EVALUATION REPORT

THE OIG HIGH RISK 7(A) LOAN REVIEW PROGRAM

September 28, 2017 Report No. 17-18

EXECUTIVE SUMMARY

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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 whether (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 March 2017 to August 2017 and an overall summary of our work to date. Using an internal loan scoring system, we selected and reviewed five early-defaulted 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 five loans for a total purchase amount of approximately $5.2 million.

What OIG Found

Our review of the five early-defaulted loans identified material lender origination and closing deficiencies that justified denial of the guaranty for one loan in the amount of $917,107. The detailed material deficiencies are contained in Appendix II. We also identified suspicious activity on two purchased loans totaling $1.9 million, resulting in formal referrals to our Investigations Division.

OIG Recommendation

We recommended that SBA require the lender to bring the one loan into compliance and, if not possible, seek recovery of approximately $917,107 from the lender.

Summary of OIG Efforts

Since FY 2014, under the OIG's High Risk 7(a) Loan Review Program, we have reviewed 20 loans with purchase amounts totaling $17.7 million. We have recommended recoveries on seven loans totaling approximately $6 million and have referred another four loans totaling $3.3 million for further investigation.

Our reviews have also identified concerns with change of ownership transactions and SBA's review of improper payments. We recommended SBA evaluate the time National Guaranty Purchase Center loan specialists have to review complex early-defaulted loans involving change of ownership transactions.

Agency Comments

SBA management agreed with the recommendation in this report to require the lender to bring the one loan into compliance and, if not possible, seek recovery of approximately $917,107. Specifically, management indicated that they have conducted a preliminary review, contacted the lender to obtain additional information about the loan, and will initiate recovery if needed.

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

Final Report Transmittal
Report Number: 17-18

DATE: September 28, 2017

TO: Linda E. McMahon
Administrator

FROM: Hannibal "Mike" Ware
Acting Inspector General

SUBJECT: *The OIG High Risk 7(a) Loan Review Program*

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 whether (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 at (202) 205-6586 or Andrea Deadwyler, Director, Credit Programs Group, at (202) 205-6616 if you would like to discuss this report or any related issues.

cc: Mary Anne Bradfield, Chief of Staff
William Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Jihoon Kim, Acting Director, Office of Financial Program Operations
Timothy E. Gribben, Chief Financial Officer and Associate Administrator for Performance Management
Christopher Pilkerton, General Counsel
Martin Conrey, Attorney Advisor, Legislation and Appropriations
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 and regulations. 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, for example, 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.

When a 7(a) loan goes into default and the lender requests guaranty payment, SBA reviews loan documentation to determine if the lender made, closed, serviced, and liquidated the loan in accordance with prudent lending standards and SBA requirements. Improper payments in the guaranty purchase process arise when an SBA purchase reviewer fails to identify material lender noncompliance with these requirements. 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 internal 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 whether (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.)

Results

Loans Reviewed in FY 2017

From March 2017 to August 2017, we reviewed five early-defaulted loans approved by lenders. SBA honored its guaranty on each loan, resulting in a total purchase amount of approximately $5.2 million. We identified material lender origination and closing deficiencies in one of the five loans. Specifically, the lender did not (1) verify the source of the required $675,000 equity injection, (2)

[1] 15 U.S.C. 636(a).
[2] Public Law 111-240, Small Business Jobs Act of 2010, September 27, 2010.

perform an adequate credit elsewhere determination, and (3) perform appropriate due diligence on the collateral available to secure the loan. The details of the deficiencies we identified on this loan are included in Appendix II.

Additionally, we identified suspicious activity in two loans totaling $1.9 million and referred them to our Investigations Division for further review. (See Table 1 for details.)

Table 1: Lender-Approved Loans Reviewed by OIG in FY 2017

Loan Number	Transaction Type	Issue Description	Purchase Amount	Recommended Recovery
1	Debt Refinance	-	$1,501,675	-
2	Business Startup	(1) Referred to Investigations	$1,028,484	-
3	Change of Ownership	(1) Referred to Investigations	$901,138	-
4	Change of Ownership	(1) Inadequate evidence for equity injection, (2) Inadequate credit elsewhere determination, (3) Insufficient collateral	$949,870	$917,107
5	Debt Refinance	-	$863,444	-
Totals			**$5,244,611**	**$917,107**

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

Summary of OIG Efforts Since FY 2014

Since FY 2014, we have performed detailed reviews on 20 loans with purchase amounts totaling $17.7 million. Overall, we identified material lender origination and closing deficiencies in 7 of the 20 loans, resulting in questioned costs of approximately $6 million. As described above, this report includes our findings and recommendation on one of the seven loans. Also, we identified suspicious activity in 4 of the 20 loans that were purchased for $3.3 million and referred them to our Investigations Division for further review. (See Appendix III for a summary of our results to date.)

