U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

ADVISORY MEMORANDUM
REPORT NO. 12-18

DATE: AUGUST 16, 2012

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

SUBJECT: A Detailed Repayment Ability Analysis is Needed on High-Dollar Early-Defaulted Loans to Prevent Future Improper Payments

Summary

In March 2012, our office issued Report No. 12-11R, *High-Dollar Early-Defaulted Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the National Guaranty Purchase Center*. In that report, we identified a concern regarding the National Guaranty Purchase Center's (NGPC) assessment of the quality and accuracy of lender underwriting. Specifically, we noted our concern that the NGPC's limited review of lender underwriting, including repayment ability analysis, was not consistent with statutory and regulatory authority and was contrary to SBA procedures. As follow-on to that report, we conducted a limited scope audit of the Small Business Administration's (SBA or the Agency) analysis of repayment ability during guaranty purchase reviews at the NGPC. In summary, this audit found that the assessment of delegated lender underwriting performed at the NGPC on early-defaulted loans was not effective in identifying whether lenders were clearly negligent in determining the borrowers' repayment ability. Based on previous audit work, our analysis indicated that improved reviews for repayment ability could result in a cost savings to the SBA of at least $43 million over the next two years.

The objective of the audit was to determine why adequate reviews of repayment ability were not being performed and the amount of federal funds that could be saved if the SBA thoroughly reviewed repayment ability during the guaranty purchase review of early-defaulted loans.[1] In meeting the objective, we reviewed repayment ability deficiencies identified during various Office of Inspector General (OIG) audits conducted from January 2008 to June 2012.[2] We also reviewed information in the SBA's Loan Accounting System. Furthermore, we interviewed SBA management officials and current and former SBA loan specialists to gain an understanding of the history and type of repayment ability

[1] Standard Operating Procedure (SOP) 50 51 3, *Loan Liquidation*, defines early-defaulted loans as those loans that default within 18 months of initial disbursement of the proceeds from an SBA loan. If the final disbursement occurs more than six months after initial disbursement, the 18-month period begins from the date of the final disbursement.

[2] We performed fieldwork for these audits between January 2008 and June 2012. OIG Report 9-16, *The Small Business Administration's Fiscal Year 2008 Improper Payment Rate for the 7(a) Guaranty Loan Program*, July 10, 2009; OIG Report 9-18, *SBA's Management of the Backlog of Post-Purchase Reviews at the National Guaranty Purchase Center*, August 25, 2009; OIG Report ROM 10-19, *Material Deficiencies Identified in Early-Defaulted and Early-Problem Recovery Act Loans*, September 24, 2010; OIG Report ROM 11-06, *Material Deficiencies Identified in Five 7(a) Recovery Act Loans Resulted in $2.7 Million of Questioned Costs,* August 22, 2011; Project 11008, *Audit of SBA's FY 2011 Improper Payment Rate*.

analyses conducted during purchase reviews at the SBA. We also held a meeting with representatives from SBA's lending community and conducted research on the oversight of lender underwriting practices performed by federal regulators from the Federal Deposit Insurance Corporation and other federal agencies with guaranteed loan programs. To assess the internal controls relevant to our objective, we examined the SBA's policies and procedures regarding loan origination, closing, and guaranty purchase.

We conducted this audit between November 2011 and March 2012 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 objective.

Background

The SBA is authorized under Section 7(a) of the Small Business Act[3] to provide financial assistance to small businesses in the form of government-guaranteed loans. The SBA's 7(a) loans are made by participating lenders under an agreement to originate, service, and liquidate loans in accordance with SBA's rules and regulations and prudent lending standards. Some 7(a) loans are made by lenders using delegated authority, which undergo very limited review by the SBA prior to loan disbursement. Others are subject to more extensive underwriting and eligibility review and approval by the SBA before loan disbursement. When a loan goes into default, the SBA will conduct a review of the lender's actions on the loan to determine whether it is appropriate to pay the lender the guaranty (which SBA refers to as a guaranty "purchase"). Under SBA regulations,[4] the SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any SBA loan program requirement or does not make, close, service or liquidate the loan in a prudent manner.

