



Audit Report



OIG-SBLF-12-006

State Small Business Credit Initiative: Montana's Use of Funds
Received from the State Small Business Credit Initiative

September 27, 2012

Office of
Inspector General

Department of the Treasury

Contents

Results in Brief	2
Background	4
Montana’s Participation in SSBCI	5
Montana Misused \$2.73 Million on Half of the Loans Reviewed.....	6
Montana Funded or Made Commitments to Five Loans for Passive Real Estate Investments	6
Montana Funded Three Loans for the Refinancing of Prior Debt	10
Administrative Costs Charged to SSBCI Were Generally Supportable, but Personnel Costs Were Not Allowable or Allocable	13
Treasury Guidance Allows Use of SSBCI for Existing Debt	14
Recommendations.....	16
Appendix 1: Objectives, Scope, and Methodology.....	19
Appendix 2: Management Comments	21
Appendix 3: Major Contributors	29
Appendix 4: Report Distribution List.....	30

Abbreviations

CDFI	Community Development Financial Institutions
EPC	Eligible Passive Company
GOED	Governor’s Office of Economic Development
OCSP	Other Credit Support Program
OIG	Office of Inspector General
OMB	Office of Management and Budget
RLF	Revolving Loan Fund
SSBCI	State Small Business Credit Initiative
The Act	Small Business Jobs Act of 2010
WPIRS	Montana Distressed Wood Product Industry Recovery and Stabilization Program

This Page Intentionally Left Blank

*The Department of the Treasury
Office of Inspector General*

September 27, 2012

Don Graves, Jr.

Deputy Assistant Secretary for Small Business, Housing, and
Community Development

This report presents the results of our audit of the State of Montana's use of funds awarded under the State Small Business Credit Initiative (SSBCI), which was established by the Small Business Jobs Act of 2010 (the Act). Montana was awarded \$13,168,350, and as of March 31, 2012, had received \$8,691,111 of the awarded funds. With the awarded funds, the State established a new small business loan participation program called the Montana State Small Business Credit Initiative. At the time of our audit in March 2012, the State had obligated or expended approximately \$7.6 million.

The Act requires the Treasury Office of Inspector General (OIG) to conduct audits of the use of funds made available under SSBCI and to identify any instances of reckless or intentional misuse. Treasury has defined reckless misuse as a use of funds that the participating state or administering entity should have known was unauthorized or prohibited, and which is a highly unreasonable departure or willful disregard from the standards of ordinary care. Intentional misuse is any unauthorized or prohibited use of funds that the participating state or its administering entity knew was unauthorized or prohibited.

Our audit objective was to test Montana's compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. To test compliance, we reviewed a judgmental sample of 16 small business loans totaling \$4.9 million that were enrolled or committed in Montana's program as of March 5, 2012. We reviewed the loans to determine whether they complied with program requirements for loan use, capital at risk, and other

restrictions. We also reviewed the administrative costs that the State charged against SSBCI funds to ensure they were accurate and supported in accordance with Treasury Guidelines and Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Government*. Appendix 1 contains a more detailed description of our audit objective, scope, and methodology.

We conducted our audit between February 2012 and June 2012 in accordance with Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained to address our audit objectives provides a reasonable basis for our findings and conclusions.

Results In Brief

Based on our sample results, we determined that Montana used \$2.73 million of SSBCI funds for business purposes that are prohibited under the Act or SSBCI Policy Guidelines. The misused funds included \$1.39 million for five loans involving passive real estate investments and \$1.34 million for three additional loans that refinanced prior debt from the same lender.

Although the loans were for prohibited purposes, we did not find the misuse of funds to be intentional or reckless, as Montana sought guidance from Treasury before enrolling the loans. Responding to Montana's inquiries, Treasury officials did not provide definitive guidance on the permissibility of passive real estate loans, and told Montana that refinancing prior debt to the same lender was allowable if the prior debt had matured and new underwriting had occurred. Further, not all of the conversations between Treasury and Montana evidencing the guidance given the State were documented, which would be needed to determine recklessness on the part of the State.

Additionally, we determined that \$3,426 in personnel costs incurred for administering the State's SSBCI program was not allowable or allocable because the costs were not properly supported as required by OMB Circular A-87.

In April 2012, Treasury revised its guidance to define “refinancing,” which is not defined in statute. Treasury’s view is that the statutory prohibition on refinancing the same lenders’ loans pertained only to existing debt that had not yet matured and that refinancing debt after it matures constitutes “re-funding,” a permitted use. We question Treasury’s basis for the policy change as it was made without a legal opinion showing how Treasury concluded that re-funding is consistent with the statutory language and intent of the SSBCI program, including the prohibition of placing prior debt under the protection of an Other Credit Support Program (OCSP) when it was not previously enrolled in an OCSP. Additionally, Treasury issued the revised guidance without putting into place additional controls to prevent misuses of funds. For example, Treasury did not limit the amount of a re-funded loan that can be used to pay off prior debt, which could result in very little new capital being extended to borrowers, and allows the re-funding of loans that have a history of non-performance. Because the majority of monies re-funded could be used to pay off prior debt at lower interest rates for lenders, re-fundings appear to primarily benefit lenders and not small business borrowers.

We recommend that Treasury notify participating states that passive real estate loans are misuses of funds and encourage the states to review their loan enrollments for compliance with SSBCI Policy Guidance that was in place at the time the loans were made. We also recommend that Treasury either provide a clear and rigorous legal analysis demonstrating how it concluded that program funds could be used to “re-fund” an existing loan to the same lender, or revise the SSBCI Policy Guidance to disallow such a result. If Treasury continues to allow re-fundings, it will need to establish controls to ensure that the borrowers are the primary beneficiaries from such transactions. Further, we recommend that Treasury establish a procedure to document its responses to state inquiries about what constitutes permissible uses of funds, and inform states that testimonial evidence will be insufficient to prove that Treasury was consulted about compliance with program requirements. Therefore, states should secure Treasury’s written approval before proceeding with loans involving a questionable use of proceeds. Finally, we recommend that Treasury disallow \$3,426 in unsupported

administrative expenses unless Montana can properly support such costs.

