There was no evidence that the borrower had difficulty maintaining current status on fixed debt obligations as a result of 9/11. Furthermore, interim 2002 financial statements showed an adequate debt service coverage and lender's credit memorandum stated the borrower requested the loan to refinance his debt because he wanted a higher reduction of principal and a lower interest rate. He did not, however, request to have his payments reduced and loan term extended.
39	"This loan is eligible for the STAR program. The borrower was in the process of purchasing this business when everything was delayed due to the events of September 11, 2001."	There was no evidence the purchase was in process prior to September 11. The Board of Directors did not approve the purchase until April of 2002 and the borrower stated he did not delay the purchase as a result of 9/11.
40	"The applicants indicated that they postponed their decision to move forward with this expansion until they could better gauge the impact on the Economy from the terrorist attacks of 9/11/01."	There was no evidence in the lender's file to support the justification. The borrower stated that his business actually increased during the fourth quarter of 2001 and first quarter of 2002. He did not indicate that he postponed his expansion as a result of 9/11.
41	"The loan is eligible for the STAR LOAN program because the seller was waiting to sell and the buyer was unsure about purchasing a cleaning business until they could wait a full year to see how the events of 9/11/01 had affected the business. They postponed the purchase until they were certain the business was stable."	There was no evidence in the lender's file that the borrower postponed the purchase as a result of 9/11. The borrower did not believe the business was adversely by 9/11 and stated the business was purchased more than a year after 9/11.
42	"This is classified as a STAR loan because the borrower wanted to purchase additional equipment, but due to the events of 9/11, was were (sic) unsure of the general economic environment. This affected liquidity and potentially the ability to cash flow additional debt service."	There was no evidence in the lender's file that the borrower postponed the purchase of the additional equipment as a result of 9/11. The lender's credit memorandum showed the loan was originally approved as a regular 7(a) loan and was converted to a STAR loan. The loan was an extension of a previous equipment loan and was needed because the borrower's original bid was low and they needed additional loan funds to fund the purchase. The credit memorandum indicated that the past 4 or 5 months were difficult for the borrower due to their move to a new location, moving production on-site, sales staff turn over and new product concentration. The borrower stated that she believes her business was greatly impacted by 9/11 because business dropped off significantly as customers would not order any inventory. She stated she had a hard time staying in business. She stated that none of this was discussed with the lender. The borrower did not indicate that she delayed the purchase of this equipment as a result of 9/11.
43	"Due to 9/11 and the downturn in the economy which reduced consumer spending and created uncertainty in the economy, the business expansion for [Borrower] was delayed and was adversely impacted by that event. The loan is thus eligible for the STAR program."	There was no evidence in the lender's loan file that the borrower delayed its business expansion as a result of 9/11. The loan was not used for the expansion. It was used to purchase inventory and refinance debt. The borrower stated that she was affected by 9/11 because she sold equipment used for broadcasting and the industry slowed down after 9/11. She stated that broadcasters focused more on what was happening with 9/11 and not on purchasing equipment. She did not indicate that she postponed her business expansion as a result of 9/11.
44	"An economic impact after 9/11 tragedy on the borrower is that they are in difficulty in securing financing from other financial institutions. The borrower planned to begin financing process earlier, but its ability to do so was hampered by the terrorist actions and their aftermath."	There was no evidence in the lender's file that the borrower had difficulty securing financing as a result of 9/11. The borrower stated he was not affected by 9/11 and that his ability to begin the financing process was not hampered by 9/11.

