Performance Audit Report

The SBA Did Not Effectively Manage Defaulted Disaster Loans to Maximize Recovery from 2006 to 2011

Final Report

For Official Use Only

September 27, 2013

Report Number 13-18

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

FINAL REPORT TRANSMITTAL
REPORT NO. 13-18

DATE: September 27, 2013

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

SUBJECT: The SBA Did Not Effectively Manage Defaulted Disaster Loans to Maximize Recovery from 2006 to 2011

This report presents the results of our audit of the National Disaster Loan Resolution Center's operations. Our audit objectives were to determine whether the Small Business Administration National Disaster Loan Resolution Center: (1) effectively managed delinquent disaster loans to maximize recovery and minimize losses, (2) complied with applicable laws and regulations, and (3) had a mission aligned with Federal debt collection objectives.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We request that you provide your management decision for each recommendation on the attached SBA Form 1824, Recommendation Action Sheet, by October 30, 2013. Your decision should identify the specific actions taken or planned for each recommendation and the target dates for completion.

We appreciate the courtesy and cooperation of the Office of Financial Program Operations during this audit. If you have any questions concerning this report, please call me at (202) 205-6586 or Terry Settle, Director, Credit Programs Group, at (703) 487-9940.

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/s/
Robert A. Westbrooks
Deputy Inspector General

EXECUTIVE SUMMARY:
The SBA Did Not Effectively Manage Defaulted Disaster Loans to Maximize Recovery from 2006 to 2011

Date: September 27, 2013
Report Number 13-18

What OIG Audited
The objectives of this audit were to determine whether the National Disaster Loan Resolution Center (NDLRC): (1) effectively managed delinquent disaster loans to maximize recovery and minimize losses, (2) complied with applicable laws and regulations, and (3) had a mission aligned with Federal debt collection objectives.

To accomplish these objectives, we evaluated the NDLRC operations overall, including its monitoring and tracking of delinquent debts recovered and the debt collection training it provided for staff.

Additionally, we reviewed a statistically valid, random sample of 65 loans of the 9,035 loans the NDLRC charged off between June 2006 and June 2011. We tested the loans to determine whether the NDLRC used all required collection tools, including: (1) transferring all borrowers and guarantors for the defaulted debts to Treasury for cross servicing (collection) and offset; (2) analyzing the loans for potential debt restructuring (workouts) in accordance with the Standard Operating Procedures; (3) liquidating the collateral; (4) renewing the Uniform Commercial Code (UCC) financing statements to preserve the SBA's security interest in non-real estate collateral, and (5) approving offers-in-compromise for unpaid loan balances, in accordance with the SOP.

We also obtained a list of all loans the NDLRC charged off from June 2006 to June 2011 that were inappropriately designated to prevent transfer to Treasury cross servicing because the loans had real estate collateral.

What OIG Found
We determined that the NDLRC did not effectively manage delinquent disaster loans to maximize recovery and minimize losses. During the five-year period from June 2006 through June 2011, we estimate that the NDLRC charged off at least \$752.6 million[1] in defaulted disaster loans without using all appropriate collection tools to maximize recovery.

Specifically, the NDLRC did not: (1) transfer all non-exempt delinquent debts to Treasury cross servicing and offset; (2) analyze most delinquent debts for workout and restructuring potential; (3) liquidate loan collateral; (4) renew UCC financing statements to retain SBA's lien priority in non-real estate collateral; or, (5) refer offer-in-compromise settlements for debts above \$500,000 to the Headquarters Claims Review Committee.

OIG Recommendations
The OIG recommended seven corrective actions. We addressed these actions to the Director, Office of Financial Program Operations.

Management Response and Actions Taken
The SBA agreed with four of the seven recommendations in this report and stated that it has taken steps to address many of the recommendations. Specifically, SBA management stated that it: (1) is working with Treasury to develop a new process for the transfer of collateralized debt to Treasury; (2) will evaluate existing management controls to ensure legally enforceable debts are transferred to Treasury appropriately; (3) offered training related to performing workouts; (4) will provide additional training for applicable staff; (5) developed and implemented a charge-off checklist; (6) will develop a plan to ensure security agreement expiration dates are identified and tracked, and security agreements are renewed prior to their lapse dates; and (7) will update its Standard Operating Procedures for Disaster Loan Servicing and Liquidation by September 30, 2013.

Additionally, the NDLRC created a foreclosure team to manage the foreclosure and liquidation of real estate assets associated with defaulted loans. In February 2012, the NDLRC began to initiate foreclosures.

1 We based this estimate upon the lower bound of the statistical error rate projections. Therefore, this figure provides the most conservative estimate for error rate occurrence and monetary impact. Refer to Appendix II, Sampling Methodology, of this report for further details.

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Introduction

This is the third in a series of reports presenting the overall results of our audit of the effectiveness of the Small Business Administration's National Disaster Loan Resolution Center (NDLRC) operations. Our first report addressed the NDLRC's non-compliance with the Debt Collection Improvement Act for loans in liquidation inventory with principal balances totaling $171.1 million. Our second report addressed the need for the Office of Financial Program Operations to renew the Uniform Commercial Code Financing statements for disaster loans with principal balances totaling $5.6 million. For additional information about these reports, please see Appendix 1.

Objectives, Scope and Methodology

Our audit objectives were to determine whether the NDLRC: (1) effectively managed delinquent disaster loans to maximize recovery and minimize losses; (2) complied with applicable laws and regulations; and (3) had a mission aligned with Federal debt collection objectives.

To accomplish these objectives, we evaluated the NDLRC operations overall, including its monitoring and tracking of delinquent debts recovered and the debt collection training it provided for staff. During the audit, we conducted two site visits at the NDLRC and interviewed key personnel. We also conducted telephone interviews of some NDLRC staff and of SBA management responsible for oversight of the NDLRC.

Additionally, we reviewed a statistically valid, random sample of 65 loans of the 9,035 loans the NDLRC charged off between June 2006 and June 2011. We tested the loans to determine whether the NDLRC used all required collection tools, including:(1) transferring all borrowers and guarantors for the defaulted debts to Treasury for cross servicing (collection) and offset; (2) analyzing the loans for potential debt restructuring (workouts) in accordance with the Standard Operating Procedures; (3) liquidating the collateral; (4) renewing the Uniform Commercial Code (UCC) financing statements to preserve the SBA's security interest in non-real estate collateral; and (5) approving offers-in-compromise for unpaid loan balances, in accordance with the SOP. We also obtained a list of all loans the NDLRC charged off from June 2006 to June 2011 that were inappropriately designated to prevent transfer to Treasury cross servicing because the loans had real estate collateral.

We conducted our review between April 2011 and February 2013. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

The Small Business Administration

The mission of the Small Business Administration (SBA or the Agency) under the Small Business Act, as amended, is to maintain and strengthen the Nation's economy by enabling the establishment and vitality of small businesses and assisting in the economic recovery of communities after disasters.

Disaster Assistance

The Disaster Loan program plays a vital role in the aftermath of disasters by providing long-term, low-interest loans to affected homeowners, renters, businesses of all sizes, and non-profit organizations. Following a disaster, the SBA offers disaster victims (1) home loans to repair or replace damaged real estate or personal property, (2) business loans to repair or replace damaged property, and (3) economic injury disaster loans to provide business working capital during disaster recovery.

According to the Code of Federal Regulations[2] or CFR, the SBA requires borrowers to pledge available collateral to the SBA to secure the loan if the loan amount exceeds $14,000 for disaster home loans or physical business loans, and $5,000 for economic injury loans. The collateral for a disaster home loan may include the damaged property, a replacement property, and other property owned by the borrower. The collateral for a business loan may include business assets such as machinery and equipment, furniture and fixtures, inventory, and accounts receivables in addition to real estate collateral. During loan origination, SBA's *Processing and Disbursement Center* is responsible for securing the loan with the best available collateral.

Disaster Loan Servicing and Liquidation

The SBA disaster loan servicing centers located in Birmingham, Alabama, and El Paso, Texas perform routine loan servicing actions. They also are responsible for issuing late payment notices, initiating automated telephone calls to borrowers, and working with delinquent borrowers to provide repayment arrangements and deferrals (postponement in payments).

When a delinquent borrower does not resume loan payments, disaster loan servicing center staff may charge off[3] the loan if it is unsecured or the loan balance is $25,000 or less. The disaster loan servicing centers transfer all secured loans with balances over $25,000 to the SBA's National Disaster Loan Resolution Center (NDLRC) located in Santa Ana, California.

Formerly known as the Santa Ana Disaster Home Loan Servicing Center and Disaster Liquidation Office, the NDLRC discontinued home loan servicing in April 2006.
The internal memorandum establishing the NDLRC stated that it was dedicated to:

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[2] 13 CFR 123.11.

[3] Charge off is the process by which SBA recognizes a loss and removes the uncollectible account from its active receivable accounts.

(1) working out payment arrangements on seriously delinquent loans, (2) liquidating loan collateral, and, (3) overseeing litigation of disaster and business loans.

The NDLRC issues demand letters to primary borrowers, garnishes some borrowers' wages in order to collect delinquent debts, and refers some debtors to the Department of Justice (DOJ) for litigation. It is responsible for liquidating any loan collateral with value if there is no reasonable prospect of the borrower repaying the loan. Following liquidation of loan collateral with value, the NDLRC is responsible for charging off the loan. According to the Loan Liquidation and Acquired Property Standard Operating Procedure,[4] charge off is justified when the SBA has completed all required liquidation and collection actions, and further collection of any substantial portion of the debt is doubtful.

The Debt Collection Improvement Act of 1996

One of the primary purposes of the Debt Collection Improvement Act of 1996 (DCIA) is "to maximize collections of delinquent debts owed to the Government by ensuring quick action to enforce recovery of debts and the use of all appropriate collection tools." An additional purpose of the DCIA is to consolidate debt collection activities within the government to minimize the government's delinquent debt collection costs. The DCIA centralized delinquent debt collection at the United States Department of the Treasury (Treasury), requiring Treasury to pursue delinquent debts that are not actively being collected by Federal creditor agencies, a program known as cross servicing.

Treasury Cross Servicing

When Federal agencies refer delinquent debts to Treasury for cross servicing, they relinquish all responsibility for servicing or collecting the debts. In order to accomplish the transfer of delinquent debts to Treasury for cross servicing, the SBA first charges off these debts. Treasury then uses a variety of collection tools to collect a debt once an agency refers it to the cross-servicing program. The tools Treasury uses include:

- Treasury demand letters;
- telephone calls between debtors and Treasury personnel to negotiate repayment arrangements;
- credit bureau reporting;
- referral to at least one private collection agency;
- administrative wage garnishment;
- referral to the Department of Justice for litigation; and,
- reporting of unpaid debts to the Internal Revenue Service as potential income to the debtor.

Treasury Offset

The DCIA also established a centralized process at Treasury known as the "Treasury Offset Program," or TOP. The TOP offsets government payments due to borrowers,

[4] SOP 50 51 2, effective December 1, 1997, page 18-2.

such as income tax refunds and social security payments, and redirects them to Federal creditor agencies to which the borrower owes a delinquent debt. When agencies submit delinquent debts to Treasury for cross servicing, Treasury also submits the debts to TOP. Transferring all delinquent debts to Treasury for cross servicing and offset when they become over 180 days delinquent ensures that the SBA complies with the DCIA and facilitates the collection of funds owed to the taxpayers.

Debts Exempt from Mandatory Transfer to Treasury

The DCIA states that agencies must refer all debts delinquent more than 180 days to Treasury Financial Management System for cross servicing and offset. However, there are some exceptions to this requirement. Specifically, the DCIA states that the requirement to transfer debts to Treasury excludes those that:

(1) are in litigation or foreclosure, or
(2) will be disposed of under an asset sales program within one year, or
(3) have been referred to a private collection contractor, or
(4) have been referred to a debt collection center, or
(5) will be collected by internal offset within 3 years, or
(6) are a class of debts specifically determined by the Secretary of Treasury at the request of the Agency head.

Treasury has also exempted debts in wage garnishment, which meet certain criteria, from mandatory transfer. Additionally, in January 2000, Treasury granted the SBA a specific exemption from transferring debts in active workout status. According to a January 3, 2000, memorandum from the Fiscal Assistant Secretary of Treasury to the SBA (Exhibit II), active workout status means that the SBA is attempting to bring the debt current with debt servicing tools (such as rescheduling or deferment of payments), rather than liquidating or foreclosing on the collateral for the debt.

If a debt is exempt from transfer to Treasury cross servicing, the SBA identifies it with a unique code, called the loan-status comment code, prior to charging off the loan. This code is used to block the loan from automated transfer by the SBA Portfolio Management Treasury System when the charge off occurs.

Review of Internal Controls

Internal control includes the plan, policies, methods, and procedures adopted by management to meet its missions, goals, and objectives. It includes the systems for measuring, reporting, and monitoring program performance. Internal control serves as a defense in safeguarding assets and in preventing and detecting errors, fraud, noncompliance with provisions of laws, regulations, contracts or grant agreements, or abuse.[5]

Effective December 1, 1997, *Standard Operating Procedure (SOP) 50 51 2, Loan Liquidation & Acquired Property*, was the primary internal control governing the SBA

[5] GAO-12-331G Government Auditing Standards.

loan liquidation activities. We tested the NDLRC's compliance with various internal controls provided by SOP 50 51 2. We determined that the NDLRC did not consistently comply with these controls. Specifically, we identified control breakdowns related to repayment arrangements (workouts), the liquidation of collateral, and offers-in-compromise.

We identified numerous other internal control weaknesses at the NDLRC. Implementing the recommendations in this report will address the identified internal control weaknesses and improve the Agency's recovery of delinquent debt associated with disaster loans.

Nature of Limited or Omitted Information

We did not omit information due to confidentiality or sensitivity, nor were there limitations to information obtained during the audit.

RESULTS

FINDING: Ineffective Management Resulted in the SBA not Maximizing Recovery for $752.6 Million in Defaulted Disaster Loans.

We determined that the NDLRC did not effectively manage delinquent disaster loans to maximize recovery and minimize losses. The NDLRC did not use all of the appropriate collection tools required by the Debt Collection Improvement Act (DCIA) or its own Standard Operating Procedures prior to charging off delinquent and defaulted disaster loans. Specifically, the NDLRC did not:

(1) transfer all of the debts to Treasury for cross servicing and collection, or offset;
(2) analyze all of the loans for the potential of offering a workout in accordance with its standard operating procedures;
(3) liquidate loan collateral;
(4) renew the financing statements necessary to retain the SBA's lien position in the collateral for some loans; or
(5) refer compromise offers for debts in excess of $500,000 to the Headquarters Claims Review Committee (HCRC) for approval as required by the NDLRC's standard operating procedures.

