UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250

DATE: June 18, 2009

REPLY TO
ATTN OF: 34099-12-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. Congress, in enacting the Recovery Act, emphasized the need for accountability and transparency in the expenditure of the funds. Further, on February 18, 2009, the Office of Management and Budget (OMB) issued initial guidance that required Federal agencies to establish rigorous internal controls, oversight mechanisms, and other approaches to meet the accountability objectives of the Recovery Act.[1] On March 20, 2009, Rural Development was authorized to begin distributing Recovery Act funds.

The Rural Business-Cooperative Service (RBS), an agency within the Rural Development mission area, operates loan programs intended to assist in business development in rural areas and promote the employment of rural residents. The purpose of the Business and Industry (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. The Recovery Act provides over $2.9 billion for guaranteed loans to RBS' B&I Guaranteed Loan Program. Our role, as mandated by the Recovery Act, is to oversee agency activities and to ensure funds are expended in a manner that minimizes the risk of improper use. This memorandum describes potential risks to Recovery Act funds administered by RBS in its B&I Guaranteed Loan Program.

[1] On April 3, 2009, OMB issued "Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009."

Based on recent audit work conducted prior to the issuance of Recovery Act funding, we found two weaknesses in the B&I Guaranteed Loan Program that could put Recovery Act funds at risk. These risks exist due to questionable eligibility criteria used by RBS in its B&I Guaranteed Loan Program. First, RBS continues to allow the use of leasehold properties to be used as loan collateral even though such collateral is generally valueless to RBS. Second, the Recovery Act prohibits borrowers from having any gross income derived from gambling activities, whereas current B&I regulations allow income from such activities to be no more than 10 percent. RBS does not have sufficient controls to ensure that borrowers who receive funding through the Recovery Act do not derive any income from gambling activities.

*Leasehold Property as Collateral*

According to Federal regulation[2] and Rural Development's Recovery Act Implementation Plan, leasehold properties continue to be allowed as collateral for a guaranteed loan. Prior to the Recovery Act, we found an instance where a lender had received an RBS loan note guarantee on a $4 million loan where the lender 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 nothing prohibits the agency from accepting leasehold property as collateral; however, they stated that leasehold property should not be accepted as the primary collateral for the loan. Leasehold property is not appropriate for securing guaranteed loans because it generally offers the Government no collateral value in securing its guaranteed loans. We recommend that leasehold properties be prohibited as collateral for Recovery Act loans.

*Gambling Revenue*

According to B&I regulation,[3] applicants are ineligible for a guaranteed loan if they derive more than 10 percent of their annual gross income from gambling activities. The Recovery Act prohibits a potential borrower from having any portion of their gross income derived from gambling activities. In addition, we found that applicants who are involved or affiliated with gambling activities can conceal that their revenue is derived from gambling activities and thus still have an opportunity to be considered eligible for a B&I guaranteed loan. We discussed this concern with RBS officials who agreed that the agency should strengthen its controls to ensure the requirements of the Recovery Act are met. We recommend that RBS 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.

We have not yet performed tests to determine if Rural Development is at risk for significant losses due to these concerns. As a result, we have no conclusions on the overall extent of potential losses that are, or may be, occurring in the program. Our concerns are that Rural Development could sustain considerable losses and could create a negative public perception of the proper use of Recovery Act funds.

[2] Title 7, *Code of Federal Regulations* (CFR), section 4279.113(d), dated January 1, 2003.
[3] 7 CFR 4279.114(h), dated January 1, 2003.

We discussed these issues in detail with agency national office officials on June 4, 2009. The national officials generally agreed with our conclusion and agreed to provide the specific corrective actions in their response to this letter.

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, Director, Rural Development and Natural Resources Division, at (202) 690-4483.

cc: Director, Financial Management Division

United States Department of Agriculture
Rural Development
Office of the Under Secretary

June 29, 2009

**TO:** Robert W. Young
Assistant Inspector General
for Audit

**FROM:** Dallas Tonsager /S/
Under Secretary
Rural Development

**SUBJECT:** American Recovery and Reinvestment Act – Business and Industry Guaranteed Loan Program (1), Audit No. 34099-12-Te

This is in response to your audit memorandum of June 18, 2009, regarding recommendations associated with the American Recovery and Reinvestment Act of 2009, P.L. 111-5 (the Recovery Act) activities.