No.	Justification Provided by Lender	Contradictory Information obtained from the lender file or borrower statement
45	"The request is submitted under the Defense Appropriations Act of 1/10/02. The subject business has been adversely affected though economic harm or disruption of business by Sept. 11, 2001 terrorist attacks, and their aftermath through the following: Difficult in securing financing. The borrower indicated that they were planning to buy the property earlier this year, but due to the terrorist attack, they had to wait and see how the business was affected."	There was no documentation of previous efforts or decisions to secure financing or of a decrease in financial position in the lender's file. The credit memorandum shows an increasing trend in revenues. The credit memorandum stated that the borrower indicated the practice is not sensitive to the economy. Furthermore, the borrower told the auditors that his business decisions were not affected by 9/11.
46	"This customer has been adversely affected by the terrorist attacks of September 11, 2001 in the following manner: Borrower has had to defer fixed asset purchases/replacement and/or scheduled maintenance."	There was no evidence in the lender file to support that the borrower had to defer its fixed asset purchase and/or scheduled maintenance. The borrower stated that her business was absolutely affected by 9/11. She said that business had begun declining prior to 9/11 (around June 2001) but got even worse after 9/11. She said that she had talked in detail with the lender regarding how 9/11 affected her business. Her business sells sweaters in a resort area and resorts were heavily affected by 9/11 as travel declined. She stated that the loan she received was to purchase real estate to relocate the business, however, her decision to purchase the real estate was not delayed by 9/11 as the underwriter indicated in his justification.
47	"The acquisition of this business was delayed due to the generally ailing 4th quarter economic conditions. The Buyer did not buy out the company until 1st quarter 2002 until the year-end fiscal data was available to better assess risk levels. The company was in a considerable growth mode in 2000 and then showed declining sales of 23% in 2001."	There was no evidence in the lender's file that the business acquisition was delayed as a result of 9/11. The credit memorandum indicated that the change of ownership was necessary because the seller violated loan covenants by converting company funds to personal uses. Furthermore, the credit memorandum showed that the decline in sales resulted from the loss of 2 partial contracts during FY 01. The borrower stated they were not affected by 9/11.
48	"This business was adversely affected by the events of 9-11-01. They were unable to open in the fourth quarter of 2001 due to the tragedy and the public's unwillingness to accept new business at that time. This resulted in lost revenue and lost profits to the business owners."	There was no evidence in the lender's file that the business' 2nd location was unable to open in the 4th quarter of 2001 due to 9/11. The credit memorandum stated that the borrower wished to establish a new practice in the same area he was practicing and would work out of both offices. Accordingly, this was not a new business. The borrower stated he was not affected by 9/11.
49	"Due to 9/11 and the downturn in the economy which reduced consumer spending, this business start-up was delayed and was adversely impacted by that event. The loan is thus eligible for the STAR program."	There was no evidence in the lender's loan file to support or contradict that the borrower delayed its start-up. The borrower stated that the start-up of her business was not delayed due to the events of 9/11.
50	"Based on conversation with the borrower, the Borrower had trouble securing financing for this project due to the economic conditions and uncertainty as a result of the terrorist attacks of 9/11/01. While growth for the company was positive in 2001, it was below projections due to the slow-down in late 2001. The company has had trouble securing financing for this venture due to the effects of 9/11 on the local economy. Many of the customers who use tanning salons are performers in casinos and work in various capacities in the casino industry. Las Vegas tourism was hit hard by 9/11 and many casino workers lost their jobs or had their hours scaled back…this is a large part of [Borrower's] customer base. The company believes that the long term prospect of Las Vegas are strong and that now is an opportune time to expand its presence in the Valley (rental rates are lower and incentives are being offered by shopping center owners due to a slow down from 9/11)."	While the justification appeared to be adequate, it was contrary to documentation in the lender's loan file and the borrower's statements. There was no evidence in the lender's loan file that the borrower could not obtain financing as a result of 9/11. The lender's credit memorandum showed the borrower experienced a 51.6% sales growth for 2001 and an annualized 2002 sales growth of 31.6%. The borrower stated that 9/11 did not affect his ability to secure financing. He further stated that his business was not affected by 9/11. He stated that although there was a slight down turn in the month following 9/11, subsequent months were not affected.

Category "VN"
STAR Justification was Vague and Neither Contrary to Nor Supported by Documentation in the Lender's Loan File or Borrower Statements

