

**AMERICA'S RECOVERY CAPITAL LOANS WERE NOT
ORIGINATED AND CLOSED IN ACCORDANCE WITH SBA'S
POLICIES AND PROCEDURES**

**Report Number: ROM 11-03
Date Issued: March 2, 2011**

**Prepared by the
Office of Inspector General
U. S. Small Business Administration**



U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Grady Hedgespeth
Director, Office of Financial Assistance

Date: March 2, 2011

John A. Miller
Director, Office of Financial Program Operations

/s/ Original Signed
From: Peter L. McClintock
Deputy Inspector General

Subject: Report on the Origination and Closing of America's Recovery Capital Loans
ROM 11-03

This report presents the results of the audit of America's Recovery Capital (ARC) loans disbursed pursuant to the American Recovery and Reinvestment Act of 2009 (Recovery Act). The Recovery Act provided the Small Business Administration (SBA) with \$730 million to expand the Agency's lending and investment programs and create new programs to stimulate lending to small businesses. Of the \$730 million received, \$255 million was authorized for SBA to establish the ARC loan program to provide small businesses access to the capital needed to drive economic recovery and retain jobs.

The audit objectives were to (1) determine if ARC loans were originated and closed in accordance with SBA's policies and procedures, and (2) identify any evidence of suspicious activity.

To answer these objectives, based on a stratified random sample design, we randomly selected a sample of 120 ARC loans from a population of 4,559 ARC loans approved between June 1, 2009 and January 31, 2010 with gross loan approvals totaling approximately \$148 million and at least one disbursement as of January 31, 2010. Of the 120 loans reviewed, 79 were lender-approved and 41 were SBA-approved loans. As of November 12, 2010, one hundred thirteen, or 94 percent of the 120 sampled loans reviewed, had been fully disbursed. See Appendix I for further details on our sampling methodology and Appendix II for a list of the sampled loans.

The audit fieldwork was performed by RER Solutions, Inc. (RER) under a contract with the Office of Inspector General (OIG). Fieldwork was conducted from April to October 2010, in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States. The contractor, RER, reviewed SBA and lender loan files using an OIG-approved checklist. For all loans examined, RER also reviewed information contained in SBA's Loan Accounting System.

BACKGROUND

The ARC loan program was a temporary program created pursuant to the Recovery Act to provide deferred-payment, interest-free loans of up to \$35,000 to “viable small businesses” experiencing “immediate financial hardship.” The program, which expired on September 30, 2010, was designed to help businesses make principal and interest payments on qualifying small business loans (QSBLs). A QSBL was defined as an existing loan that met the eligibility standards for a 7(a) loan. The SBA defined a viable small business as an established for-profit business that was a going concern and had reasonably demonstrated its projected continued operations through quarterly cash flow projections. Furthermore, the business had to show profitability or positive cash flow in at least one of the two previous years. A business suffering immediate financial hardship was defined as one that was having difficulty making payments on loans and/or meeting operating expenses as evidenced by declining sales, increasing expenses, a reduction in working capital, etcetera. At the time of program expiration, 8,869 ARC loans had been approved for approximately \$287 million.

ARC loans are 100-percent guaranteed by SBA and made by participating lenders under an agreement to originate, service, and liquidate loans in accordance with existing SBA rules and regulations. Some ARC loans were made by lenders using their delegated authority and others were approved by SBA. The SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any of the provisions of the regulations or the loan authorization, or does not make, close, service or liquidate the loan in a prudent manner.

In compliance with the Improper Payments Information Act of 2002, SBA was required to review all programs and activities for fiscal years 2009 and 2010, to determine whether they were susceptible to significant improper payments. For such programs, the SBA was required to produce an estimate of the annual amount of improper payments and submit those estimates to Congress. The Act defines an improper payment as any payment that should not have been made or that was made in an incorrect amount, including any payment to an ineligible recipient or for an ineligible service. The Act also defines a payment as any payment or commitment for future payment of Federal funds, including a loan guaranty that is made by a federal agency. The Improper Payments Elimination and Recovery Act of 2010 requires similar reviews and estimations for future fiscal years.

The Recovery Act and related Office of Management and Budget (OMB) guidance required increased oversight of programs funded under the Act to deter and detect fraud, waste, and abuse, and ensure that program goals were met. This audit was necessary due to concerns that lenders would not exercise due diligence in originating and closing loans given that the 100-percent SBA guaranty reduces lender risk.