On March 20, 2009, Rural Development was authorized to begin distributing Recovery Act funds. Please note that to date, the Business and Industry (B&I) Guaranteed Loan program has not funded any projects utilizing Recovery Act funds.

As we discussed with your office informally, the Rural Business—Cooperative Service (the Agency) is developing parameters funding business and industry guaranteed loans under the Recovery Act and in accordance with The Office of Management. and Budget (OMB) guidance provided by documents M-09-10, dated February 18, 2009, and M-09-15, dated April 3, 2009. These parameters are included in the Notice of Funding Availability (NOFA), which will announce the B&I Recovery Act funding, The draft NOFA is currently in clearance. The Agency is also developing internal guidance, to be issued to the field as the Recovery Act funds are made available. Our responses will demonstrate that your concerns are unwarranted and the Agency is implementing sufficient controls to ensure that funds are disbursed in accordance with the statutes, regulations, and industry practices to carry out our mission of creating and saving jobs in rural communities.

**Recommendation 1:** This recommendation raises concerns regarding the use of leasehold properties as collateral for Recovery Act funded B&I loans. It recommends that the use of leasehold properties as collateral be prohibited. The audit states that leasehold properties used as collateral are generally valueless.

**Response:** As you know, utilizing leasehold properties as collateral is fully recognized as an acceptable business practice in the lending community. For example, businesses in industrial parks are typically leased from the municipality or other entity that owns the park. In other cases, a private company owns the property in a holding company corporate structure and leases the property to an operating entity. Additionally, when mining natural resources, leases are standard business operating procedures.

Another example is loans made to Native Americans on Tribal lands that are typically operated under long-term leases. Attributing no collateral value to such properties will make it impossible for many businesses to qualify for Recovery Act financing, including Native Americans. We believe such an action is contrary to the intent of the Act and may impose unintended consequences to those businesses, Indian tribes, public bodies, or individuals in our outreach considerations.

In developing the B&I program-specific Recovery Act plan, we considered the statutory authority for the Recovery Act, 310B of the Consolidated Farm and Rural Development Act (CONACT), and the regulatory requirements found in 7 C.F.R. 4279. The regulations provide that leasehold values be documented in appraisals completed by State certified appraisers in accordance with the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) and Uniform Standard of Professional Appraisal Practices (USPAP). The regulations also require all loans to be adequately secured to protect the lender and the Agency. The discounted collateral value will normally be at least equal to the loan amount, except for cash-flow oriented businesses with strong profitability.

From a business point of view, we believe the agency is providing sufficient guidance to ensure effective internal controls on leasehold interests taken as collateral. Based on our analysis, the Agency has decided not to implement this recommendation.

**Recommendation 2:** This recommendation concerns gambling revenue. The audit memorandum states that the Recovery Act prohibits potential borrowers from having any portion of their gross income derived from gambling activities.

**Response:** The only reference to gambling in the Recovery Act was found in Section 1604. This section states in part: "None of the funds appropriated or otherwise made available in this Act may be used by any State or local government, or any private entity, for any casino or other gambling establishment..."

The Agency has adopted a policy to make all businesses ineligible for Recovery Act funding that derive any income from gambling (other than income from state lotteries). This is consistent with the language in the draft NOFA (currently in clearance) which will announce the B&I Recovery Act funding. This and other written guidance will be

provided to Rural Development field offices when Recovery Act funds are made available. As previously mentioned, the Agency will issue guidance prior to the disbursement of Recovery Act funds to ensure adequate controls are in place to meet the intent of the statute.

The audit memorandum further recommends that all lenders and borrowers that receive Recovery Act funds be required to certify that none of the borrower's income is derived directly or indirectly from gambling operations. From the Agency perspective, this recommended action is excessive, unnecessarily adds to the Agency and public burden, and is unnecessary because of our policy not to fund projects with income derived from gambling. Rather, to ensure lender compliance, all loan commitments will be conditioned so that Recovery Act funds are disbursed only for purposes authorized by statute.

We appreciate the opportunity to address your concerns. Once the NOFA is published, we will forward a copy to your office.