



## U.S. SMALL BUSINESS ADMINISTRATION OFFICE OF INSPECTOR GENERAL

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ADVISORY MEMORANDUM  
REPORT NO. 12-11R

**DATE:** MARCH 23, 2012

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

**SUBJECT:** High-Dollar Early-Defaulted Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the National Guaranty Purchase Center

This is the final in a series of memorandums related to our audit of twenty-five purchased 7(a) Recovery Act<sup>1</sup> loans. This memorandum summarizes the work completed on the twenty-five loans. It also serves to inform you of a finding not previously reported regarding the need for an increased degree of scrutiny and improved quality control on high-dollar early-defaulted loans at the National Guaranty Purchase Center (NGPC). This memorandum also includes an "Other Matter" section describing a deficiency we identified in one loan, which was not previously reported.

The objective of the audit was to determine whether purchased 7(a) Recovery Act loans were originated, closed, and purchased in accordance with Small Business Administration (SBA) rules and regulations and commercially prudent lending standards. For this audit, we judgmentally selected the twenty-five 7(a) Recovery Act loans approved for \$500,000 or more that had been purchased as of September 30, 2010, and which defaulted within a short period of time after they were made. The total approved amount for these loans was approximately \$27 million, and the SBA purchased its guaranteed share of the principal loan balances for approximately \$21 million.

In meeting the objective, we reviewed all origination, closing, and purchase actions as documented in the SBA and lender loan files. We also reviewed information in the SBA's Loan Accounting System and analyzed loan data. Furthermore, we interviewed current and former SBA officials at the NGPC to gain an understanding of the purchase review process, including the quality control review of early-defaulted loans. To assess the internal controls relevant to our audit objective, we reviewed the SBA's policies and procedures regarding loan origination, closing, and guaranty purchase. We conducted this audit between November 2010 and December 2011 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.

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<sup>1</sup> American Recovery and Reinvestment Act of 2009, Public Law 111-5

## Summary of Work Completed

Overall, we found that the SBA and its lenders originated, closed, and purchased 11 of the 25 sampled loans in accordance with SBA rules and regulations and commercially prudent lending standards. Material deficiencies, however, were identified in 14 of the 25 early-defaulted loans selected for audit. These deficiencies resulted in questioned costs<sup>2</sup> or recoverable guaranty payments<sup>3</sup> totaling approximately \$10.7 million.<sup>4</sup>

Of these 14 loans, the Office of Inspector General (OIG) identified material deficiencies in 10 loans while the SBA identified material deficiencies in four loans during its post purchase reviews (see Appendices I and II for a summary of the deficiencies identified on these loans). We previously reported our findings on 9 of the 10 loans in 2 separate audit reports (ROM 11-05 and ROM 11-06)<sup>5</sup> and our finding on the tenth loan is discussed below in the “Other Matter” section of this report. Recoveries totaling approximately \$2.7 million are still outstanding for two of the four loans with deficiencies identified by the SBA. As a result, we recommended that the SBA notify the OIG of any denial, repair,<sup>6</sup> or withdrawal of the purchase request by the lender on those loans to [Ex. 4] and [Ex. 4]. The previously issued audit reports included recommendations to recover the questioned costs identified on 9 of the 10 loans with OIG identified deficiencies. Our second audit report, ROM 11-06, also included recommendations to correct OIG identified SBA origination deficiencies. These reports did not, however, include recommendations to address deficiencies in the NGPC’s purchase process, which are discussed herein.

The NGPC was responsible for the purchase reviews on 9 of the 10 loans for which the OIG identified material deficiencies.<sup>7</sup> The NGPC either made a purchase error or did not identify the deficiencies during its guaranty purchase reviews on six of the nine loans, resulting in improper payments totaling approximately \$3.3 million. We noted that loan specialists did not always review high-dollar early-defaulted loans with the level of scrutiny necessary to identify all material deficiencies. Due to the high number of deficiencies identified and the resulting improper payments, we recommended that the SBA establish a specialized early default purchase review unit at the NGPC.

