

**AUDIT OF
NON-TAX DELINQUENT DEBT
WASHINGTON, DC
AUDIT REPORT NO. 9-11
July 28, 1999**

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U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20416

AUDIT REPORT
Issue Date: July 28, 1999
Number: 9-11

To: Jane P. Butler, Associate Administrator
for ~~Financial Assistance~~
[FOIA Ex. 6]
From: ~~Jonna Dye~~, Acting Assistant Inspector General
for Auditing
Subject: Audit of Non-Tax Delinquent Debt

Attached is a copy of the subject audit report. The report contains two findings with three recommendations.

The recommendations in this report are subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for audit follow-up.

Any questions or discussion of the issues contained in the report should be directed to Garry Duncan at (202) 205-[FOIA Ex 2]

Attachment

**AUDIT OF NON-TAX DELINQUENT DEBT
SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC**

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SUMMARY

This audit was performed as part of a President's Council on Integrity and Efficiency project to evaluate the effectiveness of the Government's efforts to collect non-tax delinquent debt. The audit objectives were to determine whether the U.S. Small Business Administration (SBA) complied with the collection requirements in the Debt Collection Improvement Act of 1996 (DCIA) and whether the amount of delinquent debt reported to Department of the Treasury (Treasury) was accurate. SBA had 21,510 loans valued at \$1.7 billion that were delinquent over 180 days or charged off as of December 31, 1998. We statistically selected 88 loans valued at \$6.6 million to review.

SBA has neither fully implemented all of the provisions of the DCIA nor established timeframes for full implementation. In its collection efforts, SBA used many of the collection tools described in the DCIA and in Office of Management and Budget (OMB) Circular A-129. Some delinquent debt, however, was not referred to Treasury when established referral criteria were met. Twenty-two (25 percent) of the 88 loans reviewed, valued at \$1.5 million, should have been referred to Treasury. See Appendix A for details on loans reviewed and those that should have been referred. In addition, administrative wage garnishment and Federal wage matching collection tools were not used.

The \$1.7 billion in delinquent debt reported, as of September 30, 1998, to Treasury on the Report on Receivables Due From the Public was reliable. Guarantee fee receivables, however, were overstated by approximately \$22.6 million. This occurred because cancellations and modifications to the Guarantee Fee Accounts Receivable were not being posted.

The report contains recommendations to the Associate Administrator for Financial Assistance to implement the remaining provisions of the DCIA. Recommendations on collection actions regarding disaster home loans and the reliability of guarantee fee receivables are addressed in separate reports.

The findings in this report are the conclusions of the OIG's Auditing Division based on testing of the auditee's operations. The findings and recommendations are subject to review, management decision, and corrective action by your office in accordance with exiting procedures for follow-up and resolution.

INTRODUCTION

A. BACKGROUND

With the enactment of the Debt Collection Improvement Act of 1996 (DCIA), Congress placed new emphasis on the collection of delinquent debt. One of the primary purposes of the DCIA is to maximize the collection of delinquent debts by ensuring quick action through the use of all available collection tools contained in OMB Circular A-129, "Policies for Federal Credit Programs and Non-Tax Receivables." When a debt becomes seriously delinquent – over 180 days past due – agencies are required to refer these debts to Treasury. Delinquent debt can be referred for the Treasury Offset Program (TOP) whereby Treasury diverts all or part of a Federal payment due the debtor to the debtor agency. Delinquent debt also can be referred for cross servicing whereby Treasury pursues collection through such actions as sending demand letters, making telephone calls, using skiptracing, or negotiating a compromise. Delinquent debts referred for cross servicing are automatically included in TOP, but those referred for TOP are not automatically included as part of cross servicing.

The Small Business Administration (SBA) provides financial support to small business concerns and to disaster victims, both homeowners and businesses, through direct and guaranteed loans. Direct loans are originated and serviced by SBA under the Disaster Assistance Program and fund long-range recovery for private-sector, non-agricultural disaster victims. SBA guaranteed loans are originated and serviced by participating lenders under the 7(a) Guaranteed Loan Program to assist small businesses that cannot obtain financing on reasonable terms through normal channels.

OMB Circular A-129, "Policies For Federal Credit Programs and Non-Tax Receivables", provides several techniques for collecting delinquent debts:

- contacting borrowers within 30 days after a missed payment,
- restructuring the loan.
- compromising the amount of the debt,
- foreclosure,
- referral to the Justice Department for litigation, and
- garnishment of the borrowers' salary.

