U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

ADVISORY MEMORANDUM
Report NUMBER 13-16R

DATE: June 14, 2013

TO: John A. Miller, Director, Office of Financial Program Operations

SUBJECT: Purchase Reviews Allowed $4.6 Million in Improper Payments on 7(a) Recovery Act Loans

This advisory memorandum is the first in a series of memorandums resulting from our ongoing audit of purchased 7(a) Recovery Act[1] loans. The purpose of this memorandum is to notify you of improper payments[2] made on six loans and to recommend recovery of the related questioned costs.[3] These improper payments were the result of lender deficiencies that went undetected during SBA's purchase reviews. The total approved amount for these loans was approximately $6.7 million, and the SBA purchased its guaranteed share of the principal loan balances for approximately $4.6 million.

The objective of the ongoing audit is to determine if the SBA is mitigating its risk of loss. Specifically, whether the SBA is ensuring that 7(a) Recovery Act loans were originated, closed, liquidated, and purchased in accordance with SBA's policies and procedures, and prudent lending standards.

To accomplish our objective, we used a new, internally developed, risk-based sample selection methodology. The judgmental sample scoring system allocated rating points according to perceived risks. The perceived risks included time lapse between loan approval and its transfer to liquidation, loan amount, equity injection, loan packager involvement, and the use of proceeds. We obtained a universe of 105 loans that consisted of high-dollar early defaulted Recovery Act loans, which were purchased by the National Guaranty Purchase Center (NGPC) between February 17, 2009, and January 31, 2012. Of the universe of 105 loans, we eliminated loans that were involved in previous audits or were in an unstable status due to review process or guaranty repair action. We then selected 20 loans that we were able to access from the NGPC. From those, we reviewed eight loans that were a part of the Preferred Lenders Program (PLP). We determined the risk-based sample selection methodology to be highly effective at pinpointing loans with material deficiencies to enhance the impact of our audit. In fact, material deficiencies were identified in each of the first eight loans reviewed. We identified suspicious activity in two loans and referred them to the Office of Inspector General (OIG) Investigations Division. As a result, we omitted the details of the deficiencies on those two loans from this report. The remaining six reviewed loans resulted in questioned costs totaling $4.6 million.

[1] American Recovery and Reinvestment Act of 2009, Public Law 111-5.
[2] For the purpose of this memorandum, an improper payment is defined as any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements
[3] For purposes of this memorandum, "questioned costs" are defined as costs questioned by the OIG, which were incurred as a result of material origination, closing, and purchase deficiencies made by lenders or the SBA.

To answer the objective, we reviewed all origination, closing, and purchase actions as documented in SBA and lender loan files. We also reviewed information in the SBA's Loan Accounting System for all loans examined.

We conducted this audit between March 2012 and February 2013 in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. To assess the internal controls relevant to our objective, we reviewed the SBA's policies and procedures regarding loan origination, closing and purchasing.

In addition, we designed and distributed an internal control questionnaire survey to a random sample of representatives from the Office of Capital Access and the Office of Financial Program Operations. We analyzed the survey results to aid in our understanding of the internal controls relevant to our on-going audit of 7(a) Recovery Act loans.

BACKGROUND

The Recovery Act provided the SBA with $730 million to expand the Agency's lending and investment programs, create new programs to stimulate lending to small businesses, and conduct oversight of these programs. A portion of the $730 million funding was also used for eliminating fees and increasing the maximum loan guaranty to 90 percent for eligible 7(a) loans. Accordingly, we conducted this audit due to concerns that some lenders would not exercise due diligence in originating and closing loans given that the 90 percent SBA guaranty reduced lender risk.

The SBA guarantees loans that are made by participating lenders under a Guaranty Agreement to originate, service, and liquidate loans in accordance with SBA loan program requirements (which include, among other things, SBA regulations, standard operating procedures, and other directives). When a borrower defaults on such a loan, the lender can request payment of the guaranty. Prior to paying the guaranty (which the SBA refers to as "purchasing" a guaranty), the SBA reviews loan documentation to evaluate the lender's compliance with program rules and regulations and commercially prudent lending standards. This review is SBA's primary control for ensuring lender compliance and preventing improper payments. In the event of noncompliance, the SBA may be released from its liability on a loan guaranty, in full or in part if the lender has failed to comply materially with any Loan Program Requirement for 7(a) loans. Previous OIG audits have identified material lender noncompliance in loan origination, closing, and liquidation that were not detected in SBA's purchase review processes, resulting in improper payments.

