



U.S. Department of Agriculture
Office of Inspector General
Washington, D.C. 20250



DATE: October 16, 2009

REPLY TO

ATTN OF: 34703-1-Te

TO: Dallas Tonsager
Under Secretary
Rural Development

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

SUBJECT: American Recovery and Reinvestment Act – Business and Industry Guaranteed Loan Program (1)

The American Recovery and Reinvestment Act of 2009 (Recovery Act) includes measures to modernize our nation's infrastructure, enhance energy independence, expand educational opportunities, preserve and improve affordable health care, provide tax relief, and protect those in greatest need. As you are aware, the Recovery Act authorizes approximately \$28 billion of loans, loan guarantees, and grants to the Rural Development mission area to assist in achieving the purposes of the Recovery Act. This includes programs such as business and industry, broadband services, community facilities, and single family housing. All are intended to provide economic stimulus to America's rural areas.

Along with the provisions for Rural Development, the Recovery Act mandates that the Office of Inspector General provide oversight and audits of programs, grants, and activities funded by the Recovery Act. To assist Rural Development in achieving its Recovery Act objectives and minimize the risks of inefficient or improper actions that could put taxpayers' money at risk, we have initiated a program of oversight related to Recovery Act funding.

The initial project in our oversight was to review audit recommendations that could impact internal controls over Recovery Act activities for each agency. We identified recommendations where Rural Development had not implemented the agreed-upon corrective actions within the mandatory 1 year timeframe. We then determined which of these recommendations, if left unresolved or not mitigated, would introduce a significant risk of inefficient or improper use of Recovery Act funding. In a Fast Report dated April 3, 2009, we identified 11 audit recommendations that met these criteria involving the Business and Industry Guaranteed Loan Program. During our current review, we found that Rural Development officials decided to cancel the issuance of new regulatory guidance¹ that would have addressed two additional audit recommendations meeting the above criteria and relating to safeguarding the Recovery Act funds

¹ Title 7, Code of Federal Regulations, part 5001, Rural Development Guaranteed Loan Interim Rule, dated December 17, 2008.

available through the Business and Industry Guaranteed Loan Program. These two recommendations were not included in our previous report because of actions being taken by Rural Development.

According to the Office of Management and Budget,² agencies should determine whether final action has been taken regarding weaknesses or deficiencies disclosed by prior audits in program areas under which Recovery Act funds are authorized. If final action has not been completed, agencies should: (1) expedite such action to preclude the continuance of such weaknesses or deficiencies in the administration of Recovery Act funded programs; or (2) provide an explanation of why such corrective actions cannot or should not be taken in the administration of Recovery Act funded programs.

In a meeting on August 11, 2009, Rural Development officials informed us that an interim rule that addressed issues identified by two prior audit recommendations would not be finalized. In 2002,³ we had recommended that Rural Development coordinate with the Office of the General Counsel to develop and implement a process to provide a realistic discount for the value of collateral for certain industries and specialized equipment. Rural Development had agreed to revise its guidance to address this issue.

In another audit report issued in 2003,⁴ we had recommended that Rural Development consult with the Office of the General Counsel to rescind a loan note guarantee or substantially reduce the loss payment due to a lender's failure to exercise due diligence in ensuring that the construction of the sawmill was properly planned, designed, and equipped with available funding to produce the quantities of lumber sufficient to make loan payments. Rural Development had agreed to revise its regulations in order to hold lenders financially liable for negligence during loan origination. The regulation only holds lenders financially liable for negligent servicing, not loan origination.

The proposed interim rule would have addressed these two recommendations; however, Rural Development's decision to withdraw the rule leaves these weakness unresolved. On September 10, 2009, Rural Development informed us that they would address this concern in future revisions of the current regulation.⁵

To mitigate the risks associated with unresolved audit recommendations, we recommend that Rural Development institute interim corrective actions to address identified deficiencies in its internal controls prior to expending the Recovery Act funds, while continuing to pursue permanent corrective actions.