In October 1997, SBA requested Treasury to designate SBA as a collection center for its own debt. The request was based on the fact that SBA has the structure needed to collect delinquent debts, uses many of the available collection tools, and has the accounting and information systems to provide comprehensive reports on collection activities. Designation as a collection center would allow SBA to use the same collection techniques used by Treasury. In March 1999, SBA requested a waiver from the requirement to transfer to Treasury debt that is over 180 days delinquent if it was unlikely SBA would be designated a debt collection center. As of the date of this report, SBA had not received a decision from Treasury on its requests.

SBA currently is moving away from direct loan servicing. One method of implementing the transition is through the sale of SBA owned assets. SBA's budget for Fiscal Year 1999 provides a timeline for selling purchased guaranteed loans and direct loans by the end of fiscal year 2000. If the sales program is successful, asset sale would become an ongoing project, thereby virtually eliminating delinquent government debt and the need for collection activity.

B. AUDIT OBJECTIVES AND SCOPE

The audit objectives were to determine if SBA had implemented the requirements of the DCIA and to validate the \$1.7 billion in delinquent debt reported to Treasury on the SF-220 Schedule 9, Report on Receivables Due From the Public, as of September 30, 1998. To achieve the objectives, we reviewed SBA loan files for 88 loans, totaling \$ 6.6 million. The loans were selected from a universe of 21,510 loans valued at \$1.7 billion that were delinquent for more than 180 days or charged off as of December 31, 1998. The evaluation of the reliability of the reported delinquent debt to Treasury was done by independent auditors as part of the financial statement audit for fiscal year 1998.

To evaluate implementation of the DCIA requirements, we reviewed SBA loan files and records showing loans transferred to Treasury; interviewed SBA portfolio management program officials in Headquarters and SBA loan and liquidation officers in district and branch offices; reviewed selected lender loan files; and interviewed cognizant lender personnel. During the review of SBA loan files, we also noted any documentation that evidenced lender collection activity prior to purchase of the guarantee. We recently completed an audit of collection actions for disaster home loans that supplements the results discussed in Finding 1. SBA's independent auditors performing the annual financial statement audit under the Chief Financial Officers Act verified the reliability of the \$1.7 billion delinquent debt reported to Treasury as of September 30, 1998. The results of their review are presented in Finding 2.

The fieldwork was conducted from January through March 1999. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

FINDING 1 SBA has not fully Implemented the Debt Collection Improvement Act

SBA neither fully implemented all of the provisions of the DCIA nor established timeframes for full implementation. While SBA used many of the collection tools described in the DCIA and in Office of Management and Budget (OMB) Circular A-129, some delinquent debt was not referred to Treasury when established referral criteria were met. Twenty-two of the 88 loans reviewed, valued at \$1.5 million, should have been referred to Treasury (see Appendix A). Although, SBA used various tools to collect delinquent debt for 81 (33 direct and 48 guaranteed) of the loans reviewed, including loans that should have been referred, administrative wage garnishment and Federal wage matching were not used.

Collection tools provided by the DCIA and OMB Circular A-129 include:

- *Borrower contact* – OMB Circular A-129 requires an agency to send a written request for payment to the debtor as soon as the debt becomes delinquent. Agencies are also encouraged to contact borrowers by telephone or in person. Contact with the borrower enables SBA to determine the cause of the delinquency and identify the appropriate collection tool or tools to cure the delinquency.
- *Restructure* – Restructure (or workout) consists of several approaches that can be used to resolve a delinquency, such as: (1) changing the original terms of the loan to reflect the borrower's financial position; (2) temporarily reducing or deferring loan payments; and (3) reducing the rate of interest.
- *Compromise* – An amount less than the total amount owed is accepted as payment in full by mutual agreement of the debtor and the lender.
- *Collection Agency* – Referral of delinquent debt to a private collection agency.
- *Foreclosure* – Foreclosure consists of taking possession of the collateral and applying the proceeds from the sale, after paying costs of foreclosure, to the debt.
- *Litigation* – Referral to the Department of Justice for legal action.
- *Garnishment* – Administrative garnishment of an individual's non-Federal government pay (under the DCIA a court order is not required).
- *Treasury Offset Program* – Referral to Treasury for offset for a match of delinquent debtors files against Federal payment files. When a match occurs, payment is intercepted and the debt is offset.

Exemptions from referral

The DCIA and Treasury established several conditions that exempt a delinquent debt from referral including:

- debt referred to a private collection agency or a designated collection center,
- debt scheduled for sale under an asset sales program within one year or longer if approved by OMB,
- debt in foreclosure or litigation,
- debt collectible through internal agency offset within three years,
- debt owed by a deceased person, and
- debt that is included in a bankruptcy (Chapter 7, 11, or 13) or has been discharged by bankruptcy.