RESULTS IN BRIEF

The audit identified material origination and closing deficiencies¹ in fifty-six, or an unweighted percentage of 47 percent, of the 120 ARC loans reviewed, which resulted in inappropriate loan approvals of approximately \$1.8 million because documentation in the loan files was inadequate to ensure borrowers: (1) were viable small businesses, (2) used ARC loan proceeds for existing qualifying small business loans, and/or (3) experienced financial hardship. Of the 56 loans, 13 with inappropriate approvals of approximately \$400,000 were SBA-approved and 43 with inappropriate approvals of approximately \$1.4 million were lender-approved. As of December 22, 2010, the identified deficiencies posed a \$1.6 million risk of loss to the SBA.²

Our audit also identified suspicious activity in 1 loan, which has been referred to our Investigations Division for further review. Based on the sample results, from the universe of 4,559 loans with gross loan approvals totaling approximately \$148 million, we estimate that 2,228 of the ARC loans made between June 1, 2009 and January 31, 2010, with at least one disbursement as of January 31, 2010, were not originated and closed in compliance with SBA's policies and procedures, resulting in approximately \$66.5 million in inappropriate loan approvals. Of the 2,228 loans, we estimate that 363 with inappropriate approvals totaling approximately \$9.5 million were SBA-approved, and 1,865 with inappropriate approvals totaling approximately \$57 million were lender-approved. In accordance with the Improper Payments Information Act of 2002, if adequate support cannot be obtained to overcome the identified deficiencies, these improper loan guaranties should be considered improper payments.

In order to address the loan deficiencies, we recommended that SBA flag all 56 loans to ensure the deficiencies are properly addressed should the loans default and be submitted for purchase. We also recommended that SBA notify the Office of Inspector General of any denials, repairs, withdrawals, or cancellations of SBA's guaranties made as a result of the deficiencies identified during purchase review. Further, we recommended that SBA notify the loan servicing center responsible for purchasing defaulted ARC loans of the high number of deficiencies identified and require the center to carefully review all ARC loans for compliance with SBA's requirements during its purchase review.

To prevent the occurrence of similar deficiencies in other SBA-approved loans, we recommended that SBA provide feedback to the SBA loan officers who approved the ARC loans in which deficiencies were identified. Lastly, to ensure the proper estimation of improper payments in the ARC loan program, we recommended that SBA notify the improper payment review team of the high rate of improper ARC loan guaranties identified during this audit.

Management agreed or partially agreed with all of the recommendations and proposed actions that were responsive.

¹ For purposes of this report, material deficiencies are defined as those which may result in improper payments.

² The risk of loss was calculated as SBA's share of the outstanding loan balance or the deficiency amount, whichever was less.

RESULTS

ARC Loans Were Not Originated and Closed in Accordance with SBA's Policies and Procedures

Material origination and closing deficiencies were identified in fifty-six of the 120 ARC loans reviewed, which resulted in inappropriate approvals of approximately \$1.8 million. Of the 56 loans, 13 with inappropriate approvals of approximately \$400,000 were SBA-approved and 43 with inappropriate approvals of approximately \$1.4 million were lender-approved. As shown in Table 1 below, the majority of the deficiencies identified in the 56 loans involved inadequate support for borrower viability and use of proceeds. Further, some loans did not have adequate support that the businesses were suffering immediate financial hardship. As of December 22, 2010, these identified deficiencies posed a \$1.6 million risk of loss to SBA.

Based on the sample results, from the universe of 4,559 loans with gross loan approvals totaling approximately \$148 million, we estimate that 2,228 of the ARC loans made between June 1, 2009 and January 31, 2010, with at least one disbursement as of January 31, 2010, were not originated and closed in compliance with SBA's policies and procedures, resulting in approximately \$66.5 million in inappropriate loan approvals. Of the 2,228 loans, we estimate that 363 were SBA-approved with inappropriate approvals totaling approximately \$9.5 million, and 1,865 were lender-approved with inappropriate approvals totaling approximately \$57 million. In accordance with the Improper Payments Information Act of 2002, if adequate support cannot be obtained to overcome the identified deficiencies, these improper loan guaranties should be considered improper payments. Given the high rate of deficiencies identified for the scope of our audit, we anticipate that ARC loans approved between February 1 and September 30, 2010 may also have a high deficiency rate. Our sampling methodology and projections are provided in Appendix I, and a listing of the sampled loans and deficiencies is provided in Appendix II.