The SBA incorporated a quality control review process into its purchase review process for early-defaulted loans in response to our draft report for ROM 11-05. This quality control review process began on May 9, 2011 and ended on August 9, 2011. We determined, however, that

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<sup>2</sup> For purposes of this memorandum, “questioned costs” are defined as costs questioned by the OIG, which were incurred as a result of material origination, closing, and purchase deficiencies made by lenders or the SBA.

<sup>3</sup> For purposes of this memorandum “recoverable guaranty payments” are defined as amounts that SBA has identified during post purchase reviews that should be recovered from the lender due to the lender’s failure to handle a loan in a prudent manner or in compliance with SBA loan program requirements.

<sup>4</sup> Rounded to the nearest hundred thousand.

<sup>5</sup> As part of this audit, we previously issued ROM 11-05, *Material Deficiencies Identified in Four 7(a) Recovery Act Loans Resulted in \$3.2 Million of Questioned Costs*, June 29, 2011; and ROM 11-06, *Material Deficiencies Identified in Five 7(a) Recovery Act Loans Resulted in \$2.7 Million of Questioned Costs*, August 22, 2011.

<sup>6</sup> The term “repair” means an agreement between SBA and a 7(a) lender as to a specific dollar amount to be deducted from the funds SBA pays on the lender’s guaranty in order to fully compensate SBA for an actual or anticipated loss caused by the lender.

<sup>7</sup> The purchase review on the tenth loan to [Ex. 4] was performed at the SBA’s Fresno Loan Servicing Center.

this process did not evaluate lender compliance with SBA eligibility and use of loan proceeds requirements. To address this gap in its quality control process, we recommended that the NGPC expand the scope of its quality control reviews of early-defaulted loans.

Finally, we also recommended that the SBA seek recovery of \$15,188 on the tenth loan with an OIG identified use of proceeds deficiency, which is presented in the “Other Matter” section of this report.

A draft copy of this memorandum was provided to the SBA for comment. The SBA agreed or partially agreed with all of the recommendations and made comments, proposed actions, or took actions that were responsive to OIG recommendations.

## **Background**

The Recovery Act provided the SBA with \$730 million to expand the Agency’s lending and investment programs, create new programs to stimulate lending to small businesses, and conduct oversight of these programs. Of the \$730 million received, \$375 million was authorized for the SBA to (1) eliminate or reduce fees charged to lenders and borrowers for 7(a) and 504 loans, and (2) increase its maximum loan guaranty to 90 percent for eligible 7(a) loans.<sup>8</sup> The Recovery Act and Office of Management and Budget guidance encouraged Offices of Inspectors General to conduct oversight of potential risks posed by Recovery Act programs implemented by their respective agencies. Accordingly, we conducted this audit due to concerns that (1) some lenders would not exercise due diligence in originating and closing loans given the 90 percent SBA guaranty reduced lender risk, and (2) the SBA would not properly underwrite some loans given the higher loan demand and resource constraints.

The SBA is authorized under Section 7(a) of the Small Business Act 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 SBA prior to loan disbursement. Others are subject to more extensive underwriting and eligibility review and approval by the SBA before the loan is disbursed. When a loan goes into default, the SBA will review 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”). Based on the number of deficiencies we identified on early-defaulted loans in this audit which were not identified in purchase reviews performed by the NGPC, the SBA implemented a process in which early-defaulted loans may also be randomly selected for independent quality control reviews prior to completion of the guaranty purchase. Under SBA regulations<sup>9</sup> 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.

For certain loans, as authorized by the SBA on a case-by-case basis, lenders may sell the guaranteed portion of a loan to an investor on SBA’s secondary market any time after the lender disburses the loan. If such a loan subsequently goes into default, the SBA is unconditionally

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<sup>8</sup> The maximum guaranty for SBAExpress loans remained at 50 percent.