RESULTS

The audit found that six 7(a) Recovery Act Loans were not originated and closed in accordance with SBA's rules and regulations including Standard Operating Procedure (SOP) 50 10 and the Code of Federal Regulations[4] (CFR). As the deficiencies identified in the six loans were not detected during SBA's purchase reviews, they resulted in inappropriate or unsupported disbursements of approximately $4.6 million, which are further detailed in the Appendices of this report. The deficiencies and the related requirements are summarized in Table 1, and include:

[4] 13 CFR 120.

- ***Deficiency Type A: Questionable Eligibility***
  According to SOP 50 10 5(B), the small business must meet the eligibility requirements at the time of application and, with the exception of the size standard, must continue to meet these requirements through the closing and disbursement of the loan.

- ***Deficiency Type B: Inadequate assurance of repayment ability***
  According to SOP 50 10 5(B), on SBA-guaranteed loans, the cash flow of the Small Business Applicant is the primary source of repayment. Thus, if the lender's financial analysis demonstrates that the Small Business Applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined.

- ***Deficiency Type C: Equity Injection Issues***
  Adequate equity is important to ensure the long-term survival of a business. According to SOP 50 10 5(A), the lender must include in its credit analysis a detailed discussion of the required equity and its adequacy. The SOP also requires lenders to verify the source as well as the existence of an equity injection that is greater than 1/3 of the amount of the loan or $200,000, whichever is less. Examples of credible evidence to demonstrate an equity injection came from a source consistent with SBA Loan Program requirements are outlined in SOP 50 51 3. Credible evidence would include documentation showing that the injection (1) came from a legitimate source; (2) occurred prior to the initial loan disbursement; and (3) consisted of the required amount of cash or the required value of non-cash assets.

- ***Deficiency Type D: Insufficient collateral***
  According to SOP 50 10 5(A), the SBA requires the lender to collateralize the loan to the maximum extent possible up to the loan amount. The SBA considers a loan as "fully secured" if the lender has taken security interests in all available assets with a combined "liquidation value" up to the loan amount.

Table 1 Summary of Findings

Loan Number	Borrower's Name	Deficiency Type	Amount Approved	SBA Guaranty Amount	Questioned Costs
[Ex. 4]	[Ex. 4]	A,B	$ [Ex. 4]	$1,485,000	$1,425,247
[Ex. 4]	[Ex. 4]	A	$ [Ex. 4]	$900,000	$669,963
[Ex. 4]	[Ex. 4]	B	$ [Ex. 4]	$1,180,000	$967,869
[Ex. 4]	[Ex. 4]	A,B,C	$[Ex. 4]	$675,000	$555,368
[Ex. 4]	[Ex. 4]	A,B,C,D	$ [Ex. 4]	$1,125,000	$310,637
[Ex. 4]	[Ex. 4]	C	$[Ex. 4]	$694,800	$680,900
Total			**$6,742,000**	**$6,059,800**	**$4,609,984**

Legend: A) Questionable Eligibility B) Inadequate Assurance of Repayment Ability C) Equity Injection Issues D) Insufficient Collateral

The deficiencies, which went undetected by the National Guaranty Purchase Center (NGPC), were an indication of serious flaws in the NGPC's purchase process. However, we previously issued two audit reports and made recommendations to address the deficiencies in the purchase review process.

Specifically, in March 2012, we issued Audit Report 12-11R, *High-Dollar Early-Defaulted Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the National Guaranty Purchase Center*. In that report, we identified that loan documentation was not reviewed with the level of scrutiny necessary to identify all material deficiencies on high-dollar early-defaulted loans. A subsequent report was issued by our office in August 2012, Audit Report 12-18, *A Detailed Repayment Ability Analysis is Needed on High-Dollar Early-Defaulted Loans to Prevent Future Improper Payments*. In this audit, we found that the assessment of delegated lender underwriting performed at the NGPC on high-dollar early defaulted loans was not effective in identifying whether lenders were clearly negligent in determining the borrowers' repayment ability.