Table 1. Material Deficiencies Noted in 56 Loans

Deficiency Type	Number of deficient loans in sample of 120*	Description of Deficiency	Number of deficiencies*	Approval Amounts allocated to deficiency**
Viability	33	Inadequate cash flow analysis/projections	30	\$834,172
		Unable to show profitability or positive cash flow in 1 of the 2 previous years	4	
Use of Proceeds	31	No documentation (i.e. note or credit card statement) to show that proceeds were used for QSBLs	15	\$572,574
		Documentation provided does not support the sound business use of QSBLs	10	
		Documentation shows payments were made on ineligible QSBLs	8	
Hardship	12	Inadequate evidence to support financial hardship	7	\$241,300
		Financials contradicted claimed hardship	5	
TOTALS	56		79	\$1,648,046

Source: Lender and SBA loan files

* Some loans had multiple deficiencies.

** Dollar values are allocated to each deficiency and do not overlap.

Viability

The audit determined that 33 loans approved for \$1 million, which included 8 SBA-approved and 25 lender-approved loans, did not have adequate support to demonstrate the borrower's viability as required. SBA's ARC loan procedural guide requires the borrower to be a going concern that is actively engaged in business with the expectation of indefinite continuance. The business must be able to reasonably demonstrate its projected continued operation for a reasonable period beyond the 6-month period of payment assistance with an ARC loan. Continued operation is evidenced by quarterly cash flow projections for two years that demonstrate the small business has the capacity to meet future debt service obligations, including the ARC loan. Further, SBA requires that the business provide evidence of profitability or positive cash flow in at least 1 of the past 2 years. The audit found that the 33 loans had (1) unsupported, unreasonable, or missing cash flow projections; (2) flawed cash flow analyses due to debt obligations not being considered, inappropriate add-backs to cash flow, or a general lack of repayment ability; and/or (3) inadequate evidence that the business was profitable or had positive cash flow for at least 1 of the past 2 years.

The following examples illustrate the deficiencies identified in the 33 loans:

- The SBA approved a \$35,000 loan even though the required cash flow statements were based on a loan amount of only \$11,160 and omitted debt service obligations on the borrower's delinquent 504 loan. Three different cash flow scenarios were provided for this loan. When recalculated to consider the higher loan amount and all debt service requirements, two of these scenarios showed a lack of repayment ability. Furthermore, although the third scenario did show repayment ability, it was based on unreasonable and unsupported sales projections.
- One lender approved a loan for \$35,000 even though the cash flow projections for the 2 years following loan approval showed net losses of \$73,116 and \$166,820, respectively, resulting in inadequate debt service coverage.
- The SBA approved 1 loan and lenders approved 3 loans to businesses without adequate evidence that they were profitable or had positive cash flow for at least 1 of the 2 years prior to approval of the ARC loans. In fact, the financial statements for one business showed net losses for 3 full years and the interim period before it obtained the ARC loan, and the financial analysis was inadequate to demonstrate positive cash flow for the 2 years prior to approval of the ARC loan.

Use of Proceeds

The audit determined that 31 ARC loans were approved for \$1 million without adequate support to demonstrate eligibility of the QSBLs. SBA's ARC loan procedural guide states that the use of proceeds for each QSBL must be consistent with an eligible use of proceeds for a 7(a) loan. Further, it states that ARC loans must be used to pay QSBLs that were made for sound business purposes and that each loan file must contain evidence of the QSBLs, such as a note with scheduled payments of principal and/or interest. The ARC procedural guide specifically prohibited payments on QSBLs that were (1) distributions or loans to associates of an applicant, (2) used for a purpose that did not benefit the business, (3) used to invest in real or personal property that was acquired and held primarily for sale, lease, or investment, or (4) used for a debt that did not exist prior to the ARC loan application.

Nevertheless, the SBA approved 6 ARC loans and lenders approved 25 ARC loans that did not meet QSBL requirements. For example, the SBA approved ARC loans without the required documentation to support the existence of the QSBLs or to demonstrate they were used for sound business purposes. Furthermore, lenders approved ARC loans that appeared to be used for ineligible purposes, including (1) payments to associates, (2) payments on a personal home mortgage, (3) a pass through loan to an affiliated borrower who was previously denied an ARC loan, (4) payments on QSBLs dated after ARC loan approval, and (5) payments on QSBLs of a business engaged in real estate investment.

