Performance Audit

Purchase Reviews Allowed $3.1 Million in Improper Payments on 7(a) Recovery Act Loans

January 29, 2014 Report Number 14-09

U.S. Small Business Administration
Office of Inspector General
Washington, D.C. 20416

REPORT TRANSMITTAL
REPORT NO. 14-09

DATE: JANUARY 29, 2014

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

SUBJECT: Purchase Reviews Allowed $3.1 Million in Improper Payments on 7(a) Recovery Act Loans

This report is the second in a series resulting from our ongoing audit of purchased 7(a) Recovery Act loans. The first report identified improper payments and recommended recovery on six purchased 7(a) Recovery Act loans totaling $4.6 million. The purpose of this report is to notify you of improper payments made on an additional three loans and to recommend recovery of $3.1 million less any amounts received from liquidation.

We conducted this audit 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 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 objective.

We appreciate the courtesies and cooperation of the SBA extended to the staff during this audit. Please direct any questions to me at (202) 205-7100 or Terry Settle, Director, Credit Programs Group at (703) 487-9940.

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/s/
Robert A. Westbrooks
Deputy Inspector General

EXECUTIVE SUMMARY:

Purchase Reviews Allowed $3.1 Million in Improper Payments on 7(a) Recovery Act Loans

Report Number 14-09

What the OIG Reviewed

The Recovery Act provided the Small Business Administration (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.

This report is the second in a series resulting from our ongoing audit of purchased 7(a) Recovery Act loans. The first report identified improper payments and recommended recovery on six purchased 7(a) Recovery Act loans totaling $4.6 million. This report addresses improper payments on an additional three loans. 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.

For the purposes of this audit report, we selected nine loans based on perceived risks using an internally developed OIG loan scoring system. We reviewed all loan origination, closing, and purchase actions as documented in SBA and lender loan files. We assessed these actions against all applicable SBA requirements. Further, we reviewed information in the SBA's Loan Accounting System for all loans examined.

What the OIG Found

The OIG found that three of the nine 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. As the deficiencies identified in the three loans were not identified during SBA's purchase reviews, they resulted in inappropriate or unsupported disbursements of approximately $3.1 million.

These deficiencies were categorized into the following types based on the nature of their noncompliance:

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

Additionally, we identified two loans totaling $2.5 million that were not purchased in accordance with SBA's purchase review requirements and resulted in improper payments. However, documentation provided by the lenders during our audit mitigated the identified deficiencies and therefore, we are not recommending recovery of the guaranty amounts paid by SBA for these loans.

OIG Recommendations

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

1. Seek recovery of $1,473,770 (less any amounts received from liquidation) from TD Bank on the guaranty paid by the SBA for the loan to [Ex. 4] [Ex. 4] .

2. Seek recovery of $685,691 (less any amounts received from liquidation) from Florida Community Bank (formerly First Peoples Bank) on the guaranty paid by the SBA for the loan to [Ex. 4] .

3. Seek recovery of $897,091 (less any amounts received from liquidation) from Liberty Bank on the guaranty paid by the SBA for the loan to [Ex. 4, 6] [Ex. 4, 6] .

Management Response and Actions Taken

The SBA agreed with each recommendation. The SBA has recently taken steps to improve the purchase review process for high-dollar early defaulted loans. Specifically, the SBA requires a quality control review to be performed on each high-dollar early defaulted loan before purchase. Additionally, the SBA has revised internal checklists to further assess repayment ability on early defaulted loans. Finally, the SBA has recently issued new procedures with revised underwriting standards for 7(a) loans.

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Introduction

This report is the second in a series resulting from our ongoing audit of purchased 7(a) Recovery Act[1] loans. The first report[2] identified improper payments and recommended recovery on six purchased 7(a) Recovery Act loans totaling $4.6 million. The purpose of this report is to notify you of improper payments[3] made on an additional three loans and to recommend recovery of the related questioned costs.[4] These improper payments were the result of lender deficiencies that were not identified during SBA's purchase reviews. The purchase reviews on these loans occurred between December 23, 2010, and August 1, 2012. The total approved amount for these loans was approximately $3.4 million and the SBA purchased its guaranteed share of the principal loan balances for approximately $3.1 million. We are questioning the full $3.1 million of the SBA's purchased amount. Additionally, we identified two loans totaling $2.5 million that were not purchased in accordance with SBA's purchase review requirements and resulted in improper payments. However, documentation provided by the lenders during our audit cured the identified deficiencies and therefore, we are not recommending recovery of the guaranty amounts paid by the SBA for these loans.