Both reports sought to improve the purchase review process. The critical recommendations included suggestions to: (1) expand the scope of the NGPC's quality control reviews of early-defaulted loans; (2) establish a specialized early default purchase review unit; (3) train NGPC purchase staff to perform effective analyses of lenders' repayment ability computations, and (4) revise its purchase process for high-dollar early-defaulted loans approved by lenders to verify compliance with SBA's repayment ability requirements. We will not be making similar recommendations in this report as the loans reviewed in this audit were purchased prior to the implementation of these previous recommendations. Future audits and additional loan reviews will assess the process after the implementation of our recommendations.

CONCLUSIONS

The audit found that lenders did not originate and close the six 7(a) Recovery Act loans in accordance with the SBA's loan program requirements. Furthermore, SBA loan officers did not identify the deficiencies in the six loans during their purchase reviews. The SBA purchased its guaranties on these six loans, which resulted in approximately $4.6 million of questioned costs. As a result of the identified deficiencies, we recommended that the SBA seek recovery of approximately $4.6 million.

RECOMMENDATIONS

We recommend that the Director, Office of Financial Program Operations:

1. Seek recovery of $1,425,247 from Compass Bank on the guaranty paid by the SBA for the loan to **[Ex. 4]**

2. Seek recovery of $669,963 from The Washington Trust Company on the guaranty paid by the SBA for the loan to **[Ex. 4]**

3. Seek recovery of $967,869 from High Trust Bank on the guaranty paid by the SBA for the loan to **[Ex. 4]**

4. Seek recovery of $555,368 from Monadnock Community Bank on the guaranty paid by the SBA for the loan to **[Ex. 4]**

5. Seek recovery of $310,637 from Plaza Bank on the guaranty paid by the SBA for the loan to **[Ex. 4]**

6. Seek recovery of $680,900 from American Bank of Commerce on the guaranty paid by the SBA for the loan to **[Ex. 4]**

AGENCY COMMENTS AND OFFICE OF THE INSPECTOR GENERAL RESPONSE

On March 12, 2013, we provided a draft of this advisory memorandum to the Director, Office of Financial Program Operations (OFPO) for comment. On April 26, 2013, the Director submitted formal comments, which are included in their entirety in Appendix VII. The Director concurred with three recommendations to recover $1,535,968 on three loans. The Director, however, did not concur with the three remaining recommendations to recover a total of $3,074,016 in SBA guaranties on three other loans. The Director reported that the OFPO has continued its training of National Guaranty Purchase Center (NGPC) finance professionals processing guaranty purchases for high dollar early defaults. In addition, the OFPO has differentiated the standard given to NGPC staff so additional credit is given to support purchase reviews of early-defaulted, high-dollar loans. Finally, OFPO has initiated Risk Management initiatives at the NGPC, including tracking purchase deficiencies detected during quality control reviews and providing corrective action and education. A summary of management's comments and our response for each recommendation follow:

Recommendation 1 - Seek recovery of $1,425,247 from Compass Bank on the guaranty paid by the SBA for the loan to [Ex. 4]

Management Comments

The Director did not concur with this recommendation based on the reasons provided by the OIG in its findings of questionable eligibility and inadequate assurance of repayment ability. However, he stated that the OFPO is reviewing an additional issue that the OIG did not identify, which may warrant full recovery from the lender. The Director agreed to report his findings to the OIG by June 15, 2013.

OIG Response

The Director's comments did not include an explanation for why he did not agree with the OIG's findings. Further, he did not provide the details of the additional issue that was identified for the OIG to consider and respond. This recommendation will be resolved during the audit follow-up and resolution process.

Recommendation 2 - Seek recovery of $669,963 from The Washington Trust Company on the guaranty paid by the SBA for the loan to [Ex. 4]

Management Comments

The Director concurred with this recommendation and will request a full recovery of $669,963 from the lender by May 31, 2013.

OIG Response

We consider management's comments to be responsive to the recommendation.

Recommendation 3 - Seek recovery of $967,869 from High Trust Bank on the guaranty paid by the SBA for the loan to [Ex. 4]

Management Comments

The Director did not concur with this recommendation. However, he stated that the OFPO will enter this loan into the Office of Capital Access Headquarters denial review process no later than May 31, 2013.