Loans that should have been referred

We considered that debt should have been referred to Treasury whenever it became 180 days delinquent unless there was evidence in the loan file indicating that one of the above exemptions applied. The loan files did not indicate that an exemption applied to any of the 22 loans that should have been referred when they became 180 days delinquent. Currently, loan and liquidation officers are responsible for coding loans for referral to Treasury in the loan accounting system. If a loan file is not actively being worked and a referral code is not entered in the loan accounting system the loan could become 180 days delinquent and not be referred to Treasury. The following table shows SBA's compliance with the DCIA by direct and purchased loans.

Description	Direct Loans	Purchased Loans	Total
Loans Reviewed	39	49	88
Collection Tools used	33	48	81
No Evidence of Collection Tools being used	6	1	7
Should have been referred (see note)	15	7	22

Note: Subsequent to our review of the loan files, one loan was referred for crossing servicing and notices of pending referral were sent to borrowers for four additional loans.

Loans exempt from referral

Sixty-six loans met criteria exempting them from referral to Treasury. As shown in the following table, some loans met more than one exemption criteria.

Exemption from Referral	No. of Exemptions
Bankruptcy	33
Compromise	14
Restructure (workout)	7
Collateral (Foreclosure)	26
Litigation	10
Other (Death, Investigation, etc.)	10

The 39 direct loans originated and serviced by SBA are debts to the Government at the time of disbursement. The 49 guaranteed loans, originated and serviced by

participating lenders, however, are not debts to the Government until SBA has purchased the loan guarantee. Unlike direct loans, guaranteed loans are not subject to the DCIA upon delinquency by the borrower. These loans only become subject to the DCIA when the loan guarantee is purchased by SBA and a debt to the Government is established. This generally occurs up to 120 days after the lender received the last payment. Lenders often continue to service delinquent loans after purchase on behalf of the Agency; however, SBA is responsible for ensuring that the appropriate collection techniques are used for debt collection.

Direct loans

Direct business loans consisted of loans made under the 7(a) and the disaster programs. Home loans were made under the disaster program and were reviewed separately in an audit of collection efforts at the home loan servicing centers. Fifteen business loans should have been referred to Treasury but were not and collection action should have been initiated sooner for 113 disaster home loans. SBA, therefore, may not have maximized recoveries for direct loans.

Business Loans. SBA used debt collection tools described in the DCIA and OMB Circular A-129 in servicing 33 of 39 delinquent business loans. The files for the remaining six loans contained no evidence of attempts to collect the debts. The principal tools used were borrower contact, loan restructuring, and referral for collection. Fifteen of the 39 business loans met the criteria for referral but were not referred to Treasury, as required.

Disaster Home Loans. A separate audit conducted by the Office of Inspector General showed that Disaster Home Loan Servicing Centers (Centers), which are responsible for servicing delinquent home loans, generally did not comply with the collection and referral requirements of the DCIA. The audit showed that collection and liquidation actions should have been initiated earlier for 113 of the 267 past due loans reviewed. In addition, 46 of 165 charged off disaster home loans reviewed were not referred to litigation or Treasury for further collection actions. In February 1998, SBA established a goal to contact delinquent borrowers weekly to improve timeliness of borrower contacts and amounts collected. This goal was met in February 1999 and SBA reported the currency rate and cash collections had increased about 1.5 percent and 19 percent, respectively. The audit report on the Centers made recommendations to ensure that improved collection actions continue and delinquent debt is referred for litigation or to Treasury for collection actions. In fiscal year 1998, SBA began referring unsecured disaster home loans that were over 180 days delinquent to Treasury.

Guaranteed loans

SBA used collection techniques required under the DCIA and OMB A-129 on 48 of the 49 guaranteed loans reviewed. Seven of the 49 loans that met the conditions for referral to Treasury for further collection were not referred. As a result, maximization of recoveries may not have been achieved for the seven loans.

Lender serviced purchased loans

SBA did not refer purchased guaranteed loans that continued to be serviced by the lender for administrative offset. Once SBA has purchased a guarantee, the loan becomes subject to the provisions of the DCIA and the tools available under the DCIA should be used, if appropriate. By excluding purchased loans from referral to TOP, SBA automatically excludes the use of an important collection tool and loses an opportunity to collect delinquent debt.