We estimate that between June 2006, when the NDLRC became operational in its present form, and June 2011, it did not maximize recovery for at least 7,198 loans with balances totaling approximately $752.6 million.[6] The exact amount the SBA could have recovered if it had taken all of the above listed actions is not readily quantifiable. However, the SBA can still recover a portion of the balances of the charged off loans by

[6] We based this estimate upon the lower bound of the statistical error rate projections. Therefore, this figure provides the most conservative estimate for error rate occurrence and monetary impact. Refer to Appendix II, Sampling Methodology, of this report for further details.

referring these debts to Treasury for cross servicing and offset. Based upon estimated collection rates provided by Treasury, the SBA could recover approximately $22.3 million[7] if it transfers all of the charged off loans to Treasury cross servicing. Additionally, the SBA could also recover $6 million if it now transfers all of the debts for offset. We further estimate that the SBA could recover another $11.3 million over the next two years by ensuring that all charged off disaster debts are transferred to Treasury for cross servicing and offset.[8]

One purpose of the DCIA is to ensure that Federal agencies "maximize collections of delinquent debts owed to the Government by ensuring quick action to enforce recovery of debts and the use of all appropriate collection tools." Further, the Office of Management and Budget Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables*, requires each agency to use the full range of available and appropriate delinquent debt collection techniques. However, we determined that the NDLRC did not use the full range of appropriate debt collection techniques.

We reviewed a statistically valid, random sample of 65 of the 9,035 loans the NDLRC charged off between June 2006 and June 2011. Based upon our review of the loan file documentation and related electronic Loan Accounting System information, we concluded that the NDLRC did not maximize recovery for 61 of the 65 loans from our audit sample. The NDLRC could not recover the outstanding balances for the remaining four loans from our audit sample because these debts were discharged in bankruptcy. We determined that the NDLRC did not use all collection tools required by the DCIA or its own SOPs prior to charging off the 61 loans. Therefore, the NDLRC did not maximize recovery for those loans in our sample.

The table below identifies the underlying reasons the NDLRC did not succeed in maximizing recovery. First, the table provides the dollar value of the loans the NDLRC designated to block their transfer to Treasury Cross Servicing due to management's collateral policy. The table also identifies the collection actions the NDLRC did not perform for some delinquent disaster loans and the dollars associated with those loans. Additionally, the table indicates actions the NDLRC should have taken to protect the SBA's lien position in collateral and to ensure that it maximized dollars recovered through settlement offers.[9]

[7] Based upon Treasury's estimated collection rates, the SBA could potentially recover approximately $15.9 million ($373.1 million x 4.27 percent) through cross servicing from the charged off loans not referred due to collateral and an additional $6.4 million ($149 million x 4.27 percent) through cross servicing from the charged off loans that did not have associated collateral.

[8] We estimate that the SBA will recover an additional $6.4 million ($373.1/60 months x 24 months x 4.27 percent) over the next two years by discontinuing its practice of blocking the transfer of loans with real estate collateral to Treasury cross servicing. Additionally, we estimate the SBA will recover $2.5 million ($149 million /60 x 24 x 4.27 percent) over the next two years by ensuring all debts without collateral are transferred to Treasury cross servicing. We further estimate that the SBA will recover $2.4 million ($264.4/60 x 24 x 2.26 percent) over the next two years if it transfers all defaulted disaster debts to Treasury for offset.

[9] We identified multiple errors associated with each of the loans in the statistical sample we reviewed. Therefore, we did not aggregate the dollar values reported into a single total.

Table 1 Monetary Impact Associated with NDLRC Debt Recovery Errors

Causes for Not Maximizing Delinquent Debt Recovery	Charged Off Dollars Associated with Specific Causes (in Millions)
Designated to Block Transfer to Treasury Cross Servicing Due to Management Collateral Policy	$373.1
Not Transferred to Treasury Cross Servicing – Unrelated to Collateral Policy	$149.0
Not Transferred to Treasury Offset	$264.4
Loan Not Analyzed for Workout/Restructuring Potential Per SOP Requirements	$363.8
Loan Collateral Not Liquidated	$ 83.0
UCC Financing Statements Not Renewed to Retain Lien Position in Collateral	$ 40.3
Offer-in-Compromise Settlements Above $500,000 Not Referred to HCRC	$ 10.5

We concluded that the NDLRC did not maximize recovery for delinquent and defaulted disaster loans prior to charging them off because SBA management did not:

(1) fully adhere to the Debt Collection Improvement Act or existing controls, including Standard Operating Procedures;
(2) include requirements of the DCIA in the SOP;
(3) provide oversight of loan collateral, or have an effective Management Information System to monitor and track the collateral;
(4) align the NDLRC mission with Federal debt collection objectives; or,
(5) ensure that management and staff performance goals emphasized effective debt recovery.

$373.1 Million Designated to Block Transfer to Treasury Due to Management Collateral Policy

A primary purpose of the DCIA is to "maximize collections of delinquent debts owed to the Government by ensuring quick action to enforce recovery of debts and the use of all appropriate collection tools." Further, the DCIA requires agencies to transfer all legally enforceable, non-exempt debts delinquent over 180 days to Treasury for cross servicing and offset. However, the SBA implemented a management policy to prevent the transfer of defaulted disaster loans with real estate collateral to Treasury for cross servicing and collection action. At the time of charge off, the NDLRC abandoned the loan collateral, but flagged all disaster loans with real estate collateral and coded them with the loan-status comment code to prevent the SBA's Portfolio Management Treasury system from transferring the debts to Treasury for cross servicing. This policy did not fully comply with the DCIA requirements.

We obtained a list of 9,035 loans with principal balances totaling $762.7 million the NDLRC charged off between June 2006 and June 2011 from the SBA Office of the Chief Information Officer. From these loans, we extracted those the NDLRC designated as having real estate collateral to prevent their transfer to Treasury cross servicing following charge off. The NDLRC used a loan-status comment code that indicated the presence of real estate collateral, intended to block the transfer of these debts. We determined that during the five-year period, the NDLRC designated 3,887 loans—with principal balances totaling $373.1 million—to block their transfer to Treasury cross servicing. Management believed the loans were exempt from transfer because the SBA had real estate liens securing the loans.

The SBA Based its Collateral Policy on Interpretation of a Treasury Memorandum

Management developed its policy of not transferring defaulted debts with collateral to Treasury because of its interpretation of letters it received from Treasury in January 2000. One letter granted the SBA a specific exemption from transferring debts in active workout status (see Exhibit I). Because of the way the Treasury letter to the SBA was phrased, management interpreted it to imply that all loans with collateral were exempt from transfer to Treasury for cross servicing.

A second letter from Treasury noted that:

> *In a letter dated November 23, Department of Justice strongly asserted that collateralized debt should not be referred for cross servicing prior to foreclosure because cross-servicing collection actions risk compromising the Government's ability to collect against the collateral.*

However, the NDLRC had already charged off the 3,887 loans it designated with the loan-status comment code to block transfer to Treasury. According to the loan liquidation SOP,[10] charge off is justified when the SBA has completed all required liquidation and collection actions and further collection of any substantial portion of the debt is doubtful. Therefore, the NDLRC was unlikely to foreclose or liquidate any loan collateral for the 3,887 charged off disaster loans it did not transfer to Treasury. According to the SOP, the NDLRC should have completed all required liquidation and collections actions prior to charge off and the charge off action would only be justified if further collection of any substantial portion of the debt was doubtful. By charging off the loans, the NDLRC indicated that it had completed all required liquidation and collection efforts and it deemed the loans uncollectible.

Additionally, Federal statutes[11] require that agencies initiate collection actions on delinquent debts within six years. If more than six years from either the date of delinquency or date of demand for payment elapse, generally, the Government no longer has the legal right to litigate to collect these debts.[12] Therefore, the SBA must ensure that it promptly transfers all delinquent debts to Treasury for collection. Since the SBA does not use private collection agencies as a collection tool, it is critical that it transfer delinquent debts to Treasury cross servicing for collection.

The Treasury letter exempting the SBA from referring delinquent debts to cross servicing if they are in active workout (Exhibit I) stated that:

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[10] SOP 50 51 2, effective December 1, 1997.
[11] 28 USC Section 2415 (a).
[12] The statute of limitations does not apply to foreclosure actions.

> *Once SBA determines that a workout is not feasible and, in the case of collateralized loans, completes its liquidation/foreclosure, any remaining delinquent debts remain subject to the DCIA's mandatory transfer provisions.*

Thus, according to the letter, after the SBA liquidates collateral with value, should the loan balance not be paid-in-full, the SBA must transfer the unsatisfied portion of the debt to Treasury. The Treasury letter concluded that:

> *Additionally, all other debts over 180 days delinquent are subject to mandatory transfer to Treasury under the DCIA, unless a specific statutory or regulatory exemption applies.*

The January 2000 letter that Treasury provided the SBA to clarify its decision to exempt loans in active workout status from transfer to Treasury (see Exhibit II) stated that:

> *In attempting to restructure or otherwise workout its delinquent business loans, SBA is attempting to keep the small business in operation...premature determinations to liquidate or foreclose would interfere with the program goal of keeping the small business operational.*

We believe the guidance Treasury provided to the SBA supported the Agency's strategy to offer borrowers an opportunity to work out a satisfactory repayment arrangement rather than foreclosing and liquidating loan collateral within the initial 180 days of delinquency. According to Treasury, in the case of business loans, not liquidating collateral prematurely would help keep small businesses operational. However, the 3,887 defaulted loans that were designated to block their transfer to Treasury because the loans had real estate collateral were loans charged off by the SBA. Therefore, the SBA was unlikely to provide these borrowers with future workout opportunities or liquidate the loan collateral.

The OIG contacted Treasury to determine if its letter had granted the SBA an exemption from referring collateralized delinquent debts to Treasury for cross servicing. Treasury indicated that the only special exemption it had granted to the SBA was from transferring debts in workout status.

Subsequently, the OIG facilitated a meeting between Treasury officials and SBA management on February 7, 2013. The purpose of this meeting was for Treasury to clarify that the Agency is required to send all debts delinquent over 180 days to Treasury for cross servicing, whether or not the debts have associated collateral. Treasury officials confirmed that although Treasury did grant the SBA a specific exemption from the requirement to transfer delinquent debts in workout status, it did not grant the SBA an exemption from transferring collateralized debts.

At the request of the OIG, Treasury provided written confirmation that the only exemption from transferring delinquent debts it granted to the SBA applied to debts in workout status. In this letter, Treasury stated that it understood how the SBA may have interpreted its previous written guidance to imply that debts with collateral did not have to be transferred for cross servicing. The letter also stated that it is working with SBA management to facilitate transfer of collateralized debt. (See Exhibit III).

Treasury management indicated a willingness to work cooperatively with the SBA to address any concerns the Agency may have regarding the transfer of loans with collateral. At the February 7, 2013, meeting, Treasury management stated they would transfer any specific collateralized loan back to the SBA upon request in order for the SBA to liquidate the collateral. In its March 1, 2013, letter to the OIG, Treasury stated it would not release any SBA liens without receiving SBA's prior consent. These measures indicate Treasury's intent to facilitate SBA's compliance with the DCIA.

Recommendation 1

We recommend that the Director, Office of Financial Program Operations, mandate that the NDLRC comply with the DCIA and, *develop, and implement management controls and processes related to debts*, to ensure

a. That all eligible charged off loans now designated with loan status comment code "66" are transferred to Treasury for cross servicing promptly.
b. That the NDLRC does not designate loans charged off in the future to block their transfer to Treasury for cross servicing because the loans have un-liquidated real estate collateral.

$149 Million Not Transferred to Treasury Cross Servicing–Unrelated to Collateral Policy

We performed a review of a statistical sample of 65 loans the NDLRC charged off between June 2006 and June 2011 to determine if the SBA transferred them to Treasury for cross servicing and offset as required. The SBA did not transfer 20 of the 65 loans due to the automated system failure to transfer some loans or the lack of a monitoring process for loans in litigation after charging off the loans. We estimate the SBA did not transfer approximately $149 million in defaulted debt to Treasury for cross servicing and collection due to these deficiencies.

The NDLRC's practice was to rely upon the Portfolio Management Treasury System to transfer, successfully, all debts designated for transfer to Treasury. This mainframe computer system uses batch processing to select loans for transfer to Treasury. The NDLRC had no reconciliation process in place to verify that Treasury received all debts intended for cross servicing and collection. Although the NDLRC intended for the SBA to transfer 11 of those 20 loans to Treasury, the transfer process was unsuccessful and Treasury did not receive the debts. The NDLRC did not utilize Treasury's system to verify that it received the debts, nor were the debts manually entered into Treasury's system. Further, NDLRC management did not know that Treasury had a system that the NDLRC staff could access to verify that the debts were successfully transferred. Had the NDLRC management known about the Treasury system, they could have trained the staff to use it to verify that Treasury received all debts intended for transfer to Treasury. Therefore, when NDLRC staff recognized that Treasury had not received the debts, with appropriate training, they could have manually entered the debts into the Treasury system for cross servicing and collection.

The SBA did not transfer 4 of the 20 loans from our review sample to Treasury for cross servicing and collection, as required, because the NDLRC also lacked controls to monitor loans in litigation after loan charge off. Specifically:

- Two loans designated as "in litigation" involved bankruptcy of one or more, but not all, of the borrowers or guarantors. Currently, when the SBA codes a loan to indicate that there is an associated bankruptcy, the accounting system prevents the transfer of all associated borrowers and guarantors to Treasury for collection. This problem was previously identified in an audit of the SBA's financial statements, performed by an external accounting firm. According to the accounting firm's November 2011 Management Letter, which provided updates on the progress of the issues identified in its 2010 Financial Statement Audit, the SBA is taking steps to correct this issue.
- After the judge dismissed the bankruptcy for one loan in our sample, the SBA never transferred the debt to Treasury for collection.
- The NDLRC intended to refer the final loan to legal counsel for litigation; therefore, the loan was designated as "in litigation" to prevent transfer to Treasury for collection. However, the NDLRC never referred the loan for litigation or transferred it to Treasury for collection.

We could not determine the reason the NDLRC did not transfer the five remaining loans of the 20 loans not transferred to Treasury cross servicing.

$264.4 Million Not Transferred to Treasury for Offset

In addition to reviewing the sample of 65 charged off loans to determine whether the SBA transferred them to Treasury for cross servicing, we also verified whether the SBA referred the debtors for these loans to Treasury offset.[13] We determined that the SBA was required to transfer debtors for 53 of the 65 loans to Treasury for offset. However, the SBA did not refer one or more debtors for 29 of these 53 loans, approximately 55 percent, to Treasury for offset. We estimate that the SBA did not refer all debtors for 2,257 loans, totaling at least $264.4 million, for offset as required. Therefore, Treasury was unable to offset any Federal benefits that these defaulted borrowers may have been receiving.

Recommendation 2

We recommend that the Director, Office of Financial Program Operations, mandate that the NDLRC comply with the DCIA by *developing and implementing management controls and processes related to debts*, to ensure

a. The Transfer of all legally enforceable debts already charged off, to Treasury for cross servicing.

[13] The Treasury offset program offsets government payments due to borrowers, such as income tax refunds and social security payments, and redirects them to Federal creditor agencies to which the borrower owes a delinquent debt.

b. That all debtors associated with charged off legally enforceable debts, required to be transferred to Treasury for cross servicing and offset, are successfully transferred.
c. Monitoring of loans in litigation after charge off, to confirm transfer to Treasury for collection if litigation is dismissed.

Recommendation 3

This recommendation was consolidated with recommendation two after receiving SBA Management's comments to the draft report.