On September 21, 2012, Treasury submitted a formal response, agreeing to take the recommended actions. Management's response, including a letter from Montana that states Montana's actions to address the report's concerns, is reprinted in Appendix 2. The corrective actions, if implemented as described, meet the intent of the recommendations.

Background

SSBCI is a \$1.5 billion Treasury program that provides participating states, territories, and eligible municipalities with funds to strengthen Capital Access Programs and other credit support programs that provide financial assistance to small businesses and manufacturers. Capital Access Programs provide portfolio insurance for business loans based on a separate loan loss reserve fund for each participating financial institution. Other credit support programs include collateral support, loan participation, loan guarantee, and venture capital programs. Each participating state is required to designate specific departments, agencies, or political subdivisions to implement the programs approved for funding. The designated state entity distributes the SSBCI funds to various public and private institutions, which may include a subdivision of another state, a for-profit entity supervised by the state, or a non-profit entity supervised by the state. These entities use funds to make loans or provide credit access to small businesses.

Primary oversight of the use of SSBCI funds is the responsibility of each participating state. To ensure that funds are properly controlled and expended, the Act requires that Treasury execute an Allocation Agreement with the states, setting forth internal controls and compliance and reporting requirements, before allocating SSBCI funds. SSBCI disbursements to participating states are made in three parts: the first when the Secretary approves the state for participation, and the second and third after the participating state certifies that it has obligated, transferred, or expended at least 80 percent of the previous disbursement. In addition, the participating state is required to certify that it has complied with all applicable program requirements.

Montana's Participation in SSBCI

On July 1, 2011, Treasury approved Montana's application for participation in SSBCI and awarded a total of \$13.2 million.¹ On July 18, 2011, Treasury disbursed the first part of the State's allocation, \$4.3 million, and on December 8, 2011, disbursed a second part of \$4.3 million after the State certified that it had obligated over 80 percent of its first disbursement.² At the time of our audit in March 2012, Montana had obligated or expended approximately \$7.6 million, and had requested its third and final disbursement. The State reported on December 31, 2011, that approximately \$15,000 had been used to pay program administrative costs. The \$15,000 represents 0.17 percent of the \$8.6 million received from the first and second SSBCI disbursements.

Montana used the SSBCI funds awarded by Treasury to establish a loan participation program. The program is managed by the Governor's Office of Economic Development (GOED), with assistance from the Montana Department of Commerce and the Montana Board of Investments. Under the program, primary lenders partner with approved Community Development Financial Institutions (CDFI) or local economic development organizations with a Revolving Loan Fund (RLF) to make small business loans. The CDFIs and RLFs pre-qualify, package, and submit the loan applications to Montana to request SSBCI participation in the loan financing. Three funding scenarios are possible:

- SSBCI participation with the CDFI/RLF,
- SSBCI participation with a private financial institution; or
- a combination of SSBCI, CDFI/RLF, and bank financing.

Montana sends the loan application to the Montana Board of Investments, which performs a credit analysis of the borrower. The Board's analysis, recommendation, and the application are sent to the State's Loan Committee for a funding decision. One individual each from the Montana Department of Commerce, Montana Board of

¹ Rounded up from \$13,168,350.

² The actual first and second disbursements were each \$4,345,556.

Investments, GOED, and the private sector comprise the Committee. The Montana Department of Commerce drafts commitment letters for approved applications and sends them to the applicable CDFI or RLF for the required signatures. The commitment letters include the conditions under which the loans will be made to the borrowers.

The Department of Commerce releases funds to the CDFI or RLF, which then funds the State's portion of the lender loans. The Department of Commerce has a special revenue account maintained solely for the receipt and disbursement of funds received from Treasury, and maintains separate accounts for each participating CDFI and RLF. It also maintains the loan files and prepares the quarterly reports required by Treasury. The CDFIs and RLFs manage the loans, including collecting payments, and report to the Montana Department of Commerce every quarter.

Montana Misused \$2.73 Million on Half of the Loans Reviewed

Eight (or 50 percent) of the 16 loans judgmentally selected for review, with a total value of \$2.73 million of SSBCI funds, were used for business purposes that are prohibited under SSBCI Policy Guidelines. These included \$1.39 million for five loans involving passive real estate investments and \$1.34 million for three additional loans that refinanced prior debt from the same lender.

Additionally, we found that \$3,426 in personnel costs incurred for administering SSBCI funds was not allowable or allocable as it was not properly supported as required by OMB Circular A-87.

Montana Funded or Made Commitments to Five Loans for Passive Real Estate Investments

Loan proceeds for five (or 31 percent) of the 16 loans reviewed were to acquire passive real estate investments. The Act requires that proceeds from a loan enrolled in the SSBCI program be used for a "business purpose." Under SSBCI Policy Guidelines, a business purpose includes, but is not limited to, start-up costs, working capital, business procurement, franchise fees, equipment, and inventory, as well as the purchase, construction renovation, or tenant improvements of an eligible place of business that is not for passive real estate

investment purposes. The definition of business purpose specifically excludes activities that relate to acquiring or holding passive investments such as commercial real estate ownership. Although not defined in the Act, 12 U.S.C. § 4742 defines passive real estate as property acquired and managed by an eligible small business, through the proceeds of a loan or investment, that is held primarily for sale, lease, or other disposition.

As described below, Montana expended or committed approximately \$1.39 million on five loans in which the proceeds were used to acquire passive real estate investments. For each of these loans, lenders obtained assurances from borrowers that the loan purpose was not prohibited.