Garnishment

The DCIA permits agencies to garnish non-Federal wages of delinquent borrowers to collect non-tax delinquent debt without having to obtain a court order (administrative garnishment). Before an individual's wages can be garnished, however, the debtor must be notified in writing of the intent to garnish at least 30 days prior to initiating garnishment proceedings. The agency must provide the debtor an opportunity to inspect and copy agency records related to the debt, to establish a repayment agreement, and to receive a hearing concerning the existence or amount of the debt and the terms of a repayment schedule. SBA is responsible for prescribing regulations to be followed in conducting administrative garnishment hearings.

SBA's Office of Hearings and Appeals is writing a regulation prescribing the procedures to be followed in implementing the administrative garnishment process. At the time of the audit, SBA had not established a timetable for completing the regulations so the administrative garnishment process could be used as a collection tool.

Salary offset

SBA previously matched delinquent disaster home loan debtors with the payrolls for the Department of Defense (DOD) and the U.S. Postal Service (USPS), but stopped matching with the USPS payroll in calendar year 1997 because of minimal results and SBA's ability to verify postal service employment through other sources. In Fiscal Year 1998, problems were encountered with reading DOD automated information; therefore, a DOD file match was not accomplished in 1999. Since Treasury is scheduled to implement Federal salary matching as part of TOP during the latter part of 2000, no recommendation is being made.

Recommendations:

We recommend that the Associate Administrator for Financial Assistance:

- 1A. Revise the loan accounting system procedures to automatically refer all loans delinquent over 180 days to Treasury unless an exemption code is entered into the system.

- 1B. Refer purchased loans that continue to be serviced by the lender to Treasury for offset.
- 1C. Establish a timeframe for implementing administrative garnishment of non-Federal wages.

Management Response

The Acting Assistant Administrator for Portfolio Management agreed with the recommendations and stated that: (i) system changes are in process to refer all loans delinquent over 180 days to Treasury for administrative offset unless coded exempt; (ii) lender serviced purchased loans will be referred to Treasury after the referral process for SBA loans has been implemented; and (iii) timeframes have been established for implementing wage garnishment. Complete management comments are presented in Appendix B.

Evaluation of Management's Response

The actions taken or planned are responsive to our recommendations.

FINDING 2 Non-Tax Delinquent Debt Receivables were Reliable

As of September 30, 1998, SBA accurately reported to Treasury on the Report on Receivables Due From the Public (Schedule 220-9) that it had \$1.7 billion in delinquent debt. The receivable for loan guarantee fees, however, was overstated by about \$22.6 million because loan modifications or cancellations were not recorded in the loan accounting system.

The CPA firm auditing SBA's financial statements reconciled the total delinquent receivables reported on the Schedule 220-9 to the general ledger. Because of differences in the date fields in the file furnished the auditors and the file used to prepare the Schedule 220-9, the age of the accounts in the general ledger could not be determined.

SBA does not assess collectibility of receivables for an individual loan. SBA establishes an Allowance for Doubtful Accounts and uses that as a basis for estimating the amount of non-collectible receivables. The auditors review showed that the SBA's method used to compute the estimate for the Allowance for Doubtful Accounts was acceptable and the amount was considered reasonable.

The amount of the guarantee fee charged to lenders is based on the dollar amount of the loan. Generally, the fees are payable within 90 days of SBA approval. Once the loan application is approved, SBA, the lender, and the borrower execute a loan agreement containing the conditions and requirements for the loan. Among the conditions and requirements are time limits for the disbursement of loan proceeds. This time limit cannot be exceeded without prior SBA approval. If the loan is canceled or modified, SBA refunds or adjusts the guarantee fee. The guarantee fee receivable account as of

September 30, 1998, included 9,014 loans with fees outstanding of \$22.6 million for loans with approval dates of September 30, 1997 or earlier. Office of Chief Financial Officer personnel stated SBA was aware of the problem and it should be corrected in the near future. The overstatement and recommendation for corrective action will be included in the management letter to be issued as part of the financial statement audit.

This report does not include a recommendation regarding the financial information on SBA's receivables. Any required adjustments to the financial statements and/or account balances will be made by our financial auditors when their report is issued.