<sup>9</sup> 13 Code of Federal Regulations (CFR) § 120.524.

obligated to pay the guaranty to the investor. However, the SBA will conduct what is called a “post purchase review” to identify lender imprudence or noncompliance with SBA loan program requirements, and seek repayment of the guaranty from the lender if material problems are found. Early-defaulted loans that were sold on the secondary market may also be randomly selected for a quality control review prior to completion of the post purchase review.

## Results

### **High-Dollar Early-Defaulted Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the NGPC**

#### *Rigor of Purchase Reviews at the NGPC for High-Dollar Early-Defaulted Loans Can be Improved*

Based on our review of loan files and interviews with current and former NGPC officials during the course of this audit, we determined that the NGPC does not always review high-dollar early-defaulted loans with the degree of scrutiny necessary to identify all material deficiencies.

According to SBA procedures<sup>10</sup> for early-defaulted loans, the SBA must review the lender’s purchase package with the “highest degree of scrutiny.” Additionally, 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 material loss to the SBA, repair or denial of the guaranty is appropriate.

The NGPC was responsible for the purchase reviews on 9 of the 10 loans we found to have material deficiencies. The NGPC made a purchase error and did not identify material eligibility, equity injection and use of proceed deficiencies on six of the nine loans. These errors resulted in improper payments totaling approximately \$3.3 million. The six loans are annotated with an asterisk in Appendix I. For the remaining three loans that we found to have deficiencies, the NGPC either had not yet conducted its post purchase review<sup>11</sup> or the deficiencies were made by the SBA in approving the loans and therefore were not required to be evaluated during purchase review.

We interviewed nine current and former NGPC loan specialists and supervisory loan specialists to discuss the process for conducting purchase reviews and determine why errors were made or material lender deficiencies were not identified during purchase review. Most of these NGPC loan specialists were either associated with one of the nine problem loans identified in this audit or to loans with similar deficiencies identified in previous audits. Every loan specialist we spoke to described the NGPC as a “production facility.” We found that, generally, most of the loan specialists felt that the production standards were reasonable based on the “expectations” of the NGPC. Some indicated, however, that there was pressure to make timely decisions and not enough time to complete an in-depth review, especially for those with underwriting backgrounds. Loan specialists stated it would take much more time to perform the level of

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<sup>10</sup> Standard Operating Procedures (SOP) 50 51 3, Loan Liquidation, Chapter 22.

<sup>11</sup> The SBA’s post purchase review on two loans fully agreed with our findings and recommendations to recover \$543,946.

review necessary to identify all material deficiencies and informed us that the degree of scrutiny applied to early-defaulted loans is the same regardless of loan size.

Loan specialists told us that they did not receive formal training when they started reviewing purchases; they only received on-the-job training by completing purchase reviews and receiving feedback from supervisory loan specialists. Based on the loan specialists' statements, however, we question the quality of the on-the-job training. Specifically, one loan specialist stated that supervisors had varying degrees of experience and did not consistently interpret SBA's policies and procedures. Additionally, a supervisory loan specialist stated that the supervisors did not have time to train the loan specialists assigned to them. Furthermore, when supervisory loan specialists explained their responsibilities to us, it was clear that each applied a different level of thoroughness when reviewing and approving the loan specialists' purchase review decisions.

For two of the loans we identified with deficiencies, the cognizant loan specialists were not aware of the applicable program requirements, which caused them to miss the deficiencies. For two other loans, the cognizant loan specialists were not fully aware of their responsibilities in reviewing particular compliance areas and therefore, missed the deficiencies.

Based on these interviews, we determined that errors were made and material lender deficiencies were not identified on the high-dollar early-defaulted loans due to the focus on production at the NGPC, a lack of training, and the loan specialists' unfamiliarity with SBA program requirements and purchase review responsibilities.

