

EVALUATION REPORT

The OIG High Risk 7(a) Loan Review Program Recommends \$3.2 Million in Recoveries





EXECUTIVE SUMMARY

Audit Report
No. 16-22

September
30, 2016

THE OIG HIGH RISK 7(A) LOAN REVIEW PROGRAM RECOMMENDS \$3.2 MILLION IN RECOVERIES

What OIG Reviewed

In fiscal year 2014, the Office of Inspector General (OIG) established the High Risk 7(a) Loan Review Program to minimize losses on Small Business Administration (SBA) guaranteed loans, help SBA improve the effectiveness and integrity of its 7(a) Program, and protect program dollars.

Our objectives were to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovery of guaranteed payments to lenders.

This report presents the results of our ongoing High Risk 7(a) Loan Review Program from April 2015 to September 2016 and an overall summary of our work to date. Using an internally-developed loan scoring system, we selected and reviewed eight loans to assess lender compliance with SBA's rules, regulations and procedures. These loans were approved by lenders under SBA's 7(a) Loan Guaranty Program. SBA honored its guaranty on these eight loans for a total purchase amount of approximately \$8.5 million.

What OIG Found

Our review of the eight early-defaulted loans identified material lender origination and closing deficiencies that justified denial of the guaranty for three loans totaling \$3.2 million. To facilitate SBA's timely review and recovery of these payments, we formally issued separate reports on each loan that included detailed descriptions of the identified material deficiencies. We also identified suspicious activity on two purchased loans totaling \$1.4 million, resulting in formal referrals to our Investigations Division.

In our judgment, change of ownership transactions continue to be an area of high risk for SBA. Further, three of the five loans we either formally reported on, or referred due to potential fraudulent activity, were included in SBA's FY 2015 review of improper payments. SBA did not identify the improper payments on these loans. In a previous audit, we determined that SBA's limited

reviews of lender underwriting resulted in improper payments.

OIG Recommendations

We recommended in previous management advisory memorandums that SBA require the lenders to bring the three loans into compliance and, if not possible, seek recovery of approximately \$3.2 million from the lenders. SBA agreed with our findings on each loan and is seeking recovery from the lenders.

In this report, we recommend that SBA evaluate the time National Guaranty Purchase Center (NGPC) loan specialists have to review complex early-defaulted loans involving change of ownership transactions.

Summary of OIG Efforts

To date, under the OIG's High Risk 7(a) Loan Review Program we reviewed 15 loans with purchase amounts totaling \$12.5 million. We recommended recoveries on six loans totaling approximately \$5 million and have referred another two loans totaling \$1.4 million for further investigation.

Agency Comments

SBA management agreed with the recommendation in this report. The Office of Financial Program Operations will evaluate the time NGPC loan specialists need to review complex, early-defaulted loans involving change of ownership transactions.



**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416**

Final Report Transmittal
Report No. 16-22

DATE: September 30, 2016

TO: Maria Contreras-Sweet
Administrator

Jihoon Kim
Acting Director, Office of Financial Program Operations

FROM: Troy M. Meyer /s/
Assistant Inspector General for Auditing

SUBJECT: *The OIG High Risk 7(a) Loan Review Program Recommends \$3.2 Million in Recoveries*

The attached evaluation report presents the results of our ongoing High-Risk 7(a) Loan Review Program. The objectives of our review were to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovery of guaranteed payments to lenders.

The report contains one recommendation that SBA agreed to implement. Please provide us within 90 days your progress in implementing this recommendation.

Please contact me if you would like to discuss this report or any related issues..

cc: Nicolas Maduros, Chief of Staff
Melvin F. Williams, Jr., General Counsel
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Ann Marie Mehlum, Associate Administrator for Capital Access
Tami Perriello, Associate Administrator for Performance Management
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LaNae Twite, Director, Office of Internal Controls

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Introduction

The Small Business Administration (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.¹ Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures. When a borrower defaults on an SBA-guaranteed loan, the lender can submit the loan to SBA for purchase. SBA reviews the defaulted loan to confirm the lender's compliance with the relevant SBA laws and procedures before purchasing the loan. SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply with any material SBA loan program requirement.

The SBA OIG High Risk 7(a) Loan Review Program

In fiscal year (FY) 2014, we established the High Risk 7(a) Loan Review Program to minimize losses on SBA loans, help SBA improve the effectiveness and integrity of its 7(a) Program, and protect program dollars. We established this program because previous audits of improper payments and early-defaulted loans (loans that defaulted within 18 months of initial disbursement) noted a number of lenders failed to comply with SBA loan requirements. 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. In addition, the impact from lender noncompliance with SBA's requirements may increase given that the Small Business Jobs Act of 2010 increased the maximum 7(a) loan amount from \$2 million to \$5 million, which increased the maximum SBA-guaranteed amount to \$3.75 million.²

OIG's High Risk 7(a) Loan Review Program evaluates lender compliance with SBA's requirements on 7(a) loans approved for \$500,000 or more that defaulted within the first 18 months of initial disbursement. We use an internally-developed and evolving scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance and suspicious activity by loan participants.