OIG Response

The Director's comments did not provide a specific rationale for his non-concurrence. This recommendation will be resolved during the audit follow-up and resolution process.

Recommendation 4 - Seek recovery of $555,368 from Monadnock Community Bank on the guaranty paid by the SBA for the loan to [Ex. 4]

Management Comments

The Director concurred with this recommendation and will request a full recovery of $555,368 from the lender no later than May 31, 2013.

OIG Response

We consider management's comments to be responsive to the recommendation.

Recommendation 5 - Seek recovery of $310,637 from Plaza Bank on the guaranty paid by the SBA for the loan to [Ex. 4]

Management Comments

The Director concurred with this recommendation and will request a full recovery of $310,637 from the lender no later than May 31, 2013.

OIG Response

We consider management's comments to be responsive to the recommendation.

Recommendation 6 - Seek recovery of $680,900 from American Bank of Commerce on the guaranty paid by the SBA for the loan to [Ex. 4]

Management Comments

The Director did not concur with this recommendation. He stated that the lender was contacted by the NGPC and provided additional supporting information. As a result, he believes all issues detailed in the subject finding have been resolved. This information will be provided to the OIG to satisfy this recommendation.

OIG Response

The Director did not provide a specific explanation for how the additional supporting information resolved the OIG's finding of unsubstantiated equity injection. This recommendation will be resolved during the audit follow-up and resolution process.

ACTIONS REQUIRED

Please provide your management decision for each recommendation on the attached SBA Form 1824, Recommendation Action Sheet, within 30 days from the date of this report. Your decision should identify the specific action(s) taken or planned for each recommendation and the target date(s) for completion.

We appreciate the courtesies and cooperation of the Small Business Administration during this audit. If you have any questions concerning this report, please call me at (202) 205-7390 or Terry Settle, Director, Credit Programs Group, at (703) 487-9940.

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/s/
John K. Needham
Assistant Inspector General for Auditing

Appendix I: [Ex. 4]

The deficiencies on this loan resulted in a $1,425,247 improper payment that should be recovered.

The lender, Compass Bank, was authorized by the Small Business Administration (SBA) to make guaranteed loans under the Preferred Lenders Program (PLP). As a PLP lender, the bank was permitted to process, close, service, and liquidate loans with limited documentation and review by the SBA. The lender approved a $ [Ex. 4] Recovery Act[5] loan to the borrower with a 90 percent SBA guaranty on [Ex. 4] , 2009, for the purchase of all outstanding stock of a company and for the refinancing of debt. However, the lender did not properly verify that the transaction resulted in a 100 percent ownership by the buyer. The lender also did not properly analyze repayment ability based on historical financial statements and projections. The National Guaranty Purchase Center (NGPC) purchased the loan on August 5, 2011, for $1,425,247. The loan should not have been purchased since certain requirements were not met, specifically:

Questionable Eligibility
The loan was processed as if a 10 percent owner of a company was purchasing 100 percent ownership of the same company. Through the distribution of the loan proceeds; however, we did not find adequate documentation in the lender's loan file to support the Change of Ownership action. According to Standard Operating Procedure (SOP) 50 10 5(B), for a change of ownership the lender must verify that the transaction results in 100 percent ownership by the purchasing owners. The bank provided a narrative regarding ownership showing that three individuals shared the company with 85 percent, 10 percent, and 5 percent of the ownership. However, the loan closing statements did not demonstrate that the individual with five percent ownership was bought out at closing. As a result, there is no assurance the transaction resulted in the borrower owning 100 percent of the business, as required by the SOP.