When asked how early-defaulted loans are reviewed with the "highest degree of scrutiny," NGPC management stated that additional documentation is obtained and reviewed. This documentation includes the lender's credit memorandum, support for equity injection, and verification of financial information with Internal Revenue Service (IRS) tax transcripts. While our audit found that the NGPC is obtaining this additional documentation for early-defaulted loans, our analysis of loan files and interviews with loan specialists demonstrate that loan documentation in general is not reviewed with the level of scrutiny necessary to identify all material deficiencies on high-dollar early-defaulted loans.

### *The NGPC's Quality Control Review Process for Early-Defaulted Loans Needs Improvement*

In response to our first audit report (ROM 11-05), which identified material lender noncompliance with equity injection and IRS tax verification requirements, the NGPC incorporated a temporary quality control review of early-defaulted loans into its purchase review process. This quality control review process began on May 9, 2011 and ended on August 9, 2011. The purpose was to provide the SBA with reasonable assurance that the purchase process was performing as intended and minimizing improper payments. During this 90-day period, the NGPC quality control team reviewed 183 early-defaulted loans for compliance with equity injection and IRS tax verification requirements. The NGPC identified nine loans with deficiencies, of which eight were resolved through the lenders providing additional documentation. For the remaining loan, the lender was unable to resolve the deficiency and subsequently released the SBA from liability, resulting in a cost savings of \$102,314.

Following the completion of the 90-day review, SBA officials stated they would continue to perform the early default quality control reviews on a random basis as part of the NGPC's purchase review process. We determined, however, that the NGPC's review checklist does not require an evaluation of eligibility and the use of loan proceeds to verify compliance with SBA rules and regulations. Our audit identified deficiencies on 4 of the 25 early-defaulted loans where the NGPC purchase review did not identify lender noncompliance with SBA eligibility or use of proceeds requirements.<sup>12</sup> In response to our previous reports, the SBA agreed with our findings on three of these loans, which resulted in questioned costs of \$1.7 million. The deficiency on the fourth loan resulted in questioned costs of \$15,188 and is presented below. These findings demonstrate that the scope of the early default quality control reviews should be expanded to include a thorough evaluation of eligibility and use of proceeds, as these deficiencies would not have been identified under the current process.

An additional concern regarding the NGPC's assessment of the quality and accuracy of lender underwriting was identified during this audit. Specifically, we are concerned that the NGPC's limited review of lender underwriting is not consistent with statutory and regulatory authority and is contrary to SBA procedures. This issue will be the subject of a separate limited scope review, which is currently being completed.

#### **Other Matter - Ineligible Use of Proceeds on One Loan**

We identified a deficiency on a loan to [Ex. 4] made by Pacific Mercantile Bank, which resulted in a \$15,188 improper payment that should be recovered. As a lender in the Preferred Lender Program (PLP), Pacific Mercantile Bank was permitted to process, close, service, and liquidate its loans with limited documentation and review by the SBA.

On April 2, 2009, using PLP procedures, the lender approved an \$810,000 loan to the borrower to pay off outstanding debt and for closing costs. Pacific Mercantile Bank disbursed this loan on April 13, 2009 and the borrower defaulted approximately six months later on October 15, 2009. Therefore, this loan qualifies as an early-defaulted loan in accordance with SBA policy. The SBA completed a purchase review, and on May 10, 2010, purchased the principal guaranty for \$726,561.

Our audit determined that the lender disbursed a portion of the loan proceeds for an ineligible purpose. According to SBA procedures,<sup>13</sup> loan proceeds may not be used to pay delinquent IRS withholding taxes, sales taxes, or other funds payable for the benefit of others. The lender disbursed \$16,875 of loan proceeds to pay off a federal tax lien. The SBA guaranteed portion of these loan proceeds was \$15,188. The federal tax lien notice found in the loan file indicated the lien resulted from the nonpayment of payroll withholding taxes. Therefore, this portion of the

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<sup>12</sup> See Appendix I: Loans with Material Deficiencies Identified by the Office of the Inspector General (OIG), loan numbers [Ex. 4], [Ex. 4], [Ex. 4] and [Ex. 4]. Loan numbers [Ex. 4] and [Ex. 4] also had eligibility or use of proceeds deficiencies, but the NGPC was not responsible for identifying these deficiencies prior to our audit. For one of these loans, the deficiency occurred during the SBA loan approval and therefore, was not required to be evaluated during the purchase review. For the second loan, the NGPC had not completed its post purchase review prior to our audit and therefore, did not have the opportunity to identify the deficiency.

