



U.S. Department of Agriculture

Office of Inspector General



***American Recovery and Reinvestment Act –
Business and Industry Guaranteed Loan
Program (Phase 1)***

Audit Report 34703-1-Te
March 2010



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



DATE: March 31, 2010

REPLY TO

ATTN OF: 34703-1-Te

TO: Dallas Tonsager
Under Secretary
Rural Development

Judith A. Canales
Administrator
Rural Business-Cooperative Service

THROUGH: John Purcell
Director
Financial Management Division

FROM: Gil H. Harden /s/
Acting Assistant Inspector General
for Audit

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

This report represents the results of the subject audit. The finding and recommendation was previously reported to you in a Fast Report, dated October 16, 2009. On October 23, 2009, you responded to the recommendation. Based on your response, we were able to accept management decision for the recommendation stated in the report. Excerpts of your response and the Office of Inspector General's position are incorporated with the recommendation in the report.

Please follow your agency's internal procedures in forwarding final action correspondence to the Director, Planning and Accountability Division, Office of the Chief Financial Officer.

We appreciate the courtesies and cooperation extended to us by members of your staff during this audit.

Table of Contents

| | |
|--|-----------|
| Executive Summary..... | 1 |
| Background & Objectives | 4 |
| Background..... | 4 |
| Objectives | 5 |
| Finding 1: Recommendations Left Unresolved Due to Withdrawal of Interim Rule..... | 6 |
| Recommendation 1..... | 7 |
| Scope and Methodology | 8 |
| Abbreviations..... | 10 |

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

Executive Summary

This report presents the results of our first phase of audit work related to the implementation of the American Recovery and Reinvestment Act of 2009 (Recovery Act) Business and Industry (B&I) Guaranteed Loan Program.¹ In enacting the Recovery Act, Congress emphasized the need for accountability over the expenditures of funds. In response, the Office of Management and Budget (OMB) issued guidance² that required Federal agencies to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability and transparency objectives of the Recovery Act. The Recovery Act provided a budget authority³ of \$130 million for the B&I Guaranteed Loan Program.

Our role, as mandated by the Recovery Act, is to monitor agency activities and ensure agencies expend funds in a manner that minimizes the risk of improper use. During the first phase of the Office of Inspector General (OIG) audit oversight, we focused on the development of program guidance and requirements for distributing Recovery Act funding and evaluating internal controls. Since Rural Development had not announced any loan approvals during our fieldwork (as of October 13, 2009), we did not perform tests to verify compliance with agency policies and procedures regarding loan approval nor did we conduct reviews to confirm participant eligibility. As such, we did not ascertain the overall effectiveness of the internal controls in place or whether lenders made errors or took advantage of the existing weaknesses or deficiencies cited in this report. However, we did note during the internal control review process that Rural Development has controls in place to prevent ineligible participants, such as the clearance process described below. Program participants' eligibility and loan approval will be tested in subsequent audit work.

In addition to those unresolved recommendations previously presented to Rural Development,⁴ we identified two audit recommendations that would be unresolved due to the withdrawal of an interim rule by the agency. The noted weaknesses involve the valuation of loan collateral for certain industries and specialized equipment, and the need for due diligence during loan origination. If left unresolved the weaknesses will introduce a significant risk to the Guaranteed Loan Program. On October 16, 2009, we issued a Fast Report, formally notifying Rural Development of these unresolved weaknesses and recommending that it implement corrective actions. In response, Rural Development issued two Administrative Notices to agency officials as guidance to address the noted weaknesses.⁵

¹ The American Recovery and Reinvestment Act of 2009, H.R. 1, was signed into law on February 17, 2009.

² On February 18, 2009, OMB issued "Initial Implementing Guidance for the American Recovery and Reinvestment Act of 2009." Subsequently on April 3, 2009, OMB issued "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009."

³ Budget authority is the actual cost of a program to the Government; it is funding that the Government does not recover.

⁴ Fast Report 85703-1-HQ, "Existing Risk to Rural Development's Economic Recovery Program," dated April 3, 2009.

⁵ Administrative Notice Number 4477, "Business and Industry Guaranteed Loan Program Loan Processing Issues" issued November 4, 2009 and Administrative Notice Number 4478, "Business and Industry Guaranteed Loan Program Collateral Discounting" issued November 10, 2009.