Inadequate Assurance of Repayment Ability
According to SOP 50 10 5(B), the lender's analysis must include a financial analysis of repayment ability based on historical income statements and/or tax returns and projections, including the reasonableness of the supporting assumptions. We found that the lender used a borrower-prepared, interim, seven-month financial statement for calculating repayment ability. The lender, however, did not identify that the financial statements contained discrepancies and omissions. Specifically, the interim income statement submitted on July 31, 2009, was missing three material expense items that were present on other historical financial statements provided to the lender. This included compensation of officers, salaries, and depreciation. Using historical data, we conservatively estimated these missing expenses, which resulted in an estimated loss of $329,968 instead of the $291,241 profit that was presented. Furthermore, there was evidence of off-book financing, which was missing from both the financial statements provided to the bank and the federal tax returns. The off-book financing included a restructured $785,055 promissory note dated July 10, 2009. The promissory note was issued to a company that later filed a court petition to enforce payment of the promissory note. These findings demonstrate that the lender did not consider all of the borrower's liabilities in its repayment ability analysis. A proper analysis would have identified the existence of a Uniform Commercial Code (UCC) financing statement filing dated March 25, 2009. This statement identified the borrower as the current debtor and would be evidence for additional unreported debt.

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[5] American Recovery and Reinvestment Act of 2009, Public Law 111-5

Appendix II: [Ex. 4]

The deficiencies on this loan resulted in a $669,963 improper payment that should be recovered.

The lender, The Washington Trust Company, was authorized by the SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, the bank was permitted to process, close, service, and liquidate loans with limited documentation and review by the SBA. The lender approved a $ [Ex. 4] Recovery Act loan on [Ex. 4], 2009, with a 90 percent SBA guaranty to the borrower for debt refinancing and working capital. However, the lender did not comply with the requirements for refinancing debt. The lender also did not obtain an appraisal on the property that was used as collateral, as required. The NGPC purchased the loan on December 17, 2010, for $669,963. This loan should not have been purchased since certain requirements were not met, specifically:

Questionable Eligibility (*Inappropriate Debt Refinancing*)
According to SOP 50 10 5(A), the lender must perform a written analysis that addresses all the issues of debt refinancing. The two business applicants had negative net worth as of December 31, 2008, of $140,075 and $317,022. Additionally, they were having difficulties paying the business loans that were to be refinanced with the subject SBA loan. The difficulties were evident as the bank accepted a payoff of $95,630 less than the amount due to rid itself of the non-performing loans. The lender did not consider that it— and the SBA— would likely sustain losses by refinancing the debt, and did not obtain additional collateral or alter loan terms to protect SBA's interests. Furthermore, the loan authorization indicated that the use of proceeds included debt refinancing of $854,000 and working capital of $146,000. However, the lender's narrative indicated that the $146,000 amount was actually used to refinance debt. Designating the funds as working capital may have allowed the lender to circumvent the refinancing requirements. For example, the original purpose of the loan was undocumented and that information is required for refinancing.

Questionable Eligibility (*Property Appraisal*)
According to SOP 50 10 5(A), the lender is required to obtain an appraisal for real property when the loan is greater than $250,000 and is collateralized by real property. The commercial property used as collateral for the loan was not appraised during the application process. The lender did not request the appraisal and an appraisal was not provided for the lender, as required. Instead, the lender used a September 2008 appraisal prepared for the bank holding the defaulted note that the subject loan was to refinance. The appraisal valued the property at $160,000. In June 2010, after the borrower's business showed signs of distress, the lender obtained its own appraisal of the property that valued the property at $70,000.

Appendix III: [Ex. 4]

The deficiencies on this loan resulted in a $967,869 improper payment that should be recovered.

The lender, High Trust Bank, was authorized by the SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, the bank was permitted to process, close, service, and liquidate loans with limited documentation and review by the SBA. The lender approved a $ [Ex. 4] Recovery Act loan with a 90 percent SBA guaranty on [Ex. 4], 2009, to the borrower for refinancing real estate, capital equipment leases, and a line of credit. However, the lender did not analyze repayment ability based on historical income statements and projections, including the reasonableness of the supporting assumptions to ensure the business' cash flow were adequate to service the debt. The NGPC purchased the loan on April 8, 2011, for $967,869; however, this loan should not have been purchased since certain requirements were not met, specifically:

Inadequate Assurance of Repayment Ability

According to SOP 50 10 5(B), the lender's analysis must include a financial analysis of repayment ability based on historical income statements or tax returns and projections, including the reasonableness of the supporting assumptions. The lender performed repayment ability calculations based on the borrower's projected net income for 2009. We determined that the accepted projected financial statements had material deficiencies and lacked supporting assumptions. Specifically, the projections omitted the prorated share of employee benefits and the only supporting assumption for the projected net income was the lender's statement that "the owner has taken drastic measures to reduce expenses and increase sales to level off the company." This statement was inaccurate based on the financial data provided by the borrower. Historical financial statements showed that this business did not have sufficient cash flow to service the debt. If the first quarter actuals were expanded for the three additional quarters, the financial statements would show a loss of $287,000 compared to the borrower's projected 2009 net income of $118,000. Additionally, the lender did not provide a sufficient and reasonable explanation for its projections.