- In November 2011, Montana participated with a commercial bank in financing a \$171,000 loan to a real estate holding company for the purchase, refurbishing, and leasing of a commercial building. The State financed \$85,500 of the loan. Montana was provided a lease agreement between the borrower and its affiliated business, in which the business leased 59 percent of the building space. The borrower leased the remaining building space to an unaffiliated tenant. This was a passive real estate investment because the holding company (the borrower) did not intend to occupy the space, but planned to lease all of the space either to its own businesses or to other unaffiliated tenants.
- In August 2011, Montana participated with a commercial bank in a loan to a real estate holding company that was formed specifically for the purchase of a commercial building. The principal amount of the loan was \$370,000, of which the State purchased \$183,600. The purpose of the loan was to provide long-term financing for the purchase of a commercial building, which the holding company was intending to lease to its operating company, a medical supply and consulting business. Montana obtained a lease agreement between the holding company and the operating company, in which the operating company agreed to lease only a portion of the building from September 2011 to August 2016. This was a passive real

estate investment because the holding company (the borrower) planned to lease all of the space either to its own businesses or to other unaffiliated tenants.

- In December 2011, Montana made a commitment to participate in a loan to a real estate investment company. The principal amount of the loan was \$900,000, of which the State committed to purchase \$450,000 with SSBCI funds. The purpose of the loan was to finance the construction of a new facility that will be fully leased by the real estate investment company to an operating company with the same ownership. Because the borrower intends to lease the space to an operating company, rather than occupy the space itself, the investment is considered passive.
- In December 2011, Montana committed to participate with a commercial bank in a loan to a real estate holding company and its related operating company. The principal amount of the loan was \$445,000, of which the State committed to purchase \$222,500. Approximately half of the loan proceeds were to purchase the building and half were for improvements. The holding company intends to lease the building to the related operating company. Because the borrower intended to lease the space to an operating company, rather than occupy the space itself, the investment is considered passive.
- In February 2012, Montana committed to participate with a commercial bank in a loan to a real estate holding company. The principal amount of the loan was \$900,000, of which the State committed to purchase \$450,000. The purpose of the loan was to purchase a 45,000-square-foot strip mall, 53 percent of which would be leased to an operating company with common ownership and the remainder to eight other tenants. Because the borrower intends to lease the space to an operating company and other unaffiliated companies, this is considered a passive real estate investment.

While the purchase of real estate for passive investment purposes is clearly prohibited by SSBCI Policy Guidelines, Montana officials told us they sought consultation from Treasury program staff, who did not

provide definitive guidance. For example, in June 2011, a Treasury advisor responded via e-mail to an inquiry from a Montana official, advising that “if the borrower directly or as a member of an affiliated group will be the end-user of real-estate, the loan should be permissible. That the structure of the transaction calls for an affiliated holding company does not change the outcome” Later, according to Montana officials, Treasury referred them to SBA guidelines that permit eligible passive companies (EPCs) to receive funds as an exception to the passive real estate prohibition as long as they meet the following requirements, among others:

- The EPC must use the loan proceeds to acquire or lease, and/or improve or renovate real or personal property that it leases 100 percent to one or more operating companies.
- The operating companies must be a guarantor or co-borrower. If loan proceeds include working capital or fixed assets to be owned by the operating companies, the operating companies must be a co-borrower.
- The lease between the EPC and the operating companies must be in writing and must have a remaining term at least equal to the term of the loan.

Although the guidance provided by Treasury was not definitive, Montana moved forward with the loans without further clarification or concurrence from Treasury. Also, Treasury did not follow up with Montana to determine whether the State financed any passive real estate investments and, if so, whether such loans were in compliance with program requirements.

We did not find that the State’s misuse of the funds associated with passive real estate loans was intentional or reckless. Montana sought further guidance from Treasury before enrolling the loans and therefore, had attempted to ensure its compliance with program requirements. However, Treasury mishandled Montana’s inquiries and gave the State vague answers. Treasury’s recall of the conversation differed from Montana’s in that Treasury said it told the State “it would look to current SBA practice to inform SSBCI policy on passive real estate, but that SBA regulations were not a substitute for or

binding upon the SSBCI participants.” As a result, the State was not provided a definitive answer on the permissibility of the passive real estate loans. Treasury also did not document all of its consultation with the State, which would have provided evidence essential to determining whether the State should have known such use was prohibited.

Treasury should not have sent the State away to make its own determination as to whether the loans were permissible under the program. As early as January 2011, several other states had also questioned the permissibility of passive real estate loans. However, Treasury did not publish guidance on such loans until April 25, 2012, after the loans in question were made. The guidance, issued as Frequently Asked Questions, generally adopted the SBA 7(a) guidance described previously.

Montana Funded Three Loans for the Refinancing of Prior Debt

Three of the 16 loans reviewed (or 19 percent) were for loans, totaling approximately \$1.34 million, that were previously made to borrowers by the same financial institutions and that were not originally made under Montana’s OCSP. The Act prohibits the enrollment of a loan in CAP to a borrower that refinances a loan previously made to that borrower by the same financial institution lender or an affiliate.³ Treasury extended this prohibition to all SSBCI loans in the SSBCI Policy Guidelines. In addition, Treasury’s October 2011 SSBCI Policy Guidelines require states to obtain assurance from the financial institution lender affirming that “the loan has not been made in order to place under the protection of the approved state OCSP prior debt that is not covered under the approved state OCSP and that is or was owed by the borrower to the financial institution lender or to an affiliate of the financial institution lender.”

As described below, Montana enrolled three loans that were for prior debt that was not covered by the OCSP, and was owed by the borrower to the same financial institution. Montana collected assurances from lenders that the loan proceeds would not be used for

³ The Act also lists other prohibitions.

prohibited purposes. Only one of the loans provided additional capital to the borrower beyond the debt repayment.