$363.8 Million Charged Off without Proper Workout Analysis

We estimate that between June 2006 and June 2011 the NDLRC charged off 3,028 loans with balances estimated to be at least $363.8 million, without providing a proper workout analysis. The Loan Liquidation and Acquired Property SOP[14] required staff to: (1) work with the borrower to structure a workout whenever feasible; (2) determine whether restructuring the repayment plan would help the borrower pay the debt, and (3) determine if the borrower's cash flow could support the workout plan. However, based upon our review of a statistical sample of 65 charged off loans, the NDLRC did not always comply with these requirements. Further, from the 65 loans reviewed, we determined that 18 of the borrowers contacted the SBA because they were unable to make their loan payments. The NDLRC, however, did not offer to restructure the loans for 16 of the 18 borrowers. Further, only 2 of the 18 borrowers were offered the opportunity to restructure their loans. We also concluded that the NDLRC did not determine if the borrower's cash flow could support a workout plan for any of the 18 borrowers who contacted the SBA for help.

Workouts

Of the 18 primary borrowers who contacted the NDLRC to request a workout, none received a restructured repayment plan as permitted by the SOP. We determined that of the 18 borrowers:

- 14 borrowers were provided an informal workout—the opportunity to make three payments and have their loan returned to regular servicing;
- two borrowers were offered a workout as required by the SOP—the opportunity to permanently restructure their loan terms; however, the borrowers never completed the necessary paperwork; and,
- two borrowers contacted the NDLRC and specifically requested a workout; however, there is no evidence that the NDLRC responded to the borrower's requests. The NDLRC appears to have charged off the loans off without calling the borrowers or otherwise responding to their requests for a workout.

The SBA's standard process was to issue multiple collection notices that instructed delinquent borrowers to contact the SBA if they were unable to make their disaster loan payments. However, these notices did not specifically offer repayment arrangements, or offer to restructure the delinquent borrowers' SBA disaster loans. We determined

[14] SOP 50 51 2, Effective December 1, 1997, page 5-1.

that in practice, borrowers had to contact the SBA and specifically request help in order to receive a "workout."

We further determined the NDLRC generally considered a workout as initiated whenever the borrower verbally agreed to resume payments. The NDLRC provided guidance to staff in a written document entitled "*Liquidation Collection Program*" as a tool for ensuring that staff took all required actions prior to loan charge off. The *Liquidation Collection Program* did not conform to the SOP. Instead, it instructed the Loan Specialist to contact the borrower and get a commitment to a "workout of three consecutive payments."

Generally, once the borrower successfully made three loan payments, the NDLRC practice was to return the loan to regular servicing. When initiating these informal "workouts," the NDLRC staff did not analyze the borrower's cash flow or repayment ability, or evaluate whether restructuring the repayment terms would help the borrower(s) pay the debt, as required by the SOP. The NDLRC staff did not address the underlying cause of payment delinquency or analyze the loans to determine whether they could reschedule the debt and reduce the borrower's monthly payments.

The NDLRC ultimately charged off the 14 loans from our audit sample whose borrowers made three payments and had their loans returned to regular servicing. These borrowers did not continue to make regular monthly payments; therefore, these informal "workout" attempts were not effective in ensuring the borrowers continued to pay their SBA disaster loans.

Loan Restructuring and Cash Flow Analysis

The NDLRC did not determine whether restructuring the loans would help the borrowers repay the debts or if the borrowers' cash flow could support the workout plan for these loans. This occurred due to a lack of management controls, oversight, and staff training. Had the NDLRC evaluated each borrower's financial position and offered a customized loan workout, we believe the Agency may have been able to recover some debts rather than charge them off.

Federal regulations state that if a borrower is unable to pay SBA loan installments in a timely manner for reasons substantially beyond the borrower's control, he may request that the SBA suspend the loan payments, extend the maturity, or both.[15] For one business loan in our audit sample eligible for a workout, the primary guarantor sent the SBA a letter requesting the opportunity to settle the debt for less than the full balance. However, we found no evidence the NDLRC responded to the letter. In addition, the NDLRC did not request the financial statements in order to assess repayment ability prior to charge off. The term for this charged off loan was 12 years and 7 months. Since the company was still operational, the NDLRC could have extended the loan term to 30 years and may have recovered the principal balance of $470,301. Instead, the NDLRC charged off this loan.

[15] 13 CFR 123.16.

During the audit, we learned that neither NDLRC management nor staff received formal training in credit management, debt collection, managing Federal receivables, Agency policies and procedures, or making repayment arrangements. In addition, management and staff were unfamiliar with the *Treasury Managing Federal Receivables Guide* (the Guide), which addressed many of these topics. Further, the NDLRC did not have controls to ensure that staff performed all required steps—including offering all borrowers and guarantors a workout in accordance with the SOP—prior to loan charge off. For example, the NDLRC did not have a workout checklist or a procedure in place requiring a supervisor to verify that the staff performed all of the actions required in the SOP prior to loan charge off.

The NDLRC did not identify or track the number of workout arrangements made with borrowers, or the dollars recovered from them. Without measuring the number of workouts offered and performed over time, or the associated dollars recovered due to workouts, the Agency did not have a viable method for assessing whether workouts resulted in significant recovery of delinquent debt.

Agency Workout Groups

The *Treasury Managing Federal Receivables Guide* states that agency workout groups are established for the sole purpose of resolving troubled debts. The Guide further states the agency may consider establishing a workout group if the volume and amount of its debts are large enough to warrant a special "problem account" department. Although the NDLRC charged off principal balances totaling approximately $762.7 million dollars in defaulted debt from June 2006 through June 2011, the NDLRC did not have a group specifically assigned to perform workouts. Instead, all Loan Specialists assigned to work delinquent and defaulted loans at the NDLRC were responsible for initiating workouts for homeowners and businesses, regardless of their knowledge or experience.

According to the Guide, workout groups should have the authority to decide on the appropriate actions necessary to maximize debt recovery, including rescheduling debt. Strategies developed by workout groups should be case specific; however, the workout group should establish policies that outline options for handling various debt problems. Furthermore, the Guide states that workout groups consist of loan officers, legal staff, and accounting personnel. Team members should have working knowledge and abilities in credit management and debt collection, business law, accounting, agency policies and procedures, liquidation proceedings, collateral appraisal, and management policies and procedures. They also should have communication and interpersonal skills.

Recommendation 4

We recommend that the Director, Office of Financial Program Operations, *develop and implement management controls and processes related to workouts*, to ensure

a. An assessment is made to determine the feasibility of establishing a workout group for the sole purpose of resolving troubled debts and, if feasible, establish such a group.

b. The NDLRC staff takes all required actions prior to charging off the loan, including offering the borrower a workout, evaluating the loan for potential restructuring, analyzing borrower repayment ability, and providing workout terms to the borrower in writing. Evidence that all of these actions were taken should be included in the loan file.
c. The *Liquidation Collection Program* and all related guidance conform to the SOP governing NDLRC operations and the liquidation of disaster loans.
d. All staff receives formal training in credit management, debt restructuring, debt collection, the *Treasury Managing Federal Receivables Guide*, and Agency policies and procedures.
e. That a system is established for tracking the performance of workouts to measure the dollars recovered and determine whether workouts result in significant recovery of delinquent debt.

$83 Million in Collateral Not Liquidated by NDLRC Prior to Charge-Off

Based upon the sample of 65 loans reviewed, we estimate that the NDLRC charged off loans with associated real estate collateral having a value of at least $65.5 million. In addition, we estimate that the NDLRC also charged off loans with associated business collateral having a value of at least $17.5 million without liquidating this collateral prior to charging off the loans. We were unable to obtain evidence that the NDLRC liquidated any collateral, either real estate or business, since its inception in 2006. This occurred due to inadequate management controls and oversight.

We determined that 20 of the 65 charged off loans we reviewed had associated real estate collateral with equity. The NDLRC, however, charged these loans off without liquidating the real estate collateral. Further, 5 of the 20 loans with real estate collateral also had non-real estate collateral. An additional eight loans had only non-real estate collateral, yet the NDLRC did not liquidate any of these assets. At the time of charge off, the estimated value of the real estate collateral for the 20 sample loans was approximately $2 million and the unpaid balances for these loans totaled approximately $6.1 million. Based upon the results of our sample review, we estimate that the NDLRC charged off at least 1,398 loans without liquidating the associated real estate collateral. We estimate the net collateral value of these assets was at least $65.5 million at the time of charge off. The NDLRC could potentially have recovered at least $65.5 million for the benefit of the taxpayers, since this value was net of anticipated foreclosure and resale expenses.

We also determined that the NDLRC automatically charged off all loans with manufactured home collateral without considering whether it could recover a portion of the loan balance by liquidating the collateral. The NDLRC charged off the loans regardless of whether the manufactured home was real estate or personal property. In March 2006, the Chief of Portfolio Management approved a request from what was then the Santa Ana Liquidation Center not to liquidate manufactured or mobile homes that were personal property. The NDLRC staff was unable to distinguish whether the manufactured homes included in the sample of loans we reviewed were personal property or real estate. Therefore, it charged off the loans whether the collateral was real or personal property. We determined that four of the seven manufactured homes from our audit sample were real property with positive value that the NDLRC could have potentially recovered through liquidation.

We determined that 13 of the 65 loans in our review sample had non-real estate collateral, such as machinery and equipment, inventory, and accounts receivable, at the time of charge off. Although the NDLRC made no effort to value or liquidate this collateral, we were able to estimate the associated collateral value for 4 of the 13 loans. At the time of charge off, the non-real-estate collateral for these four loans had a value of approximately $873,702. The NDLRC may have recovered all, or a portion of this value, had it attempted to liquidate the non-real estate collateral for these loans. We were unable to estimate the value of the non-real estate collateral not liquidated for the remaining nine charged off loans due to a lack of documentation in the loan files. Therefore, it was not possible to determine the amount of additional funds that the NDLRC may have recovered if it had valued and liquidated the associated non-real estate collateral for these loans. However, we were able to project that the NDLRC charged off at least 206 loans with non-real estate collateral having a value of at least $17.5 million without liquidating this collateral prior to charge off. We based this projection upon the loans from our audit sample for which the loan files indicated a value for the non-real estate collateral prior to the NDLRC charging off the loan. This dollar amount is understated because we could not determine the value of all of the non-real estate collateral associated with the charged off loans we reviewed.

The *Treasury Managing Federal Receivables Guide* states that the agency should take action to liquidate collateral when it becomes apparent that a debtor will not or cannot repay. Consistent with the Guide, SOP 50 51 2 states that if voluntary resolution of the delinquent account is not possible the staff should: (1) proceed with action against any collateral; (2) identify assets against which a judgment might be enforced; and, (3) establish a general estimate of recovery. However, the NDLRC did not provide its staff formal training regarding liquidation requirements or the evaluation of non-real estate collateral for potential recovery. Additionally, the NDLRC did not use the formula specified in the SOP to evaluate the equity in the collateral.

On August 6, 2008, NDLRC management requested approval from the Chief of Portfolio Management to waive the requirement to prepare a liquidation plan for loans with non-real estate collateral. The Chief of Portfolio Management approved this waiver the same day. Subsequently, the Santa Ana NDLRC discontinued the practice of evaluating or liquidating business assets pledged as loan collateral. However, there is no evidence that the NDLRC performed analysis to support the decision not to liquidate business collateral, such as obtaining the average liquidation value of the business assets or comparing the liquidation values to liquidation costs. Because the NDLRC did not support its decision not to liquidate any business collateral, we question the validity of the decision.

Recommendation 5

We recommend that the Director, Office of Financial Program Operations, *develop and implement management controls and processes related to liquidation*, to ensure the NDLRC:

a. Evaluates all loan collateral (both real estate and other assets) for liquidation potential within 180 days of the loan becoming delinquent.
b. Initiates liquidation action for all loan collateral (both real estate and other assets) within 180 days of the loan becoming delinquent if liquidation will result in recovery of a portion of the debt (and the costs of liquidation do not significantly exceed the anticipated recovery amount).
c. Liquidates all collateral with a recoverable value *prior* to loan charge off.
d. Creates and maintains historical records of the collateral liquidated and dollars recovered resulting from the liquidation of all collateral (both real estate and other assets).
e. Discontinues the practice of charging off all defaulted loans secured by manufactured housing without first evaluating the collateral for potential recovery.
f. Monitors and tracks all loan collateral (both real estate and non-real estate) associated with each loan assigned to the NDLRC.
g. Tracks the total real estate and non-real estate collateral available for liquidation from the loans assigned to the NDLRC.
h. Process of monitoring real estate and non-real estate collateral available for liquidation includes the capability to compare the dollars recovered through liquidation to the total collateral value.
i. Provides clear explanations for any variances between anticipated and actual dollars recovered through liquidation.
j. Staff responsible for liquidating collateral receives collateral evaluation training.

Lien Priority in Non-Real Estate Collateral Lost for Loans with Balances Totaling At Least $40.3 Million

From the statistical sample of 65 loans reviewed, we determined that the Uniform Commercial Code (UCC) Financing Statement[16] lapsed for 8 of 16 loans with non-real estate collateral. Four of these lapsed while the loans were assigned to the NDLRC. As a result, we estimate the SBA lost its lien priority in its security interest in non-real estate collateral for at least 43 loans with balances totaling at least $40.3 million during the five-year period from June 2006 through June 2011. This occurred because the NDLRC did not have a process for tracking UCC financing statement expiration dates or renewing the statements. We determined that the four remaining financing statements had lapsed while they were in regular servicing, prior to transfer to the NDLRC.

[16]Filing a document called a UCC-1 Financing Statement secures a lender's lien against a borrower for specific collateral used as payment to the lender. The filing of a UCC-1 to secure collateral is termed "perfecting" a lien.

The SBA requires disaster loan borrowers to provide collateral for loans above certain thresholds.[17] This collateral may be real estate, personal property, or both. The SBA establishes its rights to collateral—other than real estate—with a security agreement, which creates a lien and identifies what the SBA may do in the event the borrower fails to repay the disaster loan. Under the security agreement the SBA may, for example, seize and sell collateral after a default. The SBA does not need a court order to take collateral subject to a security agreement after a borrower's default.

Most UCC financing statements expire five years from the date of filing. Therefore, five years from the file-stamped date, a lien might no longer be enforceable under the UCC. To extend the creditor's lien position beyond the expiration date, a creditor must file a UCC-3 Amendment within six months of the original UCC financing statement's expiration date. To preserve its lien position in non-real estate collateral, the SBA must renew UCC financing statements or another creditor—without notice of SBA's lien—could obtain a superior lien position. Should the SBA lose its superior lien position, there may be no equity remaining in the asset for the SBA to recover in the event the loan defaults.

Although the Office of the Chief Information Officer provides the Servicing Centers a partial list of UCC financing statements that are due to lapse, the list does not identify all loan collateral. Currently, the SBA does not have a database or other management information system that contains information regarding the collateral associated with each loan. Therefore, we were unable to estimate the value of the collateral for which the security interest was lost by the Servicing Centers.

Recommendation 6

We recommend that the Director, Office of Financial Program Operations ensure that the Disaster Loan Servicing Centers and the NDLRC develop and implement a process to ensure that

a. All security agreement expiration dates associated with assigned disaster loans are identified and tracked, and the agreements are renewed prior to their lapse or expiration dates.
b. The Disaster Loan Servicing Centers provide the NDLRC the anticipated security agreement expiration dates for loans transferred from the centers to the NDLRC.