Hardship

The audit found that lenders and the SBA did not properly assess borrowers' immediate financial hardship on 12 loans approved for approximately \$391,300. To establish eligibility for the ARC loan program, SBA's procedural guide requires evidence that borrowers are having difficulty making periodic payments of principal and interest on QSBLs and/or meeting operating expenses of the business. Immediate financial hardship is demonstrated by a change in the financial condition of a small business such as a 20-percent or more decline in revenue over the preceding 12 months, a 20-percent or more increase in expenses over the preceding 12 months, or a 20-percent or more reduction in working capital, and so forth. Borrowers were required to certify that they were experiencing immediate financial hardship, identify the nature of the hardship, and provide evidence of the hardship. Lenders and the SBA were required to analyze the evidence provided and determine whether an immediate financial hardship existed.

Nonetheless, the SBA approved 1 ARC loan and lenders approved 11 ARC loans to borrowers when there was inadequate evidence to support the financial hardship or the financial information actually contradicted the claimed financial hardship. For example, financial statements for some loans showed an increase in revenue, while the borrowers cited a 20-percent decrease in sales as the reason for their hardship.

Suspicious Activity Was Identified in One ARC Loan

We identified suspicious activity in 1 of the 120 loans reviewed. This loan has been referred to the OIG Investigations Division.

RECOMMENDATIONS

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

1. Flag all 56 loans to ensure the deficiencies are properly addressed if the loans default and are submitted for purchase. Further, notify the Office of Inspector General of any denials, repairs, withdrawals, or cancellations of SBA's guaranties made as a result of the deficiencies identified during the purchase reviews.
2. Notify the loan servicing center responsible for purchasing defaulted ARC loans of the high number of deficiencies identified and require the center to carefully review all ARC loans for compliance with SBA's requirements during its purchase review.
3. Provide feedback to the SBA loan officers who approved the ARC loans in which deficiencies were identified to prevent similar deficiencies in the approval of other SBA loans.

4. Notify the improper payment review team of the high rate of improper ARC loan guaranties identified during this audit to ensure the proper estimation of improper payments in the ARC loan program.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On December 14, 2010, we provided a draft of the report to SBA for comment. On February 11, 2011, SBA provided written comments, which are contained in their entirety in Appendix III. SBA agreed or partially agreed with all of the recommendations and proposed actions that were responsive.

General Comments

The SBA stated that it was required to interpret the Recovery Act provisions with regard to viability and financial hardship, and therefore, many of the exceptions identified in the audit were based on procedural guidance that, at the agencies discretion, may still be able to be waived if the intent of the provision was met and did not violate the law. As noted in the report, the objective of our audit was to determine if ARC loans were originated and closed in accordance with SBA's policies and procedures. In this case, the only policy or procedure that existed, by which to assess lender and SBA compliance, was the ARC loan procedural guide. This guide was developed by SBA to interpret and implement the law and provide procedures for lenders and SBA to follow when making ARC loans. As the deficiencies identified in the audit were in the areas of viability, financial hardship, and use of proceeds for qualified small business loans, which were all aspects of the program established by the Recovery Act, we believe all of our findings represent violations of the intent of the provisions of the procedural guide and the law as interpreted by the SBA.

The SBA claimed that it was able to obtain additional information from lenders to support that SBA's approval of certain loans was in compliance with the procedural requirements, but also recognized that making an ARC loan decision without all required documentation was a concern. As the audit objective focused on the appropriateness of SBA and lenders' origination and closing actions, loans made without the proper documentation are still cited as deficiencies in the audit report.

The SBA also stated that the OIG did not give delegated lenders the opportunity to correct the deficiencies, so the true extent of the deficiencies is not known. However, the OIG requested the entire lender loan file for each sampled loan that was made by a delegated lender and each lender certified in writing that the documents provided constituted a complete and accurate copy of all original documents in the lender's possession pertaining to the sampled loan. As SBA recognized, making ARC loans without all required documentation is a concern. As a result, we continue to support our conclusion that the deficiencies identified on all sampled loans, including delegated and non-delegated loans, represent true and material origination and closing deficiencies and pose a significant risk of loss to the SBA. Nevertheless, our audit report has been slightly revised to clarify that the deficiencies identified were related to inappropriate loan

approvals and not necessarily improper payments if additional documentation can be subsequently obtained to address the deficiencies.