The guaranty purchase review is SBA's primary control for ensuring lender compliance and preventing improper payments in the 7(a) Program. The Improper Payments Elimination and Recovery Act of 2010 (IPERA),[5] defines improper payments as expenditures that either should not have been made or were made in incorrect amounts under statutory, contractual, administrative, or other legally applicable requirements.

The Office of Management and Budget (OMB) guidance[6] for the Improper Payments Information Act of 2002 (IPIA) and IPERA require agencies to conduct improper payment reviews for all programs and activities susceptible to significant improper payments , and to annually report their improper payment results to the President and Congress. For those programs and activities susceptible to significant improper payments,[7] the guidance also requires agencies to take actions to reduce and recover[8]

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[3] Public Law 85-536, as amended.

[4] 13 Code of Federal Regulations (CFR) § 120.524.

[5] Public Law 111-204. The IPERA amends the Improper Payments Information Act of 2002 (IPIA). Even though IPERA amends IPIA, the authorizing legislation is still named IPIA.

[6] Memorandum M-11-16, *Issuance of Revised Parts I and II to Appendix C of OMB Circular A-123.*

[7] The SBA 7(a) business loan program has been identified by OMB as susceptible to significant improper payments.

[8] For those programs and activities that have annual gross improper payment estimates that exceed $10 million.

improper payments. Improper payments in the guaranty purchase process arise when an SBA purchase reviewer fails to identify material lender deficiencies in the handling of an SBA guaranteed loan.

During the audit of purchased 7(a) Recovery Act loans,[9] we obtained evidence supporting the fact that the NGPC's purchase review process did not require loan specialists to scrutinize credit decisions made by lenders on early-defaulted loans. Specifically, for loans that defaulted early, loan specialists did not analyze the reasonableness of the lenders' underwriting, including lender assessment of borrower repayment ability. Furthermore, prior OIG audits[10] have identified loans with repayment ability deficiencies that were improperly purchased by the SBA, resulting in questioned costs of approximately $4.5 million.

The potential for future improper payments due to unidentified repayment ability deficiencies is of substantial concern given the recent statutory increase in loan limits and the $5 billion increase in the SBA's lending volume from Fiscal Year (FY) 2010 to FY 2011. Specifically, the Small Business Jobs Act of 2010[11] increased the maximum 7(a) loan amount from $2 million to $5 million, which increased the maximum SBA guaranteed amount to $3.75 million.[12] From FY 2010 to FY 2011, the volume of section 7(a) loans approved by the SBA grew from 52,936 to 53,707, or 1.46 percent. However, the SBA's guaranteed share of these loans increased from $10.3 billion to $15.4 billion, or 50 percent.
The average loan size in the SBA's portfolio is increasing. As the average loan amount increases, there is a risk that the average loan amount requested by lenders for purchase will also increase. Therefore, it is important to prevent similar repayment ability deficiencies from going undetected as the risk of loss to the SBA becomes even greater.

Results

SBA's Assessment of Lender Underwriting during the Purchase Review Process was Inconsistent with Its Own Regulations and Procedures and Improvements Could Provide the SBA the Opportunity to Put Funds to Better Use

The assessment of delegated lender underwriting performed at the NGPC on early-defaulted loans was not effective in identifying whether lenders were clearly negligent in determining the borrowers' repayment ability. As a result, the NGPC made improper payments by inappropriately purchasing the SBA guaranties on early-defaulted loans that did not have repayment ability, which resulted in unnecessary losses to the Agency. Furthermore, based on previous audit work, our analysis indicated that improved reviews for repayment ability could result in a cost savings to the SBA of at least $43 million over the next two years.

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[9] OIG Report No 12-11R, *High-Dollar Early-Defaulted Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the National Guaranty Purchase Center,* March 23, 2012.
[10] See footnote number 2 on page 1.
[11] Public Law 111-240, *Small Business Jobs Act of 2010, September 27, 2010.*
[12] For loans approved from September 27, 2010 through December 31, 2010, the maximum SBA guaranteed amount was $4,500,000 because of the temporary 90 percent SBA guaranty on eligible 7(a) loans established under the American Recovery and Reinvestment Act of 2009.