<sup>13</sup> SOP 50 10 5(A) Lender and Development Company Loan Programs.

use of proceeds was ineligible. The lender should not have disbursed the funds for this use and the SBA should not have purchased this portion of the guaranty. The SBA should recover an improper payment of \$15,188 based on the deficiency identified above.

## Conclusion

The material deficiencies identified in 14 of the 25 purchased 7(a) Recovery Act loans selected for audit resulted in questioned costs or recoverable guaranty payments totaling approximately \$10.7 million.

Loan specialists at the NGPC made a purchase error and did not detect material lender deficiencies on six of the nine NGPC loans in which we identified deficiencies.<sup>14</sup> Errors were made due to the focus on production at the NGPC, a lack of training, and loan specialists' unfamiliarity with SBA program requirements and purchase review responsibilities, which resulted in improper payments totaling approximately \$3.3 million. The inadequate purchase reviews performed by the NGPC and the resulting improper payments demonstrate that high-dollar early-defaulted loans pose a significant risk of loss to the SBA.

Additionally, the limited scope of the quality control review process for early-defaulted loans did not evaluate compliance with SBA eligibility and use of loan proceeds requirements. Therefore, this process did not provide the SBA with reasonable assurance that the loan purchase process is performing as intended.

## Recommendations

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

1. Notify the OIG of any denial, repair or withdrawal of the guaranty on the loan made to [Ex. 4] which was reviewed by the SBA and warrants a possible recovery of \$1,336,089, plus interest.
2. Notify the OIG of any denial, repair or withdrawal of the guaranty on the loan made to [Ex. 4] which was reviewed by the SBA and warrants a possible recovery of \$1,330,708, plus interest.
3. Establish a specialized unit of well-trained, highly experienced loan specialists to perform purchase reviews with the level of scrutiny necessary to identify all material deficiencies on early-defaulted loans approved for \$500,000 or more.
4. Expand the scope of the NGPC quality control reviews of early-defaulted loans to include a thorough review of eligibility and use of proceeds.
5. Seek recovery of \$15,188, plus interest, from Pacific Mercantile Bank on the guaranty paid by the SBA for the loan to [Ex. 4]

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<sup>14</sup> The six loans include the loan to Refrigerant Exchange Corp, which is presented as an Other Matter in this memorandum.

## **Agency Comments and Office of Inspector General Response**

On February 16, 2012, we issued a draft of this memorandum and provided it to the SBA for comment. On March 19, 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. The SBA's comments, proposed actions, and actions taken were responsive to the recommendations.

### **Recommendation 1**

*Notify the OIG of any denial, repair or withdrawal of the guaranty on the loan made to [Ex. 4] which was reviewed by the SBA and warrants a possible recovery of \$1,336,089, plus interest.*

#### ***Management Comments***

The SBA fully agreed with our recommendation. However, the SBA stated that servicing of the loan was assumed by the FDIC after the originating lender was closed and placed into receivership on November 12, 2010. This was before the SBA's denial decision had been finalized. The FDIC does not recognize claims that were unfinalized as of the date of the receivership. Therefore, the SBA has no recourse against the FDIC.

#### ***OIG Response***

The SBA's comments are responsive to the recommendation.