- On September 22, 2011, Montana participated with a commercial lender in a revolving line of credit to a Montana sporting goods company. The principal amount of the loan was \$980,000, of which the State purchased \$490,000. The purpose of the loan was to pay off the working capital portion of a revolving line of credit that originally expired in July 2011. The lender extended the maturity date to September 1, 2011, through a Change in Terms, which gave the lender additional time to enroll the loan in the SSBCI program, which it did on September 22, 2011.
- On January 10, 2012, Montana used approximately \$410,000 in SSBCI funds to participate in an \$820,000 loan to an outdoor gear and clothing retailer. The loan proceeds were to be used to pay off \$650,000 in outstanding principal on a commercial note from the same lender and provide additional funds for improvements and reserves. The original note had a maturity date of January 1, 2017, which was later changed to March 1, 2012.
- On February 29, 2012, Montana purchased \$437,500 of an \$875,000 loan to an electric motor sales and repair business. The purpose of the loan was to refinance the majority of a \$916,000 loan maturing in March 2012. The prior note originated February 28, 2011, and a Change in Terms extended the maturity to March 31, 2012. A separate note in the amount of \$40,000 was to be issued by the commercial lender to cover the remainder of the financing.

The purpose of the new loans described above was to refinance existing debts that were owed to the same financial institutions and that were not already under the protection of a state OCSP. In our view, this purpose appears to be at odds with the meaning of the program's authorizing statute, which prohibits the enrollment of a loan to a borrower that refinances a loan previously made to that borrower by the financial institution lender or its affiliates. This purpose also contradicts the SSBCI Policy Guidelines that were in place at the time

the loans were made, which prohibit enrollment of a loan that replaces prior debt to the same lending institution that was not made under an approved state OCSP. In addition, only one of the loans cited above provided additional capital to the borrower beyond the debt repayment.

However, we did not find that the State's misuses of funds associated with the refinancings were intentional or reckless. Montana sought general guidance from Treasury before enrolling the loans, and therefore had attempted to ensure its compliance with program requirements. Specifically, before the three loans were made in April 2011, Treasury communicated to Montana officials that unpaid balances on term loans and lines of credit that had reached maturity would qualify for SSBCI financing. In addition, prior to completion of the second loan, Montana officials again sought clarity regarding the refinancing prohibition. Treasury responded to Montana's inquiry by informing it that loans would be considered eligible for refinancing as long as there was new and complete underwriting, and the prior notes had matured. This guidance was subsequently formalized in April 2012.

We found that Treasury attempted to clarify the Act's prohibition by defining "refinancing," which is not defined in statute. Treasury's view is that the statutory prohibition on refinancing the same lenders' loans pertained only to existing debt that had not yet matured. Limiting the effect of the statutory prohibition allowed lenders to refinance their own loans immediately after they matured (or, as shown in the examples above, within months of the loans maturing) as long as new underwriting had occurred. Treasury officials told OIG that in these instances, using SSBCI to refinance a loan with the same lender was "re-funding" of the loan, and a permitted use. OIG found no references in the Act or in Treasury's SSBCI Policy Guidelines to "re-funding."

In defining refinancing, Treasury officials said they consulted with Federal regulators and attempted to apply a definition that was consistent with the banking industry's definition. While this was an important step to understand how the banking community views refinancings, we do not believe it provided Treasury a sufficient basis

for determining what the statute was intended to allow. Treasury told us that its program officials and attorneys determined that a literal interpretation of the “no refinancing” rule could lead to impractical, even absurd results, and thus applied rules of construction and analogies from other programs to arrive at an interpretation that made sense. However, Treasury has not been able to provide evidence of formal legal opinion to show that this was the intended application of the statute. Regardless of the interpretation of the statute, the three loans did not appear to benefit the borrowers in any way, and therefore, appeared to be inappropriate uses of SSBCI funds.

Administrative Costs Charged to SSBCI Were Generally Supported, but Personnel Costs Were Not Allowable or Allocable

We determined that \$3,426 out of \$15,148 in administrative costs charged against SSBCI funds as of December 31, 2011, was not allowable or allocable to the program. Participating states must follow cost standards for state and local governments as prescribed in OMB Circular A-87. According to the OMB circular, only actual expenses incurred that are allowable, reasonable, and allocable can be considered chargeable costs.

Although the personnel costs charged to the SSBCI program appeared reasonable, we determined that they were not allowable and allocable because the Montana Department of Commerce’s Business Resources Division, which oversees the SSBCI program, did not maintain time sheets to track actual time spent working on the SSBCI program. In addition to the SSBCI program, the Business Resources Division oversees the State’s Wood Product Industry Recovery and Stabilization Program (WPIRS). The Business Resources Division allocates 20 percent of its personnel costs (including salaries and benefits) to SSBCI and 80 percent to WPIRS. Montana officials explained that these ratios were determined by estimating the time that existing staff would expend on the SSBCI and WPIRS programs, and provided a departmental budget supporting the allocations. Therefore, the actual rate at which staff allocated their time could not be established. Because Montana did not account for all administrative costs correctly, Treasury should disallow \$3,426 unless the State can provide adequate supporting documentation.

Treasury Guidance Allows Use of SSBCI for Existing Debt

SSBCI Policy Guidelines prohibit enrollment of a loan that replaces prior debt to the same lending institution and that was not made under an approved state OCSP. In addition, Section 3005(e)(7)(A)(iii) of the Act states that under this program, lenders “shall not allow the enrollment of a loan to a borrower that is a refinancing of a loan previously made to that borrower by the same financial institution lender or an affiliate of the financial institution lender.” The use of “shall not” suggests that if a purpose or effect of the loan is to refinance an existing loan, SSBCI funds cannot be used for that loan.

Aware of the statutory prohibition, on April 25, 2012, Treasury issued “Frequently Asked Questions” addressing the use of SSBCI funds for existing debt. The new guidance stated that financial institution lenders may use SSBCI funds to support a new extension of credit that repays the amount due on a matured loan or line of credit when all the following conditions are met:

- the new loan or line of credit includes the advancement of new monies to a small business borrower (excluding closing costs);
- the new credit supported with SSBCI funding is based on a new underwriting of the small business’s ability to repay and a new approval by the lender/investor;
- proceeds from the new credit will only be used to satisfy the outstanding balance of a loan or line of credit that has already matured or otherwise reached the end of its term, and the prior debt was used for an eligible business purpose, as defined by the SSBCI Policy Guidelines; and
- the new credit has not been extended for the sole purpose of refinancing existing debt owed to that same financial institution lender.