In accordance with IPERA, agencies are required to take actions to reduce improper payments. According to SBA regulations,[13] the applicant must be creditworthy and loans must be so sound as to reasonably assure repayment. The SBA's own procedures[14] state that,

> on SBA-guaranteed loans, the cash flow of the small business applicant is the primary source of repayment, not the liquidation of collateral. Thus, if the lender's financial analysis demonstrates that the small business applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available.

According to SBA procedures for early-defaulted loans,[15] during the purchase review, the SBA must review the lender's purchase package with the "highest degree of scrutiny." Also, the recommending official must determine whether the lender's failure to make or close the loan in accordance with SBA requirements or prudent lending practices allowed or contributed to the early default. If the SBA purchase review indicates that the lender's actions or omissions resulted in a loss to the SBA, the procedures provide that repair or denial of the guaranty is appropriate. These same procedures define a repair as a specific agreed-upon dollar amount between the SBA and a 7(a) lender, which represents the actual or anticipated loss, caused by the lender and is deducted from the SBA's guaranty payment. Furthermore, the procedures explain that a denial of the SBA's liability is justified when a lender's actions or omissions caused, or could cause a material, total, or near total loss on a loan.

We determined that the NGPC did not adequately assess lender underwriting during purchase reviews based on interviews with current and former SBA and NGPC officials who managed the NGPC operations or had performed purchase reviews. Management at the NGPC required loan specialists to perform a superficial review of the lenders' credit memorandum, which did not allow them to determine whether early-defaulted loans approved under delegated authority had repayment ability. Specifically, according to SBA management and a NGPC document describing the purchase review process, the NGPC's assessment of creditworthiness was limited to verifying that the lender's credit memorandum included certain elements.[16] However, loan specialists were not expected to evaluate whether the financial analyses of repayment ability performed by the lenders actually demonstrated reasonable assurance of repayment from the cash flow of the business. This limited assessment was performed regardless of the loan amount and was inconsistent with SBA's procedures which call for "the highest degree of scrutiny" on early-defaulted loans. As a result, the NGPC inappropriately purchased the SBA guaranties on early-defaulted loans that did not have repayment ability and incurred unnecessary losses to the Agency. While this can occur regardless of the dollar amount, prior audits have identified the issue to be significant with high-dollar[17] early-defaulted loans.

Historically, high-dollar loans have much lower early-default rates than smaller loans.[18] For example, since 2007, high-dollar loans accounted for just about 6 percent of all early-defaulted loans.

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[13] 13 CFR § 120.150.

[14] Standard Operating Procedure (SOP) 50 10 5(D), *Lender and Development Company Loan Programs*.

[15] SOP 50 51 3, *Loan Liquidation*.

[16] These elements include collateral, credit history, credit elsewhere, management, capitalization, and repayment ability.

[17] For the purposes of this report, high-dollar loans are defined as those loans that were approved for $500,000 or more.

[18] For the purposes of this report, smaller loans are defined as those loans that were approved for less than $500,000.

Nevertheless, these loans account for a significant portion of the guaranty amounts purchased by the SBA on early-defaulted loans. For example, since 2007, high-dollar loans accounted for approximately $469 million, or 48%, of the guaranty amounts purchased by the SBA on early-defaulted loans. As a result, when high-dollar loans default early, the SBA should consider them "high-risk" and scrutinize the lenders' underwriting, including their repayment ability analyses.