We previously reported that for 6 of the 15 loans we reviewed, the lender did not adhere to loan origination and closing requirements.[3] As a result, we recommended that SBA require the lenders to bring the six loans into compliance, and, if not possible, seek recovery from the lenders of approximately $5 million.

In addition, we reported concerns with change of ownership transactions and SBA's review of improper payments. For example, our reviews of the loans found material lender deficiencies or suspicious activity in change of ownership transactions. Our Investigations Division has also identified significant fraud in change of ownership transactions. As a result, we recommended that SBA evaluate the time National Guaranty Purchase Center (NGPC) loan specialists have to review complex early-defaulted loans involving change of ownership transactions.[4] We also explained that four loans we reported on or referred to our Investigations Division were included in either SBA's FY 2014 or FY 2015 reviews for improper payments. Although those loans were reviewed for lender compliance by loan specialists, SBA did not identify or report the improper payments totaling $4.5 million associated to these loans. We noted that preventing improper payments in the 7(a) guaranty purchase review process continues to be a challenge for the Agency.

[3] SBA OIG Report 15-09, *The OIG High Risk 7(a) Loan Review Program Recommends $1.8 Million in Recoveries* (March 20, 2015); SBA OIG Management Advisory 16-08, (January 7, 2016); SBA OIG Management Advisory 16-11 (March 17, 2016); SBA OIG Management Advisory 16-19 (August 16, 2016).

[4] SBA OIG Report 16-22, *The OIG High Risk 7(a) Loan Review Program Recommends $3.2 Million in Recoveries* (September 30, 2016).

Actions Taken by SBA

SBA reviewed the six loans we previously reported on 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 $1.3 million on three loans. SBA did not recover the guaranty from the lender on another loan. SBA is reviewing the remaining two loans.

Recommendation

We recommended that the Director for the Office of Financial Program Operations:

1. Require Wells Fargo to bring the loan into compliance and, if not possible, seek recovery of $917,107, plus interest, on the guaranty paid by SBA for the loan to [redacted] and [redacted].

Analysis of Agency Response

SBA management agreed with the findings stating they conducted a preliminary review, and unless the lender provides additional information, "a deficiency appears to exist." If the lender cannot provide information that would bring the loan into compliance, the loan will be sent to headquarters for the denial review process. Management's planned corrective actions are sufficient to address the recommendation. See Appendix IV for SBA management's formal comments which are included in their entirety.

Summary of Actions Necessary to Close the Report

The following provides the status of the recommendation and the necessary actions to close the recommendation.

1. **Resolved.** Management has contacted the lender to obtain additional information to bring the loan into compliance. They stated the loan will be sent to headquarters for the denial review process which includes initiating recovery as appropriate, if the lender cannot overcome the issues identified. This recommendation can be closed when SBA provides evidence that the lender provided information to mitigate the finding or recovered the appropriate amount from the lender if necessary.

Appendix I: Objective, Scope, and Methodology

This report presents the results of our ongoing High Risk 7(a) Loan Review Program from March 2017 to August 2017 and an overall summary of our work to date. Our objectives were to determine whether (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.

To accomplish our objectives, we used an internal loan 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 93 high-dollar/early-defaulted 7(a) loans that were approved by lenders under the Preferred Lenders Program. Under the Preferred Lenders Program, loans undergo very limited review by SBA prior to loan disbursement. SBA purchased these loans between October 1, 2014, and September 30, 2016. We eliminated loans that had not received a completed purchase review by NGPC. We then selected five loans based on their assigned score and considered other factors, such as the outstanding balance of the loan and the period to default.

We also reviewed origination and closing actions as documented in SBA loan files. We assessed these actions against all applicable SBA requirements and 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.

Appendix II: Evaluation of Loan to [redacted] and [redacted]

Background

As part of the Preferred Lenders Program, SBA authorized the lender (Wells Fargo Bank) to process, close, service, and liquidate SBA-guaranteed loans with limited review by SBA. On July 16, 2014, the lender approved an SBA loan for $1,358,500 with a 75 percent SBA guaranty to the borrowers [redacted] and [redacted]) to purchase an existing landscaping business for $1,680,000. The loan was disbursed on August 1, 2014. The borrowers made 14 payments, including 3 interest-only payments and 11 full principal and interest payments, before defaulting on the loan in December 2015. SBA honored and purchased its guaranty on January 21, 2016, for $949,870. SBA's share of the loan's outstanding balance was reduced to $917,107, due to recoveries during the liquidation process.