According to Treasury officials, if these conditions are met, the transaction constitutes “re-funding” of existing debt, and not refinancing, which is prohibited by the Act. We question Treasury’s basis for the change as we were informed that the revised guidance was written without any formal legal analysis of possible conflicts with the Act’s statutory prohibition on using SSBCI funds to refinance

existing debt, or with a rationale on why the change was needed. In addition, it is not clear why Treasury revised its guidance without addressing the issue of placing an existing debt with the same lender under the protection of an OCSP when the loan was not previously made under an OCSP.

Treasury also issued the revised guidance without putting into place additional controls to prevent the misuse of funds. For example, the guidance would authorize participating states to use SSBCI funds to “re-fund” debt from the same lenders as long as some portion of the loan proceeds would be used for purposes other than paying off the existing debt. This means that theoretically 99 percent of the loan could be used to pay off prior debt with only 1 percent of the proceeds providing additional capital to the borrower. Treasury officials have also interpreted the guidance to permit the re-funding to occur in the months preceding loan maturity, even though its guidance states that doing so would constitute a refinancing of the debt. The new guidance would also allow states to extend SSBCI funds to support loans that have a history of non-performance, which may not be an appropriate use of Federal funds.

Most importantly, we believe that permitting existing debt to be re-funded is inconsistent with the Act’s purpose to increase small business credit and create jobs, and is a transaction that primarily benefits lenders and not small business borrowers. Allowing states to use their SSBCI disbursements to re-fund existing loans, with no limits on the amount that can be re-funded, may result in little new capital being extended to small businesses and may bring prior debt (including non-performing debt) under the protection of the SSBCI program. For these reasons, Treasury should prepare a legal opinion determining whether re-funding transactions are permissible and to demonstrate that such transactions would benefit borrowers and further the objectives of the SSBCI program.

Recommendations

We recommend that the Deputy Assistant Secretary for Small Business, Housing, and Community Development:

- 1) Notify participating states that loans for passive real estate are considered a misuse of funds and encourage them to review their loan enrollments to ensure compliance with guidance that was in place at the time the loans were made.

Management Response

Treasury agreed with this recommendation. Management said it will encourage participating states to review their loan enrollments for compliance with guidance that was in place at the time the loans were made.

OIG Comments

We consider Treasury's action to be responsive to our recommendation.

- 2) Provide a clear and rigorous analysis documenting how Treasury concluded that some refinancing of existing debt from the same lender, or "re-funding," is consistent with the statutory language, or amend the program procedural guidance to remove that possibility.

Management Response

Treasury accepted this recommendation. Management stated that it will provide OIG with thorough documentation of the analysis it performed in support of SSBCI policy on "new extensions of credit for the purpose of satisfying a prior obligation to the same financial institution lender or an affiliate."

OIG Comments

During the audit, Treasury was unable to provide evidence that it prepared a legal analysis or opinion, which would allow some refinancing of existing debt from the same lender, and gave conflicting accounts of whether a legal analysis of the issue was performed. In a September 14, 2012, meeting with the OIG Treasury officials stated that a legal analysis is now underway and will be provided to the OIG.

Providing a legal opinion on this issue will meet the intent of our recommendation.

- 3) If the legal analysis concludes that re-fundings are permissible, establish controls to ensure that the borrowers are the primary beneficiaries from re-fundings.

Management Response

Treasury stated that “if appropriate,” it will establish controls to clarify that borrowers would be the primary beneficiaries.

OIG Comments

We consider Treasury’s action to be responsive to our recommendation.

- 4) Inform states that, for funds used or committed from the date of this report, the OIG will not accept testimonial evidence as proof that states secured guidance from Treasury that their intended use of funds met program requirements.

Management Response

Treasury accepted this recommendation and management said it will inform participating states that OIG will not accept testimonial evidence to establish a proper use of SSBCI funds.

OIG Comments

We consider Treasury’s action to be responsive to our recommendation.

- 5) Require that SSBCI program officials immediately establish a procedure to document communication with participating states and designated entities regarding the application of program requirements.

Management Response

Treasury agreed with this recommendation and management said it will implement a procedure for documenting its communications with participating states.

OIG Comments

We consider Treasury's action to be responsive to our recommendation.

- 6) Require Montana to provide documentation supporting the \$3,426 in administrative expenses. If the State is unable to do that, disallow the entire \$3,426.

Management Response

Treasury stated that Montana is unable to provide the documentation for those costs, and Treasury will disallow them.

OIG Comments

We consider Treasury's action to be responsive to our recommendation.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the evaluation. If you wish to discuss the report, you may contact me at (202) 622-1090 or Lisa DeAngelis, Audit Director, at (202) 927-5621.

/s/

Debra Ritt

Special Deputy Inspector General for

Office of Small Business Lending Fund Program Oversight

Appendix 1: Objectives, Scope, and Methodology

The objective of our audit was to test the participating state's compliance with program requirements and prohibitions to identify reckless or intentional misuse. As of March 5, 2012, Montana had used approximately \$7.6 million in Federal Funds through its participating program, the Montana State Small Business Credit Initiative.

The scope of our audit included all SSBCI small business loan enrollment activity in the program from Montana's approval as an SSBCI participant on July 1, 2011, to Montana's request for disbursement of its third installment on March 5, 2012. During this period, Montana SSBCI had approved SSBCI funds for participation in 29 loans totaling approximately \$7.6 million.

We reviewed program policies, procedures, and other written guidance provided by Montana SSBCI in order to understand and assess the following:

- Procedures in place to administer the program and ensure compliance with the requirements of the Act and associated Treasury guidelines.
- Accounting and reporting processes, including methodologies for calculating and reporting administrative expenses.