The loan deficiencies identified during the audit indicate there were serious flaws in the NGPC's purchase process at the time the loans were purchased. However, we previously issued two audit reports and made recommendations to address the deficiencies in the purchase review process. The recommendations included suggestions to: (1) establish a specialized early default purchase review unit and (2) 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. Further, the SBA has made progress in addressing these previous recommendations and improving its purchase process over high-dollar early-defaulted loans.

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 applied the scoring system to a universe of 75 high-dollar[5] early defaulted[6] Recovery Act loans. Additionally, we eliminated loans that were involved in previous audits or were in an unstable status due to the SBA review process or guaranty repair action. We then selected nine loans that we were able to access from the National Guaranty Purchase Center (NGPC).

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

[2] Advisory Memorandum 13-16R, *Purchase Reviews Allowed $4.6 Million in Improper Payments on 7(a) Recovery Act Loans,* issued June 14, 2013.

[3] For the purpose of this report, 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.

[4] For purposes of this report, "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.

[5] For purposes of this report, "high-dollar" is defined as loans approved for $500,000 or more.

[6] For purposes of this report, "early defaulted" as loans that default within 18 months of initial loan disbursement.

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 four of the nine loans reviewed. We also identified suspicious activity in one of the four loans with material deficiencies and referred it and another loan to the Office of Inspector General (OIG) Investigations Division. As a result, we omitted the details of these loans from this report. The remaining three loans with material deficiencies resulted in questioned costs totaling $3.1 million.

To further 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 December 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.

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's rules and regulations. 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. 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.

Nature of Limited or Omitted Information

We identified suspicious activity in two loans and referred them to the OIG Investigations Division. As a result, we omitted the details of these loans from this report.

Review of Internal Controls

The SBA's internal control systems Standard Operating Procedure (SOP)[7] provides guidance on the implementation and maintenance of effective systems of internal control as required by OMB.[8] According to OMB, effective systems of internal control improve the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls.

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 aide in our understanding of the internal controls relevant to our on-going audit of 7(a) Recovery Act loans.

Results

The audit found that three 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.[9] As the deficiencies identified in the three loans were not identified during SBA's purchase reviews, they resulted in inappropriate or unsupported disbursements of approximately $3.1 million, which are further detailed in the Appendices of this report. The deficiencies and the related requirements are summarized in Table 1, and include:

- ***Deficiency Type A: Questionable Eligibility***
  According to SOP 50 10 5, 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, on SBA-guaranteed loans, the cash flow of the Small Business Applicant is the primary source of repayment, not the liquidation of collateral. Thus, if the lender's financial analysis demonstrates that the Small Business Applicant lacks reasonable assurance of repayment in a timely manner form the cash flow of the business, the loan request must be declined, regardless of the collateral available.

- ***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, the lender must include in its credit analysis a detailed discussion of the required equity and its adequacy. Additionally, SOP 50 51 requires lenders to verify the source as well as the existence of an equity injection that is greater than one-third 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.

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[7] SOP 00 02, *Internal Control Systems.*
[8] US Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control,* 2004.
[9] Title 13 Code of Federal Regulations, *Business Credit and Assistance*.

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.

Table 1 Summary of Findings

Loan Number	Borrower's Name	Deficiency Type	Amount Approved	SBA Guaranty Amount	Questioned Cost^
[Ex. 4]	[Ex. 4]	A,B,C	$1,640,000	$1,476,000	$1,473,770
[Ex. 4]	[Ex. 4]	B	$750,000	$675,000	$685,691
[Ex. 4, 6]	[Ex. 4, 6]	A,B	$999,950	$899,955	$897,091
Total			**$3,389,950**	**$3,050,955**	**$3,056,552**

Source: SBA Loan Accounting System and OIG results
Legend: A) Questionable Eligibility B) Inadequate Assurance of Repayment Ability C) Equity Injection Issues
^ Includes interest purchased

The loan deficiencies identified during the audit indicate there were serious flaws in the NGPC's purchase process at the time the loans were purchased. 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.