Results

We identified material lender noncompliance with SBA's loan origination and closing requirements. Specifically, the lender did not verify the source of the required $675,000 equity injection, perform an adequate credit elsewhere determination, or perform appropriate due diligence on the collateral available to secure the loan. As a result, we recommend that SBA require Wells Fargo to bring the loan into compliance and, if not possible, seek recovery of $917,107, plus interest, on the guaranty paid by SBA.

Equity Injection

The lender did not obtain the source of the equity injection for the loan in accordance with SBA requirements. SOP 50 10 5(F) states that lenders must verify the equity injection prior to disbursing loan proceeds and must maintain evidence of such verification in their loan files. Verification of a cash injection requires the following documentation:

1. A copy of a check or wire transfer along with evidence that the check or wire was processed showing the funds were moved into the borrower's account or escrow;

2. A copy of the statements of account for the account from which the funds are being withdrawn for each of the two most recent months prior to disbursement showing that the funds were available; and

3. A subsequent statement of the borrower's account showing that the funds were deposited or a copy of an escrow settlement statement showing the use of the cash.

We identified that the lender did not adequately verify the source of the required $675,000 cash injection. The personal financial statement noted the principal had $900,000 cash available because he sold a business in South Africa. We found multiple wire transfers totaling $1.4 million that were made into the personal and business bank accounts. However, the loan file did not include statements for the accounts from which the funds were withdrawn. As a result, we were unable to determine the owner of those accounts. Because the required equity injection was 40 percent of the $1,680,000 purchase price of business, we consider this a material effect on this change of ownership transaction.

Credit Elsewhere Determination

The loan file did not include evidence to support the lender completed an adequate credit elsewhere determination for the borrowers. According to 13 CFR 120.101, SBA requires the lender to certify or otherwise show that the desired credit is unavailable to the applicant on reasonable terms and conditions from non-Federal sources without SBA assistance. SOP 50 10 5(F) states that the purpose of the credit elsewhere test is to determine whether the Small Business Applicant, along with its principals, has the ability to obtain some or all of the requested loan funds from alternative sources without causing undue hardship. It further states that the lender must determine that the Small Business Applicant is unable to obtain the loan on reasonable terms without a Federal Government guaranty, and some or the entire loan is not available from the resources of the applicant business or personal resources of the principals of the applicant business.

The personal financial statement showed that the principal had $900,000 cash available because he had sold a business in South Africa. In addition, the personal resources section of the lender's credit approval report noted total personal available liquid assets of $900,000. As described above, wire transfers totaling $1.4 million were made into the personal and business bank accounts, but the loan file did not include documentation on the value and owners of the accounts from which funds were withdrawn. Further, the lender explained in its loan file that the principal had rental income and other companies in South Africa. The lender should have obtained all personal and business account statements affiliated with the borrowers to determine the total available personal and business resources. For its credit elsewhere determination, the lender noted the borrowers needed a longer maturity than its policy permitted. We question whether the borrowers could not obtain a regular commercial business loan without the SBA guarantee.

Insufficient Collateral

The lender did not secure available collateral for the loan in accordance with SBA requirements. SOP 50 10 5(F) states lenders must use commercially reasonable and prudent practices to identify collateral items. It also states that if there is a collateral shortfall (not fully-secured) on the SBA-guaranteed loan, the lender will be required to take available equity in the personal real estate of the principals when the equity in the real estate is 25 percent or more of the property's fair market value.

We identified that during the loan application process, the principal purchased personal real estate. A bank statement and an accompanying cleared check in the loan file showed an $85,000 escrow deposit for the personal real estate in May 2014. Another bank statement showed a wire transfer to an attorney for over $200,000, approximately 1 month after the escrow deposit was made. Public records showed that prior to the approval of the SBA loan, the principal purchased the home for $975,000 and took out a mortgage of $682,500. In addition, the borrowers' loan applications for the SBA loan signed by the principal included the address of the new home.

We did not find evidence in the loan file that the lender conducted an analysis to determine the available equity in the personal residence. Based on the public records, we determined that at the time of the loan closing there was $292,500 (or 30 percent) in available equity in the personal residence. As this amount exceeds the 25 percent SOP requirement and the loan was not fully secured, the lender was required to take the personal residence as collateral. The lender did not take a lien on this collateral and therefore was not in compliance with SOP 50 10 5(F).

Conclusion

We determined that the lender did not originate and close the loan in accordance with SBA's requirements. SOP 50 10 5(F) states that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. Further, 13 CFR 120.524 states that SBA is released from liability on the guaranty (in whole or in part) if the lender failed to comply with any material SBA loan program requirement; failed to make, close, service, or liquidate a loan in a prudent manner; or the lender's improper action or inaction placed SBA at risk.