No.	Justification Provided by Lender	Additional Info obtained from lender loan file or borrower statements
51	"Due to the result of the terrorist attacks perpetuated against the U.S. on September 11th, 2001 the applicant's ability to purchase a commercial property was hampered by the terrorist actions and their aftermath. As a result, the applicant was not able to secure a financing of conventional loan; therefore, the applicant is requesting an SBA loan under the STAR program."	There was no evidence in the lender's loan file to support or contradict that the applicant was unable to secure financing for the purchase of commercial property.
52	"The applicants stated they planned to open the new business for some time, but the events of 9-11 delayed their decision in doing so. Therefore, the applicant is eligible for the STAR program. [Lender] requests that this loan be reclassified as a STAR loan."	There was no evidence in the lender's loan file to support or contradict that the applicant planned to open the new business for some time and the events of 9/11 delayed their decision in doing so. We could not obtain current contact information for the borrower.
53	"Borrower was uncertain about proceeding the project and initiating the application until there were clear signs confidence was restored the nation and the economy would resume moving forward."	There was no evidence in the lender's loan file to support or contradict that the borrower delayed his start-up. The borrower stated that he believes he was laid off from his previous employer in 2/02 as a result of 9/11 and signed on with a franchise to start his own business is 5/02. The loan was approved on 7/26/02 and was used to purchase equipment and inventory and for working capital.
54	"This customer has been adversely affected by the terrorist attacks of September 11, 2001 in the following manner: Borrower has suffered loss in annual business volume."	The borrower's tax returns did indicate a down turn in gross receipts from FY 2000 to FY 2001, however, an analysis or monthly breakdown of gross receipts was not found in the loan file. Therefore, it is impossible to determine if the loss in annual business volume was a result of 9/11. We could not obtain current contact information for the borrower.
55	"This loan qualifies under the STAR Loan program, as our borrower would have gone into business sooner had it not been for September 11, 2001 and the impact on the economy. Borrower had to delay the opening of the business."	There was no evidence in the lender's loan file to support or contradict that the borrower delayed its start-up due to 9/11.
56	"This business was adversely affected by the events of 9-11-01. They were unable to open in the fourth quarter of 2001 due to the tragedy and the public's unwillingness to accept new businesses at that time. This resulted in lost revenue and lost profits to the business owners."	There was no evidence in the lender's loan file to support or contradict that the borrower delayed its start-up due to 9/11.
57	"The applicant has been adversely affected by the events of 9-11. The events of 9-11 has caused down turn in overall economy which in turn has limited the applicant's ability to secure a conventional financing for the proposed purchase. Based on its difficulty in obtaining financing due to the events of 9-11, the applicant is determined to be eligible for STAR program."	There was no evidence in the lender's loan file to support or contradict that the borrower could not obtain financing as a result of 9/11.
58	"[Borrower] has been planning to expand their business by adding on to their existing facility and upgrading their equipment. Because this business is closely tied to the new construction industry the borrower has been reluctant to expand his business due to the impact 9/11 had on the economy."	There was no evidence in the lender's loan file to support or contradict that the borrower was reluctant to expand his business. The borrower's financial statements indicated a strong growth in income from 1999 through 2003 with no significant increase in costs. The borrower did not respond to our inquiries.
59	"Transaction qualifies for the STAR program. The customer had originally intended to purchase this business in late 2001. However, due to the events occurring on 9/11/01, the project was postponed until now. The customer was unsure of the event's impact on personal investments which represented sources of liquidity. In addition, borrower was unsure of the economy in general and how this would impact the business being purchased."	There was no evidence in the lender's loan file to support or contradict that the borrower postponed the purchase of the business. The borrower did not respond to our inquiries.

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

DATE: December 19, 2005

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

/S/ original signed

FROM: Michael W. Hager
Associate Deputy Administrator for Capital Access

SUBJECT: Draft IG Audit of SBA's Administration of the Supplemental Terrorist Activity Relief (STAR) Loan Program

Thank you for the opportunity to review the draft audit report on SBA's Administration of the Supplemental Terrorist Activity Relief (STAR) Loan Program. We appreciate the work that went into the audit and are providing the Office of Inspector General (OIG) with the following comments.

First, we want to reiterate that every eligible business, directly or indirectly impacted by the September 11th terrorist attacks, was able to receive a STAR loan. As your report notes, the STAR loan program expired with over one third of the budgetary authority established for the program unused and "qualified borrowers were not precluded from receiving STAR loans due to a lack of funds." In fact, Congress subsequently authorized SBA to use the excess budgetary authority more broadly – for loan guarantees for small businesses generally, including those <u>not</u> adversely affected by the terrorist attacks.

Second, OIG's audit report appears to misunderstand the purpose of the STAR loan program, which is different from SBA's disaster loan program. SBA's disaster loan program was available to those businesses directly impacted by the September 11th terrorist attacks. The disaster loan program has significantly more favorable terms and rates. In fact, we believe that those borrowers in the STAR loan program that OIG has concluded were clearly eligible for a STAR loan could have received the more favorable terms available through the disaster loan program.

SBA believes that most, if not all, STAR loan program borrowers were eligible for the STAR loan program. At the same time, SBA acknowledges that more rigorous controls over the purchase review process can be put in place prior to approving purchases of STAR loans to confirm eligibility. However, it is important to remember that (1) there were more than sufficient funds available for all borrowers; (2) SBA did provide clear guidance as to the breadth and depth of situations eligible for the STAR loan program and clearly established standards for the analysis and documentation required to support a STAR loan; and (3) the direction provided to lenders either orally or through Agency directives was consistent with that guidance. All of these points are made either directly or indirectly in the draft audit report. We also wish to note that OIG reviewed and approved the Procedural Notices for the STAR loan program before they were issued. Presumably, OIG reviewed the notices for the adequacy of guidance, criteria and internal controls before providing its concurrence.