$10.5 Million Loan Improperly Settled

The NDLRC accepted a settlement[18] of $100,000 to release the SBA's lien on the sole guarantor's residence and his unconditional loan guaranty for a business loan with a balance of $10.8 million. In addition to offering the SBA a settlement of $100,000, the guarantor also facilitated the sale of two real estate properties for which the SBA held

[17] 13 CFR 123.11 requires borrowers to pledge available collateral to the SBA to secure the loan if the loan amount exceeds $14,000 for disaster home loans or physical business loans and $5,000 for economic injury loans.

18 According to SOP 50-52-1, the terms "compromise" or "settlement" can be used interchangeability or together to mean the resolution of a debt for less than the amount due through mutual agreement between the debtor and the SBA.

senior liens. The SBA received approximately $244,000 from the sale of the two properties. An unpaid loan balance of $10.5 million remained following the receipt of these proceeds. According to the SOP, the NDLRC was not authorized to approve the guarantor's settlement offer.

According to SOP 50 51 2, the Santa Ana Disaster Loan Servicing and Liquidation Office, which is now the NDLRC, can approve compromises of principal amount forgiven of up to $500,000. When claims exceed $500,000, the Headquarters Claims Review Committee (HCRC) approval is required. Therefore, the NDLRC exceeded its authority by approving the settlement. According to the SOP, the NDLRC should have referred the settlement offer to the HCRC. The NDLRC did not have controls in place to ensure that the loan was referred to the HCRC as required by the SOP.

We believe the complexity of the settlement offer in question, and the fact that the unpaid disaster loan balance exceeded $10.5 million, indicated that the settlement offer should have been elevated to the Headquarters Claims Review Committee, as required by the SOP.

Recommendation 7

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

a. Implement controls to ensure the NDLRC only approves offer-in-compromise settlements as authorized by the Standard Operating Procedures.

NDLRC Operations Were Not Designed to Achieve Effective Debt Recovery

Management did not design NDLRC operations to maximize delinquent debt recovery. While the NDLRC performed some debt collection actions, it had no strategy to maximize overall recovery or recovery for individual loans. The NDLRC's mission was not aligned with the Federal debt collection objectives specified in the DCIA. Furthermore, the NDLRC did not have fundamental policies, procedures, and practices that would enable the SBA to maximize debt recovery. During the audit, we observed that management oversight of the NDLRC was limited. Specifically, SBA management did not:

- measure the overall performance of the NDLRC;
- maintain records or perform analysis indicating whether the NDLRC or its individual staff succeeded in recovering debts;
- monitor or track staff debt recovery performance results for assigned loans;
- ensure that loans intended for transfer to Treasury for cross servicing were transferred;
- ensure that all legally enforceable, non-exempt debts delinquent over 180 days were transferred to Treasury cross servicing and offset as required by the DCIA;
- monitor the volume or success of workouts the NDLRC performed, or ensure they were performed in accordance with written guidance provided in its standard operating procedures;

- ensure the NDLRC liquidated collateral;
- provide oversight to ensure the NDLRC or disaster loan servicing centers renewed financing statements to maintain the SBA's security interest in non-real estate collateral;
- provide controls to ensure the NDLRC approved offer-in-compromises settlements only within the parameters specified in its written procedures; or,
- detect breaches of the internal controls.

According to OMB Circular A-123, programs must operate and resources must be used consistent with agency missions, in compliance with laws and regulations, and with minimal potential for waste, fraud, and mismanagement. Effective organization, policies, and procedures, commonly referred to as internal control, are tools to help program and financial managers achieve results and safeguard the integrity of their programs.[19] We believe that the weak control environment that pervaded all of NDLRC's operations adversely affected the agency's ability to maximize delinquent debt recovery.

NDLRC's Mission Not Aligned with Federal Debt Collection Objectives

The SBA did not design the NDLRC to achieve the Federal debt collection objectives specified by the DCIA. These objectives are to maximize recovery of delinquent debts, ensure quick action to enforce debt recovery, and use all appropriate collection tools. We were unable to identify any written guidance instructing the NDLRC to comply with these DCIA objectives. The April 2006 memorandum that established the NDLRC did not fully address the DCIA debt collection objectives. While it addressed two of the collection tools agencies may use to recover delinquent debts, it did not address nine other available collection tools.[20] Similarly, the SOP governing NDLRC operations did not specifically address the DCIA objectives.

As previously described, the SBA did not use all appropriate collection tools to maximize recovery, such as transferring all delinquent debts to Treasury for cross servicing and offset, liquidating all collateral with value, or rescheduling debts in accordance with the SOP.

Staff Uncertain of NDLRC's Mission

Interviews of the NDLRC staff indicated that some employees were uncertain of the purpose or mission of the NDLRC, or their role in accomplishing it. We interviewed various staff members and asked them to explain the mission of the NDLRC.
We received a variety of responses, some indicating that the mission was to "resolve loans." Additionally, the *2010 NDLRC Employee Desk Reference Guide* stated that the objective of the NDLRC is to bring problem loans to resolution. However, the *Desk Reference Guide* did not define the meaning of "bring problem loans to resolution."

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19 OMB Circular A-123

20 The Treasury Managing Federal Receivables Guide lists delinquent debt collection tools available to Federal agencies.

Likewise, the Personal Business Commitment Plans for the NDLRC Director and staff did not contain performance objectives related to maximizing debt recovery, enforcing quick action to recover debts, or ensuring the use of all collection tools. Instead, these plans contained requirements that emphasized customer service.

NDLRC Management Could Not Provide Basic Performance Information

Based upon the results of our audit work, we concluded the NDLRC did not meet the DCIA objective to maximize recovery. At the outset of the audit, NDLRC management was unable to provide data that identified or specified the dollars the NDLRC recovered through its collection efforts. Therefore, management did not have the necessary information to determine whether the NDLRC maximized recovery for the delinquent debts that the NDLRC serviced. However, during the course of the audit, management developed a methodology intended to identify the dollars recovered.[21]

As noted in our Management Advisory[22] issued July 9, 2012, the SBA did not ensure quick action to enforce recovery for its current inventory of delinquent disaster loans. Specifically, approximately 39 percent of the loans in current inventory on December 31, 2011, totaling $171 million were in excess of 180 days delinquent, but the SBA had not transferred the debts to Treasury for cross servicing and collection. The Advisory also noted that the NDLRC had a backlog of 736 assets associated with loans totaling approximately $80.2 million in current inventory that it had identified for foreclosure. Although the NDLRC identified the loan collateral for liquidation between 2006 and 2011, it had taken no further action.

NDLRC Policies and Procedures Were Inadequate

Standard Operating Procedures are a fundamental internal control used to communicate management directives regarding daily operations to all levels of an organization. Typically, management makes specific changes to the operating procedures in advance of implementation and incorporates them into the written procedures. This ensures they are easily accessible by all staff and that all functional groups within the entity are aware of the procedures approved for use at any given time.

Prior to November 1, 2011, the primary management control governing NDLRC operations and liquidation activities was SOP 50 51 2. However, the SBA did not incorporate the requirements of the Debt Collection Improvement Act of 1996 into the SOP. The SOP did not provide guidance for ensuring quick action to enforce debt recovery or require the use of all appropriate collections tools. In particular, the SOP did not provide controls for ensuring that the Agency transferred all non-exempt debts over 180 days delinquent to Treasury for cross servicing and offset, as required by the DCIA.

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[21] OFPO provided the OIG with recovery data for the NDLRC following the audit. However, we did not verify the accuracy of the information.

[22] OIG Report 12-14, *The Small Business Administration Did Not Maximize Recovery for $171 Million in Delinquent Disaster Loans in Liquidation*

Originally, SOP 50 51 2 applied to all SBA loans, including disaster loans. However, on November 15, 2010, the SBA issued a revised *SOP 50 51 3* providing updated guidelines for liquidation of SBA loans, with the *exception* of disaster loans. On November 19, 2010, the SBA Administrator issued *Policy Memorandum 5000-1186* that directed the Agency to adhere to the policy and procedures contained in *SOP 50 51 2* for disaster loan liquidation until a new SOP was issued. This policy memorandum expired November 1, 2011, and to date, the SBA has not issued a revised SOP governing disaster loan liquidation or NDLRC operations.

Furthermore, during our audit, the NDLRC modified several procedures without incorporating them into the SOP. The NDLRC management informally communicated the revised procedures to staff via email. For example, the NDLRC modified the procedure it used to determine the recoverable value of real estate assets. The new formula differed from the approved formula specified in the SOP. However, the NDLRC implemented the new formula without incorporating it into the SOP and without formal approval. We believe this practice undermines the relevance of the SOP and compromises the internal control environment.

Recommendation 8

We recommend that the Director, Office of Financial Program Operations

a. Re-evaluate the structure and design of the NDLRC to ensure that its operations are designed to maximize recovery of delinquent debts.
b. Develop and publish a clear mission statement for the NDLRC that clearly aligns with Federal debt collection objectives.
c. Update the SOP, governing delinquent disaster loan collection and asset liquidation to incorporate the Federal debt collection objectives and requirements specified by the DCIA.
d. Establish a performance management process that emphasizes effective debt recovery.
e. Ensure that routine procedural changes, such as modifying the formula for evaluating collateral, are incorporated into the SOP.

Management Actions Taken and in Progress

As a result of the audit, the Office of Financial Program Operations developed an ad hoc management report quantifying the dollars the Agency recovered for delinquent disaster loans assigned to the NDLRC.

In October 2011, the NDLRC created a foreclosure team to manage the foreclosure and liquidation of real estate assets associated with defaulted loans. As of January 2012, the NDLRC had nearly 700 loans in foreclosure inventory it had identified for foreclosure between 2006 and 2011. In February 2012, the NDLRC began to initiate foreclosures and implemented a process to monitor and track them. As of November 2012, the NDLRC staff informed us that they had initiated foreclosure for approximately 75 real estate collateral assets and had successfully foreclosed on seven of them. Some loans were removed from the foreclosure list due to payment in full of the loan balance, determination that the collateral no longer had recoverable value, or a borrower workout.

According to the Center Director, the NDLRC foreclosure efforts resulted in a number of borrowers making an initial "good faith" payment and committing to resume making regular payments to avoid foreclosure. The NDLRC director stated that the assigned Loan Specialist would monitor the loans for six months to ensure that the borrowers continue to make regular payments. However, this foreclosure process pertains only to loans in current inventory, not previously charged off loans with collateral.

Further, SBA management also stated that it is working with Treasury to develop a new process for the transfer of collateralized debt to Treasury, has developed a charge-off checklist, and has already offered some training to staff.

Conclusion

The NDLRC did not effectively manage delinquent disaster loans to maximize debt recovery and minimize losses. During the five-year period from June 2006 through June 2011, the NDLRC charged off approximately $752.6 million without using all appropriate collection tools. Specifically, the NDLRC did not refer all borrowers and guarantors to Treasury for cross servicing and offset, did not liquidate real estate or business collateral, and did not analyze all delinquent disaster loans for the potential to restructure them in accordance with the SOP.

The NDLRC's lack of focus on maximizing delinquent debt recovery indicates that SBA's approach to oversight and management of the NDLRC needs to be strengthened. The NDLRC did not have a stated mission, effective policies and procedures, trained staff, or basic performance data to indicate what amount, if any, of the delinquent and defaulted disaster debt it had recovered. Significant improvements are needed in order to ensure the NDLRC maximizes debt recovery and minimizes losses.

Agency Comments and Office of Inspector General Response

On May 7, 2013, we provided a draft copy of this report to SBA management for comment. On June 17, 2013, SBA management provided a formal response, which is included in its entirety in Appendix IV. A summary of management's comments and our response follows.

The SBA agreed with four of the seven recommendations in this report and stated that it has taken steps to address many of the recommendations. Specifically, SBA management stated that it: (1) is working with Treasury to develop a new process for the transfer of collateralized debt to Treasury; (2) will evaluate existing management controls to ensure legally enforceable debts are transferred to Treasury appropriately ; (3) offered training related to performing workouts; (4) will provide additional training for applicable staff; (5) developed and implemented a charge-off checklist; (6) will develop a plan to ensure security agreement expiration dates are identified and tracked, and security agreements are renewed prior to their lapse dates; and (7) will update its

Standard Operating Procedures for Disaster Loan Servicing and Liquidation by September 30, 2013.

The Agency partially agreed with two recommendations. While the Agency agreed to transfer loans now designated with loan status comment code "66" that blocked the transfer of these debts to Treasury for collection, it disagreed to transfer these debts immediately. The Agency intends to re-evaluate these charged off loans with collateral. It intends to determine whether the collateral has increased in value and could be liquidated or if the borrower can resume payments, enter into a workout, or settle the debt before transferring the debts to Treasury for collection. Similarly, the Agency also agreed to develop and implement a process for liquidation, but stated that it would first conduct a cost-benefit analysis to evaluate whether specific recommended controls were cost effective.

The SBA's management did not concur with recommendation number seven. This recommendation advised the Director of OFPO to ensure the NDLRC only approves settlements as authorized by the Standard Operating Procedures. The SBA stated that the Small Business Act grants the SBA Administrator the authority to settle SBA claims without limitation. Therefore, Department of Justice approval is not needed for the SBA to accept an offer in compromise on loans with balances exceeding $1 million (unless the loan is already in litigation).

Management's comments indicated that recommendation number three was a duplication of recommendation number two. Recommendation number three included in our draft report pertained to the need for the SBA to ensure that it refers all legally enforceable debts to Treasury for *offset,* while recommendation number two applied to the transfer of debts to Treasury for *cross servicing*. To address management's concerns, we have consolidated recommendations two and three in the final report.

General Agency comments and the OIG responses are summarized in Table 2 below.

Table 2 Agency Comments and OIG Response

Agency Comments	OIG Response
The title of the audit report is misleading because it leads the reader to believe that the SBA had a reasonable chance to recover $752.6 million from defaulted disaster loans. This amount is actually the remaining unpaid loan balance on non-performing disaster loans. The statement assumes that a 100 percent recovery on distressed loans, secured mainly by junior liens, is a legitimate possibility. OIG cannot support this assumption and does not offer a reasonable alternative, rather it leaps to the conclusion, without statistical evidence that transfer to Treasury for cross-servicing would result in complete recovery of the defaulted loan balances.	We have revised the title of the final report to address the agency's concerns that the title was misleading.