Since 2008, we have performed five audits[19] that focused on the origination, closing, servicing, liquidation, or purchase actions on problem or defaulted 7(a) loans. During these audits, we reviewed 21 high-dollar early-defaulted loans approved by lenders under delegated authority. We determined that 8 of these loans, or 38 percent, did not have repayment ability (see Appendix II for a summary of the deficiencies identified on these loans). Six[20] of these eight loans were inappropriately purchased by the NGPC resulting in questioned costs of approximately $4.5 million. While the remaining two loans have not been purchased, they still represent inappropriate loan approvals by the lenders of approximately $1.5 million. In consideration of our findings on the six loans, the SBA was able to recover approximately $2 million on two loans. For the remaining four of the six loans purchased by the NGPC, either recovery efforts are still underway or the SBA did not seek recovery from the lenders due to extenuating circumstances (i.e. statute of limitations, lender out of business).[21]

Based on our results, the credit memorandum reviews performed by the NGPC loan specialists were not effective to identify whether lenders were clearly negligent in determining the borrowers' repayment ability. Thus, SBA funds could be put to better use if loan specialists thoroughly analyzed repayment ability during the guaranty purchase reviews of high-dollar early-defaulted loans approved under delegated authority. We estimated that thorough reviews leading to repairs and denials made by the SBA—on high-dollar early-defaulted loans that lack repayment ability—could result in cost savings of at least $43 million (See Appendix I for additional information on the details of our analysis).

Historically, the SBA has delegated the credit decisions to the lenders for loans approved under the SBA's Preferred Lenders Program (PLP)[22] and had instructed its loan specialists to not second-guess lenders' credit decisions. This was evident from interviews we conducted with SBA management officials. Prior to centralizing the guaranty purchase process at the NGPC in 2004, purchase reviews occurred in the SBA's 70 district offices.[23] There was much inconsistency in the district office reviews, including how repayment ability was analyzed. The inconsistencies in the purchase review process continued after the centralization and until the NGPC underwent a business process re-engineering in 2007, which included revisions to its guaranty purchase process.

During this re-engineering process, the Office of Financial Assistance (OFA) instructed the NGPC to standardize its reviews of the lenders' credit memorandum (including repayment ability) on early-

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[19] See footnote number 2 on page 1.

[20] See Appendix II: High-Dollar Early-Defaulted Loans with Repayment Ability Deficiencies, loan numbers [Ex. 4], [Ex. 4], [Ex. 4], [Ex. 4], [Ex. 4], and [Ex. 4].

[21] See Appendix II: High-Dollar Early-Defaulted Loans with Repayment Ability Deficiencies, loan numbers [Ex. 4], [Ex. 4], [Ex. 4], and [Ex. 4].

[22] Under the PLP, SBA authorizes experienced lenders to make SBA guaranteed loans, subject only to a brief eligibility review and assignment of a loan number by the SBA. In addition, PLP lenders are expected to handle servicing and liquidation of their SBA loans with limited involvement of the SBA.

[23] See SBA's Budget Request and Performance Plan, FY 2003 Congressional Submission.

defaulted loans. Specifically, the OFA directed the NGPC to review only the credit memorandum components and to not second-guess the lenders' credit decisions. An internal document developed in September 2011 and approved by NGPC management confirmed this directive and clarified the credit memorandum elements that would be evaluated for early-defaulted loans. These clarifications were still not sufficient for loan specialists to determine whether lenders were clearly negligent in determining the borrowers' repayment ability. We also found that loan specialists at the NGPC had not been trained to perform a detailed analysis of repayment ability.

Conclusion

The SBA will continue to incur unnecessary losses on early-defaulted loans if the NGPC does not implement a process to verify compliance with SBA repayment ability requirements. Additionally, until this change is made, the SBA will not be in full compliance with IPERA because it will not identify improper payments resulting from repayment ability deficiencies. We believe, at a minimum, an effective review for repayment ability on early-defaulted loans should include a thorough examination of the credit memorandum, and verification that:

- cash flow was calculated correctly (included appropriate adjustments and no material errors),
- projected revenues exceeded projected expenses,
- projections were adequately supported by reasonable assumptions, and
- historical figures used by lenders were supported by historic financial statements or tax transcripts for existing businesses.