As of the end of our fieldwork (October 13, 2009), Rural Development had not announced any B&I loan approvals involving Recovery Act funds. The Recovery Act authorized approximately \$130 million in budget authority for the Department of Agriculture to guarantee B&I loans. When the subsidy rate⁶ multiplier is applied to the \$130 million authorized for this program, Rural Development will be able to fund B&I guaranteed loans of approximately \$1.6 billion. Obligation goals for each State office have been established and published in an Administrative Notice, which also provides guidance regarding the funds made available for the B&I program by the Recovery Act. The funds are being held at the national office and will be allocated to the States on a loan by loan basis. Rural Development's goal is to expend all available funds, focusing on Recovery Act funds first since they expire September 30, 2010.⁷ However, Rural Development has not fully obligated its funds for the past 2 years and has had extensive carryover. In fiscal year 2008, it obligated \$1.4 billion, the highest dollar value of loan guarantees made in the last 5 years. In 2009, it obligated \$1.1 billion and will have a carryover into fiscal year 2010 of approximately \$496 million, with an additional \$993 million from the fiscal year 2010 appropriation. With \$1.6 billion in Recovery Act funds as well as the annual appropriation and carryover funding available,⁸ Rural Development may face challenges obligating all available funding sources including Recovery Act funds.

Rural Development implemented a clearance process specifically to approve projects requesting Recovery Act funding. The State offices will review projects to ensure they meet the Recovery Act requirements. Eligible projects are entered into a restricted shared site, from which national office staff reviews the projects and creates a listing of proposed projects. Each listing generally contains multiple individual projects for B&I guaranteed loans. The listing of proposed projects is submitted to the Office of the Secretary, OMB, and potentially the White House for concurrence. State offices will be notified of those projects selected for obligation and funds will be allocated to the States for their approved loans. Rural Business-Cooperative Service stated that it takes approximately 2-4 weeks to receive feedback from OMB. At the request of the lender, time sensitive projects may be pulled from the listing and processed through the regular B&I program, typically due to this lengthy clearance process for Recovery Act-funded projects.⁹

As of November 27, 2009, 13 listings have entered the clearance process. Nine of them have completed the process and are awaiting obligation totaling approximately \$210.7 million or 13 percent of the available \$1.6 billion for the B&I program. Rural Development is in the process of developing a nationwide outreach program to improve program awareness and increase program usage. An Administrative Notice¹⁰ instructed the States to "develop and implement an outreach plan to assist in eliminating disparity in program delivery" and included steps to take in preparation for its development. Although the implementation of the B&I Recovery Act program may seem delayed, no projects have been held up. According to Rural Development, this is because it has funds from multiple authorities readily available to fund

⁶ In fiscal year 2010, the subsidy rate creates \$12.30 in loans for every \$1 budget authority to determine program level lending.

⁷ Rural Development has several funding authorities, e.g., Recovery Act, fiscal year 2010 annual appropriation, carryover, and disaster funding.

⁸ Carryover (\$496 million) + fiscal year 2010 appropriation (\$993 million) + Recovery Act (\$1.6 billion) = Total funds available (\$3.089 billion)

⁹ The processing goal for the normal B&I Guaranteed Loan Program was 45 days in 2009 and 40 days in 2010.

¹⁰ Administrative Notice Number 4471, B&I Guaranteed Loan Program, Recovery Act, dated August 20, 2009.

projects that are ineligible for Recovery Act funding or that elect not to go through the clearance process and/or additional restrictions and requirements to obtain Recovery Act funds.

Recommendation Summary

For the two prior audit recommendations presented in the Fast Report, we recommended that Rural Development institute interim corrective actions to address identified deficiencies in its internal controls prior to expending Recovery Act funds, while continuing to pursue permanent corrective actions.

Agency Response

Agency national office officials generally agreed with our finding and recommendation as presented in the Fast report. They proposed corrective actions that should address the existing risks of insufficient collateral and lender negligence during loan origination that would result in significant loss to the program.

The agency responses are posted on our website with the applicable Fast Report. These reports can be found at http://www.usda.gov/oig/recovery/recovery_reports.htm.

OIG Position

We agreed with the agency's proposed corrective actions and reached management decision on this recommendation.

Background & Objectives

Background

In response to the economic downturn and increasing unemployment rate, Congress passed the American Recovery and Reinvestment Act of 2009 (Recovery Act). The Recovery Act authorized \$130 million for the Business and Industry (B&I) Guaranteed Loan Program, which provided for a lending level of approximately \$1.6 billion. Funds were made available under this authority through September 30, 2010.