Agency Comments The OIG continues to assert that the Agency is not in compliance with the DCIA referral requirements for defaulted loans with collateral. The SBA's policy was consistent with the Agency-specific exemptions letter the SBA received from Treasury. The OIG's assertion of non-compliance is unfounded. Moreover, all eligible delinquent loans, including collateralized debt, were referred to the TOP.	**OIG Response**We made minor revisions to our report to place more emphasis on our finding that the NDLRC did not effectively manage delinquent disaster loans to maximize recovery and minimize losses and slightly less emphasis on the agency's lack of compliance with the DCIA. Specifically, the assertion regarding the SBA's noncompliance with the DCIA was removed from the Executive Summary of the report. Further, in the body of the report, rather than stating that SBA's policy "did not comply with the DCIA", we revised the wording to state "the policy did not *fully* comply with the DCIA requirements." While Treasury, in its letter dated March 1, 2013, stated it understood how the SBA could have interpreted its January 2000 letter to imply that debts with collateral were exempt from the transfer requirement, the letter further stated that Treasury and the SBA agreed that the SBA would begin transferring collateralized debts to Treasury for collection. According to the letter, Treasury does want the SBA to transfer all eligible, delinquent debts, including debts with collateral, in effect bringing the SBA into full compliance with the DCIA. At the time of our audit work, Treasury's records of TOP referrals, obtained from Treasury DMS staff, did not include a record of all eligible delinquent debtors for 29 of 53 loans from our statistically valid audit sample, indicating that the SBA did not refer all eligible debtors to TOP. We verified that TOP had received only eligible debts. As stated on page 15 of the report, we did not verify the transfer for 12 of the loans because the borrowers were not eligible for transfer to TOP. We did not include deceased borrowers and borrowers in litigation status, including bankruptcy, because these borrowers are ineligible for transfer to TOP.
OIG disclosed that no additional analysis took place to determine whether or not these debtors had standard exemptions from mandatory transfer to Treasury. SBA and all federal agencies are statutorily barred from referring borrowers in exempted classes. The most common exempted classes include borrowers that have filed bankruptcy, are facing foreclosure or other litigation proceedings, and borrowers that have settled their debts. This is another example where, without due diligence, a blanket statement is misleading.	OFPO misunderstood the OIG's statement. We had already determined whether or not the transfer should have occurred; i.e. whether or not there was a standard exemption. However, as stated in the report, we determined that the SBA was required to transfer debtors for 53 of the 65 loans in our audit sample to TOP. The SBA did not refer one or more debtors for 29 of the 53 loans.
The SBA plans to evaluate charged off loans to determine if the equity position has improved to the point where the property can be foreclosed upon before transfer to Treasury cross-servicing. This plan was discussed at a meeting with the SBA, the OIG, and Treasury in February 2013. The OIG's recommendation to immediately transfer all charged off debts not previously transferred to	We estimate there are over 5,000 charged-off loans with real estate collateral that the NDLRC staff would be required to re-evaluate under the SBA's proposed plan. Some of these loans have multiple pieces of associated collateral. Currently, the NDLRC has a staff of five people assigned to evaluate real estate collateral for equity and potential foreclosure. In addition, there is a large number of

Treasury is inconsistent with the SBA's plan.	loans still assigned to the NDLRC, not charged off, that the NDLRC has flagged for potential foreclosure. Therefore, we question the feasibility of a staff of five reviewing the loan collateral on 5,000 charged off loans in a reasonable amount of time and will request a specific plan of action by SBA to ensure effective resolution during our audit follow up process.
On page 7, the OIG lists the many tools that Treasury utilizes in the cross-servicing program. OIG neglected to mention that the SBA also utilizes multiple collection tools, including demand letters, SBA-initiated telephone calls with borrowers and the negotiation of repayment arrangements, credit bureau reporting, administrative wage garnishment, referral to the Department of Justice for litigation, and reporting of unpaid debts to the Internal Revenue Service.	Page 7 of the report provides background information regarding the tools Treasury uses during cross servicing. In response to management's comments, however, we have also identified in the background section the various collection tools used by the SBA.
On page 11, the OIG indicated that the NDLRC abandons collateral at the time of charge-off. This is an incorrect statement. Only current efforts to recover on real estate collateral are abandoned due to insufficient equity, but the lien on the collateral is not released. It is SBA's full intention to review these loans after time to identify potential equity or lien positions improvements.	We identified 18 loans from the statistical sample of 65 charged-off loans for which the NDLRC concluded that the collateral had no value. In all 18 cases, the 327 form that justified the charge-off action stated "abandon collateral and charge-off loan" as the "cause" for the action. Ten of the 18 loans were coded "66" to prevent the transfer of the debts to Treasury cross servicing and collection.
On page 12, the OIG makes an erroneous assumption that with respect to enforced debt collection, either through foreclosure or suits against obligors or guarantors, the Agency must sue within 6 years of default. There is currently much case precedent, including most of the United States Courts of Appeal that holds there is no statute of limitations for foreclosure actions brought by the Federal government.	Page 12 of the report does not refer to foreclosure. The statute of limitations we referred to was in regard to initiating collection actions, including bringing suit for a deficiency judgment whenever the creditor agency is unable to recover the full loan balance via foreclosure and liquidation of the collateral. However, based upon management's comment, we have added a footnote to page 12 of the report to clarify that there is no statute of limitations on foreclosure actions.

Agency Comments On page 26, the OIG identifies a Policy Notice that indicated "Until the issuance of this SOP (SOP 50 52 2), the disaster loan liquidation policy and procedures contained in SOP 50 51 2 will remain in full force and effect." While that policy notice has expired, the Office of Capital Access has reported annually on the status of SOP 50 52 2 issuance, which is currently expected for completion in September 2013.	**OIG Response**Standard Operating Procedures are a fundamental internal control intended to communicate management's directives and provide guidance to staff. The SOP governing the NDLRC was last updated in December 1997. While the OIG has been updated on the status of the SOP, we continue to maintain our position that a new SOP is imperative to this process.
On page 18, the OIG describes their sample of 18 loans, of which 14 were transferred to servicing after making 3 on time payments, but were subsequently charged off. However, as of April 30, 2013, OFPO conducted a review of the entire population of loans returned to servicing by the NDLRC between July 1, 2011 and June 30, 2012. The review found that 1,737 of 2,201 loans, or 79%, remained in servicing or were paid in full, as indicated in the following chart. Of these loans, only 6% were charged off.	The scope of the audit included loans the NDLRC charged off between June 2006 and June 2011. Our audit findings were consistent with an analysis performed by the NDLRC in February 2011. The NDLRC conducted an audit of 100 loans. According to the NDLRC Director, the results indicated that 50 percent of the loans currently assigned to the NDLRC were previously assigned and then returned to regular servicing. These loans were at the NDLRC for the second time. We recognize that the NDLRC may have made changes to their processes subsequent to completion of our audit fieldwork.

Recommendation 1

Management Comments

OFPO partially concurs with this recommendation. Treasury and OFPO are currently developing a new process for the transfer of collateralized debt. The new process will allow Treasury to aggressively collect these debts without compromising future equity positions on real estate collateral. However, OFPO stated that the immediate transfer of charged off loans coded "66" is neither prudent nor reasonable as the economy has improved and loans need to be reviewed to determine if the equity situation has improved and either the borrower can resume payments, enter a workout or compromise, or the property can be foreclosed upon before transfer to Treasury cross servicing. As indicated in the narrative above, this was discussed as the plan at the February 2013 meeting. OFPO will develop a plan to transfer the charged off debt coded "66" in a prudent manner and continue to update the OIG on the progress of this process development.

OIG Response

Management's comments were partially responsive to the recommendation.
We commend the SBA on working with Treasury to facilitate the transfer of charged off loans with collateral to Treasury cross servicing. However, the NDLRC currently has a staff of five people assigned to evaluate real estate collateral for equity and potential foreclosure. In addition, there is a large number of loans still assigned to the NDLRC, not charged off, that the NDLRC has flagged for potential foreclosure. Therefore, we question the feasibility of a staff of five reviewing the loan collateral on 5,000 charged

off loans in a reasonable amount of time. We will request a specific plan of action by the SBA to ensure effective resolution during our audit follow up process.

Recommendation 2

Management Comments

OFPO concurs with this recommendation. After completion of the process development references in recommendation 1, OFPO will evaluate existing management controls to ensure legally enforceable debts are transferred to Treasury appropriately and develop controls as necessary.

OIG Response

Management's comments are responsive to the recommendation; however, management has not provided a target date for implementation. A target date for implementation is necessary and will be obtained during our audit follow up process.

Recommendation 3

Management Comments

This audit recommendation is a duplication of recommendation #2.

OIG Response

In response to management's comments, we have consolidated recommendations two and three from the draft report. These recommendations now appear as recommendation number two in this final report.

Recommendation 4

Management Comments

OFPO concurs with this recommendation. Staff has been offered training on multiple occasions, including training from the Department of Treasury on Debt Collection in FY 2012. OFPO will continue to coordinate additional training for applicable staff members. Additionally, a charge-off checklist has been developed since the audit and is in use by Santa Ana NDLRC staff to ensure all necessary actions take place prior to charge-off. Of those objectives not addressed, OFPO will develop an implementation plan by August 30, 2013.

OIG Response

Management's comments were responsive to the recommendation.

Recommendation 5

Management Comments

OFPO partially concurs with this recommendation. OFPO will conduct a review of each objective and conduct a cost benefit analysis, if applicable, to determine inclusion in the implementation plan. An implementation plan will be developed by August 30, 2013.

OIG Response

Management's comments are partially responsive to the recommendation. According to the memorandum that created the NDLRC, it is responsible for managing the liquidation of all loan collateral with value. All of the steps included in the recommendation are essential for effectively managing and liquidating loan collateral. We continue to maintain our position that each recommended control should be fully implemented and do not believe conducting a cost benefit analysis is necessary. This recommendation will be resolved during the audit follow-up process.

Recommendation 6

Management Comments

OFPO concurs with this recommendation and will develop an implementation plan by August 30, 2013.

OIG Response

Management's comments were responsive to the recommendation.

Recommendation 7

Management Comments

OFPO disagrees with this recommendation as the assertion in the draft audit report indicates that all offers in compromise for loans exceeding $1,000,000 must be handled by the Department of Justice. Under the Small Business Act 15 U.S.C, 634(b) the SBA Administrator is given independent compromise (i.e. settlement) authority to settle SBA claims without limitation. Therefore, DOJ approval is not needed except when the case is in litigation as they have authority in those situations.

OIG Response

The OIG agrees that the Small Business Act gives the SBA the authority to settle SBA claims without limitation. However, according to SOP 50 51 2, effective

December 1, 1997, when a claim exceeds $500,000, the NDLRC must refer the settlement offer to the Headquarters Claims Review Committee (HCRC). Therefore, the NDLRC exceeded its authority by approving the settlement. The NDLRC did not have controls in place to ensure that the loan was referred to the HCRC as required by the SOP.

We have revised our finding to note the requirement for the NDLRC to refer claims over $500,000 to the HCRC, not to DOJ.

Recommendation 8

Management Comments

OFPO concurs with this recommendation. In February 2011, SBA initiated a disaster loan servicing process improvement effort, which explored several efforts for improvement. Among those improvements were those identified by the OIG. Additionally, SBA is updating its policies, including the Standard Operating Procedures for Disaster Loan Servicing and Liquidation, which we anticipate will be cleared and in use by the end of fiscal year 2013. OFPO will review these recommended objectives and prepare an implementation plan by August 30, 2013.

OIG Response

Management's comments are responsive to the recommendation and implementation will be monitored during the audit follow-up process.

Appendix I: Scope and Methodology

Our audit objectives were to determine whether the Small Business Administration (SBA) National Disaster Loan Resolution Center (NDLRC): (1) effectively managed delinquent disaster loans to maximize recovery and minimize losses, (2) complied with applicable laws and regulations, and (3) had a mission aligned with Federal debt collection objectives.

Evaluation of Effectiveness of Management of Delinquent Disaster Loans

To determine whether the NDLRC effectively managed delinquent disaster loans to maximize recovery and minimize losses, we conducted site visits at the NDLRC in May and July 2011, conducted multiple interviews of NDLRC management and staff, and reviewed various records. We also requested copies of managerial exception reports used at the NDLRC; however, the staff indicated that there were none.

Additionally, we obtained a spreadsheet from the Office of the Chief Information Officer (OCIO) containing all loans the NDLRC charged off from June 2006 through June 2011. We used the spreadsheet from OCIO to obtain a statistically valid random sample of 65 loans, stratified by principal balance. The interest associated with the universe of charged off loans was not identified in the spreadsheet provided by OICIO that we used to select a random sample of loans for review. However, during our review of the sample items, we identified the associated interest and it was included in the projected amounts. We then reviewed actual loan files and the related Loan Accounting System information to determine whether the NDLRC maximized recovery prior to charge off.

We also reviewed the 65 sampled loans to determine:

(1) the loan detail, including whether the loan was a business or home loan;
(2) the principal and interest amount charged off;
(3) the history of events that occurred for the loan, for example, bankruptcy, foreclosure by the first lien holder, probate, non-payment of property taxes, etc.;
(4) whether the borrowers and guarantors associated with each loan were provided with a workout in accordance with SOP 50 51 2;
(5) whether the NDLRC approved an offer-in compromise settlement for the loan in accordance with SOP 50 51 2;
(6) whether there was collateral associated with the loan;
(7) if there was non-real estate collateral (business assets), whether the NDLRC and the servicing center had renewed the UCC financing statements to preserve SBA's priority interest in the collateral; and,
(8) whether the NDLRC liquidated collateral with value associated with the loan.

This report identifies our *statistical projections* of the total dollars for which the NDLRC did not maximize recovery due to various NDLRC errors. Based upon the errors we observed by reviewing a statistically valid, random sample of 65 loans the NDLRC charged off between June 2006 and June 2011, we projected the total number of loans and the corresponding total loan balances, including principal and interest that the NDLRC processed with errors. These errors included: (1) not referring all debtors associated with the loan to Treasury for cross servicing and offset, (2) not analyzing all of the loans for workout potential in accordance with the SOP,[23] (3) not liquidating loan collateral with value prior to loan charge off, (4) not renewing UCC

[23] SOP 50 51 2, effective December 1, 1997.

financing statements to preserve the SBA's lien priority in non-real estate collateral, and (5) not referring loans with balances over $500,000 to the HCRC for approval of compromise offers as required by SOP 50 51 2.

From our review of the sample of 65 loans, we observed that the NDLRC staff routinely designated all loans with real estate collateral with a specific loan status comment code ("66") intended to prevent the loans from transfer to Treasury cross servicing following charge off. Therefore, we analyzed the spreadsheet with all loans the NDLRC had charged off between June 2006 and June 2011 to identify loans the NDLRC coded to prevent transfer to Treasury cross servicing because the loans had associated real estate collateral. We then totaled the number and associated dollar value of these loans.

This report identifies the *actual* total number of loans and associated *actual* total principal balances the NDLRC coded with a specific loan status comment code ("66") intended to block the transfer of the loans to Treasury cross servicing.

We excluded loans with loan-status-comment code "66" from our statistical projections related to Treasury cross servicing transfer errors the NDLRC made for the 65 loans in our audit sample. This allowed us to report the *actual* number of loans and associated dollar value that the NDLRC coded as having real estate collateral to block their transfer to Treasury, separately from other Treasury cross servicing errors the NDLRC made.

During our review of the sample of loans, if the loan had associated real estate collateral, we computed the recoverable equity value using the formula specified in SOP 50 51 2. We then compared our collateral analysis results with the one performed by the NDLRC, if any.
We also made a determination regarding whether the loan had associated collateral that the NDLRC should have liquidated. We reviewed the information contained in the Centralized Loan Chron System (CLCS) comments for pertinent details.

We determined whether each loan in our audit sample had associated non-real estate collateral. We reviewed the loan file information to determine the value of associated non-real estate collateral, if the loan file noted any value. We also determined whether the financing statement used to secure the non-real estate collateral was still in effect, or had lapsed. If the financing statement had lapsed, we determined whether it lapsed while the loan was assigned to the NDLRC or to the disaster loan-servicing center.

Evaluation of NDLRC Compliance with Laws and Regulations

Using the statistically valid random sample of 65 loans, we reviewed actual loan files to determine whether the NDLRC's recovery efforts were consistent with Federal laws, regulations and other guidelines, such as the Treasury Managing Federal Receivables Guide. We also verified whether the actions performed for each loan in the audit sample were conducted in accordance with internal guidance specified in SOP 50 51 2.