Furthermore, the NGPC purchase staff will require training to perform effective reviews for repayment ability and prevent future improper payments. We estimate that if the Agency implements Recommendations No. 1 and No. 2, which specifically address these issues, a cost savings of at least $43 million will be realized over the next two years. Finally, as this report focuses on the risk to the SBA for high-dollar early-defaulted loans, we believe it would also be beneficial for the SBA to perform detailed analyses of repayment ability for smaller lender-approved early-defaulted loans.

Recommendations

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

1. Direct the NGPC to revise its purchase process for high-dollar early-defaulted loans approved by lenders to verify compliance with SBA's repayment ability requirements, including the performance of a detailed analysis of the lenders' computation of repayment ability.

2. Properly train NGPC purchase staff in the revised purchase process to perform effective analyses of lenders' repayment ability computations and verify compliance with SBA requirements.

3. Perform a risk assessment to determine if it is beneficial for purchase reviews of smaller (less than $500,000) lender-approved early-defaulted loans to include a detailed analysis of the lenders' computation of repayment ability.

Agency Comments and Office of Inspector General Response

On June 21, 2012, we provided a draft of this memorandum to the SBA for comment. On July 24, 2012, the SBA provided written comments, which are summarized below and contained in their entirety in Appendix III. The SBA agreed or partially agreed with all of the recommendations and the SBA's comments, proposed actions, and actions taken were responsive to the recommendations.

Management Comments

Management stated that it is fully committed to eliminating improper payments from all SBA loan programs. Management cited its efforts to date to improve the quality of lender credit underwriting and the underwriting reviews performed at the NGPC, including enhanced training and quality control feedback. Management's response also stated that it has formed a working group to review its Standard Operating Procedures and determine whether additional clarity is needed for lenders and staff to apply consistent underwriting standards. Further, management's response recognized that cost savings will occur by looking more carefully at high-dollar early-defaulted loans, but cited its plan to determine the accuracy of the OIG's $43 million estimate. Finally, management stated that it did not agree that all eight cases cited by the OIG as examples of loans with repayment ability deficiencies warranted denial for credit analysis alone and had other factors warranting their denial.

OIG Response

We commend the Agency for recognizing the need to improve its reviews of lender underwriting on high-dollar early-defaulted loans and for its training efforts to date. The $43 million funds for better use estimate covers a two-year period and assumes both years' activities are largely comparable. This estimate was derived in coordination with our statisticians based on the results of two loans that the Agency agreed had material lender noncompliance with the SBA's repayment ability requirements. The statistically valid methodology used to reach this estimate is disclosed in Appendix I of this report. We agree that many of the other cases cited as examples in this report included additional material deficiencies that could also support denial of liability. However, we maintain that the repayment ability deficiencies noted for each example in Appendix II of this report demonstrates material noncompliance or gross negligence on behalf of the lender that alone support denial of the SBA's guaranty.

Recommendation 1

Direct the NGPC to revise its purchase process for high-dollar early-defaulted loans approved by lenders to verify compliance with SBA's repayment ability requirements, including the performance of a detailed analysis of the lenders' computation of repayment ability.

Management Comments

The SBA partially agreed with our recommendation. Management stated that it is in the process of augmenting its purchase review process on high-dollar early-default loans to include identification of material deficiencies in a lender's analysis of repayment ability. Management also stated that it has made recent process improvements in this area by allocating additional review time for high-dollar early-default loans. Finally, management stated it will perform further analysis on the OIG's $43 million estimate of funds for better use to determine its accuracy.

OIG Response

The SBA's comments are responsive to the recommendation. As discussed above, the $43 million funds for better use estimate covers a two-year period and assumes both years' activities are largely comparable. This estimate was derived in coordination with our statisticians using loans that the Agency agreed had material lender noncompliance with the SBA's repayment ability requirements.
The statistically valid methodology used to reach this estimate is disclosed in Appendix I of this report.

Recommendation 2

Properly train NGPC purchase staff in the revised purchase process to perform effective analyses of lenders' repayment ability computations and verify compliance with SBA requirements.

Management Comments

The SBA agreed with our recommendation. Management stated that it will continue to train NGPC purchase staff in the revised purchase process to perform effective analyses of lender's repayment ability computations and verify compliance with SBA requirements.