Further, the SBA has made progress in addressing the report recommendations and improving its purchase process over high-dollar early-defaulted loans. Specifically, the SBA has: (1) required quality control reviews prior to loan purchase on all high-dollar early defaults, (2) revised internal checklists to further assess repayment ability on early defaulted loans, and (3) issued new procedures with revised

underwriting standards for 7(a) loans. Future audits and additional loan reviews will assess the process after the full implementation of our recommendations.

Conclusion

The audit found that lenders did not originate and close the three 7(a) Recovery Act loans in accordance with the SBA's rules and regulations, and commercially prudent lending standards. Furthermore, SBA loan officers did not identify the deficiencies in the three loans during their purchase reviews. The SBA purchased its guaranties on these three loans, which resulted in approximately $3.1 million of questioned costs. As a result of the identified deficiencies, we recommend that the SBA seek recovery of approximately $3.1 million less any amounts received from liquidation.

Recommendations

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

1. Seek recovery of $1,473,770 (less any amounts received from liquidation) from TD Bank on the guaranty paid by the SBA for the loan to [Ex. 4] .

2. Seek recovery of $685,691 (less any amounts received from liquidation) from Florida Community Bank (formerly First Peoples Bank) on the guaranty paid by the SBA for the loan to [Ex. 4] .

3. Seek recovery of $897,091 (less any amounts received from liquidation) from Liberty Bank on the guaranty paid by the SBA for the loan to [Ex. 4, 6] [Ex. 4, 6] .

Agency Comments and OIG Response

On December 23, 2013, we provided a draft of this report to the Director of the Office of Financial Program Operations for comment. On January 23, 2014, the Agency submitted formal comments, which are included in their entirety in Appendix V. A summary of management's comments and our response follows.

General Management Comments

The Agency agreed with all of our recommendations and stated that it has made progress in improving its purchase process. The SBA stated that it has required quality control reviews of high-dollar early default loans, enhanced its internal control checklist to further assess repayment ability on early default loans, and issued new procedures with revised underwriting standards for 7(a) loans. The SBA stated that it is also continually improving its processes and quality control program in the NGPC.

The SBA noted that the NGPC concurred with one loan and did not concur with the other two. Finally, the SBA noted that all three cases have been transferred to Headquarters, where they are undergoing the Office of Capital Access' (OCA) Denial Review Process, with appropriate action to be taken upon final resolution.

OIG Response

We commend the Agency's OFPO on its efforts to improve its purchase review process. We note that the Agency agreed with our recommendations for recovery and that each loan will undergo review during the Office of Capital Access' (OCA) Denial Review Process.

Recommendation 1 - Seek recovery of $1,473,770 (less any amounts received from liquidation) from TD Bank on the guaranty paid by the SBA for the loan to [Ex. 4] .

Management Comments

The OFPO agreed with this recommendation. The OFPO stated that it will proceed with this loan according to the OCA's Denial Review Process.

OIG Response

Management's comments were responsive to the recommendation. The management decision for this recommendation is considered resolved and the recommendation will remain open pending final action.

Recommendation 2 - Seek recovery of $685,691 (less any amounts received from liquidation) from Florida Community Bank (formerly First Peoples Bank) on the guaranty paid by the SBA for the loan to [Ex. 4] [Ex. 4] .

Management Comments

The OFPO agreed with this recommendation. The OFPO stated that it will proceed with this loan according to the OCA's Denial Review Process.

OIG Response

Management's comments were responsive to the recommendation. The management decision for this recommendation is considered resolved and the recommendation will remain open pending final action.

Recommendation 3 - Seek recovery of $897,091 (less any amounts received from liquidation) from Liberty Bank on the guaranty paid by the SBA for the loan to [Ex. 4, 6] [Ex. 4, 6] .

Management Comments

The OFPO agreed with this recommendation. The OFPO stated that it will proceed with this loan according to the OCA's Denial Review Process.

OIG Response

Management's comments were responsive to the recommendation. The management decision for this recommendation is considered resolved and the recommendation will remain open pending final action.