In addition, we obtained access to the Treasury database system containing all loans transferred to Treasury to determine whether each borrower and guarantor for the 65 loans in our audit sample were transferred to Treasury for cross servicing and collection. We contacted the

Appendix I: Scope and Methodology

Treasury SBA liaison to determine whether the loans in the audit sample were referred to Treasury for offset.

Evaluation of NDLRC Mission Alignment with Federal Debt Collection Objectives

To evaluate whether or not the NDLRC mission was aligned with Federal debt collection objectives, we interviewed managerial staff responsible for oversight of the NDLRC. We also interviewed managerial and other staff assigned to the NDLRC to ascertain their perspective on the mission of the NDLRC. We also obtained and reviewed the internal memorandum used to establish the NDLRC. We reviewed the tasks outlined in the memorandum to determine if they conformed to Federal laws and regulations.

We requested the NDLRC performance goals and individual performance objectives for the staff to determine whether they contained goals for overall dollar recoveries, number or dollar value of loans to place in workout status or to liquidate. The NDLRC itself had no performance objectives; therefore, no analysis could be performed. However, we did analyze the staff Personal Business Commitment Plans to determine whether they contained performance objectives related to debt recovery.

Additionally, we obtained and reviewed the NDLRC's formal training records for the most recent fiscal year to determine whether the staff received training in Federal credit management or debt collection, agency regulations, or Standard Operating Procedure 50 51 2, the agency's written procedures that pertain to loan liquidation.

Finally, we requested the dollars recovered by the NDLRC; however, there were no reports available containing NDLRC recoveries. The only available report tallied dollars recovered by Treasury via offset together with dollars recovered by the NDLRC. Subsequently, management developed a report to use on an ad hoc basis that compiled the dollars attributed to the NDLRC. We did not verify the accuracy of the data contained in this report because it was supplied to OIG at the end of the audit, after the exit briefing had already taken place.

Use of Computer-Processed Data

The SBA Office of the Chief Information Officer (OCIO) provided us with a spreadsheet containing a list of all disaster loans charged off by the Santa Ana NDLRC, the Birmingham Disaster Loan Servicing Center, and the El Paso Disaster Loan Servicing Center from June 2006 to June 2011. The data contained in this spreadsheet was extracted from the Loan Accounting System.

The NDLRC provided several spreadsheets containing monthly records of the NDLRC current inventory of assigned loans, referred to as the "Manager's Report." The information contained in the Manager's Report was extracted from SBA's loan accounting system. The loan accounting system is audited annually by an external accounting firm and no material issues related to the loan accounting system data were identified. Therefore, we considered the data to be reliable for the purposes of our review.

Appendix I: Scope and Methodology

We analyzed the Manager's Report containing the NDLRC current inventory as of December 31, 2011 to identify assigned loans in excess of 180 days delinquent that should have been transferred to Treasury for cross servicing in accordance with the Debt Collection Improvement Act. We also analyzed the report to determine how many of the loans were designated for foreclosure and administrative wage garnishment. Additionally, we analyzed it to obtain the age of the loans containing the foreclosure designation.

Prior Coverage

Four prior OIG Audit Division reports identified findings related to the SBA's delinquent disaster debt collection.

- Audit Report Number 12-05, *SBA's FY 2011 Financial Statement Audit*, issued December 15, 2011.
- Audit Report Number 11-05, *Audit of SBA's FY 2010 Financial Statements Management Letter*, issued December 15, 2010.
- Audit Report Number 7-26, *Audit of Liquidation of Disaster Loans*, issued June 1, 2007.
- Evaluation Report Number 5-3-H-004-006, *SBA Loan Servicing and Debt Collection Activities*, issued March 31, 1995.

Appendix II: Sampling Methodology

In order to determine whether the NDLRC maximized recovery for loans assigned between June 2006 and June 2011, we first obtained the universe of disaster loans charged off between June 2006 and June 2011 from SBA's Office of the Chief Information Officer. We then identified the loans assigned to the NDLRC office code at the time of charge off. Next, we consulted a professional statistician in order to obtain a statistically valid sample of loans charged off by the NDLRC during the five -year period beginning June 2006 and ending June 2011.

The statistician consultant extracted a statistically valid, random sample of 65 loans, stratified by the principal loan balance, drawn from the universe of 9,035 loans the NDLRC charged off between June 2006 and June 2011. After analyzing the documentation for the loans in our sample as described in Appendix I, Scope and Methodology, we provided the statistician consultant with the results of our loan sample review. The loan documentation for the sample of 65 loans we reviewed contained the associated interest for each of the loans. We provided the interest amounts to the statistician for projection purposes for the 61 loans for which we identified processing errors. The statistician then provided the lower and upper error limit, including principal and interest, at a 95 percent confidence level for attributes we selected.

The statistician consultant also provided point estimates for the errors we identified. However, we did not use the point estimates to project the number or dollar value of errors the NDLRC made for the loans we reviewed. Because the lower limit provides the most conservative estimate for error rate occurrence and associated dollars, we chose to use it for the error projections presented in this audit report.

The table below summarizes the audit projections provided by the statistician consultant for the sample of 65 loans we reviewed.

Table 3 Treasury Transfer and Referral Error Projections for Sample Loans Reviewed

Error Projections for 65 Sample Loans Reviewed[24]				
Exception Type		Point Estimate	Lower Bound (95%CI)	Upper Bound (95%CI)
Summary - Exceptions for All Loans in Review Sample	Loans with Exceptions (*Number*)	8,191	7,198	9,184
	Loans with Exceptions (*Dollars*[25])	$845,093	$752,597	$937,589
	Loans Not Processed Timely (*Number*)	6,740	5,427	8,053
Treasury Referral Exceptions - No Real Estate Designation in Loan Accounting System	Loans Not Transferred to Treasury **Cross Servicing** (*Number*)	2,908	1,454	4,361
	Loans Not Transferred to Treasury **Cross Servicing** (*Dollars*[26])	$263,058	$149,047	$377,069
	Loans Not Referred to Treasury **Offset** (*Number*)	3,785	2,257	5,314
	Loans Not Referred to Treasury **Offset** (*Dollars*[27])	$392,266	$264,353	$520,178

[24] Dollars values are in millions.

[25] The dollar value of the estimate includes principal and interest.

[26] The dollar value of the estimate includes principal and interest.

[27] The dollar value of the estimate includes principal and interest.

Appendix II: Sampling Methodology

Table 4 Other Error Projections for 65 Sample Loans Reviewed[28]

Exception Type		Point Estimate	Lower Bound (95%CI)	Upper Bound (95%CI)
Workout Exceptions	Loans with Non-SOP Compliant Workout (*Number*)	4,514	3,028	5,999
	Loans with Non-SOP Compliant Workout (*Dollars*[29])	$485,539	$363,843	$607,235
Collateral Exceptions	Loans with Business (Non-Real Estate) Collateral Not Liquidated (*Number*)	708	206	1,210
	Business (Non-Real Estate) Collateral Asset Value at Charge Off (*Dollars*)	$57,134	$17,452	$ 96,816
	Loans with Real Estate Assets Not Liquidated (*Number*)	2,756	1,398	4,113
	Real Estate Collateral Asset Value at Charge Off (*Dollars*)	$140,331	$65,520	$215,142
	Loans with Real Estate and Business Assets Not Liquidated (*Dollars*)[30]	$377,516	$251,767	$503,266
UCC Exceptions	Loans - UCC Lapsed at NDLRC (*Number*)	212	43	381
	Loans - UCC Lapsed at NDLRC (*Dollars*)[31]	$113,011	$40,254	$185,769

[28] Dollars values are in millions.
[29] The dollar value of the estimate includes principal and interest.
[30] The dollar value of the estimate includes principal and interest.
[31] The dollar value of the estimate includes principal and interest.

Appendix III: List of Exceptions

Table 5 Exceptions for Sample Loans Reviewed, by Exception Type

Sample	Loan #	All Borrowers Transferred to Treasury Cross Servicing	All Borrowers Referred to Treasury Offset	Workout Analysis Performed	Real Estate Liquidated	Business Collateral Liquidated	UCC Financing Statements Renewed by NDLRC	UCC Financing Statements Renewed by Disaster Servicing
1	FOIA Ex. 4	NO	YES	N/A	N/A	N/A	N/A	N/A
2		NO	YES	YES	NO	N/A	N/A	N/A
3		N/A	N/A	N/A	N/A	N/A	N/A	N/A
4		N/A	N/A	N/A	N/A	N/A	N/A	N/A
5		NO	YES	NO	N/A	N/A	N/A	N/A
6		NO	NO	NO	N/A	N/A	N/A	N/A
7		NO	NO	NO	NO	N/A	N/A	N/A
8		NO	NO	YES	N/A	N/A	N/A	N/A
9		NO	YES	NO	N/A	N/A	N/A	N/A
10		N/A	N/A	N/A	NO	N/A	N/A	N/A
11		NO	YES	YES	N/A	N/A	N/A	N/A
12		NO	NO	YES	N/A	N/A	N/A	N/A
13		NO	NO	YES	N/A	N/A	N/A	N/A
14		NO	YES	NO	N/A	N/A	N/A	N/A
15		NO	YES	NO	NO	N/A	N/A	N/A
16		NO	N/A	YES	NO	N/A	N/A	N/A
17		NO	NO	NO	N/A	N/A	N/A	N/A
18		NO	YES	NO	N/A	N/A	N/A	N/A
19		NO	NO	NO	NO	N/A	N/A	N/A
20		NO	NO	NO	N/A	N/A	N/A	N/A
21		NO	NO	NO	N/A	NO	N/A	N/A
22		YES	YES	NO	N/A	N/A	N/A	N/A
23		NO	NO	YES	N/A	N/A	N/A	N/A
24		NO	NO	NO	N/A	NO	N/A	N/A
25		NO	NO	NO	N/A	N/A	N/A	N/A
26		NO	NO	NO	N/A	N/A	N/A	N/A
27		NO	YES	NO	NO	N/A	N/A	N/A
28		N/A	NO	N/A	NO	N/A	N/A	N/A
29		NO	YES	NO	N/A	N/A	N/A	N/A
30		N/A	N/A	N/A	N/A	N/A	N/A	N/A
31		NO	NO	NO	NO	N/A	N/A	N/A
32		N/A	NO	N/A	N/A	NO	N/A	N/A

Appendix III: List of Exceptions

Table 5 Exceptions for Sample Loans Reviewed, by Exception Type

Sample	Loan #	All Borrowers Transferred to Treasury Cross Servicing	All Borrowers Referred to Treasury Offset	Workout Analysis Performed	Real Estate Liquidated	Business Collateral Liquidated	UCC Financing Statements Renewed by NDLRC	UCC Financing Statements Renewed by Disaster Servicing
33		YES	N/A	N/A	N/A	NO	NO	N/A
34		NO	NO	NO	NO	N/A	N/A	NO
35		NO	NO	NO	N/A	N/A	N/A	N/A
36		NO	YES	YES	NO	NO	N/A	N/A
37		YES	N/A	N/A	N/A	N/A	N/A	N/A
38		NO	YES	NO	N/A	N/A	N/A	N/A
39		NO	N/A	YES	NO	N/A	N/A	N/A
40		NO	NO	YES	N/A	N/A	N/A	N/A
41		NO	NO	NO	NO	N/A	N/A	N/A
42		NO	YES	NO	NO	N/A	N/A	N/A
43		NO	YES	YES	NO	NO	N/A	N/A
44		NO	NO	NO	N/A	NO	N/A	N/A
45		NO	YES	NO	N/A	N/A	N/A	N/A
46		NO	YES	N/A	NO	N/A	N/A	N/A
47		N/A	N/A	N/A	N/A	N/A	N/A	N/A
48		YES	NO	YES	N/A	NO	N/A	N/A
49	FOIA Ex. 4	NO	YES	NO	N/A	N/A	N/A	N/A
50		N/A	NO	N/A	N/A	N/A	NO	N/A
51		N/A	YES	NO	N/A	NO	N/A	N/A
52		NO	YES	YES	NO	N/A	N/A	N/A
53		NO	NO	N/A	NO	NO	N/A	N/A
54		NO	NO	YES	NO	NO	N/A	NO
55		YES	NO	NO	N/A	NO	N/A	NO
56		NO	NO	NO	N/A	NO	NO	N/A
57		NO	NO	NO	N/A	N/A	N/A	N/A
58		N/A	N/A	NO	N/A	NO	N/A	N/A
59		YES	YES	YES	N/A	N/A	N/A	N/A
60		NO	YES	NO	NO	NO	N/A	NO
61		NO	NO	YES	N/A	NO	NO	N/A
62		N/A	YES	N/A	N/A	N/A	N/A	N/A
63		NO	YES	NO	N/A	N/A	N/A	N/A
64		YES	N/A	NO	N/A	N/A	N/A	N/A
65		YES	N/A	NO	N/A	N/A	N/A	N/A

Appendix IV: Management Comments

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

MEMORANDUM
June 17, 2013

To: John K. Needham
Assistant Inspector General for Auditing

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

Subject: Response to Draft Report on Project No. 11802

The Office of Financial Program Operations (OFPO) has reviewed the Office of Inspector General's (OIG) draft audit report and has several comments below. While OFPO is open to receiving constructive feedback recommending operational improvements, OFPO takes exception with the manner in which this report was written. The report is overly lengthy and contains factually incorrect and misleading statements, not the least of which is the report title. It also provides narrow directives rather than useful and actionable recommendations. In addition, OFPO takes exception with the adversarial manner in which the audit was conducted, and is of the opinion that a collaborative discourse would have provided a more useful audit report. OFPO welcomes the chance to change the audit relationship with the OIG to a positive one in which both sides are willing to discuss differences. While improvements are possible, the report fails to mention the valuable work that is being done at the National Disaster Loan Resolution Center (NDLRC); namely, upholding the disaster loan program's mission of assisting disaster victims while maintaining good stewardship of taxpayer funds.

The Small Business Administration's (SBA) Disaster Loan Programs are the primary form of federal assistance for the repair and rebuilding of non-farm, private sector disaster losses, and are the only form of SBA assistance offered to homeowners and renters. SBA's focus, with respect to disaster loans, is to remedy the effects of natural disasters, while maximizing recoveries and minimizing losses to the taxpayer. Due to the nature of the program, SBA's collateral position is weaker than it typically is in SBA's guaranteed loan programs, thus loan recoveries are more difficult. It is for these reasons that SBA offers every delinquent borrower ample opportunity for repayment relief, such as loan term restructure, workout, and payment deferments, prior to resorting to enforced collection, including foreclosure or transfer to the U.S. Department of Treasury (Treasury) for collection.

Treasury recognized the unique nature of SBA's disaster loans when it granted an Agency-specific exemption from the statutory requirement to transfer nontax debts to Treasury for collection. This exemption is described in a letter dated January 3, 2000, to SBA from th Treasury Under Secretary of Domestic Finance. The letter is attached as Exhibit "A," and is supported by an internal Treasury memorandum, also attached as Exhibit "B." These documents are referred to in the OIG draft audit report and in our response.

