



U.S. Department of Agriculture

Office of Inspector General



Review of Lender with Business and Industry Guaranteed Loan in Louisiana

**Audit Report 34099-12-Te
December 2009**



DATE: December 29, 2009

REPLY TO

ATTN OF: 34099-12-Te

TO: Dallas Tonsager
Under Secretary
Rural Development

Judith A. Canales
Administrator
Rural Business-Cooperative Service

THROUGH: John Purcell
Director
Financial Management Division

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Review of Lender with Business and Industry Guaranteed Loan in Louisiana

Summary

The Rural Business-Cooperative Service (RBS) is an agency within the Department of Agriculture's (USDA) Rural Development mission area. RBS guarantees loans made by private lenders to borrowers in the nation's rural areas. Loans guaranteed by the Business and Industry (B&I) Guaranteed Loan Program are intended to improve the economic and environmental climate in rural communities by supporting businesses.

In a letter dated March 6, 2007, the RBS National Office requested that USDA's Office of Inspector General (OIG) review the loan portfolio of one of its lenders because of the elevated default rates of its loans.¹ This report presents the results of our review of 1 of 4 loans from the lender's portfolio of 34 loans. The borrower for this loan is based in Louisiana. On December 22, 2003, the lender obtained a loan note guarantee of 80 percent on a \$4 million loan. Loan funds were approved to refinance debt, pay off accounts payable, provide working capital, provide contingency and reserve funds, and cover closing fees and costs.

OIG found no misrepresentation or negligent servicing by the lender—the lender disclosed all required information to the RBS State office, and all conditions upon which the loan was approved were met by the date of loan closing or within an acceptable timeframe.

¹ As of March 31, 2007, the lender had 34 B&I guaranteed loans for about \$92.6 million, of which 15 were either in default or liquidation, with a potential loss to the Government of about \$30.9 million. OIG received information concerning the March 31, 2007, portfolio from the Farm Credit Administration.

Although the loan reviewed was made before the passage of the American Recovery and Reinvestment Act of 2009 (Recovery Act) and had no involvement with the Recovery Act, we identified two weaknesses in the B&I Guaranteed Loan Program that could put funds provided by the Recovery Act at risk.² First, RBS allows the use of leasehold properties to be used as loan collateral. Second, the Recovery Act prohibits borrowers from using loan funds to facilitate gambling operations, whereas current B&I regulations allow a borrower to have income from such operations to be no more than 10 percent. We made recommendations to strengthen controls relating to these areas in a Fast Report issued to RBS on June 18, 2009.

Background

RBS operates loan programs intended to assist in the business development of the nation's rural areas and promote the employment of rural residents. The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities. These loans are not intended for borrowers in substandard financial circumstances.

To accomplish its mission, RBS, through the B&I Guaranteed Loan Program, which is administered by the various Rural Development State offices, guarantees loans made by private lenders. A lender provides the loan to the borrower, and Rural Development guarantees repayment of a percentage of the loan if the borrower defaults. The guarantee allows the lender to have additional capital available for other loans.

Regulations require lenders to be responsible for loan origination, servicing the loan, and taking servicing actions of a prudent lender. Regulations also state that a guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation of which a lender or holder has actual knowledge at the time it becomes such a lender or holder or which a lender or holder participates in or condones.³

As of March 31, 2007, the lender had 34 B&I guaranteed loans for approximately \$92.6 million—15 of the 34 loans were either in default or in liquidation, with a potential loss to the Federal Government of approximately \$30.9 million.

Objective

The objective of our review was to determine if the lender complied with program regulations.

Scope and Methodology

This review concentrated on the lender RBS requested that we review and one of its B&I guaranteed loans to a borrower operating in Louisiana. To accomplish the objective, we reviewed regulations, policies, and procedures that provide guidance for the making, servicing, and liquidating of B&I guaranteed loans. We reviewed supporting documentation

² The Recovery Act provided over \$2.9 billion for guaranteed loans to the B&I Guaranteed Loan Program. On March 20, 2009, Rural Development was authorized to begin distributing these funds.

³ Title 7, *Code of Federal Regulations* (CFR), section 4279.72(a), dated January 1, 2003

to verify the accuracy of the lender's applications, certifications, disbursement of funds, and other loan activities. Additionally, we reviewed documentation provided by RBS, and the Safe and Soundness review⁴ conducted by the Farm Credit Administration on the lender. Specifically, we reviewed the Louisiana Rural Development State office's loan files, and the lender's files. We interviewed State office personnel, the packager of the loan, and received legal guidance from the Office of the General Counsel.