As OIG states in the draft report, "it is not [the OIG's] position that the recipients . . . were unqualified for the STAR loan program." Rather, OIG "conclude[d] that eligibility could not be determined for these recipients due to the lack of adequate STAR justifications and supporting documentation in the lenders' loan files." Lenders were provided clear direction both orally and in writing by SBA on the requirement to document their files. SBA will improve its internal controls governing the guaranty purchase review process to ensure that these justifications are provided prior to purchase but a requirement for lenders was clearly established and communicated.

Further, lenders are aware that loans are reviewed for requirements at purchase and would have no basis for believing a purchase request would not be evaluated for STAR loan program eligibility. SBA did not waive any requirements to document the analysis in the file supporting a borrower's eligibility for the STAR loan program. In fact, our guidance repeatedly discussed documentation requirements.

The statute established eligibility for the STAR loan program as a "small business adversely affected by the September 11, 2001 terrorist attacks and their aftermath." Given the broad statutory mandate and the general concern at the time that the September 11th terrorist attacks would have a significant negative impact on the national economy, SBA interpreted its statutory mandate most broadly, and SBA's interpretation in this regard must be accorded due deference. Guidance issued by SBA in procedural notices and public statements supported that determination and was consistent throughout the program. As the draft report states, SBA Procedural Notice 5000-779 established a requirement that the lender prepare and maintain in its loan file a statement summarizing its analysis and its conclusion that the loan was eligible for the STAR loan program; a statement merely concluding that a borrower was eligible without the analysis was insufficient. The statements made by the AA/FA quoted in the draft report, such as that SBA would "be looking for a document that [a lender had] put in the file where [the lender] discuss[ed] how the business was adversely affected," were consistent with these requirements. While the AA/FA's statement may not have repeated the procedural notice word for word, the intent was the same – simply providing a concluding statement was insufficient without the accompanying analysis, i.e., a document discussing how the business was adversely affected was required.

With regard to OIG's recommendations 1-3, SBA agrees that if another nation-wide disaster relief program is established within the 7(a) program that the factors identified by OIG should be incorporated going forward, as appropriate to the specific situation. With regard to the recommendations provided relative to the STAR loan program, SBA agrees that lenders should submit STAR loan justifications when seeking SBA's purchase of a STAR loan guaranty and has already implemented this recommendation. With regard to recommendation number five, while we believe that SBA has established standards as to what constitutes an eligible loan that should guide purchase reviewers, SBA will review its existing guidance and determine if additional guidance is necessary. With regard to the last two recommendations related to treatment of

STAR loans either already purchased or future purchase requests without adequate justification of eligibility, we do not object to the intent of the recommendation but will need to ascertain the availability of appropriated funds from the relevant year as well as assess any legal implications of the recommendation.

We are available to discuss any questions you may have with our comments.

Comments on the Draft OIG Report on the STAR Loan Program
From the Former Associate Deputy Administrator for Capital Access and the Former Associate Administrator for Financial Assistance
December 20, 2005

Thank you for providing this opportunity for us to offer comments on the draft OIG audit report on the STAR loan program. In general, we agree with the official Agency comments. Particularly, with regard to the implication in the OIG report that we (Bew and Butler) exceeded the intent of the STAR loan program, we would reiterate the Agency position that our words -- written and oral -- fully reflected the policy of the Agency. And we would note that they also reflected the policy that was discussed and concurred with, at the highest levels within the Agency; and, as we believe, also concurred with by the congressional staff most closely involved with the creation and implementation of the STAR program. What we did during those dark days after September 11, 2001 was play very small roles in getting assistance to America's small businesses in an effort to try to keep our economy from faltering. At the time, and still today, we believe that what we did was fully in keeping with the intent of Congress and the desires of the Administration.

With regard to the specific Agency comments on the report, we share the concern expressed by the Agency that the OIG report fails to reflect a full understanding of the purpose of the program. And, we would add our opinion that the report is deficient in that it does not provide any historical context for the authorization and implementation of the STAR program.