In addition, we judgmentally selected a sample of 16 loans enrolled in Montana SSBCI as of March 5, 2012 for review. During March and April, we conducted off-site reviews of each of the 16 loans from our offices in Washington, D.C. We compared the documentation in the loan files to the specific requirements and prohibitions of the Act and associated Treasury guidelines. We also interviewed officials from the Federal Reserve Board and the Federal Deposit Insurance Corporation to determine the importance of reviewing the payment history of prior debt when approving loan refinancings.

We conducted our audit between February 2012 and June 2012 in accordance with Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence

obtained to address our audit objectives provides a reasonable basis for our findings and conclusions.

Appendix 2: Management Comments



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 21, 2012

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Ritt:

Thank you for the opportunity to review your draft report entitled *Montana's Use of Funds Received from the State Small Business Credit Initiative* (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

The Report identifies instances of Montana's non-compliance with State Small Business Credit Initiative (SSBCI) program requirements. In response, with your consent, Treasury transmitted a copy of the Report to Montana program officials on August 2, 2012. Treasury directed Montana to submit a written reply describing its efforts to bring Montana's Loan Participation Program into conformity with SSBCI use of funds requirements. Further, in accordance with Recommendation 6 of the Report, Treasury directed Montana to provide documentation of certain claimed administrative expenses, along with a description of any steps taken to remedy the lack of adequate controls noted in the Report. Montana's reply, enclosed, articulates in detail the measures Montana has taken and plans to take in order to address the Report's concerns. The reply also states that Montana will be unable to provide documentation of \$3,426 in administrative costs, so Treasury will disallow those expenses.

The Report also notes several areas in which the Office of the Inspector General's (OIG) audit work would have been aided by additional written documentation of SSBCI activities. Treasury values the role of OIG under the Small Business Jobs Act of 2010 in auditing the use of SSBCI funds. Accordingly, Treasury accepts all of the Report's recommendations regarding enhanced written documentation. In response to Recommendation 4, Treasury will inform Participating States that OIG will not accept testimonial evidence to establish a proper use of SSBCI funds. In response to Recommendation 5, Treasury agrees to implement a procedure for documenting its communications with Participating States. Finally, in response to Recommendations 2 and 3, Treasury will provide OIG with thorough written documentation of the analysis it performed in support of SSBCI's policy on new extensions of credit for the purpose of satisfying a prior obligation to the same financial institution lender or an affiliate. If appropriate, Treasury will establish controls to clarify that borrowers should be the primary beneficiaries from such activity.

Treasury has begun a review of the loans the Report identifies as "misuse" and will carefully consider whether additional action is warranted. Treasury's preliminary review supports Montana's statement that state program officials "attempted to accommodate all submitted SSBCI loan applications within the intent and spirit of the Treasury's SSBCI program." Treasury will continue to review these loans and will make an ultimate determination based on an evaluation of the timing of Montana's actions and the

advice Montana received from Treasury at the time the loans were made, Montana's response to the Report concerning subsequent remedial measures, and the criteria set forth in the Allocation Agreement.

More generally, Treasury agrees that all Participating States could benefit from a reminder about proper use of SSBCI funds in the context of passive real estate. Therefore, in response to Recommendation 1, Treasury will encourage Participating States to review their loan enrollments for compliance with guidance that was in place at the time the loans were made.

Last, we have also enclosed additional technical comments on wording in the report.

Thank you once again for the opportunity to review the Report. Treasury looks forward to our work together throughout the course of the SSBCI program.

Sincerely,

A handwritten signature in black ink, appearing to read "Don Graves, Jr.", written in a cursive style.

Don Graves, Jr.
Deputy Assistant Secretary for Small Business,
Community Development, and Affordable Housing
Policy

Enclosures

OFFICE OF THE GOVERNOR
STATE OF MONTANA

BRIAN SCHWEITZER
GOVERNOR



JOHN BOHLINGER
LT. GOVERNOR

August 15, 2012

Mr. Don Graves, Jr.
Deputy Assistant Secretary for Small Business, Community Development and Housing
Policy
United States Department of Treasury
1500 Pennsylvania Ave., NW
Room 2313
Washington, DC 20220

Dear Mr. Graves:

We appreciate receiving the draft report titled "*Montana's Use of Funds Received from the State Small Business Credit Initiative*" enclosed with your letter of August 2, 2012. We understand that this draft report is from your Department's Office of Inspector General (OIG) and is reviewing the activities of the Treasury Department in implementing the State Small Business Credit Initiative (SSBCI) using the Montana SSBCI efforts as a framework, given the speed by which Montana ramped up the SSBCI program in the state.

We appreciated learning from the beginning of the draft report, in the "Results in Brief" section, that as the OIG reviewed the Department's activities as they related to Montana, the OIG did not find any loan-related shortcomings on the part of Montana because Montana had "sought guidance from Treasury before enrolling the loans."

Before addressing the three specific items listed in your letter dated August 2, 2012, we would like to emphasize the importance of the SSBCI funding to the small businesses of the State of Montana and the assistance provided by Treasury SSBCI program staff in helping to minimize the impacts of the recession on some of our small businesses.

The State Small Business Credit Initiative Act of 2010 states the following in the opening paragraph:

"many companies, particularly small businesses have found it increasingly difficult to get new loans to keep their businesses operating and banks are tightening requirements or cutting off existing lines of credit even when the businesses are up to date on their loan repayments;"

Once we learned of the opportunity to create a small business credit support program in Montana with SSBCI funds, our overriding objective was to get the funding to Montana small businesses as quickly as possible where it could do the most good. Our team immediately went to work in putting together the information to design a program that would work in Montana, we applied to your agency for participation in the program, received your approval for the program, received our first allocation, and implemented the program as expeditiously

STATE CAPITOL • P.O. BOX 200801 • HELENA, MONTANA 59620-0801
TELEPHONE: 406-444-3111 • FAX: 406-444-5529 • WEBSITE: WWW.MT.GOV

as possible. We did not want to take so long to design and implement the program that its purpose would no longer exist.