In March 2008, we issued subpoenas to obtain more detailed documentation from the lender and the loan packager. Throughout the subpoena process, we corresponded with the lender's general counsel via conference calls and e-mail. Fieldwork was performed from August 2007 to June 2009. In June 2009, OIG was notified that the lender filed foreclosure in Federal court, which resulted in the U.S. Marshals seizing the leasehold property used as collateral.

The loan reviewed was made before the passage of the Recovery Act and had no involvement with the Recovery Act. However, since this law was passed during the course of our review (February 2009), we expanded our analysis of this loan to determine if any of the conditions identified put Recovery Act funds at risk. We did not perform tests to determine if the agency was at risk for significant losses due to these concerns regarding Recovery Act funds. Therefore, we have no conclusions on the overall extent of potential losses that are, or may be, occurring in the program. We plan to examine these controls through a more extensive assessment of program activities related to the Recovery Act.

We conducted this performance review in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the review 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 provides a reasonable basis for our findings and conclusions based on our audit objectives.

Finding 1: Control Weaknesses Provide Opportunities for Guarantees on Ineligible Loans

We identified two weaknesses in the B&I Guaranteed Loan Program that could put Recovery Act funds at risk. These risks related to the use of leasehold property as collateral and gambling revenue. The concerns we identified are detailed as follows.

Leasehold Property as Collateral

According to Federal regulation⁵ and the Recovery Act, leasehold properties continue to be allowed as collateral for a guaranteed loan. Prior to the Recovery Act, we found an instance where a lender received an RBS loan note guarantee on a \$4 million loan and presented leasehold property as the primary collateral for the B&I loan. In this instance, the borrower defaulted on the guaranteed loan, the lessor took possession of the leasehold property, and RBS was left with no collateral to offset its loss caused by the borrower's default on the guaranteed loan. RBS officials explained that the Recovery Act does not prohibit the agency

⁴ The review primarily focused on the lender's asset quality, portfolio management, capital adequacy, earnings (relative to capital accretion), and liquidity. It also included a review of management areas such as planning, internal controls, and information systems as they related to the lending function.

⁵ 7 CFR 4279.113(d), dated January 1, 2003, and 7 CFR 4279.113(d), dated January 1, 2009

from accepting leasehold property as collateral; however, they stated that leasehold property should not be accepted as the primary collateral for the loan.

Gambling Revenue

According to B&I regulations,⁶ applicants are ineligible for a guaranteed loan if they derive more than 10 percent of their annual gross income from gambling operations. The Recovery Act⁷ prohibits borrowers from using loan funds to facilitate gambling operations. In addition, we found that applicants who are involved or affiliated with gambling operations can conceal that their revenue is derived from gambling and thus still have an opportunity to be considered eligible for a B&I guaranteed loan. We discussed this concern with RBS officials who concurred that the agency should strengthen its controls to ensure the requirements of the Recovery Act are met.

We discussed these concerns with RBS officials on June 4, 2009, and made the following recommendations. The agency responded to these recommendations on June 29, 2009, which is posted on our website.

Recommendation 1

Prohibit the use of leasehold properties as collateral for Recovery Act loans.

Agency Response

RBS did not concur with this recommendation and stated that using leasehold properties as collateral is fully recognized as an acceptable business practice in the lending community. The agency believes that it is providing sufficient guidance to ensure effective internal controls on leasehold interests taken as collateral.

OIG Position

We accept management decision for this recommendation. Our decision is based on the fact that we did not perform testing of guaranteed loans and cannot reference errors or mistakes attributable to this identified weakness. We plan to examine this control as we continue our assessment of program activities related to the Recovery Act.

Recommendation 2

Require all lenders and borrowers that receive Recovery Act funds to certify that none of the borrower's income is derived directly or indirectly from gambling operations.

Agency Response

RBS did not concur with this recommendation because, from the agency's perspective, it was excessive and it unnecessarily added to the burden of the agency and the public. Further, the action was unnecessary because the agency's policy is to not fund projects with income derived from gambling. The agency stated that all loan commitments will

⁶ 7 CFR 4279.114(h), dated January 1, 2003

⁷ The American Recovery and Reinvestment Act of 2009, section 1604, dated January 6, 2009. This act was signed into law by the President of the United States on February 17, 2009.

be conditioned so that Recovery Act funds are disbursed only for purposes authorized by the statute.

OIG Position

We accept management decision for this recommendation. Our decision is based on the fact that we did not perform testing of guaranteed loans and cannot reference errors or mistakes attributable to this identified weakness. We plan to examine this control as we continue our assessment of program activities related to the Recovery Act.