### **Recommendation 2**

*Notify the OIG of any denial, repair or withdrawal of the guaranty on the loan made to [Ex. 4] which was reviewed by the SBA and warrants a possible recovery of \$1,330,708, plus interest.*

#### ***Management Comments***

The SBA fully agreed with our recommendation. The SBA made a notation in the chron system advising the NGPC to provide notice on any denial, repair, withdrawal or cancellation of guaranty resulting from the identified deficiencies to the OIG. The NGPC is also currently reviewing additional documentation the lender recently submitted to overcome the identified deficiencies. If the documentation provided by the lender does not overcome the stated deficiencies, the NGPC will request recovery from the lender. The OFPO will provide an update to the OIG by May 31, 2012.

#### ***OIG Response***

The SBA's comments and proposed actions are responsive to the recommendation.



### **Recommendation 3**

*Establish a specialized unit of well-trained, highly experienced loan specialists to perform purchase reviews with the level of scrutiny necessary to identify all material deficiencies on early-defaulted loans approved for \$500,000 or more.*

#### ***Management Comments***

The SBA partially agreed with our recommendation. The SBA stated that the OFPO and NGPC take seriously the need to allocate resources most effectively so that purchase reviews of high dollar loans are conducted consistent with policy, procedures and regulations, and sufficient to identify all material deficiencies on early-defaulted loans approved for \$500,000 or more. The SBA also noted that the OFPO and NGPC must determine the means by which this will be accomplished while balancing the other vital work of the center. Furthermore, the SBA stated that addressing this recommendation will involve some reallocation of resources, staff training, staff skill augmentation, SOP changes, and internal controls. The OFPO and NGPC have begun the process of making these changes, and believe the process will be completed by September 30, 2012.

#### ***OIG Response***

The SBA's comments are responsive to the recommendation. We will monitor the SBA's actions during the audit follow-up process to determine if the appropriate level of scrutiny is occurring on early defaulted loans approved for \$500,000 or more.

### **Recommendation 4**

*Expand the scope of the NGPC quality control reviews of early-defaulted loans to include a thorough review of eligibility and use of proceeds.*

#### ***Management Comments***

The SBA fully agreed with our recommendation. The NGPC has recently incorporated the early-default quality control review into its all-encompassing random quality control reviews to ensure all applicable SBA policies and procedures are addressed during the purchase review process.

#### ***OIG Response***

The SBA's comments and actions taken are responsive to the recommendation.

### **Recommendation 5**

*Seek recovery of \$15,188, plus interest, from Pacific Mercantile Bank on the guaranty paid by the SBA for the loan to [Ex. 4]*

### ***Management Comments***

The SBA fully agreed with our recommendation. The NGPC will notify the lender of the deficiency by April 30, 2012 and request repayment of \$15,188 related to this deficiency by June 30, 2012.

### ***OIG Response***

The SBA's comments and proposed actions are responsive to the recommendation.

### **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 memorandum. 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 memorandum, 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. Loans with Material Deficiencies Identified by the OIG<sup>^</sup>**

#	Loan Number	Borrower Name	Loan Type	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Questioned Costs
1	[Ex. 4]	[Ex. 4]	PLP	A,D	1) The lender did not adequately verify the source of \$164,900 of equity allegedly injected into the business. 2) The legitimacy of two promissory notes is questionable. 3) Documentation in the loan file showed that the 25% owner of the selling corporation was also a manager of the buying company.	\$1,782,000	\$1,445,021*
2	[Ex. 4]	[Ex. 4]	PLP	D	1) The lender did not adequately verify and document the source for the \$1 million of required equity injection.	\$1,700,000	\$1,376,641*
3	[Ex. 4]	[Ex. 4]	GP	C	1) The SBA did not consider the effect the borrower's affiliated business had on repayment ability.	\$1,350,000	\$763,277
4	[Ex. 4]	[Ex. 4]	GP	A,C,E	1) The effects of the borrower's affiliated businesses were not fully considered in determining the size and repayment ability of the borrower. 2) The SBA purchased this loan at a higher guaranty percentage than authorized.	\$1,290,000	\$1,161,000*
5	[Ex. 4]	[Ex. 4]	CLP	B	1) A portion of the loan refinanced debt originally used for floor plan financing.	\$1,074,000	\$191,702*
6	[Ex. 4]	[Ex. 4]	EWCP	B	1) The lender did not appropriately ensure that the loan proceeds were used as required in the loan authorization.	\$1,000,000	\$106,802*
7	[Ex. 4]	[Ex. 4]	PLP	B	1) Approximately \$15,000 was used to pay off an IRS federal tax lien on withholding taxes.	\$810,000	\$15,188*
8	[Ex. 4]	[Ex. 4]	PLP	C	1) The lender's cash flow analysis did not	\$675,000	\$506,250