Please provide a written response within 5 days that outlines your corrective action on this matter. If you have any questions, please contact me at (202) 720-6945, or have a member of your staff contact Steve Rickrode, Audit Director, Rural Development and Natural Resources Programs, at (202) 690-4483.

² Office of Management and Budget, Memorandum for the Heads of Departments and Agencies, M-09-15, Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009, section 3.10, dated April 3, 2009.

³ Rural Development Liquidation of Business & Industry Guaranteed Loan, Washington State, Audit Report 34601-7-SF, dated December 2002.

⁴ Rural Development Lender Servicing of Business & Industry Guaranteed Loans in Georgia, Audit Report 34601-4-At, dated January 2003.

⁵ Title 7, Code of Federal Regulations, part 4279, Guaranteed Loanmaking, dated January 1, 2008.



United States Department of Agriculture
Rural Development

October 23, 2009

TO: Robert W. Young
Assistant Inspector General for Audit

FROM: Dallas Tonsager /S/
Under Secretary
Rural Development

SUBJECT: American Reinvestment and Recovery Act
Business and Industry Guaranteed Loan Program (1)
Report #34703-1-Te

This is in response to your October 16, 2009, memorandum in which you requested a response outlining our corrective action to your recommendations for the subject program to mitigate risk in administering Business and Industry Guaranteed Loan Program funds made available under the American Reinvestment and Recovery Act.

We have drafted the attached Administrative Notices (ANs) for approval of distribution to Agency officials addressing both collateral discounting as well as loan processing issues. This guidance will be in effect for 1 year and at which time it expires, we expect to have our regulations enhanced to incorporate this information. We expect these ANs to be finalized and effective by November 30, 2009. In the event our enhanced regulation is not published upon expiration of these ANs, they will be reissued to continue the enforcement of these requirements.

If you have any questions, please feel free to contact the Business and Industry Division, at 202-690-4103.

Attachments

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Washington, DC 20250-9410 or call (800) 795-3272 (voice) or (202) 720-6382 (TDD).

RD AN No. _____ (4279-B)

TO: State Directors, Rural Development
ATTN: Business Programs Directors
SUBJECT: Business and Industry Guaranteed Loan Program
Loan Processing Issues

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice (AN) is to provide guidance in processing loans under the Business and Industry (B&I) Guaranteed Loan Program.

COMPARISON WITH PREVIOUS AN:

There are no previous ANs on the subject.

IMPLEMENTATION RESPONSIBILITIES:

The purpose of this AN is to clarify the Agency policy concerning several loan processing issues. These policies apply to all B&I loans funded in fiscal year 2010. The policy has not changed to fund all loans eligible for ARRA funding with ARRA funds.

Please be reminded that RD Instruction 4279-B, section 4279.101(b), states in part: "... It is not intended that the guarantee authority will be used for marginal or substandard loans or for relief of lenders having such loans." Loan underwriting standards are not being relaxed.

EXPIRATION DATE:
October 31, 2010

FILING INSTRUCTIONS:
Preceding RD Instruction 4279-B

- **Percent of guarantee**

RD Instruction 4279-B, section 4279.119(b), establishes the maximum percent of guarantee permitted. While the cited paragraph provides for flexibility in establishing the percent of guarantee, the Agency policy is to grant the maximum percent of guarantee permitted by the regulations on all B&I loans. Risk mitigation measures may be considered as appropriate, including but not limited to requiring additional equity through a capital injection, additional collateral including secured personal guarantees, longer repayment terms, or subordinated debt and gap financing.

If after considering these risk mitigation measures, the State Office determines that the percentage of guarantee should be reduced, National Office review and concurrence is required.