Objectives

Our objectives were to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovery of guaranteed payments to lenders. (See Appendix I for information on our Scope and Methodology.)

¹ Title 15 U.S. Code Section 636(a).

² Public Law 111-240, Small Business Jobs Act of 2010, September 27, 2010.

Results

From April 2015 to September 2016 we reviewed eight early-defaulted loans approved by lenders. SBA honored its guaranty on each loan, resulting in a total purchase amount of approximately \$8.5 million. We identified material lender origination and closing deficiencies in three of the eight loans. Because of the lenders' material noncompliance with SBA's origination and closing requirements, we recommended SBA require the lenders to bring the three loans into compliance, and if not possible, SBA seek recovery of approximately \$3.2 million from the lenders. (See Table 1 for details). Additionally, we identified suspicious activity in two loans totaling \$1.4 million and referred them to our Investigations Division for further review.

Table 1: Lender Approved Loans Reviewed by OIG

Loan Number	Transaction Type	Deficiency Type [^]	Deficiency Description	Purchase Date	Purchase Amount	Recommended Recovery
1	Debt Refinance	A, B	A) Ineligible use of proceeds B) Affiliates not considered in financial analysis	2/11/2015	\$1,205,359	\$850,791
2	Change of Ownership	-	-	1/29/2015	\$573,204	-
3	Change of Ownership	A	A) Unreliable business valuation and no fixed asset appraisal	11/19/2014	\$903,297	\$299,318
4	Debt Refinance	-	-	10/29/2014	\$921,853	-
5	Change of Ownership	R	-	10/22/2014	\$599,910	-
6	Debt Refinance	R	-	10/6/2014	\$799,159	-
7	Change of Ownership	-	-	9/9/2014	\$1,419,275	-
8	Leasehold Improvements	C	C) Final construction plans not obtained, Interim and final site inspections not performed	6/23/2014	\$2,046,465	\$2,046,465
Totals					\$8,468,522	\$3,196,574

Source: Lender loan files, SBA loan files and results of OIG's reviews

[^]Deficiency Type Legend: A) Eligibility Deficiency, B) Repayment Ability Deficiency, C) Closing Deficiency, R) Referred to Office of Investigations

To facilitate SBA's timely review and recovery of these improper payments, we formally issued three management advisory memorandums to SBA that included detailed descriptions of the identified material deficiencies and recommendations for recovery. SBA substantially agreed with the findings presented each of the three memorandums and has contacted the lenders to obtain clarification, additional documentation, or seek recovery.

Areas of Concern

Since we began reviewing high-dollar/early-defaulted 7(a) loans in FY 2014, we have performed detailed reviews on 15 loans with purchase amounts totaling \$12.5 million. Overall, we identified material lender origination and closing deficiencies in 6 of the 15 loans, resulting in questioned costs of approximately \$5 million. In addition, we identified suspicious activity in two loans totaling \$1.4 million and referred them to our Investigations Division for further review. Our reviews have identified concerns with change of ownership transactions and SBA's review of improper payments.

Change of Ownership Transactions

We note that 8 of the 15 loans we reviewed financed change of ownership transactions. Additionally, 4 of these 8 loans, purchased for a total of \$2.8 million, either had material lender deficiencies or indications of suspicious activity. We believe that change of ownership transactions are one of the riskiest transactions financed by SBA. Prior audits have identified the following deficiencies in change of ownership transactions:

- Ineligible structures: partial change of ownership, seller retained control of the business;
- Inadequate support for equity injection: no evidence that the injection occurred, evidence provided supported an injection into a different business
- Lack of repayment ability: unverified seller's financial statements, all liabilities not considered, impact of affiliates not considered, unsupported projected sales; and
- Inadequate business valuation: business valuations not obtained as required.

Further, our Investigations Division has identified significant fraud in change of ownership transactions. In FY 2009, we issued an information notice that recommended lenders and other program participants perform a higher level of due diligence in reviewing change of ownership transactions.³

SBA recently issued guidance to strengthen its controls over change of ownership transactions. Specifically, SBA updated its Standard Operating Procedures (SOPs) to include experience requirements for certified real property appraisers conducting business appraisals for special purpose properties.⁴ Further, Agency officials noted that several recent denial of SBA guaranty liability cases involved change of ownership transactions.