Appendix I: Scope and Methodology

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 75 loans that consisted of high-dollar early defaulted Recovery Act loans that were a part of the Preferred Lenders Program (PLP), which were purchased by the NGPC between February 17, 2009, and December 31, 2012. Of the universe of 75 loans, we eliminated loans that were involved in previous audits or were in an unstable status due to the SBA's review process or guaranty repair action. We then selected nine loans that we were able to access from the NGPC. 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.

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

Use of Computer-Processed Data

We relied on information from the SBA's Mainframe Loan Accounting System to score loans using an internal scoring system developed by the OIG. Previous OIG engagements have verified that the information maintained in this system is reasonably reliable. Further, data elements associated to reviewed loans were verified against source documentation maintained in the SBA's purchased loan files. As a result, we believe the information is reliable for the purposes of this audit.

Prior Coverage

Small Business Administration-Office of Inspector General Reports

> 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,* issued March 23, 2012.
>
> Audit Report 12-18, *A Detailed Repayment Ability Analysis is Needed on High-Dollar Early-Defaulted Loans to Prevent Future Improper Payments,* issued August 16, 2012.
>
> Advisory Memorandum 13-16R, *Purchase Reviews Allowed $4.6 Million in Improper Payments on 7(a) Recovery Act Loans,* issued June 14, 2013.

Appendix II: [Ex. 4]

The deficiencies on this loan resulted in a $1,473,770 improper payment that should be recovered.

The lender, TD 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 on [Ex. 4] , 2009, with a 90 percent SBA guaranty to [Ex. 4] for the purchase of land and improvements, construction, and working capital. However, the Lender (1) did not verify that the full amount of the equity injection was received, (2) processed the loan as a startup business instead of a change of ownership as required, and (3) did not properly analyze repayment ability based on historical financial statements. The loan defaulted within 15 months from the first disbursement with the borrower making only four of the required principal and interest loan payments. The NGPC purchased the loan on August 1, 2012, for $1,473,770. This loan should not have been purchased since certain requirements were not met, specifically:

Equity Injection Issues

According to SOP 50 10 5(A), lenders must verify the equity injection prior to disbursing loan proceeds and must maintain evidence of such verification in their loan files. Verifying a cash injection requires documentation such as a copy of a check along with evidence that the check was processed. Additionally, SOP 50 51 2(C), requires for any cash injection that is greater than one-third of the loan amount or $200,000, whichever is less, the lender must also verify and document the source of the cash injection. The loan authorization required that the borrowers inject $300,000 in equity prior to disbursement. The lender did not properly verify the source of the equity injection, that the money was injected into the business prior to disbursement of the SBA loan, or that the full amount of the equity injection was received. Loan documentation showed that $202,837 was provided in connection with the loan closing and at the time the SBA loan was disbursed. However, adequate documentation supporting the source of these funds was not provided. Finally, copies of three checks totaling $100,000 were provided by the borrowers at closing. However, no evidence was present in the loan file supporting that two of these checks totaling $50,000 were processed.

Questionable Eligibility (Change of Ownership)

The lender improperly categorized the business as a start-up even though the bank's own credit memorandum stated that the transaction was for the acquisition of an existing business. In addition, the sales agreement referred to as the "Agreement for Restaurant Sale and Purchase" between the buyer and seller included restrictive covenants and goodwill. Finally, the settlement statement showed $601,000 of the transaction was for purchasing a business. Therefore, this loan should have been processed as a change of ownership and the lender should have adhered to SBA requirements that pertain to a change of ownership transaction. According to SOP 50 10 5(A), for a change of ownership, the lender must analyze and verify the historical earnings of the business and perform a business valuation. The loan documentation did not contain either of these.

Appendix II: [Ex. 4]

Inadequate Assurance of Repayment Ability

According to SOP 50 10 5(A), 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 loan documentation did not include an adequate assessment of reasonableness supporting how the business would achieve sales of $1.7 million within the first year. Additionally, the lender's analysis did not support how the business would achieve a net income before taxes rate that was more than three times the industry average. The absence of an initial month-by-month financial analysis makes it difficult to evaluate repayment ability of a business in transition of ownership. This was especially important considering that there would be $150,000 of renovations that would impact the business' ability to generate revenue. The loan defaulted within 15 months from the first disbursement with the borrower making only four of the required principal and interest loan payments.