The Rural Business-Cooperative Service (RBS), an agency within the Department of Agriculture's Rural Development mission area, is responsible for administering the B&I Guaranteed Loan Program to improve, develop, or finance business, industry, and employment, and improve the economic and environmental climate in rural communities. This is achieved by bolstering the existing private credit structure through the guarantee of quality loans that will provide lasting community benefits. The B&I program is a lender-driven program that provides a loan guarantee to a bank or other approved lender to finance private businesses located in rural areas. The commercial lender applies to RBS for the loan guarantee. Upon approval of a loan guarantee (or signing of Form RD 1940-3, Request for Obligation of Funds Guaranteed Loan), the agency will issue a conditional commitment to the lender, containing all conditions under which a loan note guarantee will be issued. Once all conditions have been met, the agency will issue and execute the loan note guarantee. A lender would provide the loan to the borrower and Rural Development would guarantee repayment of a portion of the loan in the event the borrower defaulted. The lender is responsible for making, servicing, and collecting the loan.

On July 24, 2009, a Notice of Funding Availability was published in the Federal Register, announcing the availability of the B&I Recovery Act assistance and outlining the additional provisions that apply to the award of these Recovery Act funds. For the most part, Recovery Act funded loans will be processed and serviced in the same way as regular B&I loans using existing program regulations. Adjustments were made to several features of the B&I program, including the percentage of guarantee, guarantee fee, and annual renewal fee.

Specifically, Rural Development will guarantee a maximum of 90 percent on all Recovery Act funded loans that score at least 55 priority points¹¹ under the agency's priority scoring criteria outlined in the current regulations.¹² In addition, Rural Development reduced the initial guarantee fee from 2 percent to 1 percent and eliminated the annual renewal fee. The funds will be distributed on a first-come-first-served basis; however, 10 percent of the Recovery Act funding is allocated for businesses located in persistent poverty counties. In addition to the purposes and entities that are ineligible for funding under the regular B&I program, the following purposes are ineligible under the Recovery Act: zoos; aquariums; convenience stores, unless the store provides quality jobs and sells or will sell E85 fuel upon completion of the project; pools; water parks; hotels/motels and other facilities that have pools or water parks; golf courses; casinos or other gambling establishments; and museums.

¹¹ States are to score applications consistent with the criteria specified in Rural Development Instruction 4279-B, section 4279.155, with 10 Administrator discretionary points being awarded to projects where the borrower provides quality jobs and meets at least one of the four demographic criteria (area of outmigration, high unemployment, under-served groups/under-represented areas, and persistent poverty counties).

¹² Title 7, Code of Federal Regulations, part 4279, Guaranteed Loanmaking, subpart B, 4279.155, Loan Priorities, dated January 1, 2008.

The Recovery Act also mandates that the Office of Inspector General (OIG) provide oversight of programs, grants, and activities funded by the Recovery Act and administered by the Department of Agriculture. 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 initiated a multiphase program of oversight related to Recovery Act funding. Audit work in the first phase was focused on overseeing the development of program guidance and requirements for distributing Recovery Act funding and evaluating internal controls. Additional phases will focus on assessing the effectiveness of the internal controls.

Objectives

The objectives of Phase 1 were to determine if: (1) Recovery Act-related programs are timely and effectively implemented; (2) proper internal controls are in place to ensure that the Recovery Act objectives are achieved; and (3) program participants meet eligibility requirements.

Finding 1: Recommendations Left Unresolved Due to Withdrawal of Interim Rule

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 initiated a program of oversight related to Recovery Act funding. The initial project in our oversight was to review unresolved audit recommendations that could impact internal controls over Recovery Act activities. The results of this initial project were reported on April 3, 2009. In that report, we identified 11 prior recommendations that if left unresolved or not mitigated would introduce a significant risk of inefficient or improper use of Recovery Act funding.

During our current review, we identified two additional prior audit recommendations that Rural Development officials had originally planned to resolve by the issuance of a rule that was then under consideration. However, Rural Development officials informed us that a decision had been made to cancel the issuance of this rule. As a result, Rural Development's B&I Recovery Act loan program remains at risk. Specifically, in 2002,¹³ 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 2003,¹⁴ 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 a 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 holds lenders financially liable only for negligent servicing, not loan origination. On September 10, 2009, Rural Development informed us that it would address this concern in future revisions of the current regulation.¹⁵

According to OMB,¹⁶ 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.

OIG issued a Fast Report, dated October 16, 2009, which formally notified Rural Development that these recommendations were left unresolved due to the withdrawal of the new regulatory

¹³ "Rural Development Liquidation of B&I Guaranteed Loan, Washington State," Audit Report 34601-7-SF, dated December 2002, Recommendation 1.