OIG Response

The SBA's comments are responsive to the recommendation.

Recommendation 3

Perform a risk assessment to determine if it is beneficial for purchase reviews of smaller (less than $500,000) lender-approved early-defaulted loans to include a detailed analysis of the lenders' computation of repayment ability.

Management Comments

The SBA agreed with our recommendation. Management stated a risk assessment will be performed to determine if it is beneficial for purchase reviews of other lender approved early-default loans to include a detailed analysis of the lender's computation of repayment ability.

OIG Response

The SBA's comments are responsive to the recommendation.

Actions Required

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

We appreciate the courtesies and cooperation of the Small Business Administration during this audit.

If you have any questions concerning this report, please call me at (202) 205-7390 or Terry Settle, Director, Credit Programs Group at (703) 487-9940.

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/S/ original signed
John K. Needham
Assistant Inspector General for Auditing

Appendix I. Funds Be Put to Better Use

Under the Inspector General Act of 1978, as amended,[24] "funds be put to better use" is defined as funds that could be used more efficiently if management of an establishment took actions to implement and complete the recommended action. This includes costs not incurred by implementing recommended improvements related to the operations of the establishment, a contractor, or grantee.

We used results from the 2008 Improper Payments (2008 IPIA) audit to establish an amount of funds that could be put to better use if the SBA thoroughly analyzed repayment ability during the guaranty purchase reviews of early-defaulted loans. This audit encompassed a full year of SBA purchases totaling 13,022 loans for approximately $869 million.[25] From these purchases, we identified a population of 139 high-dollar early-defaulted loans[26] with SBA guaranteed payment amounts totaling $94.2 million. We audited two of the 139 loans during the 2008 IPIA audit. We identified lender noncompliance with the SBA's repayment ability requirements on both of these loans. These two loans resulted in total improper payments of approximately $2 million.

Using the audit population and results described above, our statistician calculated an estimate of the minimum improper payment rate in the population. The calculations performed by the statistician provided that if there were only two improper payments in the population of 139 transactions, it is extremely unlikely that both of them would be selected in a sample size of two. In fact, there was only a 1-in-9,591 chance for that to occur. Using this information and a 95% confidence interval, the statistician then determined the number of loans within the population that had repayment ability deficiencies that resulted in improper payments. Specifically, they estimated the lower bound of a one-sided 95% confidence interval. As a result, we can be 95% confident that the improper payment rate was at least the estimated lower bound shown below.

Based on the statistician's methodology, in terms of the number of loans, this bound was determined to be at least 22.3%, or 31, of the 139 loans. The methodology is based on a Hypergeometric probability density:

$$\mathrm{f(M)} = \frac{\binom{\mathrm{M}}{2}\binom{139-\mathrm{M}}{0}}{\binom{139}{2}}$$

where $\binom{\mathrm{M}}{2}$ is the number of combinations of sample size M from which two improper payments are selected. The second part of the numerator $\binom{139-\mathrm{M}}{0}$ is the number of combinations of 139-M proper payments from which none were selected in the sample. The lower bound of a one-side 95% confidence interval is the lowest M such that $\mathrm{f(M)} \geq 5\%$? Based on the above equation, $\mathrm{f}(31) \approx 4.85\%$. In terms

[24] 5 USC App. 3.

[25] These loans were purchased between April 1, 2007 and March 31, 2008.

[26] Loans approved by delegated lenders for $500,000 or more that defaulted within 18 months and were purchased at the NGPC.

of dollars, this bound was determined to be 22.8%, or $21.5 million[27] of the $94.2 million in the population.

As a result, we conclude with 95% confidence that there were at least 31 loans totaling approximately $21.5 million that lacked repayment ability and should not have been purchased by the NGPC. Projecting the $21.5 million over the next two years, we believe the SBA will realize a cost savings of at least $43 million (less any associated costs) if the NGPC revises its purchase process to include a detailed repayment ability analysis for high-dollar early-defaulted loans.