Finally, the SBA claimed that by working with the OIG, it was determined that 3 of the 15 SBA-approved loans identified in the draft report as having deficiencies were actually processed in accordance with the intent of the ARC loan procedural guide requirements. The OIG, however, only agreed that 2 of the 15 SBA-approved loans for which deficiencies were identified had been processed in accordance with the intent of the guide, and as a result, these 2 deficiencies were removed from the report. The SBA has not yet reviewed the 43 lender-approved loans with identified deficiencies, but stated its review of delegated and non-delegated loans will continue. Based on clarification obtained from SBA in relation to line of credit QSBLs, however, we did remove the deficiency on one lender-approved loan from our audit results.

Recommendation 1

The SBA agreed to flag all loans identified with outstanding deficiencies and stated it will issue a procedural memo to the ARC guaranty purchase centers to provide notice to the OIG of any denials, repairs, withdrawals or cancellations of SBA's guaranties resulting from the identified deficiencies. The SBA will also review each outstanding deficiency and provide notes in the chron system for all loans with deficiencies to be resolved at the time of guaranty purchase. SBA's proposed actions are responsive to recommendation 1.

Recommendation 2

The SBA agreed to notify the ARC loan guaranty purchase centers of the high number of deficiencies identified and stated it will issue a procedural memo to the centers advising them to conduct comprehensive guaranty purchase reviews on all ARC loans for compliance with SBA's requirements. SBA's proposed actions are responsive to recommendation 2.

Recommendation 3

The SBA agreed to provide feedback to SBA loan officers associated with the ARC loans in which deficiencies were identified. SBA's proposed action is responsive to recommendation 3.

Recommendation 4

The SBA partially agreed with this recommendation, stating it was not clear that there were improper payments since additional work may result in obtaining supporting documentation, or they may determine certain procedural requirements can be waived after the fact, if a decision is made that the intent of the provision was met. Accordingly, the SBA disagreed that there was a high improper payment rate but agreed that the

improper payment review team should be made aware of the high number of deficiencies identified by the OIG and plan accordingly.

As stated above, the OIG believes that all of the loan deficiencies identified in the audit represent violations of the intent of the ARC loan procedural guide provisions and do not believe that waiving the provisions, after the fact, is an acceptable practice to be taken by the SBA in addressing the identified deficiencies. Furthermore, while additional supporting documentation may be subsequently obtained, the loans in question were approved without adequate support and therefore, at this time, are considered improper payments within the scope of this audit. Until the SBA completes its review of all loans in question and provides evidence of compliance with the procedural requirements, the agency's claim that there is not a high improper payment rate in this program cannot be supported.

ACTIONS REQUIRED

Please provide your management response for each recommendation on SBA Forms 1824, *Recommendation Action Sheet*, within 30 days from the date of this report. Your responses should identify the specific actions taken or planned to fully address each recommendation and the target dates for completion.

We appreciate the courtesies and cooperation of the Office of Capital Access during this audit. If you have any questions concerning this report, please call me at (202) 205-6586 or Jeff Brindle, Acting Director, Recovery Oversight Group at (202) 205-7490.

APPENDIX I. SAMPLING METHODOLOGY

The universe was pulled from SBA's Loan Accounting System and consisted of 4,559 ARC loans that were approved between June 1, 2009 and January 31, 2010 with at least one disbursement as of January 31, 2010. The universe was broken into two strata – one with 1,677 ARC loans totaling \$55,593,038 and one with 2,882 ARC loans totaling \$92,367,057. Based on information contained in SBA's Loan Accounting System, it appeared the first stratum represented SBA-approved ARC loans while the second stratum represented lender-approved ARC loans. Therefore, upon consultation with a statistician, we used Interactive Data Extraction and Analysis Software (IDEA) to randomly select 60 loans from each stratum for a total sample size of 120 loans. Subsequent to this extraction; however, we learned that the first stratum actually included both SBA and lender-approved loans.³ As a result, our sample in fact consisted of 41 SBA-approved loans and 79 lender-approved loans.

In addition to a point estimate, our estimation also produces a margin of error, which quantifies the precision based on by sample-to-sample variation. Sampling precision is indicated by ranges, or confidence intervals, that have upper and lower limits at a certain confidence level. Calculating at a 90-percent confidence level means the chances are 9 out of 10 that, if we reviewed all of the loans in the total population, the resulting values would be between the lower and upper limits, with the population point estimates being the most likely amounts.

In consultation with the statistician, the following projections using Stata v.11 software were performed to calculate the precision statistics at a 90-percent confidence level. Projecting our sample results to the universe of 4,559 ARC loans with gross loan approvals totaling approximately \$148 million, we estimated that 2,228 loans made between June 1, 2009 and January 31, 2010 with at least one disbursement as of January 31, 2010 were not originated and closed in accordance with SBA's policies and procedures, resulting in inappropriate loan approvals totaling approximately \$66.5 million. The tables below show the breakdown of the projected numbers per type of loan. The first table reports the projected error rates, the second table reports the number of errors, and the third table illustrates the projected deficiency amounts.