On September 11, 2001, when the terrorists attacked U.S. citizens on U.S. soil, they destroyed far more than planes and buildings, and they took a toll far greater than the lives that were so tragically lost. By their actions on that day, the terrorists forever took away Americans' sense of security and our feeling that we were somehow insulated from the terrorist activities that frequently take place in other countries. In the aftermath of 9/11, vast numbers of Americans actually experienced the various stages of grief -- eschewing restaurant meals, movie dates, and shopping expeditions for quiet times in their homes with their families. In addition, immediately after 9/11, many Americans could not travel, and later, many chose not to travel. As a result of this so-called "cocooning" effect, there was a very real concern that the stability of the American economy was at risk -- and, a very real bi-partisan and virtually universal desire to make sure that we did not allow the terrorists' actions to cause the American economy to falter. That concern was so great that America's leaders actually called on Americans to defeat the intent of the terrorists by getting back to their day-to-day activities as quickly as possible. It was in this environment that the STAR loan program was conceived and implemented. What is missing from the OIG analysis is any acknowledgment of that environment.

In the days and weeks that followed 9/11, SBA staff met frequently with small business committee staff in both the Senate and the House to discuss ways to help assist small businesses that, although not eligible for SBA disaster assistance, had none-the-less been directly or indirectly affected by the terrorist activities of 9/11 and their aftermath. And, although the report does not reflect it, many of us involved in those discussions recall strong bi-partisan agreement that SBA should do as much as it could as quickly as it could to help bolster the economy. Even the name "STAR," coined by SBA staff in the Office of Financial Assistance is an indicator of the context in which the program was developed -- a very real patriotic intent to do all we could to help America thrive after so unimaginable an event.

The OIG report criticizes SBA for not providing detailed guidance as to what constituted "adverse impact." What it fails to acknowledge is the fact that because the attacks were so unprecedented, there was no way for us to imagine or gauge what short- and long-term affects the attacks would have on the American economy, particularly on its small business segment. This is important because it created a situation that demanded a creative approach to assure the best possible structuring of the program to address multiple unknowns. What is also missing in the OIG report is any acknowledgment that all parties involved in the implementation of the STAR program were, at that time, in agreement with the proposed inclusive and far-reaching approach. Unfortunately, to the best of our knowledge, many of those individuals, particularly those outside SBA, were not asked to provide their recollections or insight about the program's origins and intent for inclusion in the OIG report.

Obviously we agree with the Agency's contention that SBA provided clear guidance and that additional "guidance provided to lenders either orally or through Agency directives was consistent with that guidance." Nothing quoted in the OIG report can be construed as giving lenders carte blanche to find all loans eligible for STAR. Rather, SBA staff guidance, both in writing and orally, was consistent in that lenders were made fully aware of their responsibility to document in their files the bases for their determinations of STAR program eligibility. At that time, the desire of the Agency and the Congress was that the STAR program be used to the maximum extent appropriate to assure that the economy remained strong.

As to the issue of what can be imputed from the clearances of the STAR notices by OIG and others, it must be noted that, when the notices were being cleared, those clearing them apparently believed that the requirements specified for lenders were adequate. Second-guessing today whether it may have been more appropriate to have SBA review lenders' eligibility assessments prior to loan approval is therefore not appropriate. However, it may be appropriate to consider such process for similar loan programs that may be enacted in the future.

As to the issue of what lenders should expect regarding post-approval examinations by SBA, we note that in the cited speech made by the former AA/FA in May, 2002, she specifically stated that, for PLP and post-purchase reviews, SBA would be looking for documents in the lenders' files that discussed how the businesses were adversely affected. In order to encourage lenders to make STAR loans, we needed to give them some level of comfort that we would not later "play gotcha" to deny guaranty liability or otherwise penalize lenders. We believed then, and continue to believe, that given the circumstances at the time, the guidance that we provided was appropriate. Now, however, the SBA OIG is engaging in the very conduct that we thought our guidance would preclude -- second- guessing even those justifications that appear to meet the broad program eligibility guidelines. Here, we should note, however, that we certainly agree that those loan folders that contain no justification, or provide just boiler plate "the loan is eligible" language, cannot be construed to be eligible for the program.

In summary, in addition to the specific language changes and additions that we are recommending, we would also recommend that consideration be given to extending the work under this audit to enable OIG to interview other individuals involved in creating and implementing what became known as the STAR program. In this regard, we particularly recommend that staff on the congressional committees at the time the program was created be interviewed. We also recommend that interviews be conducted with SBA's former Chief of Staff, the former ADA for Management and Administration, the former Counselor to the Administrator, the former ADA for Capital Access, the former Acting ADA/CA and other current and former SBA employees directly and indirectly related to the implementation of this program. The information gained by conducting such interviews will allow a more complete and comprehensive OIG audit report.