State Directors should take full advantage of their authority to grant exceptions for 90 percent guarantees on loans of \$2 million or less, as provided in section 4279.119(b)(3). However, all 90 percent guarantees must be submitted to the National Office for tracking purposes to ensure we do not exceed the annual limit. Once the limit has been reached the guaranteed percentage for the remainder of the FY will not exceed 80 percent. There is no annual limit on granting 90 percent guarantees for ARRA loans.

- **Planning and Performing Development including Issuing the Guarantee Prior to Construction**

RD Instruction 4279-B, section 4279.181, authorizes issuing the guarantee prior to construction. The intent of this AN is to facilitate the issuance of the guarantee prior to construction, when warranted. We recognize that there may be increased risk to the Agency in that the project may not be satisfactorily completed with the available funds. This could result in the need for additional loans or equity to complete the project or the possible failure of the business and loss to the Agency. We believe the mitigation measures described in this AN will protect the interests of the Government while considering the interests of rural lenders and businesses in the current economic climate.

RD Instruction 4279-B, section 4279.156(b), clearly states the lender is responsible for monitoring the progress of construction and undertaking the reviews and inspections necessary to ensure that construction conforms with applicable code requirements; proceeds are used in accordance with the approved plans, specifications, and contract documents; and that funds are used for eligible project costs. The administrative language in the cited instruction indicates that the lender would normally be expected to have inspections made by a qualified individual prior to any progress payment. There is no absolute requirement that the goal be achieved by the use of an independent professional applying these methods. After careful review, if it appears that the use of an independent professional is the only

method which assures that the regulation's requirements are achieved, one may be required. If other less expensive or rigorous methods will achieve the same result, they may be utilized. The decision should be made on a case-by-case approach and be reasonable, under the specific circumstances of the case.

The lender should normally ensure the use of any borrower funds in the project first, have a complete set of plans and specifications at the lending institution, have a firm construction contract(s) and provisions for change order approval, retainage percentage, and disbursement schedule, and obtain lien waivers from all contractors prior to disbursements.

The Administrative language also states that the lender should normally ensure that the borrower has a 100 percent performance and payment bond on the contractor. There may be cases where a 100 percent performance and payment bond is prohibitively expensive or unavailable. In those cases, in lieu of a performance and payment bond, the lender may provide the Agency with its construction monitoring plan, acceptable to the Agency. This plan may include contracting with a reliable and experienced firm. The Agency's experience with the lender and the complexity of the project should be considered in determining whether the construction monitoring plan is acceptable.

Other means to mitigate the Agency's risk when issuing the guarantee prior to construction may include:

- Requiring the use of American Institute of Architects (AIA) contracts and documents;
- Requiring firm fixed-price construction contracts;
- Requiring construction contracts through an independent general contractor and not allowing the owner to act as the general contractor;
- Requiring all construction contracts and equipment quotes be firm or fixed price contracts and all be received for the entire project before loan closing and issuing the guarantee;
- Requiring an additional 5 percent balance sheet equity; and
- Requiring adequate contingency funds.

As a reminder, the Tangible Balance Sheet Equity requirement must be met at loan closing and must include the entire guaranteed loan amount on the balance sheet.

RD Instruction 4279-B, section 4279.156(a), requires that the lender ensure that the project functions at the level and quality contemplated by the application through the use of accepted architectural and engineering practices and conformation with all applicable Federal, State, and local codes and requirements. There is no regulatory requirement that the projections be verified by the use of an independent professional applying these methods. After careful review, if it appears that the use of an independent professional is the only method that assures that the

regulatory requirements are achieved, one may be required. If other less expensive or rigorous methods will achieve the same result, they may be utilized. The decision should be made on a case-by-case approach and be reasonable, under the specific circumstances of the case.

- **Interim/construction financing**

RD Instruction 4279-B, section 4279.113(s), states that the takeout of interim financing is eligible provided the lender submits a complete preapplication or application which proposes such interim financing prior to completing the interim loan. This means that the preapplication or application must be submitted prior to the last scheduled disbursement of the interim loan. If the interim financing does not meet these requirements, it is considered debt refinancing and must meet the requirements for debt refinancing in accordance with section 4279.113(r) to be eligible.