Appendix IV: [Ex. 4]

The deficiencies on this loan resulted in a $555,368 improper payment that should be recovered.

The lender, Monadnock Community Bank, was authorized by the SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, the bank was permitted to process, close, service, and liquidate loans with limited documentation and review by the SBA. The lender approved a $ [Ex. 4] Recovery Act loan with a 90 percent SBA guaranty on [Ex. 4], 2009, for the purchase of three businesses, and their assets, inventory, and working capital. However, the lender did not properly analyze repayment ability based on historical financial statements, or evaluate the need for an equity injection. The NGPC purchased the loan on August 25, 2011, for $555,368; however, the loan should not have been purchased since certain requirements were not met, specifically:

Inadequate Assurance of Repayment Ability
According to SOP 50 10 5(A), the loan request must be declined if the lender's financial analysis demonstrates that the small business applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business. The lender's underwriting was insufficient to ensure repayment.

The lender improperly calculated the total annual payments for the SBA Loan. The lender stated that the total required debt service was $115,638 when the loan agreements demonstrated it was $176,257. Additionally, the lender's own calculations of the Debt Service Coverage Ratios (DSCR) of 0.06 for 2007 and 0.40 for 2008, demonstrated an inability for this business to service the SBA loan debt. There was also no explanation as to why the borrower's sales were expected to increase by $209,000, or 20 percent in 2009 when the business appraisal estimated only a $10,000 increase. The borrower also overstated their income by approximately $12,000, or 7.1 percent, for 2007 when compared against tax returns. The adjustment yields an operating loss of $9,580. Based on the unsupported projections and insufficient historical cash flow demonstrated there was not reasonable assurance of repayment ability for this loan.

Questionable Eligibility (*Inadequate Analysis of Business Plan or Managerial Experience*)
Considering the borrower's prior incursion into this industry, which resulted in the board of directors removing him as president, a thorough analysis of a business plan and managerial experience would have been prudent. The lender, however, did not perform an analysis as to how the change of ownership would have benefited the businesses as required by SOP 50 51 5(A). The Lender did not document any industry related experience of the borrower or management experience related to geographic or product diverse entities. Furthermore, there was no business plan in place to achieve the successful integration and continued operation of the three businesses.

Equity Injection Issue
According to SBA's SOP 50 51 5(A), the lender must include in its credit analysis a detailed discussion of the required equity and its adequacy. The only recorded discussion or analysis of equity injection was a statement in the credit memorandum saying that the $106,000 certificate of deposit (CD) provided by the borrower as additional collateral would also be considered an equity injection. There is neither a record of the deposit nor any mention in the Loan Authorization.

Appendix V: [Ex. 4]

The deficiencies on this loan resulted in a $310,637 improper payment that should be recovered.

The lender, Plaza Bank, was authorized by the SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, the bank was permitted to process, close, service, and liquidate loans with limited documentation and review by the SBA. The lender approved a $ [Ex. 4] Recovery Act loan with a 90 percent SBA guaranty on [Ex. 4], 2009, for debt refinancing. However, the lender did not properly analyze repayment ability based on historical financial statements and projections. Additional deficiencies included an inadequate analysis of managerial experience and an unverified equity injection. The NGPC purchased the loan on February 10, 2011, for $310,637; however, this loan should not have been purchased since certain requirements were not met, specifically:

Inadequate Assurance of Repayment Ability

The borrower's pro forma income statement for May 2009 through April 2010 included an approximate 132 percent increase in sales and an approximate 133 percent increase in income when compared to the 2008 historical data.[6] Our review, however, did not identify support to justify this increase.