Appendix III: [Ex. 4]

The deficiencies on this loan resulted in a $685,691 improper payment that should be recovered.

The lender, Florida Community Bank (formerly First Peoples 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 on [Ex. 4] , 2009, with a 90 percent SBA guaranty to [Ex. 4] for working capital. The lender did not, however, properly analyze repayment ability as required and in accordance with prudent lending standards. The loan defaulted within 10 months from the first disbursement with the borrower unable to satisfy the 18-month interest only payment period established by the lender. The NGPC purchased the loan on May 23, 2011, for $685,691. 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(A), 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. The lender's analysis showed the borrower's company was insolvent. Specifically, net income for the business had declined from $947,424 in 2006 to ($816,624) in 2008. Further, net income for the next 12 months of operations was projected to be ($671,041). The survival of the subject company, [Ex. 4] , was largely dependent on working capital from the SBA loan to sustain the company until the housing industry recovered. However, there was no industry market analysis, support for pro-forma revenue projections, or evidence that the distributed working capital would be sufficient.

In 2008, First Peoples Bank refinanced all outstanding debt of [Ex. 4] in the approximate amount of $3 million. As a result, the lender was at risk of substantial loss if the business failed. The business' Debt Service Coverage Ratio (DSCR) for three years prior to the approval of the SBA loan was (0.65), (0.40), (1.31), and for the pro-forma was (1.07). The lender's analysis did not predict adequate ability to service the debt until 2012, approximately two and a half years after the SBA loan was approved. Further, the lender's credit memorandum stated that $200,000, or 76 percent of the company's existing cash held as collateral, would be used to pay down the business' outstanding debt to First Peoples Bank once the SBA loan proceeds were disbursed. This was further evidence that the business was having trouble paying its existing debt. Finally, as the proceeds from the SBA loan would serve to replace the $200,000 of business cash used to pay off the lender's outstanding debt, this transaction could also be considered a transfer of risk from the lender to the SBA.

Appendix IV: [Ex. 4, 6]

The deficiencies on this loan resulted in an $897,091 improper payment that should be recovered.

The lender, Liberty 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 on [Ex. 4], 2009, which was subsequently modified to $999,950, with a 90 percent SBA guaranty to [Ex. 4, 6] (the borrower). The purpose of the SBA loan was for the refinance of a previous loan, repairs and maintenance, and working capital. However, the lender did not properly analyze repayment ability, the business plan and managerial experience of the borrower, the need for an equity injection, the underlying values of the liquidation plan for collateral, its ability to provide the loan under debt refinancing requirements, or the use of loan proceeds to pay past due taxes. The loan defaulted within 15 months from the first disbursement. The NGPC purchased the loan on January 7, 2011 for $897,091. 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(A), 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. Additionally, the SOP states that 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 tax returns for years 2006, 2007, and 2008 indicated a net business income of ($22,078), ($23,861), and ($11,034), respectively. The lender did not provide an income statement or statement of cash flows as required. Additionally, the lender used unsupported net operating income figures that conflicted with the businesses tax returns in their historical and projected debt service analysis. This is disconcerting considering the lender acknowledged within its credit memorandum that the business had poor financial recordkeeping and performance.

The lender's credit memo stated that, "The past two years of insufficient cash flow have caused deferred maintenance and past due taxes, both which will be remedied with loan proceeds." The loan file did not identify the amount required to become current on the borrower's taxes or satisfy maintenance requirements. Furthermore, this statement suggests that cash flow had historically been insufficient to maintain the business. It is also important to note that the business revenue was the borrower's only source of personal income. However, there was no mention of the borrower's draw on the business income or how the borrower had been financing his expenses while the business suffered. Because the loan files were missing key financial statements, we were not able to verify the lender's calculated repayment ability. Based on historical income information and statements made by the lender, however, we determined that it was reasonable to question the repayment ability of the borrower. This loan should not have been made and the SBA should not have purchased the guaranty without the required documentation supporting the lender's conclusion of repayment ability.