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[27] This dollar amount was determined by including the 2 loans that were actually tested and conducting 1,000 simulation runs of 29 additional randomly selected improper payments and using the average total dollar amount. As a result, each simulation run had a total count of 31 improper payments and their total payment amount was divided by the total payment amount for the entire population of 139 loans.

Appendix II. High-Dollar Early-Defaulted Loans with Repayment Ability Deficiencies

#	Loan Number	Borrower Name	Deficiency Description	Approved Amount	Questioned Costs^	Recoveries Made
1	[Ex. 4]	[Ex. 4]	The lender based its cash flow on figures recorded under the accrual method of accounting, and ignored the impact of changes on the balance sheet. The lender did not take into consideration the increase in Accounts Receivable and increase in Accounts Payable. While the lender calculated a positive cash flow of $209,500, we conducted our own cash flow analysis using the Cash Flow Statement Method approach and determined the business had a negative cash flow of -$92,643.	$560,000	$456,426	$0*
2	[Ex. 4]	[Ex. 4]	The lender failed to adequately demonstrate repayment ability from a Cash Flow Statement as well as verify that the liquid assets of the borrowers were sufficient to initially service the SBA debt.	$2,000,000	$1,464,279	$1,484,235*
3	[Ex. 4]	[Ex. 4]	The lender inappropriately added back $209,000 of personal income and a partner's $29,000 guaranteed payment without explanation. When we removed these items from the cash flow computation, the business did not demonstrate repayment ability.	$1,345,000	$984,124	$0*

Appendix II. High-Dollar Early-Defaulted Loans with Repayment Ability Deficiencies

#	Loan Number	Borrower Name	Deficiency Description	Approved Amount	Questioned Costs^	Recoveries Made
4	[Ex. 4]	[Ex. 4]	The lender's cash flow analysis did not consider the impact the two affiliated businesses would have on the borrower's repayment ability. According to the lender's credit memorandum, these two businesses were not sufficient to cover the borrower's personal living expenses.	$675,000	$506,250	$522,894*
5	[Ex. 4]	[Ex. 4]	The historical and interim debt service coverage was inadequate. Repayment ability was based on projections without underlying reasonable assumptions.	$1,115,900	$998,033	$0*
6	[Ex. 4]	[Ex. 4]	The lender used projected cash flow for an existing business to show repayment ability, which historically had negative cash flow. The projections included a 149 percent increase in sales that was not justified.	$525,000	$79,622	$0*
7	[Ex. 4]	[Ex. 4]	A CPA-prepared statement of cash flow included in the lender's loan file demonstrated that the borrower did not have repayment ability. It appears that the lender ignored the CPA-prepared statement and instead calculated repayment ability using the rule of thumb method. It was imprudent to ignore a professionally prepared statement and rely solely on a self-prepared rule of thumb computation to support loan approval.	$976,000	$0~	$0

Appendix II. High-Dollar Early-Defaulted Loans with Repayment Ability Deficiencies

#	Loan Number	Borrower Name	Deficiency Description	Approved Amount	Questioned Costs^	Recoveries Made
8	[Ex. 4]	[Ex. 4]	The lender prepared both Uniform Credit Analysis (UCA) and rule of thumb cash flow statements. The UCA cash flow statement clearly reflected the borrower's inability to repay the loan, but the lender approved the loan relying on the rule of thumb cash flow method for which some of the relied-upon figures could not be verified. We also found that the lender did not consider an affiliate of the borrower in its cash flow computations.	$500,000	$0~	$0
	Totals			**$7,696,900**	**$4,488,734**	**$2,007,129**

^Questioned costs identified by the OIG in various audits conducted from January 2008 to June 2012 (see footnote number 2 on page 1).
*Six loans purchased by the SBA as of May 21, 2012.
~The SBA had not purchased these loans at the completion of the previous audits. Therefore, the OIG did not report questioned costs on these two loans in the previous audit reports.