Projected Error Rates			
Type of Loan	Projected Error Rate	Lower Limit (90% CI)	Upper Limit (90% CI)
SBA-Approved	31.7%		
Lender-Approved	54.6%		
Total	48.9%	41.2%	56.6%

³ Stratification criteria are auxiliary to the estimation. Mislabeling strata does not introduce a bias in the resultant estimates. However, it could introduce imprecision, which can lead to a larger margin of error.

Projected Error Counts

Type of Loan	Projected Error Count	Lower Limit (90% CI)	Upper Limit (90% CI)
SBA-Approved	363		
Lender-Approved	1,865		
Total	2,228	1,876	2,580

Projected Error Amounts

Type of Loan	Projected Deficiency Amount	Lower Limit (90% CI)	Upper Limit (90% CI)
SBA-Approved	\$ 9,517,255		
Lender-Approved	\$ 57,030,190		
Total	\$ 66,547,445	\$ 55,241,303	\$ 77,853,565

APPENDIX II. SAMPLED LOANS AND DEFICIENCIES

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
1	[FOIA ex. 4]		-		\$35,000	\$0
2			-		\$35,000	\$0
3			A,B	(A) Inadequate cash flow analysis, (B) Purpose/Eligibility for \$11,504 other institution debt unsupported	\$35,000	\$35,000
4			B	(B) Business use of HELOC refinanced with commercial line of credit not supported	\$35,000	\$35,000
5			A	(A) No profitability previous 4 years; Unable to show positive cash flow in 1 of the 2 previous years	\$35,000	\$35,000
6			B	(B) Business use of \$3,700 credit card debt not supported	\$35,000	\$3,700
7			-		\$35,000	\$0
8			-		\$35,000	\$0
9			A	(A) Projections show negative cash flow	\$35,000	\$35,000
10			-		\$35,000	\$0
11			A	(A) Projections are unreasonable and include incorrect add-backs	\$35,000	\$35,000
12			-		\$35,000	\$0
13			B	(B) Proceeds used to pay owner of the business	\$35,000	\$25,000
14			B,C	(B) Business use of HELOC not supported, (C) Financials contradicted hardship claim	\$35,000	\$35,000
15			-		\$35,000	\$0
16			A	(A) No profitability or positive cash flow in previous 2 years	\$35,000	\$35,000
17			-		\$32,300	\$0
18			A	(A) Inadequate cash flow projections	\$35,000	\$35,000
19			-		\$35,000	\$0
20			-		\$35,000	\$0
21			-		\$35,000	\$0
22			-		\$35,000	\$0
23			A,B,C	(A) No cash flow projections, (B) No support for QSBLs, (C) No support for hardship	\$35,000	\$35,000
24			-		\$35,000	\$0

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
25	[FOIA ex. 4]		-		\$35,000	\$0
26			-		\$35,000	\$0
27			-		\$35,000	\$0
28			-		\$15,200	\$0
29			A	(A) Inadequate cash flow analysis; Did not consider all debts	\$35,000	\$35,000
30			B	(B) Missing some support for QSBLs; Some debt incurred after loan approval	\$35,000	\$13,958
31			-		\$35,000	\$0
32			A	(A) Personal income relied upon without considering personal expenses and all business debt	\$8,200	\$8,200
33			A	(A) Cash flow did not consider affiliates and debt service	\$35,000	\$35,000
34			-		\$18,500	\$0
35			-		\$35,000	\$0
36			A	(A) No profitability or positive cash flow in previous 2 years; ARC loan not considered in cash flow	\$35,000	\$35,000
37			A	(A) Inadequate cash flow projections; Business not a going concern	\$35,000	\$35,000
38			-		\$35,000	\$0
39			-		\$35,000	\$0
40			-		\$35,000	\$0
41			-		\$35,000	\$0
42			-		\$29,000	\$0
43			A,C	(A) Inadequate cash flow analysis, (C) Financial statements contradicted hardship claim	\$26,300	\$26,300
44			-		\$35,000	\$0
45			-		\$35,000	\$0
46			-		\$35,000	\$0
47			-		\$35,000	\$0
48			-		\$35,000	\$0
49			-		\$35,000	\$0
50			-		\$35,000	\$0
51			B	(B) No support for part of use of proceeds	\$33,800	\$12,000
52			-		\$31,800	\$0
53			-		\$35,000	\$0