¹⁴ "Rural Development Lender Servicing of B&I Guaranteed Loans in Georgia," Audit Report 34601-4-At, dated January 2003, Recommendation 1.

¹⁵ Title 7, Code of Federal Regulations, part 4279, "Guaranteed Loanmaking," dated January 1, 2008.

¹⁶ OMB, Memorandum for the Heads of the Departments and Agencies, M-09-15, "Updated Implementing Guidance for the Recovery Act," section 3.10, dated April 3, 2009.

guidance. Rural Development generally agreed with our conclusions and provided a written response, detailing the corrective actions to be implemented.

Recommendation 1

Institute interim corrective actions to address previously identified internal control deficiencies prior to expending Recovery Act funds, while continuing to pursue permanent corrective actions.

Agency Response

On October 23, 2009, the Under Secretary for Rural Development stated in response to our Fast Report that Administrative Notices have been drafted for distribution to agency officials addressing both collateral discounting as well as loan processing issues. This guidance will be in effect for 1 year and by the time it expires, regulations are expected to be enhanced to incorporate this information. In the event the enhanced regulation is not published upon expiration of these Administrative Notices, they will be reissued to continue the enforcement of these requirements.

OIG Position

Rural Development issued Administrative notices on November 4, 2009 and November 10, 2009 addressing these weaknesses. We accept management decision for this recommendation.

Scope and Methodology

We conducted our audit of the B&I Guaranteed Loan Program at the Rural Development National Office in Washington, D.C. The Rural Development State Office in Temple, Texas, was judgmentally selected to be contacted for information based on its close proximity to the OIG Southwest Regional Office and it had the highest amount of B&I guaranteed loan funds obligated for fiscal year 2008 at the time of our review. As of October 13, 2009, Rural Development had not announced Recovery Act funds obligations for any projects under the B&I Guaranteed Loan Program.

In performing our review, we used a multiphase approach. Audit work in this phase (phase 1) was performed to monitor development of program guidance and requirements for distributing Recovery Act funding for B&I guaranteed loans; evaluate internal controls used to ensure program objectives are achieved; and monitor performance goals established to measure B&I Guaranteed Loan Program effectiveness in meeting the purposes of the Recovery Act. Specifically, to monitor the development of program guidance and requirements for distributing Recovery Act funding for B&I guaranteed loans, we interviewed Rural Development National Office officials and obtained and reviewed regulations and guidance. We also contacted the Rural Development Texas State Office for information related to guidance received from the national office. In addition, we documented the application process and identified the internal controls in place.

To evaluate internal controls used to ensure program objectives are achieved, we reviewed the appropriate management decision documents as well as regulations, Administrative Notices, Unnumbered Letters, and any other guidance used to administer the program. We also reviewed prior OIG audit recommendations which had not reached final action or were affected by the withdrawal of the interim rule. In addition, we conducted interviews with Rural Development National Office officials. Furthermore, we discussed the compliance reviews to be conducted to ensure that funds are expended on authorized uses and meet the purposes of the Recovery Act. We also interviewed Rural Development Texas State Office officials to verify the process and procedures used at the State office level for projects approved using Recovery Act funds.¹⁷

In order to monitor Rural Development's performance goals established to measure the B&I Guaranteed Loan Program's effectiveness in meeting the purposes of the Recovery Act, we reviewed the performance measures stated in Rural Development's Recovery Act Implementation Plan specifically for this program. We also reviewed the program assessment report prepared by OMB and Federal agencies found on ExpectMore.gov.

In addition, we obtained and reviewed the following:

- American Recovery and Reinvestment Act of 2009;
- Notice of Funds Availability;
- Recovery Act-related OMB Guidance;
- President's Memorandum;
- Fiscal Year 2008 Performance and Accountability Report;

¹⁷ Testing of Recovery Act implementation will be conducted in subsequent audit work.

- Fiscal Year 2008 Federal Managers Financial Integrity Act Report;
- Fiscal Year 2008 B&I Management Control Review; and
- 2007 and 2008 Business and Cooperative Programs Assessment Reviews.

We conducted our fieldwork from June through October 2009.

We conducted this performance audit in accordance with generally accepted 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 provides a reasonable basis for our findings and conclusions based on our audit objectives.

Abbreviations

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| B&I | Business and Industry |
| OIG | Office of Inspector General |
| OMB | Office of Management and Budget |
| Recovery Act | American Recovery and Reinvestment Act of 2009 |
| RBS | Rural Business-Cooperative Service |