When a preapplication or application is filed that involves the takeout of interim financing, the Agency should immediately notify the applicant that during the period of application review and processing, the applicant must not take any actions (i.e., initiate construction) that would have an adverse impact on the environment or limit the range of alternatives to be considered by the Agency during the environmental review process. It is very important that the lender be notified that the Agency cannot approve the loan and issue the Conditional Commitment until the environmental process is complete and that the Agency assumes no responsibility or obligation for interim loans advanced prior to the Conditional Commitment being issued.

If you have any questions, please contact the Business and Industry Division, Processing Branch at (202) 690-4103.

JUDITH A. CANALES
Administrator
Business and Cooperative Programs

RECALL: S:\RBS\BPFiles\DABP\AN - UL\AN BI processing issues merged 10-14-09.doc
Final:tw:10/22/09

RD AN No. ____ (4279-B)

TO: State Directors, Rural Development
ATTN: Business Programs Directors
SUBJECT: Business and Industry Guaranteed Loan Program
Collateral Discounting

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice (AN) is to provide guidance concerning acceptable discounting of collateral for Business and Industry (B&I) guaranteed loans.

COMPARISON WITH PREVIOUS AN:

There is no previous AN on this subject.

IMPLEMENTATION RESPONSIBILITIES:

In accordance with RD Instruction 4279-B, section 4279.131(b), collateral must have documented value sufficient to protect the interest of the lender and the Agency. The discounted collateral value will normally be at least equal to the loan amount, and lenders will discount collateral consistent with sound loan-to-value policy.

Office of Management and Budget Circular A-129 states, in part, that financing should be limited by not offering terms (including the financing of closing costs) that result in a loan-to-value equal to or greater than 100 percent. RD Instruction 4279-B, section 4279.131(b), requires a loan-to-discounted (or loan to net market) value not to exceed 100 percent, except as outlined in section 4279.131(b)(2). Section 4279.131(b)(2) allows loan-to-value (or loan to market value) coverage to be discounted accordingly for those businesses with a documented successful financial history where cash flow and profitability are strong, but under no circumstances should the loan-to-value (loan to market value) ever be equal to or greater than 100 percent. It is expected that the business must have been profitable in all of the years for which we have historical financial statements in order to be considered successful.

EXPIRATION DATE:
October 31, 2010

FILING INSTRUCTIONS:
Preceding RD Instruction 4279-B

The type, quality, and location of collateral are relevant factors used to assess collateral adequacy and appropriate levels of discounting. Factors to be considered in the discounted value of collateral should include the type and marketability of the collateral and alternative uses of the collateral. That is, specialized buildings or equipment will be discounted greater than multi-purpose facilities or equipment. General guidelines typically include discounting general-use real estate and improvements to 70 – 80 percent of market value, machinery and equipment to 50 – 70 percent of market value, raw inventory and finished inventory to 50 – 60 percent of book value, and receivables (less than 90 days old) to 50 – 60 percent of book value. Typically, work (inventory) in process and receivables older than 90 days are discounted to \$0 value. Individual cases, local markets, audits of inventory and receivables, and other economic factors will impact discounted collateral values. If discounting of collateral is more generous than the ranges above, the file should clearly document your reasoning. Additionally, if your discounting is more generous than what the lender used in its credit analysis, that reasoning should also be documented in the file.

If you have any questions, please contact the Business and Industry Division, Loan Processing Branch, at (202) 690-4103.

JUDITH A. CANALES
Administrator
Business and Cooperative Programs

cc:

Griffin
Kieferle
Parker
DABP
ADMIN

B&I:Griffin:720-6802:bg:draft 10/1/09
bg:final 10/2/09

recall: ANdiscountcollateral.doc