While these Agency efforts are notable, further improvements are needed. The 7(a) loans reviewed under our High Risk 7(a) Loan Review Program are often complex and require time and research to validate the appropriateness of lender actions. We observed that in some cases, SBA loan specialists questioned lenders on the material compliance issues we identified. However, these loan specialists ultimately accepted explanations and documentation from lenders that did not cure the deficiencies. We noted loan specialists are generally required to complete loan file reviews within six hours. Due to the risk they present, we believe that SBA should evaluate whether six hours is an appropriate amount of time to allow loan specialists to review complex change of ownership transactions.

³ SBA Information Notice 9000-1793, *Detecting Fraud in Small Business Administration Lending Programs* (April 7, 2009).

⁴ SOP 50 10 5H, *Lender and Development Company Loan Programs*, May 1, 2015.

Identifying Improper Payments

While we noted improvement in SBA's 7(a) purchase review process, we remain concerned about the effectiveness of SBA's efforts to prevent improper payments. Specifically, four loans we formally reported on or referred to our Investigations Division were included in either SBA's FY 2014 or FY 2015 reviews for improper payments. During its improper payments reviews, SBA examines loan files to determine if lenders complied with the 7(a) Loan Program requirements. SBA did not identify or report the improper payments totaling \$4.5 million associated to these loans. Upon receiving our reports, SBA substantially concurred with our findings on the loans and confirmed them as improper payments.

Preventing improper payments in the 7(a) guaranty purchase review process continues to be a challenge for the Agency. SBA estimated a FY 2015 improper payment rate of 0.9 percent for its 7(a) purchases program. We have initiated an audit to test the accuracy of SBA's FY 2015 estimated improper payment rate.

Actions Taken by SBA

SBA reviewed the six loans with recommended recoveries totaling approximately \$5 million and contacted lenders to obtain additional information on the material deficiencies we identified. To date, SBA has recovered approximately \$207,000 on one loan. The remaining five loans are still under review. Based on our findings, SBA also plans to request additional documents from lenders for debt refinance transactions at guaranty purchase and has used our findings to enhance its training of loan guaranty staff.

Recommendation

We recommend the Acting Director for the Office of Financial Program Operations (OFPO):

1. Evaluate the time NGPC loan specialists have to review complex early-defaulted loans involving change of ownership transactions.

Summary of Actions Necessary to Close the Report

SBA management provided formal comments that are included in their entirety in Appendix III. The following provides the status of the recommendation and the necessary actions to close the report.

1. **Resolved.** OFPO management will evaluate the time NGPC loan specialists need to review complex, early-defaulted loans involving change of ownership transactions. This recommendation can be closed when OFPO provides us the results of its evaluation.

Appendix I: Scope and Methodology

This report presents the results of our ongoing High Risk 7(a) Loan Review Program from April 2015 to September 2016 and an overall summary of our work to date. Our objectives were to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovery of guaranteed payments to lenders. We will continue to revise our scope and methodology to ensure the most effective use of OIG resources and future analyses.

To accomplish our objectives, we used an internally-developed and evolving OIG scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance and suspicious activity by loan participants. These attributes include, but are not limited to, the time lapse between loan approval and its transfer to liquidation, loan amount, equity injection, loan packager involvement, and the use of loan proceeds. We obtained a universe of 98 high-dollar/early-defaulted 7(a) loans that were approved by lenders under the Preferred Lenders Program (PLP), which underwent very limited review by SBA prior to loan disbursement. SBA's National Guaranty Purchase Center (NGPC) purchased these loans between October 1, 2013, and February 29, 2016. We eliminated loans that had not received a completed purchase review by NGPC. We then selected eight loans based on their assigned score and considered other factors, such as the outstanding balance of the loan and the period to default.

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

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's quality standards for inspection and evaluation. These standards require that we adequately plan inspections, present all factual data accurately, fairly, and objectively, and that we present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objectives.

Use of Computer-Processed Data

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

Prior Coverage

Small Business Administration Office of Inspector General Reports

Advisory Memorandum 12-18, A Detailed Repayment Ability Analysis is Needed on High-Dollar Early-Defaulted Loans to Prevent Future Improper Payments (August 16, 2012). This report noted that SBA's assessment of lender underwriting on early-defaulted loans was not effective in identifying whether lenders were clearly negligent in determining the borrowers' repayment ability.

Audit Report 13-07, *The Small Business Administration's Improper Payment Rate for 7(a) Guaranty Purchases Remains Significantly Underestimated* (November 15, 2012). This report noted that SBA's fiscal year 2011 improper payments estimate for the 7(a) program was significantly understated.

Advisory Memorandum 13-16R, *Purchase Reviews Allowed \$4.6 Million in Improper Payments on 7(a) Recovery Act Loans* (June 14, 2013). This memorandum noted six 7(a) Recovery Act loans were not approved in accordance with SBA's requirements. SBA loan officers did not identify the deficiencies in the six loans during their purchase reviews. We recommended that SBA seek recovery of approximately \$4.6 million.