Questionable Eligibility (*Inadequate Analysis of Business Plan or Managerial Experience*)

To comply with 13 CFR 120.150(a), the character, reputation, and credit history of the applicant, its associates, and guarantors should be evaluated by the lender. During our review, we determined that the owner had made financial decisions that were detrimental to the continued success of the business prior to loan disbursement. Specifically, after renting the building for approximately seven months, the borrower purchased the building by signing two 6-month balloon payment notes totaling $1,750,000. However, the borrower did not have the certification needed to signify the business as a competent and reliable manufacturer. This certification is necessary to make competitive bids for contracts. Additionally, the borrower had a history of poor financial decisions. He had already filed for bankruptcy once, had installment agreements with the Internal Revenue Service for 2004 and 2007 back taxes, and was accumulating credit card debt to operate the business.

Collateral Adequacy

The lender applied a liquidation factor of 90 percent to calculate a collateral value of $1,494,000. However, no accompanying information was found to support why the SBA's recommendation of 75 percent liquidation factor for commercial property was disregarded in lieu of a liquidation factor of 90 percent.[7]

Additionally, the lender did not consider whether the $760,000 variance between the sales comparison approach and income approach to valuation was appropriate in its final value determination. There were additional assets available to secure the loan, and therefore, the inflated liquidation value of the commercial property allowed the lender to ignore the other available collateral and caused this loan to be insufficiently collateralized.

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[6] Expanded to a 12-month period

[7] SOP 50 51 02, Chapter 17, paragraph 9.a.

Appendix V: [Ex. 4]

Equity Injection Issue (*Unsubstantiated Equity Injection*)
The lender did not include the required $169,000 equity injection as an item in the loan authorization even though the bank required it in the credit memorandum. Additionally, the lender did not substantiate the source of the equity injection. The loan file included a gift letter, a bank statement showing fund availability for the gift, and a final closing statement showing a deposit of $172,000 into the lender's account. The file, however, did not contain any substantial evidence that the funds presented at closing truly originated from the gift check or wire transfer. According to SOP 50 10 5(A), large unexplained deposits should always be questioned and the source of the funds documented.
A promissory note, "gift letter" or financial statement alone is generally not sufficient evidence of cash injection.

Appendix VI: [Ex. 4]

The deficiencies on this loan resulted in a $680,900 improper payment that should be recovered.

The lender, American Bank of Commerce, was authorized by the SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, the bank was permitted to process, close, service, and liquidate loans with limited documentation and review by the SBA. The lender approved a $[Ex. 4] Recovery Act loan with a 90 percent SBA guaranty on [Ex. 4], 2009, to pay outstanding debt and purchase inventory and working capital, but did not adequately verify equity injection. The NGPC purchased the loan on March 31, 2011, for $680,900; however, the loan should not have been purchased since certain requirements were not met, specifically:

Unsubstantiated Equity Injection

The lender's credit memorandum and, more importantly, the SBA loan authorization required a $400,000 equity injection to be used for inventory purchases. Instead, the loan file evidenced:

1. Two wire transfer deposits totaling $100,000 from unidentified or unsubstantiated sources.
2. No proof of deposit into the business account for two checks totaling $100,000.
3. Three partial standby debt agreements totaling $350,000, two of which were executed approximately eight months after loan disbursements began and one executed at an unknown time.
4. Invoices for both equipment and inventory some of which were purchased as much as three months before the purported equity injections occurred and five months before the loan was approved.

According to SOP 50 10 5(A), lenders must verify the injection prior to disbursing loan proceeds and must maintain evidence of such verification in their loan files. Furthermore, SOP 50 10 5(A) requires "debt that is on partial stand-by (interest payments only being made) may be considered equity only when there is adequate historical business cash flow available to make the payments." The two most recent tax transcripts provided by the borrower, prior to loan approval, showed an operating loss of $71,457 in 2006, and a loss of $314,897 in 2007.

Appendix VII: Agency Comments

U.S. SMALL BUSINESS ADMINISTRATION

WASHINGTON, D.C. 20416

MEMORANDUM
April 26, 2013

To: John K. Needham
Assistant Inspector General for Auditing

From: John A. Miller
Director, Office of Financial Program Operations

Subject: Response to Draft Advisory Memorandum Identifying $4.6 Million in Improper Payments on Six 7(a) Recovery Act Loans, Project No. 12503A

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Recovery Act") (P.L. 111-5). The Recovery Act provided the SBA with $730 million to expand the Agency's lending and investment programs and create new programs to stimulate lending to small businesses. Of the $730 million received, $375 million was authorized for the SBA to (1) eliminate or reduce fees charged to lenders and borrowers for 7(a) and 504 loans, and (2) increase its maximum loan guaranty to 90 percent for eligible 7(a) loans. The OIG conducted this audit due to concerns that lenders would not exercise due diligence in originating and closing loans given the 90 percent SBA guaranty reduced lender risk.