#	Loan Number	Borrower Name	Loan Type	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Questioned Costs
					consider the impact the two affiliated businesses would have on the borrower's repayment ability.		
9	[Ex. 4]	[Ex. 4]	PLP	A	1) The lender did not properly verify the accuracy of the seller's financial information as required in a change of ownership transaction. 2) The project lacked feasibility because the borrower paid more for the business than it was worth due to an inadequate business valuation.	\$632,000	\$37,696
10	[Ex. 4]	[Ex. 4]	Patriot Express	C	1) The lender's credit analysis did not demonstrate a reasonable assurance of repayment/the projections were unreasonable.	\$500,000	\$373,532
<b>Totals</b>						<b>\$10,813,000</b>	<b>\$5,977,109</b>

Deficiency Type Legend:

- A. Eligibility
- B. Use of Proceeds
- C. Repayment Ability
- D. Equity Injection
- E. Improper Guaranty Amount

^ Questioned costs amounts were determined as of audit report issuance and may not reflect the amounts that will actually be recovered by the SBA as a result of the audit follow-up process.

\* Loans with errors made by the NGPC during purchase reviews.

**Appendix II. Loans with Material Deficiencies Identified by the SBA**

#	Loan Number	Borrower Name	Loan Type	Deficiency Type (See Legend)	Approved Amount	SBA's Share of the Outstanding Balance at Purchase Review
1	[Ex. 4]	[Ex. 4]	GP	A,B,C	\$1,500,000	\$1,336,089
2	[Ex. 4]	[Ex. 4]	GP	A,B	\$1,500,000	\$1,330,708
3	[Ex. 4]	[Ex. 4]	PLP	D,E	\$1,500,000	\$1,339,171
4	[Ex. 4]	[Ex. 4]	PLP	A	\$900,000	\$668,636
	<b>Totals</b>				<b>\$5,400,000</b>	<b>\$4,674,604</b>

Deficiency Type Legend:

- A. Use of Proceeds
- B. Equity Injection
- C. Site Visit
- D. Eligibility
- E. Loan Maturity

## Appendix III. Agency Response



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

MEMORANDUM  
March 19, 2012

To: Peter L. McClintock  
Deputy Inspector General

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

Subject: Response to Draft Advisory Memorandum on the High-Dollar Early-Default Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the National Guaranty Purchase Center, Project No. 10508B

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

The draft report is the final in a series of memorandums related to the OIG's audit of twenty-five purchased 7(a) Early-Defaulted Recovery Act loans. The report summarizes the OIG's work completed on the twenty-five loans and also serves to inform SBA of the need for an increased degree of scrutiny and improved quality control on high-dollar early-defaulted loans at the National Guaranty Purchase Center (NGPC).

The OIG noted concerns with the level of scrutiny NGPC loan specialists provide during purchase reviews of high-dollar early-defaulted loans. The OIG attributed the current level of scrutiny to NGPC's focus on production, lack of training, and loan specialists' unfamiliarity with SBA program requirements and purchase review responsibilities. Office of Financial Program Operations (OFPO) and NGPC recognize the importance training plays in ensuring loan specialists possess the knowledge and skills necessary to perform all purchase reviews with the utmost scrutiny while maintaining productivity standards. OFPO and NGPC plan to provide credit underwriting training to all NGPC purchase review staff. In addition, OFPO's quality control program offers monthly training sessions to all purchase review staff, and provides both general and individualized feedback based on quality control review results. OFPO and NGPC are confident the training and feedback provided to loan specialists will enhance their knowledge and skill in detecting material deficiencies in high-dollar early-defaults.