**SCHEDULE OF LOANS REVIEWED, STATUS, AND IDENTIFICATION
OF LOANS THAT SHOULD HAVE BEEN REFERRED**

Sample Number	Loan Number	Borrower	Loan Status	Loans That Should Be Referred	
				Direct	Guaranteed
			In Liquidation		
1			Charged Off		X
2			Charged Off		
3			In Liquidation		
4			Regular Servicing		
5			In Liquidation		
6			Charged Off		
7			Charged Off		
8			In Liquidation		
9			In Liquidation		
10			Charged Off		
11			Charged Off		X
12			Charged Off	X	
13			In Liquidation		X
14			In Liquidation		
15			Charged Off		X
16			In Liquidation	X	
17			Charged Off		X
18			In Liquidation		
19			In Liquidation		
20			In Liquidation	X	
21			Charged Off		
22			Charged Off		
23			Regular Servicing		
24			In Liquidation	X	
25			In Liquidation		
26			In Liquidation	X	
27			Regular Servicing	X	
28			In Liquidation		
29			In Liquidation		
30			In Liquidation		
31			In Liquidation	X	
32			Charged Off		
33			In Liquidation		
34			In Liquidation		
35			In Liquidation		
36			In Liquidation		
37			In Liquidation		
38			In Liquidations		
39			In Liquidations		
40			In Liquidations		
41			In Liquidations		
42			Regular Servicing		
43			Charged Off		
44			Charged Off		X
45			Charged Off		

**SCHEDULE OF LOANS REVIEWED, STATUS, AND IDENTIFICATION
OF LOANS THAT SHOULD HAVE BEEN REFERRED**

Sample Number	Loan Number	Borrower	Loan Status	Loans That Should Be Referred	
				Direct	Guaranteed
46	7		Charged Off		
47			In Liquidations	X	
48			Charged Off		
49			Charged Off	X	
50			Charged Off		
51			Charged Off	X	
52			In Liquidations	X	
53			In Liquidations		
54			Charged Off		
55			In Liquidations	X	
56			In Liquidations		
57			In Liquidations		
58			In Liquidations		
59			Charged Off		
60			In Liquidations		
61			Charged Off		
62			Charged Off		
63			In Liquidations	X	
64			In Liquidations		
65			Charged Off		
66			Charged Off		
67			Charged Off		
68			Charged Off		
69			Charged Off		
70			In Liquidations		
71			In Liquidations		
72			In Liquidation		
73			In Liquidation		X
74			In Liquidation		
75			In Liquidation		
76			In Liquidation	X	
77			Charged Off		
78			Charged Off		
79			In Liquidations		
80			Charged Off		
81			Regular Servicing	X	
82			In Liquidation		
83			In Liquidation		
84			Charged Off		
85			Charged Off		
86			Charged Off		
87			In Liquidation		
88			In Liquidation		

FOIA Ex. 4



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: July 1, 1999

TO: Garry Duncan, Acting Assistant Inspector General for Auditing

FROM: Arnold S. Rosenthal, AA/PM [FOIA Ex. 6]

SUBJECT: Draft Audit Report – Audit of Non-Tax Delinquent Debt

We appreciate the opportunity to review the above draft audit report and have the following comments on your recommendations:

1A. Revise the loan accounting system procedures to automatically refer all loans delinquent over 180 days to Treasury unless an exemption code is entered into the system.

Comment: We agree with this recommendation and are working with the Office of Chief Information Officer (OCIO) to implement the systems changes to refer all loans delinquent over 180 days to Treasury for purposes of administrative offset (TOP) unless a loan is coded exempt because of a pending workout, bankruptcy or other proceeding that would not be consistent with offset. We anticipate that the systems changes will be completed by August 31, 1999, and that field office instructions will be issued by that date.

1B. Refer purchased loans that continue to be serviced by the lender to Treasury for offset.

Comment: We agree with this recommendation. First, however, we will implement the referral process for SBA serviced loans, and then for lender serviced accounts after any systems problems are identified and corrected for the SBA serviced portfolio. Also, we need to ensure that lenders are aware that their loans in liquidation may be offset after guaranty purchase so they can notify SBA to remove loans from the offset process if an offset would impair ongoing proceedings including foreclosure or litigation, or adversely affect other actions such as bankruptcy.

1C. Establish a timeframe for implementing administrative garnishment of non-Federal wages.

Comment: We agree with this recommendation. We are coordinating with the Office of Hearings and Appeals and the Office of General Counsel for publication of wage garnishment regulations. A draft of the regulations has been completed and will be put into clearance shortly. Initial target dates are the following:

- 9/30/99 – publication of proposed regulations in the Federal Register.
- 11/30/99 – publication of final regulations.
- 12/30/99 – field office notice issued or amendment to SOP 50 51 advising field offices of new procedures.

Finally, as a matter of information, we note that of the 22 cases in your sample that you indicate should have been referred to Treasury:

- 2 have been transferred to Treasury for cross servicing
- 3 are marked “workout – don’t refer”
- 5 are coded bankruptcy, and
- 4 are marked “refer.”

Of the remaining 8 loans, all except one are classified in regular servicing or liquidation and should be referred when systems changes are implemented by OCIO. The other loan is a charged off account that apparently has not been sent to Treasury. We are checking to determine why this has not occurred.

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