Appendix IV: [Ex. 4, 6]

Debt Refinancing

According to SOP 50 10 5(A), applications that include the refinancing of same institution debt may not be processed using PLP procedures. The lender improperly refinanced the debt of the borrower in a way that violated SBA regulations. In the loan authorization, $944,829 was listed as a use of proceeds for payment of outstanding debt on a note held by the previous owner of [Ex. 4], [Ex. 6]. [Ex. 6] has owned and operated the motel since July 2006 with original financing provided by [Ex. 6]. [Ex. 6] received a loan from Liberty Bank for which he used [Ex. 6] debt as security. By issuing the loan to [Ex. 6], the lender was in effect refinancing debt held by its own institution, which required the loan to be submitted to the SBA for review and approval. The repayment to [Ex. 6] allowed Liberty Bank to effectively refinance its unsecured note to [Ex. 6] with a secured SBA-guaranteed note to [Ex. 6]. The lender issued the loan to [Ex. 6] under the procedures of the Preferred Lending Program.

By not following the SBA regulations pertaining to refinancing debt, the lender created a conflict of interest where the approval of the loan to the borrowers resulted in the fulfillment of a note held as security, which might not otherwise have been paid. In effect, the Bank swapped a loan that was unsecured for a loan based on [Ex. 4] repayment ability that was secured, effectively transferring its risk to the SBA. This gives the impression that the lender viewed the risk of the borrower not being able to repay its debt as substantial enough to warrant a new, SBA-guaranteed loan.

Payment of Delinquent Taxes

Per SOP 50 10 5(A), loan proceeds must not be used to pay delinquent IRS withholding taxes, sales taxes or other funds payable for the benefit of others. The lender approved a portion of the loan proceeds to be used to pay delinquent property taxes. However, the lender did not describe the exact amount of the loan proceeds, which would be used for this purpose. As they were likely paid from working capital proceeds, documentation was not available to determine the amount.

Appendix V: Agency Comments

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

MEMORANDUM
January 23, 2014

To: Robert A. Westbrooks
Deputy Inspector General

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

Subject: Response to Draft Report on Purchase Reviews Allowed $3.1 Million in Improper Payments on 7(a) Recovery Act Loans

Thank you for the opportunity to review the draft report. We appreciate the role of the Office of Inspector General (OIG) plays in assisting management in ensuring that these programs are effectively managed.

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 three loans that OIG believes warrant immediate attention by the agency in order to recover $3.1 million of improper payments. The loans reviewed in the audit were purchased by the National Guaranty Purchase Center (NGPC) between December 23, 2010 and August 1, 2012. Deficiencies identified in the three loans included:

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

The three loans were originated by Preferred Lender Program (PLP) lenders. The audit found that these lenders did not originate and close the three 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 three loans during their purchase reviews.

SBA has made progress in improving its purchase process, as mentioned by OIG in the draft report. SBA has (1) required quality control reviews over high-dollar early default loan cases prior to loan purchase, (2) enhanced its internal control checklist to further assess repayment ability on early default loans, and (3) issued new procedures with revised underwriting standards for 7(a) loans. SBA is also continually improving its processes and quality control program in the NGPC.

NGPC has reviewed and concurred with one of the three loans cited and does not concur with the remaining two cases. All three cases have been transferred to Headquarters, where they are undergoing the Office of Capital Access (OCA) Denial Review Process with appropriate action to be taken upon final resolution.

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

1. **Seek recovery of $1,473,770 (less any amounts received from liquidation) from TD Bank on the guaranty paid by the SBA for the loan to** [Ex. 4]

   OFPO concurs with this recommendation, and will proceed according to the OCA Denial Review Process. It should be noted that the NGPC did not concur with OIG's recommendation.

2. **Seek recovery of $685,691 (less any amounts received from liquidation) from Florida Community Bank (formerly First Peoples Bank) on the guaranty paid by the SBA for the loan to** [Ex. 4] .

   OFPO concurs with this recommendation, and will proceed according to the OCA Denial Review Process. It should be noted that the NGPC did not concur with OIG's recommendation.

3. **Seek recovery of $897,091 (less any amounts received from liquidation) from Liberty Bank on the guaranty paid by the SBA for the loan to** [Ex. 4, 6] .

   OFPO concurs with this recommendation, and will proceed according to the OCA Denial Review Process. NGPC concurred with OIG's recommendation.

Again, thank you for the opportunity to review the draft report. Please let us know if you need additional information or have any questions regarding our response.