With the objective of timeliness in mind, we were very aware and continue to be aware of the need to implement and administer the program in compliance with the regulations issued for its proper operation. As we started the program, we instructed our banking, business, and minority communities about the program to the best of our ability. We worked closely with SSBCI program staff at Treasury and sought guidance when needed. Our team consists of many members who have been involved in small business lending for significant lengths of time and understand some of the ways that implementation can be most effective. Our intent has always been to support our small business sector and improve the economy in Montana within the regulations of the Treasury SSBCI program and consistent with Treasury's recommendations.

Your staff is to be commended for working with us to implement our program so we could invest these funds effectively and quickly. We believe that we have made a difference with this program in Montana and we believe that many Montana businesses have been helped through some difficult situations with this funding. One of the significant benefits of our program is that the funds will eventually revolve through the local Community Development Finance Institutions/Revolving Loan Funds (CDFI/RLF) to many more Montana small businesses, helping them to succeed in the decades to come.

Request #1 - letter of August 2:

Describe any previous, current, or planned efforts to bring the program rules for the Montana SSBCI Loan Participation Program into conformity with the FAQ on passive real estate investment.

Previous and Current Efforts:

The Montana SSBCI Loan Committee reviews all loan applications and also reviews staff analysis to ensure compliance with FAQ guidelines. We have always required a new credit analysis be submitted by the lender and CDFI/RLF along with the Montana SSBCI Program loan application. The internal staff analysis of the credit also ensures the borrower has the strength and ability to repay the loan, in addition to complying with the FAQ guidelines. The loan committee has turned down and returned loan applications for potential borrowers who did not demonstrate a "need" for the money, as required by the Treasury SSBCI program.

Prior to the issuance of the FAQ's released on April 25, 2012, the Montana SSBCI (MT SSBCI) team frequently asked Treasury for assistance and direction in the implementation of our MT SSBCI loan participation program. In addition, we regularly sent emails to our CDFI/RLFs to keep them informed of the changes to and clarifications of the MT SSBCI participation program.

After receiving approval from Treasury to move forward with the MT SSBCI loan participation program, we conducted meetings throughout the state explaining the program and encouraging applications. Our marketing was so successful, that within five months ending December, 2011, 30 applications were submitted. Within the next three months ending March, 2012, 34 additional applications were received. Due to the length of time it took to get clarification on some issues, many of the matured loans held by the applying

lenders had to be extended so they would not appear to be past due. As a result, it may have appeared that the borrower was/had a problem credit, when, in fact, the loan was extended due to the time it took for clarification of questions concerning Treasury's SSBCI program. Banking regulations require any loan 90 days or more past due to be put on nonaccrual. Bank regulators then view the loan as a problem credit. The lenders extended these "good" loans while waiting for the MT SSBCI staff to complete its analysis of the applications. In some cases, the borrowers and lenders could not wait that long and withdrew their applications.

- On March 21, 2012, after a conference call with Treasury, MT SSBCI staff sent an email to all participating CDFI/RLFs outlining the highlights of the conference call and informed the CDFI/RLFs that MT SSBCI was suspending the processing of all real estate secured SSBCI applications until Treasury issued their final guidelines. The email suggested that Treasury was considering adopting SBA guidelines relative to passive income properties. In addition, clarification was given concerning the required loan documents that were necessary to refinance a fully matured loan held by the applying lender.
- On April 20, 2012, MT SSBCI staff sent to all participating CDFI/RLFs additional clarification from Treasury on passive real estate.
- On June 14, 2012, MT SSBCI staff forwarded to all CDFI/RLFs Treasury's FAQ, which was considered to be the final policy guidance for the SSBCI program. In addition to sending Treasury's FAQ, MT SSBCI also sent Treasury's response to the questions submitted to Treasury on May 5, 2012 requesting additional clarification on a number of specific topics.

As a result of the April 25 FAQ guidance, MT SSBCI staff reviewed all of our unprocessed applications to see if any of the applications we had received would be ineligible. Some were found to be ineligible and were sent back to the submitting CDFI/RLF as ineligible for funding.

We have added items to the MT SSBCI commitment letters: (1) requiring submission of executed leases between the eligible passive company (EPC) and the operating company (OC) prior to release of funds, (2) requiring the lease between the EPC and OC be for the term equal to or greater than the term of the loan in which SSBCI funds have been used, including any renewals and/or extensions to the lease and (3) we included the additional certifications needed to comply with the April 25, 2012 FAQ in the commitment letter.

With reference to the five loans considered to be passive real estate investments in the OIG report, MT SSBCI did not release any MT SSBCI funds until there was assurance from the CDFI/RLF and the lender that the 50% or greater occupancy criteria was met by the OC. In one of the five subject cases, a second OC was in the process of being formed by the borrower within the allowable 12 month period, which would then make the loan eligible under Treasury's SSBCI April 25, 2012 FAQ.

The MT SSBCI loan committee required the five subject loans comply with the anticipated April 25, 2012 FAQ even before the FAQ was formally issued. In some cases, both the EPC

and OC were co-borrowers. We attempted to accommodate all submitted SSBCI loan applications within the intent and spirit of the Treasury's SSBCI program. At no time did we entertain a MT SSBCI loan application that was clearly outside the guidance provided.

None of the EPCs were "Investment Firms;" they were just "mom and pop" owned real estate holding companies from which their commonly owned OC would lease space. In every one of the five listed loans, the EPC was a single asset real estate holding company. All of the EPCs were formed upon the advice of the OC's accountant, primarily for tax purposes.