We found there was insufficient evidence in the loan file to support the source of the required $675,000 equity injection. Further, the lender did not adequately assess whether the borrowers met the credit elsewhere test and satisfied the collateral requirements to secure the SBA loan. Consequently, the lender's material noncompliance with SBA requirements while originating and closing the loan resulted in a potential loss to SBA of over $900,000.[5]

[5] Proceeds from the liquidation process may further reduce this amount.

Appendix III: Summary of OIG Efforts Since FY 2014

Loan Number	Transaction Type	Issue Description	Purchase Amount	Recommended Recovery	Recovery Status
1	Debt Refinance	(1) Ineligible use of proceeds, (2) Affiliates not considered	$1,205,359	$850,791	Under review by SBA
2	Change of Ownership	-	$573,204	-	-
3	Change of Ownership	(1) Unreliable business valuation, (2) No fixed asset appraisal	$903,297	$299,318	SBA recovered $860,000[6]
4	Debt Refinance	-	$921,853	-	-
5	Change of Ownership	(1) Referred to Investigations	$599,910	-	-
6	Debt Refinance	(1) Referred to Investigations	$799,159	-	-
7	Change of Ownership	-	$1,419,275	-	-
8	Leasehold Improvements	(1) Final construction plans not obtained, (2) Interim and final site inspections not performed	$2,046,465	$2,046,465	Under review by SBA
9	Change of Ownership	-	$265,465	-	-
10	Working Capital	-	$878,289	-	-
11	Business Start-up	(1) Unsupported projections, (2) Inadequate working capital	$471,905	$235,952	SBA recovered $236,000
12	Business Start-up	-	$265,011	-	-
13	Change of Ownership	(1) Partial change of ownership, (2) Unsupported financial statements, (3) No business license	$413,704	$413,704	SBA recovered $207,000
14	Change of Ownership	-	$845,152	-	-
15	Change of Ownership	(1) Lacked independent business valuation, (2) Affiliates not considered	$900,175	$900,175	No recovery from lender
16	Debt Refinance	-	$1,501,675	-	-
17	Startup Restaurant	(1) Referred to Investigations	$1,028,484	-	-
18	Change of Ownership	(1) Referred to Investigations	$901,138	-	-
19	Change of Ownership	(1) Unsupported equity injection, (2) Inadequate credit elsewhere determination, (3) Insufficient collateral	$949,870	$917,107	-
20	Debt Refinance	-	$863,444	-	-
Totals			**$17,752,834**	**$5,899,465**	-

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

[6] SBA determined during its review of the loan that a full denial was warranted and sought recovery from the lender.

SBA

OFFICE OF FINANCIAL PROGRAM OPERATIONS

RESPONSE TO EVALUATION REPORT

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

TO: Hannibal M. Ware, Acting Inspector General
Office of Inspector General (OIG)

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

SUBJECT: Response to Draft Report on The OIG 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 enhance the effectiveness of the review of guaranty purchase requests. SBA also recognizes the importance training plays in ensuring its employees possess the knowledge and skills required to perform guaranty purchase reviews and works diligently to ensure it provides quality training for their continued improvement.

In FY 2014, OIG established the High Risk 7(a) Loan Review Program. As part of this effort, OIG initiated ongoing reviews of high-dollar/early-defaulted 7(a) loans purchased by the NGPC between October 1, 2013 and May 31, 2014. In a July 21, 2014 Audit Entrance Conference, the OIG stated that it planned to review and report individual loan findings to management on an ongoing basis, and indicated that in doing so, the NGPC could address deficiencies on recent guaranty purchases providing for a more efficient and effective resolution.

SBA has made substantial progress in reviewing complex high dollar early default loans by evaluating the time allowed to review and process these risky purchases. As a result of these assessments the SBA has increased the time required to complete a thorough review of complex early default loans. The improvements to the processing of these risky purchases has resulted in the National Guaranty Purchase Center identifying more instances of repayment ability issues as well as referred cases to investigations for potential fraud. The continuing review of process improvements has contributed to the enormous strides The National Guaranty Purchase Center has made in studying complex early default purchases.

The 2017 draft report outlines the OIG's concerns regarding its review of high-dollar/early defaulted loans purchased in the NGPC and identified deficiencies in one of the five loans reviewed. The loan was purchased in 2016, with SBA's exposure at $953,698. OIG recommends that OFPO, 'R*equire Wells Fargo to bring the loan into compliance and, if not possible, seek recovery of $917,107, plus interest, on the guaranty paid by SBA for the loan to* [redacted] Exemptions 4 and 6 *and* [redacted] Exemptions 4 and 6

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

After conducting a preliminary review, and absent additional information from the lender, a deficiency appears to exist. The lender has been notified of the deficiency and is currently conducting research. OFPO will work with lender to obtain documentation to bring loan into compliance. If the issues are not overcome at that point the loan will be sent to HQ for the denial review process.