Appendix III. Management Comments

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

MEMORANDUM
July 24, 2012

To: John Needham
Assistant Inspector General for Auditing

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

Subject: Response to Draft Advisory Memorandum on A Detailed Repayment Ability Analysis is needed on High-Dollar Early-Defaulted Loans to Prevent Future Improper Payments, Project No. 12002

Thank you for the opportunity to review the draft memorandum. The report outlines the OIG's concerns regarding the National Guaranty Purchase Center's (NGPC) assessment of the quality and accuracy of delegated lender underwriting practices on high dollar early default loans. The report also contained an estimate of the amount of federal funds which could be saved if these underwriting practices were thoroughly reviewed.

The Office of Financial Program Operations (OFPO) is fully committed to eliminate improper payments from all SBA loan programs. SBA enhanced its training for the lending industry to include additional emphasis on credit underwriting quality, and provided case examples of extremely poor credit analyses that warranted denial of liability. NGPC has been training staff in the areas of credit underwriting and commercial credit. In April of this year, SBA commercial underwriting experts conducted credit underwriting training sessions in the NGPC for loan specialists and supervisors. During May, NGPC conducted IPERA training for all guaranty purchase loan specialists and supervisors, with an emphasis on credit underwriting. SBA also recently procured commercial loan credit correspondence training courses for NGPC loan specialists and supervisors. Finally, OFPO conducts quality control feedback training for center staff, and is emphasizing the importance of high dollar early default loans. These focused efforts will continue as part of OFPO and NGPC's ongoing efforts to assist loan specialists in enhancing their knowledge and skills in identifying material deficiencies in all loan guaranty purchase reviews, including the area of credit underwriting.

In addition, the Associate Administrator for the Office of Capital Access and the Directors of the Office of Credit Risk Management, Office of Financial Assistance, and OFPO have agreed to form a working group to review the sections of the SOP 50 10 5 to address repayment assessment to determine if more clarity and direction is required for lenders and staff to consistently apply consistent underwriting standards.

The report estimated SBA could save $43 million if NGPC revises its guaranty purchase review process to include a detailed repayment ability analysis for high dollar early-defaulted loans. This estimate was derived by OIG's statistician, and is explained in the appendix to their report. While we agree that there will be savings by looking more carefully at high dollar early defaulted loans, we are going to have our statistician review OIG's analysis to determine the accuracy of the $43 million estimate.

As noted above OFPO and NGPC have taken steps to identify and address material deficiencies in credit underwriting on early-defaulted loans. We believe it is vital to the continued success of SBA's lending programs that the deficiencies identified in this type of review be material to a loss incurred by SBA in order to warrant a denial of liability recommendation. Appendix II of the OIG's report contains 8 cases cited as examples of loans with repayment ability deficiencies. We do not agree that all cases warranted denial for credit analysis alone. There were other factors as well. In at least one case, we denied liability for loan closing deficiencies, not credit analysis.

Management's response to the recommendations contained in the report follows:

1. ***Direct the NGPC to revise its purchase process for high-dollar early-defaulted loans approved by lenders to verify compliance with SBA's repayment ability requirements, including a detailed analysis of the lender's computation of repayment ability.***

OFPO partially agrees, and is in the process of augmenting its purchase review process on high-dollar early default loans to include identification of material deficiencies in a lender's analysis of repayment ability. Recent process improvements have already been made, including allocating additional review time for high dollar early defaults. Also, SBA will conduct an analysis of the OIG's $43 million estimate of funds for better use.

2. ***Properly train NGPC purchase staff in the revised purchase process to perform effective analyses of lender's repayment ability computations and verify compliance with SBA requirements.***

OFPO agrees, and will continue to train NGPC purchase staff in the revised purchase process to perform effective analyses of lender's repayment ability computations and verify compliance with SBA requirements.

3. ***Perform a risk assessment to determine if it is beneficial for purchase reviews of other (less than $500,000) lender approved early-default loans to include a detailed analysis of the lender's computation of repayment ability.***

OFPO agrees, and will perform a risk assessment to determine if it is beneficial for purchase reviews of other (less than $500,000) lender approved early-default loans to include a detailed analysis of the lender's computation of repayment ability.