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
54	[FOIA ex. 4]		A	(A) Inadequate cash flow projections	\$16,600	\$16,600
55			-		\$35,000	\$0
56			-		\$35,000	\$0
57			B	(B) A portion of proceeds not supported	\$25,000	\$11,210
58			-		\$35,000	\$0
59			B	(B) Proceeds used for personal mortgage	\$21,100	\$21,100
60			A,B	(A) No historical financial information, (B) No support for QSBLs	\$35,000	\$35,000
61			-		\$35,000	\$0
62			-		\$35,000	\$0
63			A,B	(A) Cash flow did not consider all debt, (B) Proceeds disbursed to an associate	\$35,000	\$35,000
64			B,C	(B) Business use of credit card debt not supported, (C) Financials contradicted hardship claim	\$35,000	\$35,000
65			B	(B) Business use of credit card debt not supported	\$35,000	\$35,000
66			B	(B) No support for QSBL	\$35,000	\$35,000
67			B	(B) No support for QSBL	\$35,000	\$35,000
68			A	(A) Cash flow did not consider all debt	\$24,000	\$24,000
69			-		\$35,000	\$0
70			A,B	(A) Inadequate cash flow, (B) Business use of \$15,088 not supported	\$35,000	\$35,000
71			C	(C) Financials contradict hardship claim	\$35,000	\$35,000
72			-		\$35,000	\$0
73			-		\$35,000	\$0
74			A	(A) Incorrect add-backs to cash flow	\$35,000	\$35,000
75			-		\$35,000	\$0
76			-		\$35,000	\$0
77			A,B,C	(A) Projections show negative cash flow, (B) No support for QSBLs and disbursements made for real estate investment, (C) No support for hardship	\$35,000	\$35,000
78			-		\$35,000	\$0
79			C	(C) Financials contradict hardship claim	\$35,000	\$35,000
80			-		\$35,000	\$0
81			-		\$17,100	\$0
82			-		\$35,000	\$0

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
83	[FOIA ex. 4]		A	(A) Unreasonable projections-significant decrease in COGS	\$35,000	\$35,000
84			-		\$22,000	\$0
85			-		\$35,000	\$0
86			-		\$35,000	\$0
87			-		\$35,000	\$0
88			A	(A) Projections not prepared correctly	\$35,000	\$35,000
89			B	(B) Business use not supported	\$35,000	\$35,000
90			A	(A) Cash flow did not consider all debt	\$35,000	\$35,000
91			A,C	(A) No cash flow projections, (C) No support for hardship	\$35,000	\$35,000
92			B	(B) No support for QSBL	\$35,000	\$35,000
93			A	(A) Projections indicate losses	\$19,900	\$19,900
94			A,B	(A) Projections are unreasonable-increased sales, missing expenses, (B) Business use not supported for \$5,486	\$32,600	\$32,600
95			-		\$35,000	\$0
96			B	(B) Business use not supported	\$35,000	\$12,670
97			-		\$35,000	\$0
98			-		\$35,000	\$0
99			-		\$35,000	\$0
100			A,B	(A) No cash flow projections; (B) No support for QSBLs	\$29,700	\$29,700
101			-		\$35,000	\$0
102			B	(B) Proceeds used for personal home mortgage	\$35,000	\$35,000
103			A,B	(A) Inadequate cash flow analysis, (B) No support for QSBL	\$35,000	\$35,000
104			B	(B) Some QSBLs dated after ARC loan approval	\$35,000	\$14,865
105			A	(A) Inadequate cash flow projections	\$26,600	\$26,600
106			A,B,C	(A) No cash flow projections, (B) No support for QSBLs, (C) No support for hardship	\$15,000	\$15,000
107			-		\$35,000	\$0
108			B	(B) No support for QSBL	\$35,000	\$35,000
109			A	(A) Inadequate cash flow projections	\$18,500	\$18,500
110			-		\$25,000	\$0
111			-		\$35,000	\$0

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
112	[FOIA ex. 4]		A,B	(A) No cash flow projections, (B) No support for some QSBLs and business use not supported for others	\$35,000	\$35,000
113			-		\$35,000	\$0
114			A,C	(A) Borrower not an operating concern, (C) No support for hardship	\$35,000	\$35,000
115			B	(B) No support for QSBL	\$35,000	\$21,143
116			B,C	(B) Pass thru loan to affiliate previously denied an ARC loan, (C) No evidence of hardship	\$35,000	\$35,000
117			-		\$35,000	\$0
118			C	(C) No evidence of hardship	\$35,000	\$35,000
119			-		\$35,000	\$0
120			-		\$35,000	\$0
	Totals				\$3,953,200	\$1,648,046

* Deficiency amount was calculated as the potential improper payment amount associated with the identified deficiencies.