Evaluation Report 14-08, *Improvement is Needed to Ensure Effective Quality Control at Loan Operation Centers* (January 17, 2014). This report noted that SBA established a quality control program and developed quality control review activities at each of its loan operation centers. However, our evaluation found that quality control activities were not being performed at the Centers in accordance with SBA's guidance.

Audit Report 14-09, *Purchase Reviews Allowed \$3.1 Million in Improper Payments on 7(a) Recovery Act Loans* (January 29, 2014). This report noted that three 7(a) Recovery Act loans were not approved in accordance with SBA's requirements. SBA loan officers did not identify the deficiencies in the three loans during their purchase reviews. We recommended that SBA seek recovery of approximately \$3.1 million.

Evaluation Report 15-09, *The OIG High Risk 7(a) Loan Review Program Recommends \$1.8 Million in Recoveries* (March 20, 2015). This report noted our findings of material lender origination and closing deficiencies in three early-defaulted loans that justified denial of the guaranty for three loans totaling \$1.8 million.

Management Advisory 16-08, (January 7, 2016). This report noted our findings of material lender origination and closing deficiencies in one loan that justified denial of the guaranty of \$299,318.

Management Advisory 16-11, (March 17, 2016). This report noted our findings of material lender origination and closing deficiencies in one loan that justified denial of the guaranty of \$2 million.

Management Advisory 16-19, (August 16, 2016). This report noted our findings of material lender origination and closing deficiencies in one loan that justified denial of the guaranty of \$850,791.

Appendix II: Summary of OIG Results

Loan Number	Transaction Type	Deficiency Type^	Deficiency Description	Purchase Amount	Recommended Recovery	Recovery Status
1	Debt Refinance	A, B	A) Ineligible use of proceeds B) Affiliates not considered	\$1,205,359	\$850,791	In SBA's denial review process
2	Change of Ownership	-	-	\$573,204	-	
3	Change of Ownership	A	A) Unreliable business valuation and no fixed asset appraisal	\$903,297	\$299,318	Contacted lender to seek recovery
4	Debt Refinance	-	-	\$921,853	-	
5	Change of Ownership	R	-	\$599,910	-	
6	Debt Refinance	R	-	\$799,159	-	
7	Change of Ownership	-	-	\$1,419,275	-	
8	Leasehold Improvements	C	C) Final construction plans not obtained, Interim and final site inspections not performed	\$2,046,465	\$2,046,465	Under review by SBA OGC
9	Change of Ownership	-	-	\$265,465	-	
10	Working Capital	-	-	\$878,289	-	
11	Business Start-up	B	B) Unsupported projections, inadequate working capital	\$471,905	\$471,905	Contacted lender to seek recovery
12	Business Start-up	-	-	\$265,011	-	
13	Change of Ownership	A, B, C	A) Partial change of ownership, B) Unsupported financial statements, C) No business license	\$413,704	\$413,704	SBA recovered \$207,000
14	Change of Ownership	-	-	\$845,152	-	
15	Change of Ownership	A, B	A) Lacked independent business valuation B) Affiliates not considered	\$900,175	\$900,175	Under review by SBA
Totals				\$12,508,223	\$4,982,358	

Source: Lender loan files, SBA loan files and results of OIG's reviews

^Deficiency Type Legend: A) Eligibility Deficiency, B) Repayment Ability Deficiency, C) Closing Deficiency, R) Referred to Office of Investigations

**SBA
OFFICE OF FINANCIAL PROGRAM OPERATION'S
RESPONSE TO EVALUATION REPORT**



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

MEMORANDUM
September 23, 2016

To: Troy M Meyer
Assistant Inspector General for Auditing

From: Jihoon Kim
Acting Director, Office of Financial Program Operations

Subject: Response to Draft Report 15011D High Risk 7(a) Loan Review Program

We appreciate the role the Office of Inspector General (OIG) plays in working with management in ensuring that our programs are effectively managed, and for the feedback provided in this draft report.

The Small Business Administration (SBA) strives to ensure proper payments on guaranty purchases consistent with SBA's regulations and policies. The Office of Financial Program Operations (OFPO) takes great pride in its continuous improvement efforts at the National Guaranty Purchase Center (NGPC) and is always looking for ways to improve the effectiveness of the review of guaranty purchase requests.

Management's response to the recommendation in the draft report is noted below:

- 1. Acting Director for Office of Financial Programs Operations (OFPO) should evaluate the time National Guaranty Purchase Center NGPC loan specialist have to review complex, early-defaulted loans involving change of ownership transactions.***

OFPO agrees and we will evaluate the time NGPC loan specialists need to review complex, early-defaulted loans involving change of ownership transactions. We will provide OIG with findings from our evaluation.