One of the five subject loans was for the formation of a new business and creation of new jobs, another of the subject loans was for the expansion of an existing business from out of their home into their own facility and two of the subject loans were for purchases of facilities replacing properties they were renting from other owners. All of these five loans were made within the intent and spirit of Treasury's SSBCI program. At the present time, two of the five loans have been funded with MT SSBCI money. The remaining three loans have not made application for release of funds. None of the EPC loans were for the purchase or construction of speculative real estate, which would not qualify under the SSBCI program.

Planned Efforts:

At the MT SSBCI Executive Committee meeting held on August 7, 2012, the Committee discussed and agreed to include the April 25, 2012 FAQ as part of the MT SSBCI loan policy. In addition, the Executive Committee voted to add to the commitment letter a requirement that a copy of any third-party leases be included in the required documents in addition to the original lease between the eligible passive company and the operating company before funds will be released.

In an effort to bring the MT SSBCI participated loans funded prior to the issuance of the April 25, 2012 into compliance, staff will contact the CDFI/RLFs to ensure they have a lease between the EPC and OC for 100% of the facility and subleases for third-party tenants, if any. It will be difficult to get guarantees or additional certifications after the fact, however, staff will try.

Request #2 - letter of August 2:

Describe any previous, current, or planned efforts to bring the program rules for the Montana SSBCI Loan Participation Program in to conformity with the FAQ on new extensions of credit for the purpose of satisfying a prior obligation to the same financial institution or its affiliate.

Previous and Current Efforts:

The MT SSBCI loan committee reviews all loan applications and staff analysis to ensure compliance with FAQ guidelines. We have always required a new credit analysis be submitted by the lender and CDFI/RLF along with the MT SSBCI loan application. In addition, MT SSBCI does its own analysis of the credit to ensure the borrower has the strength and ability to repay the loan, in addition to complying with the FAQ guidelines. The loan committee has turned down and returned loan applications for potential borrowers who

did not demonstrate a “need” for the money, as required by the Treasury’s SSBCI program. We included in the original MT SSBCI loan application, that all lenders designate the loan to be considered as: pass, watch, substandard, or doubtful. All applications considered by our loan committee were rated “pass”. One application listed the loan to be considered a “watch” and was returned to the CDFI/RLF as unacceptable.

- On March 21, 2012, after a conference call with Treasury, we sent an email to all participating CDFI/RLFs outlining the highlights of the conference call and provided clarification to the CDFI/RLFs concerning the required loan documents that were necessary to refinance a fully matured loan held by the applying lender.
- On June 14, 2012, the MT SSBCI program forwarded to all CDFI/RLFs the final FAQ, which we considered to be the final policy guidance for the Treasury’s SSBCI program. In addition to sending Treasury’s FAQ, MT SSBCI also sent Treasury’s response to the questions submitted to Treasury on May 5, 2012 requesting additional clarification on a number of specific topics, including financing of existing loans held by the lender.

As a result of the April 25, 2012 FAQ guidance, we reviewed all of our unprocessed applications to see if any of the applications we had received would be ineligible. Some were found to be ineligible and were sent back to the submitting CDFI/RLF as ineligible for funding.

A complete loan analysis by the lender and CDFI/RLF must accompany every application to ensure that a new credit decision was made for the new loan. Consideration of existing lender loans, without a full and complete credit analysis by the lender is not acceptable.

We are now including in the MT SSBCI commitment letter a requirement that lenders send copies of matured loan documents for all loans that were paid through the new credit in which MT SSBCI funds were used. In addition, for all lender held debt to be paid off with MT SSBCI money, the lender must provide to the MT SSBCI program the original use of funds to ensure the original use of loan proceeds qualify under the Treasury’s SSBCI program.

Planned Efforts:

Our program will revisit each loan committed and approved by MT SSBCI, but not yet funded, that includes any payoff of a matured loan held by the applying lender to ensure compliance with the FAQ.

Request #3 - letter of August 2:

Provide the documentation requested in Recommendation 5 of the Report with respect to administrative expenses and a description of any previous, current, or planned efforts to bring program rules for the Montana SSBCI Loan Participation Program in to conformity with Section 4.2 of the Allocation Agreement.

The practice for the Montana Department of Commerce, Business Resources Division had been to estimate the time that staff spends on programs and then to budget and charge accordingly. As a result, the Division had not maintained, until the time this was brought to

our attention, program-specific time sheets to track actual personnel time spent administering the MT SSBCI program. Based upon conversations with the Treasury Office of the Inspector General that occurred during the ongoing audit, we have now developed a program specific time sheet and put it to use as of July 1, 2012, the beginning of the new state fiscal year. Based on the findings and recommendation in the audit report, Montana is using the adopted timesheet for MT SSBCI activity to ensure compliance with the requirements of OMB Circular A-87. This will help Montana track actual personnel expenses incurred, which will then be considered chargeable costs to the MT SSBCI program as they will be allowable and allocable. We note that the audit report did not challenge the reasonableness of the costs.

Thank you for giving us the opportunity to respond to your questions and we look forward to working with your agency in the future to further improve Montana's small business climate.

Sincerely,

A handwritten signature in blue ink, appearing to read "Evan Barrett", with a stylized flourish at the end.

Evan Barrett
Chief Business Development Officer

Appendix 3: Major Contributors

Debra Ritt, Special Deputy Inspector General

Lisa DeAngelis, Audit Director

Clayton Boyce, Audit Director

John Rizek, Supervisory Auditor

Andrew Morgan, Auditor

Safal Bhattarai, Auditor

Anita Visser, Referencer

Appendix 4: Report Distribution List

Department of the Treasury

Deputy Secretary

Office of Strategic Planning and Performance Management

Risk and Control Group

Office of Management and Budget

OIG Budget Examiner

United States Senate

Chairman and Ranking Member

Committee on Small Business and Entrepreneurship

Chairman and Ranking Member

Committee on Finance

Chairman and Ranking Member

Committee on Banking, Housing, and Urban Affairs

United States House of Representatives

Chairman and Ranking Member

Committee on Small Business

Chairman and Ranking Member

Committee on Financial Services

Government Accountability Office

Comptroller General of the United States