The memorandum identifies six loans that OIG believes warrant immediate attention by the agency in order to recover $4.6 million of improper payments. The loans reviewed in the audit were purchased by the National Guaranty Purchase Center (NGPC) between February 17, 2009 and January 31, 2012. Deficiencies identified in the six loans included:

- Questionable Eligibility
- Inadequate Assurance of Repayment Ability
- Equity Injection Issues
- Insufficient Collateral

The six loans were originated by Preferred Lender Program (PLP) lenders. The audit found that these lenders did not originate and close the six 7(a) Recovery Act loans in accordance with the SBA's rules and regulations, and commercially prudent lending standards. Furthermore, OIG believes that SBA loan officers at the NGPC did not identify the deficiencies in the six loans during their purchase reviews.

In FY 2013, OFPO has continued its training of NGPC finance professionals processing guaranty purchases for high dollar early defaults. To date, 21 of the 40 finance professionals have completed the intensive commercial lending and credit training and its certification test, with the remainder to complete the training by November. Additionally, OFPO has differentiated the standard given to NGPC staff so additional credit is given to support purchase reviews for early defaulted, high dollar loans. This differentiation on credit provides additional time for loan officers to be more effective and thorough during purchase reviews. Finally, OFPO has initiated risk management initiatives at NGPC including the close tracking of purchase deficiencies detected during quality control reviews and providing ongoing corrective action and education. NGPC and OFPO management will continue to collaborate with the OIG in an effort to reduce improper payments.

Management's response to the recommendations in the draft report is noted as follows:

1. Seek recovery of $1,425,247 from Compass Bank on the guaranty paid by SBA for the loan to **[Ex. 4]**

OFPO does not concur with this recommendation based on the reasons provided by the OIG in its findings of Questionable Eligibility and Inadequate Assurance of Repayment Ability. OFPO is reviewing an additional issue that OIG did not identify, which may warrant full recovery from the lender. OFPO will report its findings to the OIG by June 15, 2013.

2. Seek recovery of $669,963 from the Washington Trust Company on the guaranty paid by the SBA for the loan to **[Ex. 4]**

OFPO concurs with this recommendation regarding the OIG's findings of Questionable Eligibility. OFPO will request full recovery of $669,963 from the lender by May 31, 2013.

3. Seek recovery of $967,869 from High Trust Bank on the guaranty paid by SBA for the loan to **[Ex. 4]**

OFPO does not concur with this recommendation that the OIG's findings of Inadequate Assurance of Repayment Ability led to an improper payment. OFPO will enter this into the

OCA HQ denial review process no later than May 31, 2013.

4. Seek recovery of $555,368 from Monadnock Community Bank on the guaranty paid by SBA for the loan to **[Ex. 4]**

OFPO concurs with this recommendation. OFPO agrees with OIG's findings of Questionable Eligibility, and will request full recovery of $555,368 from the lender by May 31, 2013.

5. Seek recovery of $310,637 from Plaza Bank on the guaranty paid by SBA for the loan to **[Ex. 4]**

OFPO concurs with this recommendation and the OIG's findings of an Equity Injection Issue (Unsubstantiated equity injection) for this loan. OFPO will request full recovery of $310,637 from the lender by May 31, 2013.

6. Seek recovery of $680,900 from American Bank of Commerce on the guaranty paid by SBA for the loan to **[Ex. 4]**

OFPO does not concur with the recommendation. The lender was contacted as part of the NGPC audit response effort, and has provided additional supporting information. All issues detailed in the subject finding have been resolved as a result of additional information provided by the lender. This information will be provided to the OIG to satisfy this recommendation.

Thank you for the opportunity to review the draft memorandum. Please let us know if you need additional information or have any questions regarding our response.