Deficiency Type Legend:

- A. Viability
- B. Use of Proceeds
- C. Hardship

APPENDIX III. AGENCY COMMENTS



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

MEMORANDUM
February 10, 2011

To: Peter L. McClintock
Deputy Inspector General

From: Grady Hedgespeth
Director, Office of Financial Assistance

John A. Miller
Director, Office of Financial Program Operations

Subject: Response to Draft Report on the “America’s Recovery Capital Loans were not Originated and closed in accordance with SBA’s policies and procedures”, Project No. 10505A

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

As part of the Recovery Act, SBA implemented the America’s Recovery Capital (ARC) loan program to give viable small businesses suffering immediate financial hardship temporary financial relief to help ride out uncertain economic times and return to profitability. Almost 9,000 ARC loans were approved, sustaining small businesses and retaining jobs critical to the nation’s economy.

In establishing the ARC Loan Program, SBA was required to interpret the ARRA provisions regarding viability and financial hardship. Many of the exceptions identified by OIG in its audit of the ARC Loan Program were based upon procedural guidance that, at the agencies discretion, may be able to be waived if the intent of the provision was met and did not violate the law.

Based on the Agency’s review of certain SBA approved loans, staff was able to obtain additional information from the lender to comply with the procedural requirements. While we understand that making an ARC loan decision without all required documentation is a concern, the loan itself met the requirements. In its audit, OIG also reviewed loans that were made on a delegated, basis but did not give delegated lenders

the opportunity to correct the deficiencies so the true extent of the deficiencies is not known.

In following through on your review our analysis indicates that 44 of the 59 loans identified as having material deficiencies were approved under delegated authority by delegated lenders, and 15 were approved by SBA in our 7(a) loan guaranty processing center. We have been begun to review the deficiencies identified by OIG, and working with OIG have determined that 3 of the 15 loans were processed in accordance with the intent of ARC. Our review of the delegated and non-delegated loans will continue.

Management's responses to the specific recommendations included in the draft report are provided below:

1. Flag all 59 loans to ensure the deficiencies are properly addressed if the loans default and are submitted for purchase. Further, notify the Office of Inspector General of any denials, repairs, withdrawals, or cancellations of SBA's guaranties made as a result of the deficiencies identified during the purchase reviews.

OFPO agrees with this recommendation and plans the following actions:

- Flag all loans identified with the outstanding deficiencies.
- Issue a procedural memo to the ARC guaranty purchase centers to provide notice on any and all denials, repairs, withdrawals or cancellations of guaranties resulting from identified deficiencies to Office of Inspector General.
- OFPO will review and address each outstanding deficiency and will provide brief notes on the chron system for all loans with outstanding deficiencies to be resolved at the time of guaranty purchase.

2. Notify the loan servicing center responsible for purchasing defaulted ARC loans of the high number of deficiencies identified and require the center to carefully review all ARC loans for compliance with SBA's requirements during its purchase review.

OFPO concurs with this recommendation and will issue a procedural memo to the ARC loan guaranty purchase centers to conduct comprehensive guaranty purchase review on all ARC loans for compliance with SBA's requirements.

3. Provide feedback to SBA loan officers who approved the ARC loans in which deficiencies were identified to prevent similar deficiencies in the approval of other SBA loans.

OFPO concurs with this recommendation and plans the following actions:

- Identify SBA loan officers associated with referenced ARC loans.
- Provide feedback to identified SBA loan officers.

4. Notify the improper payment review team of the high rate of improper ARC loan guaranties identified during this audit to ensure the proper estimation of improper payments in the ARC loan program.

OFPO partially agrees with this recommendation. Given the nature of the work done by OIG in the audit, it is not clear that there are improper payments since additional work may result in obtaining supporting documentation or SBA may determine that it can waive certain procedural requirements, after the fact, if a decision is made that the intent of the provision was met. In either case, these would not be improper payments. Accordingly, SBA disagrees with the conclusion that there is a high improper payment rate but agrees that the improper payment review team should be made aware of the situation and plan accordingly in its future testing.

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