The Treasury memorandum, Exhibit "B," provides the rationale for the exemption as follows:

> "Disaster loans are authorized by law, and obtained by debtors, to help victims of disaster recover from earthquakes, fires, floods, hurricanes, tornadoes or other significant devastation. SBA points out that "... because of the slow economic recovery process resulting from widespread devastation in many disaster locations... the workout process cannot always be completed within 180 days of initial delinquency..." Accordingly, premature determinations to accelerate or liquidate disaster loans would interfere with the program goal of assisting disaster victims to overcome the effects of the disaster...
>
> Additionally... the Department of Justice (DOJ) strongly asserted that collateralized debt should not be referred for cross-servicing prior to foreclosure because cross-servicing collection actions risk compromising the Government's ability to collect against the collateral. To the extent the subject class of debts is collateralized, DOJ has indicated that the Government's financial interests would be best protected by granting an exemption." (Exhibit B)

The title of this audit report, "The SBA Did Not Effectively Manage Defaulted Disaster Loans to Maximize Recovery on $752.6 Million in Loans from 2006 to 2011The SBA Did Not Effectively Manage Defaulted Disaster Loans to Maximize Recovery on $752.6 Million in Loans from 2006 to 2011" is misleading. It leads the reader to believe that the SBA had a reasonable chance to recover $752.6 Million from defaulted disaster loans. This amount, $752.6 million, is actually the remaining unpaid balance of delinquent, non-performing disaster loans at the time of the audit. It does not indicate the recoverable value, or estimated market value, of the loans based upon the collateral status and repayment strength of the obligor(s). The statement assumes that a 100 percent recovery rate on a distressed loan portfolio, secured mainly by junior liens with little or no equity, is a legitimate possibility. **OIG cannot support this assumption and does not offer a reasonable alternative**, rather, it leaps to the conclusion, ***without any reference to statistical evidence*** that transfer to Treasury for cross-servicing would result in complete recovery of the defaulted loan balances.

In order to realistically assess the NRDLC's effectiveness at maximizing recoveries and minimizing losses, OFPO conducted an analysis of recovery data on loans resolved (Charged Off or Paid In Full) in the NRDLC during fiscal years 2011 and 2012. The analysis focused on 932 loans with a combined default balance of $78.3 million that were either (1) referred to the Treasury Offset Program (TOP) initially then transferred to Debt Management Service (DMS), or cross-servicing, after real estate collateral was liquidated, and (2) loans in which collateral was liquidated prior to charge off, and were referred to DMS immediately upon charge off. The analysis found that SBA's recoveries on this group of loans totaled $20.2 million, which equates to a recovery rate of 26 percent. Of that amount $16 million, or **80 percent, of the recoveries were generated by SBA.** These facts show the NRLDC's effectiveness at minimizing taxpayer losses by utilizing internal Agency collection tools in conjunction with those of Treasury's Financial Management Service. While process improvements and improved efficiencies are possible, this strategy and its results should not be summarily dismissed.

Additionally, the OIG asserts that the SBA's policy of not referring loans with real estate collateral for cross servicing is out of compliance with the Debt Collection Improvement Act (DCIA) of 1996. The SBA's policy was based upon interpretation of the January 3, 2000 Agency-specific exemption letter from Treasury (Exhibit "A") that states, "Once SBA determines that a workout is not feasible, and in the case of collateralized loans, completes its liquidation/foreclosure, any remaining delinquent debts remain subject to DCIA's mandatory transfer provisions." The OIG's assertion is incorrect and appears to be based upon the OIG's own interpretation of the letter. This despite the fact that just recently, in a letter dated March 1, 2013 to the OIG, Treasury's Assistant Commissioner of Debt Management Services stated that SBA's interpretation of the January 3, 2000 exemption letter was understandable:

> "Based on the language in the [SBA exemption] letter, we understand how SBA could have interpreted the letter as having exempted all collateralized debts from the transfer requirement. Following an inquiry from your office [OIG] and discussions with SBA Director John Miller, Office of Financial Program Operations, and his staff in January 2013, Treasury and SBA agree that SBA will begin transferring collateralized debts to Treasury for collection when SBA has determined that foreclosure on the collateral is not feasible. SBA can provide additional details about this process." (Exhibit C)

After a number of discussions with OIG personnel, they continue to assert the Agency is not in compliance with the DCIA referral requirements for defaulted loans with collateral. As already noted, this position is untenable given Treasury's position as expressed in their letter to SBA quoted above. The SBA's policy that was in place at the time of the audit was consistent with the Agency-specific exemption letter SBA received, and OIG's assertion of non-compliance is unfounded. Moreover, all eligible delinquent loans, including collateralized debt, were referred to the TOP.

TOP is the most effective collection tool at Treasury, as evidenced by Treasury data that shows 60 percent of recoveries on loans referred for cross-servicing were generated through the offset program. The audit report correctly states that all non-exempt delinquent loans are transferred to TOP regardless of collateral status. The report further states that one or more debtors in approximately 55 percent of the loan sampled were not referred to TOP. In recent follow-up conversations with the OIG auditors, ***OIG disclosed that no additional analysis took place to determine whether or not these debtors had standard exemptions from mandatory transfer to Treasury***. SBA and all federal agencies are statutorily barred from referring borrowers in exempted classes. The most common exempted classes include borrowers that have filed bankruptcy, are facing foreclosure or other litigation proceedings, and borrowers that have settled their debts. This is another example where, without due diligence, a blanket statement is misleading. SBA views TOP as an extremely effective tool to collect delinquent debt, and strives to utilize the program whenever possible.

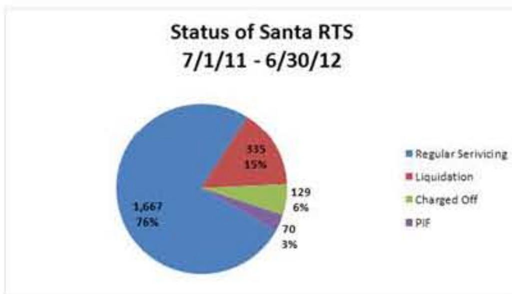
SBA maintains a close working relationship with Treasury's Financial Management Service with the goal of maintaining compliance with federal debt collection guidelines, and as such, is continually revising debt collection policies and procedures in order to efficiently collect delinquent debt and minimize taxpayer losses. After recent discussions, SBA and Treasury are instituting a process to refer SBA collateralized debts with minimal or no equity for cross-servicing. The new process will allow Treasury to aggressively collect these debts without compromising future equity positions on real estate collateral. As the new process takes shape, it is in the best interest of the taxpayer, and the disaster victims, to develop a plan to evaluate these loans and determine if the borrower's financial condition has improved to the point where they are able to resume payments, enter a workout, or settle their debt. SBA will also evaluate the loans to determine if equity position has improved to the point where the property can be foreclosed upon before transfer to Treasury cross-servicing. This plan was discussed at a meeting with SBA, the OIG, and Treasury in February 2013 but is, however, inconsistent with the recommendation made in this audit report.

Finally, OFPO identified several inconsistencies and/or inaccuracies in this document. In particular, the following are a few statements needing immediate clarification in the draft audit report.

- On page 7, the OIG lists the many tools that Treasury utilizes in the cross-servicing program. OIG neglected to mention that the SBA also utilizes multiple collection tools, including, demand letters, SBA-initiated telephone calls with borrowers and the negotiation of repayment arrangements, credit bureau reporting, administrative wage garnishment, referral to the Department of Justice for litigation, and reporting of unpaid debts to the Internal Revenue Service as potential income to the debtor (of which the information is supplied by Treasury but SBA executes issuance of the 1099c).
- On page 11, the OIG indicated that the NDLRC abandons collateral at the time of charge-off. This is an incorrect statement. Only current efforts to recover on real estate collateral are abandoned due to insufficient equity, but the lien on the collateral is not released. It is SBA's full intention to review these loans after time to identify potential equity or lien position improvements. In SOP 50 52 1 and SOP 50 51 2, states, "Charge off is the process by which SBA recognizes a loss and removes the uncollectible account from its active receivable accounts. A charge off does not affect SBA's rights to collect the loan from the borrower and does not reduce SBA's ability to proceed with any available remedy."
- On page 12, the OIG makes an erroneous assumption that with respect to enforced debt collection, either through foreclosure or suits against obligors or guarantors, the Agency must sue within 6 years of default. There is currently much case precedent, including most of the United States Courts of Appeal that holds that there is no statute of limitations for foreclosure actions brought by the federal government. So foreclosure suits would not be barred long after the 6 years. A number of the decisions involve SBA loans. It is also erroneous to automatically conclude that 6 years from the date of default a deficiency suit is barred. A number of varying circumstances in cases give SBA some leeway to avoid a statute of limitations problem. For example, correspondence sent by the

debtor or guarantor may be construed as a reaffirmation of the debt, such as compromise offers that we did not accept, or failed workouts the restart the running of the statute of limitations. At least one state allows collection of the debt for those amortization payments that are outside the limitation period. Therefore, it is too simplistic to assume a debt is not enforceable if it has been in default for 6 years.

- On page 26, the OIG identifies a Policy Notice that indicated that "Until the issuance of this SOP [SOP 50 52 2], the disaster loan liquidation policy and procedures contained in SOP 50 51 2 will remain in full force and effect." While that policy notice has expired, the Office of Capital Access, of which OFPO is a component office, has reported annually on the status of the SOP 50 52 2 issuance, which is expected for completion in September 2013. Additionally, the OIG has received regular updates since 2010 regarding this disaster loan SOP update – most recently in March of 2013.
- On page 18, the OIG describes their sample of 18 loans, of which 14 were transferred to servicing after making 3 on time payments, but were subsequently charged off. However, as of April 30, 2013, OFPO conducted a review of the entire population of loans returned to servicing by the NDLRC between July 1, 2011 and June 30, 2012The review found that 1,737 of 2,201 loans, or 79%, remained in servicing or were paid in full, as indicated in the following chart. Of these loans, only 6% were charged off.



SBA and OFPO value the OIG's role as an independent, objective resource for useful recommendations that lead to operational improvements and increased vigilance in the protection of taxpayer funds, and welcomes constructive feedback in these areas as they are critical components of meeting the SBA mission. The report presents a series of recommendations, with 34 instructional sub-recommendations, many of which the SBA has implemented or is in the process of implementing. Some recommendations may be too prescriptive to allow the SBA the flexibility to manage operations and balance limited resources. This is not conducive to good management and does not lend itself usefully for the application of process improvement. The best results are achieved when the OIG and SBA work together to identify deficiencies and a plan to implement corrective actions in support of the Agency's mission.

Taking into account the above narrative, OFPO is providing additional information in response to the OIG recommendations as follows:

1. ***We recommend that the Director, Office of Financial Program Operations mandate that the NDLRC comply with the DCIA, develop, and implement management controls and***

processes related to DEBTS, to ensure

a. ***That all charged off loans now designated with loan status comment code "66" are transferred to Treasury for cross servicing immediately.***
b. ***That the NDLRC does not designate loans charged off in the future to block their transfer to Treasury for cross servicing because the loans have un-liquidated real estate collateral.***

OFPO partially concurs with this recommendation. Treasury and OFPO are currently developing a new process for the transfer of collateralized debt. The new process will allow Treasury to aggressively collect these debts without compromising future equity positions on real estate collateral. Additionally, the **immediate** transfer of charged off loans coded "66" is neither prudent nor reasonable as the economy has improved and loans need to be reviewed to determine if the equity situation has improved and either the borrower can resume payments, enter a workout or compromise, or the property can be foreclosed upon before transfer to Treasury cross servicing. As indicated in the narrative above, this was discussed as the plan at the February 2013 meeting. OFPO will develop a plan to transfer the charged off debt coded "66" in a prudent manner and continue to update the OIG on the progress of this process development.

2. ***We recommend that the Director, Office of Financial Program Operations mandate that the NDLRC comply with the DCIA by developing and implementing management controls and processes related to DEBTS, to ensure***
   a. ***The Transfer of all legally enforceable debts, already charged off, to Treasury for cross servicing.***
   b. ***That all debtors associated with charged off legally enforceable debts, required to be transferred to Treasury for cross servicing, are successfully transferred.***
   c. ***Monitoring of Loans in litigation after charge off, to confirm transfer to Treasury for collection if litigation is dismissed.***

OFPO concurs with this recommendation. After completion of the process development references in recommendation 1, OFPO will evaluate existing management controls to ensure legally enforceable debts are transferred to Treasury appropriately and develop controls as necessary.

3. ***We recommend that the Director, Office of Financial Program Operations mandate that the NDLRC complies with the DCIA by developing and implementing management controls and processes related to DEBTS, to ensure***
   a. ***The Transfer of all legally enforceable debts, already charged off, to Treasury for cross servicing.***
   b. ***That all debtors associated with charged off legally enforceable debts required to be transferred to Treasury for cross servicing are successfully transferred.***
   c. ***Monitoring of Loans in litigation after charge off, to confirm transfer to Treasury for collection if litigation is dismissed.***

This audit recommendation is duplication of recommendation #2. See response above.

4. *We recommend that the Director, Office of Financial Program Operations, develop and implement management controls and processes related to WORKOUTS, to ensure*

a. ***An assessment is made to determine the feasibility of establishing a workout group for the sole purpose of resolving troubled debts and, if feasible, establishes such a group.***
b. ***Staff consistently determines whether restructuring a delinquent loan would help the borrowers repay when providing a workout.***
c. ***That NDLRC staff ascertains whether the borrower's cash flow is adequate to satisfy the terms of the workout plan when determining whether a workout should be provided.***
d. ***The Liquidation Collection Program and all related guidance conform to the SOP governing NDLRC operations and the liquidation of disaster loans.***
e. ***All staff receives formal training in credit management, debt restructuring, debt collection, the Treasury Managing Federal Receivables Guide, and Agency policies and procedures.***
f. ***All necessary actions are taken prior to charge off of the loan, including offering the borrower a workout, evaluating the loan for potential restructuring, analyzing borrower repayment ability, and providing workout terms to the borrower in writing.***
g. ***That a system is established for tracking the performance of workouts to measure the dollars recovered and determine whether workouts result in significant recovery of delinquent debt.***

OFPO concurs with this recommendation. Staff has been offered training on multiple occasions, including training from the Department of Treasury on Debt Collection in FY2012. OFPO will continue to coordinate additional training for applicable staff members. Additionally, a charge-off checklist has been developed since the audit and is in use by Santa Ana NDLRC staff to ensure all necessary actions take place prior to charge-off. Of those objectives not addressed, OFPO will develop an implementation plan by August 30, 2013.

5. *We recommend that the Director, Office of Financial Program Operations develop and implement management controls and processes related to LIQUIDATION, to ensure the NDLRC:*

a. ***Evaluates all loan collateral (both real estate and other assets) for liquidation potential within 180 days of the loan becoming delinquent.***
b. ***Initiates liquidation action for all loan collateral (both real estate and other assets) within 180 days of the loan becoming delinquent if liquidation will result in recovery of a portion of the debt (and the costs of liquidation do not significantly exceed the anticipated recovery amount).***
c. ***Liquidates all collateral with a recoverable value prior to loan charge off.***
d. ***Creates and maintains historical records of the collateral liquidated and dollars recovered resulting from the liquidation of all collateral (both real estate and other assets).***
e. ***Discontinues the practice of charging off all defaulted loans secured by manufactured housing without first evaluating the collateral for potential recovery.***
f. ***Monitors and tracks all loan collateral (both real estate and non-real estate) associated***

with each loan assigned to the NDLRC.

g. ***Maintains historical records indicating the pertinent loan details for which collateral was liquidated, including the dollars recovered from liquidation.***
h. ***Tracks the total real estate and non-real estate collateral available for liquidation from the loans assigned to the NDLRC.***
i. ***Process of monitoring real estate and non-real estate collateral available for liquidation includes the capability to compare the dollars recovered through liquidation to the total collateral value.***
j. ***Provides clear explanations for any variances between anticipated and actual dollars recovered through liquidation.***
k. ***Staff responsible for liquidating collateral receives collateral evaluation training.***

OFPO partially concurs with this recommendation. OFPO will conduct a review of each objective and conduct a cost benefit analysis, if applicable, to determine inclusion in the implementation plan. An implementation plan will be developed by August 30, 2013.