The OIG also noted concerns with the scope of NGPC's early default quality control review process. The OIG's concerns revolved around the lack of evaluation for lender compliance with SBA eligibility and use of loan proceeds during the NGPC's review of 183 early-defaulted loans between May 9, 2011 and August 9, 2011. SBA agrees that the quality control review for early-defaulted loans should include evaluation of lender compliance with eligibility and use of loan proceeds requirements. NGPC has recently incorporated early-default quality control review measures into the existing random quality control review for all applicable loans. Therefore, all early-defaulted loans sampled for quality control review now undergo evaluation for lender compliance with SBA eligibility and use of loan proceeds in addition to a thorough review of the lender credit memorandum, including repayment ability, support for equity injection and verification of financial information with IRS tax transcripts.

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

1. ***Notify the OIG of any denial, repair or withdrawal of the guaranty on the loan made to [Ex. 4] which was reviewed by the SBA and warrants a possible recovery of \$1,336,089, plus interest.***

OFPO concurs with this recommendation. Servicing of this loan was assumed by FDIC after the originating lender was closed and placed into receivership on November 12, 2010, and before the SBA's denial decision had been finalized. FDIC does not recognize claims that were not finalized as of the date of the receivership. Therefore, SBA has no recourse against FDIC.

2. ***Notify the OIG of any denial, repair or withdrawal of the guaranty on the loan made to [Ex. 4] which was reviewed by the SBA and warrants a possible recovery of \$1,330,708, plus interest.***

OFPO concurs with this recommendation and is in the process of taking the following actions:

A notation was made in the chron system advising the NGPC to provide notice on any denial, repair, withdrawal or cancellation of guaranty resulting from the identified deficiencies to Office of Inspector General. NGPC is currently reviewing additional documentation the lender recently submitted to overcome the identified deficiencies. If the documentation provided by the lender does not overcome the stated deficiencies, NGPC will request recovery from the lender. OFPO will provide an update to the OIG by May 31, 2012.

**3. Establish a specialized unit of well-trained, highly experienced loan specialists to perform purchase reviews with the level of scrutiny necessary to identify all material deficiencies on early-defaulted loans approved for \$500,000 or more.**

OFPO partially concurs with this recommendation and plans to take the following actions:

OFPO and NGPC take seriously the need to allocate resources most effectively so that purchase reviews of high dollar loans are conducted consistent with policy, procedures and regulations, sufficient to identify all material deficiencies on early defaulted loans approved for \$500,000 or more. OFPO and NGPC must determine the means by which this will be accomplished while balancing all of the other vital work of the center. This will involve some reallocation of resources, staff training, staff skill augmentation, SOP changes, and internal controls. OFPO and NGPC have begun the process of making these changes, and believe the process will complete by September 30, 2012.

**4. Expand the scope of the NGPC quality control reviews of early-defaulted loans to include a thorough review of eligibility and use of proceeds.**

OFPO concurs with this recommendation.

NGPC has recently incorporated the early-default quality control review into its all-encompassing random quality control reviews to ensure all applicable SBA policies and procedures are addressed during the purchase review process.

**5. Seek recovery of \$15,188, plus interest, from Pacific Mercantile Bank on the guaranty paid by the SBA for the loan to [Ex. 4]**

NGPC concurs with this recommendation and agrees the portion of loan proceeds used to pay delinquent IRS withholding taxes was an ineligible use of loan proceeds. NGPC will notify the lender of the deficiency by April 30, 2012 and request repayment of \$15,188 related to this deficiency by June 30, 2012.

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.