6. We recommend that the Director, Office of Financial Program Operations ensure that the Disaster Loan Servicing Centers and the NDLRC develop and implement a process to ensure that

a. ***All security agreement expiration dates associated with assigned disaster loans are identified and tracked so they are renewed prior to their lapse or expiration dates.***
b. ***The Disaster Loan Servicing Centers provide the NDLRC the anticipated security agreement expiration dates for loans transferred from the centers to the NDLRC.***

OFPO concurs with this recommendation and will develop an implementation plan by August 30, 2013.

7. We recommend that the Director of the Office of Financial Program Operations

a. ***Implement controls to ensure the NDLRC only approves offer-in-compromise settlements as authorized by the Standard Operating Procedures.***

OFPO disagrees with this recommendation as the assertion in the draft audit report indicates that all offers in compromise for loans exceeding $1,000,000 must be handled by the Department of Justice. Under the Small Business Act 15 U.S.C 634 (b) the SBA Administrator is given independent compromise (i.e. settlement) authority to settle SBA claims without limitation. Therefore, DOJ approval is not needed except when the case is in litigation as they have authority in those situations.

8. We recommend that the Director, Office of Financial Program Operations

a. ***Re-evaluate the structure and design of the NDLRC to ensure that its operations are designed to maximize recovery of delinquent debts.***
b. ***Develop and publish a clear mission statement for the NDLRC that clearly aligns with Federal debt collection objectives.***

c. ***Update the SOP, governing delinquent disaster loan collection and asset liquidation to incorporate the Federal debt collection objectives and requirements specified by the DCIA.***
d. ***Establish a performance management process that emphasizes effective debt recovery.***
e. ***Ensure that routine procedural changes, such as modifying the formula for evaluating collateral, are incorporated into the SOP.***

OFPO concurs with this recommendation. In February 2011, SBA initiated a disaster loan servicing process improvement effort, which explored several efforts for improvement. Among those improvements were those identified by the OIG. Additionally, SBA is updating its policies, including the Standard Operating Procedures for Disaster Loan Servicing and Liquidation, which we anticipate will be cleared and in use by the end of fiscal year 2013. OFPO will review these recommended objectives and prepare an implementation plan by August 30, 2013.

Please let us know if you need additional information or have any questions regarding our response.

Exhibit I: Treasury Memorandum Approving Workout Exemption

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.
January 3, 2000

UNDER SECRETARY

Mr. John L. Gray
Associate Deputy Administrator for Capital Access
U.S. Small Business Administration
Washington, DC 20416

Dear ~~Mr. Gray~~ John:

We have reviewed your request that the Small Business Administration (SBA) be designated a debt collection center, and also a subsequent request for an exemption from the mandatory transfer of debt provisions of the Debt Collection Improvement Act of 1996 (DCIA). Although we have not designated SBA as a debt collection center, we have approved SBA's request for an exemption from mandatory transfer of disaster and regular business loans over 180 days delinquent that are in active workout.

The decision to deny SBA's October 30, 1997, request, which was supplemented by information submitted on April 10, 1998, to be designated a debt collection center for purposes of servicing SBA's debts is based on the results of the evaluation conducted by the Financial Management Service (FMS) staff and has been communicated to your staff. FMS' determination was subsequently reviewed and confirmed by the Application Review Committee, which is comprised of officials from the Departmental Offices of Treasury and the Department of Justice. The decision is consistent with the broad mandate and the responsibility granted to Treasury under the DCIA to provide centralized administration and oversight of the delinquent debt collection program.

During the review and analysis of the request to be designated as a debt collection center, FMS worked with SBA to better understand SBA needs and to identify appropriate solutions. FMS encouraged SBA to review its debt portfolio and consider whether, for certain debts, an exemption from the DCIA requirement to transfer debt to Treasury was more appropriate than receiving approval as a debt center. Subsequent to those discussions, FMS received your letter dated March 26, 1999, requesting an exemption for certain SBA debt over 180 days delinquent.

As permitted under the DCIA, I approve your request for exemption from mandatory transfer of disaster and regular business loans over 180 days delinquent that are in active workout. The exemption request was evaluated based on standards and factors described in FMS' rule concerning the Transfer of Debts to Treasury for Collection, published in the Federal Register on April 28, 1999. Based on that evaluation, we determined that mandatory transfer of these debts would interfere with program goals, and, in the case of collateralized debt, would not be in the best interests of the United States.

This exemption applies only to the specific class of debts identified above. Once SBA determines that a workout is not feasible and, in the case of collateralized loans, completes its liquidation/foreclosure, any remaining delinquent debts remain subject to the DCIA's mandatory transfer provisions. Additionally, all other debts over 180 days delinquent are subject to mandatory transfer to Treasury under the DCIA, unless a specific statutory or regulatory exemption applies.

We look forward to your continued cooperation as we complete the implementation of the debt collection authorities under the DCIA.

Sincerely,

FOIA Ex. 6

Gary Gensler
Under Secretary for Domestic Finance

cc: Donald Hammond
Steven App
Kathleen Haggerty

Exhibit II: Treasury Memorandum Explaining Support for Workout Exemption

DEPARTMENT OF THE TREASURY
FINANCIAL MANAGEMENT SERVICE
WASHINGTON, D.C. 20227

COMMISSIONER

January 3, 2000

MEMORANDUM FOR GARY GENSLER
UNDER SECRETARY FOR DOMESTIC FINANCE

THROUGH: DONALD V. HAMMOND FOIA Ex. 6
FISCAL ASSISTANT SECRETARY

FROM: RICHARD L. GREGG FOIA Ex. 6

SUBJECT: Small Business Administration's Requests to be Designated as a Debt Collection Center and for an Exemption of Debts from Mandatory Transfer to Treasury under the Debt Collection Improvement Act of 1996

ACTION FORCING EVENT:

By letter dated October 30, 1997, Mr. John L. Gray, Associate Deputy Administrator for Capital Access, U.S. Small Business Administration (SBA), requested designation of the SBA as a debt collection center under the provisions of the Debt Collection Improvement Act of 1996 (DCIA) for the purpose of servicing its own debt. Mr. Gray submitted additional information concerning SBA's debt collection program on April 10, 1998.

Mr. Gray also submitted a letter dated March 26, 1999, requesting an exemption from the mandatory transfer of debt provisions of the DCIA to Treasury if the request for designation as a debt collection center was denied. The exemption request is for a class of SBA debts that are over 180 days delinquent, but are in active workout.

RECOMMENDATION:

That you sign the attached correspondence denying SBA's request to be designated as a debt collection center to service its own debt, and granting the request that certain debts be exempt from the mandatory transfer provisions of the DCIA.

___✓___Approve ________Disapprove ________Let's Discuss

BACKGROUND/ANALYSIS:

The response proposed for your signature advises SBA that you deny the request to designate SBA as a debt collection center and that you grant the request for exemption for the class of debts consisting of delinquent disaster and business loans which are in active workout.

The DCIA authorizes the Secretary of the Treasury to designate debt collection centers on the basis of their performance in collecting delinquent debt. In December 1996, the Financial Management Service (FMS) published policies, standards, and procedures for agency application to become a debt collection center (FMS Guidelines). The FMS Guidelines allow for two levels of application: 1) application for designation as a debt collection center for purposes of collecting agency-owned debts, referred to in the FMS Guidelines as a waiver; and 2) application for designation as a debt collection center for collecting agency-owned and other Federal debts, referred to as cross-servicing. Both designations are intended to recognize that certain Federal debts have unique servicing requirements, and transfer to FMS for collection may not be cost-effective.

We are recommending denial of SBA's request to be designated a debt collection center for the following reasons:

(1) SBA's compliance with the DCIA requirement to transfer debts to Treasury for collection (cross-servicing) enhances and supplements SBA's debt collection activities without interfering with SBA's debt collection process. SBA has transferred $647M of debt to FMS, resulting in collections of $5.6M as of September 30, 1999.

(2) SBA's use of private collection contractors declined prior to its participation in cross-servicing, indicating that SBA is not maximizing its use of private collection contractors. All debts referred to FMS for cross-servicing may be referred to private collection contractors under the new Government-wide contract.

(3) The absence of any unique servicing requirements was a critical factor in the evaluation.

The Application Review Committee, which is comprised of officials from the Departmental Offices of Treasury and the Department of Justice, concurred with FMS' recommendation to deny the waiver request.

While the letter denying SBA's debt collection center application was proceeding through the approval process, SBA submitted a letter dated March 26, 1999, requesting an exemption from cross-servicing for a class of debts over 180 days delinquent that are in active workout. The exemption request was submitted in the event that SBA's debt collection center application was denied. The exemption request covers delinquent disaster and business loans that are in active workout.

Based on the factors detailed below, we recommend that SBA's second request be granted.

The DCIA requires the heads of Federal agencies to transfer debts owed to the United States which are more than 180 days delinquent to Treasury for debt collection action. The DCIA contains specific statutory exemptions from mandatory transfer of delinquent debts to Treasury for debts that (1) are in litigation or foreclosure; (2) will be disposed of under an asset sales program; (3) have been referred to a private collection contractor; (4) have been referred to a Treasury-designated debt collection center; and (5) will be collected under internal offset within 3 years. Additionally, the DCIA authorizes the Secretary of the Treasury to exempt any other class of debts from mandatory transfer to Treasury upon the request of an agency or otherwise. See 31 U.S.C. § 3711(g).

FMS issued a final rule concerning "Transfer of Debts to Treasury for Collection." (See 64 FR 22905, April 28, 1999; codified at 31 CFR 285.12) The final rule established the standard for consideration of exemptions from mandatory transfer as whether such exemption is in the best interests of the Government, considering the following factors: (1) protection of the Government's financial interests; (2) interference with the goals of the program under which the debts arose; and (3) consistency with the purposes of the DCIA.

SBA has requested an exemption for debts which are more than 180 days delinquent which are in active workout, that is, where SBA is attempting to bring the debts current with debt servicing tools (such as rescheduling or deferment of payments), rather than liquidating or foreclosing on the debts. SBA reported that as of December 31, 1998, there were $88 million of delinquent debts which fell into this category. Approximately 83 percent of the subject class of debts consisted of delinquent disaster loans ($73 million - $22 million in home loans and $51 million in business loans). The remaining 17 percent ($15 million) represented debts from SBA's regular business programs.

SBA also reported that as of CY 1998, 5.6 percent ($2.186 billion) of SBA's $39 billion portfolio of direct and guaranteed loan obligations consisted of debts over 180 days delinquent. Of the $2.186 billion of debts over 180 days delinquent, approximately 96 percent ($2.098 billion) was either (1) transferred to Treasury/FMS in accordance with the DCIA ($578 million - 26.44 percent), or (2) exempt from mandatory transfer to Treasury ($1.494 billion in liquidation/foreclosure, and $26 million serviced by private lenders/third parties - 69.53 percent). These statistics indicate that exemption of the delinquent disaster and business loan debts would affect relatively small amounts of SBA's overall portfolio (approximately 0.22 percent), and of SBA's debts over 180 days delinquent (approximately 4 percent). These are the most current data available from SBA.

Disaster loans are authorized by law, and obtained by debtors, to help victims of disasters recover from earthquakes, fires, floods, hurricanes, tornadoes or other significant devastation. SBA points out that "...because of the slow economic recovery process resulting from widespread devastation in many disaster locations...the workout process cannot always be completed within

180 days of initial delinquency…." Accordingly, premature determinations to accelerate or liquidate disaster loans would interfere with the program goal of assisting disaster victims to overcome the effects of the disaster.

Similarly, in attempting to restructure or otherwise workout its delinquent business loans, SBA is attempting to keep the small business in operation. Financial analysis, development of an acceptable business plan and loan restructure occasionally cannot be completed in 180 days of default. While these loans are all collateralized, premature determinations to liquidate or foreclose would interfere with the program goal of keeping the small business operational.

Additionally, in a letter dated November 23, 1998, concurring in the denial of SBA's application for debt collection center designation, the Department of Justice (DOJ) strongly asserted that collateralized debt should not be referred for cross-servicing prior to foreclosure because cross-servicing collection actions risk compromising the Government's ability to collect against the collateral. To the extent the subject class of debts is collateralized, DOJ has indicated that the Government's financial interests would be best protected by granting an exemption.

Considering all applicable factors, it is in the best interests of the Government to grant SBA's request for an exemption from the statutory requirement to transfer the identified class of debts to Treasury for collection action.

Attachment

Exhibit III: Treasury Letter Confirming Debts with Collateral Not Exempt from Treasury Cross Servicing

DEPARTMENT OF THE TREASURY
FINANCIAL MANAGEMENT SERVICE
WASHINGTON, D.C. 20227

March 1, 2013

Mr. John K. Needham
Assistant Inspector General for Auditing
Office of Inspector General
U.S. Small Business Administration

Dear Mr. Needham,

This letter addresses your question concerning an exemption granted by the U.S. Department of the Treasury (Treasury) to the Small Business Administration (SBA) from the statutory requirement to transfer delinquent nontax debts to Treasury for collection. The Debt Collection Improvement Act of 1996 (DCIA) generally requires Federal agencies to transfer nontax debts more than 180 days delinquent to the U.S. Department of the Treasury (Treasury) for collection. By letter dated January 3, 2000, Treasury approved SBA's request for an exemption from mandatory transfer of disaster and regular business loans over 180 days delinquent that are in active workout. At the time, Treasury determined that mandatory transfer of these debts would interfere with program goals and, in the case of collateralized debt, would not be in the best interests of the United States.

Based on the language in the letter, we understand how SBA could have interpreted the letter as having exempted all collateralized debts from the transfer requirement. Following an inquiry from your office and discussions with SBA Director John Miller, Office of Financial Program Operations, and his staff in January 2013, Treasury and SBA agree that SBA will begin transferring collateralized debts to Treasury for collection when SBA has determined that foreclosure on the collateral is not feasible. SBA can provide additional details about this process.

Treasury and SBA staff are working together to facilitate the transfer to Treasury for collection all eligible collateralized debts. Based on preliminary planning discussions, we expect transfers to begin in Spring 2013. Because these debts are collateralized, Treasury and SBA agree that Treasury will not compromise any debts without approval from SBA. This process will allow SBA to determine whether the compromise value is greater than potential collection value from collateral liquidation. Treasury and SBA will continue to assess the effectiveness of this approach with respect to compromising the collateralized debts in this portfolio.

We look forward to continuing our debt collection partnership with SBA.

Sincerely,

FOIA Ex. 6

Jeffrey J. Schramek
Assistant Commissioner
Debt Management Services

cc: John A. Miller