

**ANNUAL CREDIT REVIEWS FOR GULF
COAST HURRICANE DISASTER LOAN
DISBURSEMENTS**

Report Number: 08-10

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



U.S. Small Business Administration
Office Inspector General

Memorandum

To: Herbert L. Mitchell, Associate Administrator
Office of Disaster Assistance

Date: March 28, 2008

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Report on the Annual Credit Reviews for Gulf Coast Hurricane Disaster Loan Disbursements
Report No. 08-10

This report summarizes the results of our audit of annual credit reviews for Gulf Coast Hurricane disaster loan disbursements. We initiated the audit in response to the increasing number of defaulted Gulf Coast disaster loans processed by the Small Business Administration (SBA). The audit objective was to determine the adequacy of SBA's monitoring efforts to ensure that the financial status of borrowers had not deteriorated to levels that would adversely impact their loan repayment ability. Specifically, we determined whether (1) the credit reviews were conducted before disbursements were made, (2) all required financial documents were obtained, and (3) SBA took appropriate measures to cancel loans when there were adverse changes in the financial condition of borrowers.

As of September 30, 2007, we identified 11,217 loans totaling \$1.1 billion in disbursements for which one or more disbursements occurred over a year after loan approval. Based on review requirements that were in effect at the time of disbursement (ODA changed the 1-year requirement to 18 months and then to 24 months), we determined that 1,117 of these loans required a credit review, using the applicable timeframe for an updated credit/financial review. We reviewed a statistical sample of 159 of these loans. We examined entries in SBA's Disaster Credit Management System (DCMS) for each of the sampled loans to determine the timing of the credit reviews, whether all required financial documents were obtained, and whether SBA took action to address adverse changes in the financial status of borrowers. We also interviewed officials working in SBA's Office of Disaster Assistance (ODA) Processing and Disbursement Center (PDC) in Fort Worth, Texas to determine what, if any, controls were in place to prevent the PDC from disbursing funds when the required reviews were not performed.

We conducted the audit from October 2007 to January 2008 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

BACKGROUND

Following the 2005 Gulf Coast hurricanes, ODA approved more than 160,000 disaster loans to help homeowners, renters, businesses and nonprofit organizations return to pre-disaster condition. As of January 25, 2008, SBA had disbursed approximately \$6.3 billion of the approved loans.

Because rebuilding efforts in the Gulf Coast region have been slow due to the extensive damage caused by the hurricanes, many disaster loans were not fully disbursed until long after they were initially approved. During this lengthy disbursement period, the financial condition of many borrowers changed due to the loss of businesses and employment in the Gulf Coast region.

To ensure that loan disbursements are not made to borrowers who cannot afford to repay them, SBA requires a review of borrower creditworthiness prior to disbursing funds. Standard Operating Procedure (SOP) 50 30 states that a credit review will be made prior to a disbursement when 12 months have passed since the date of loan authorization, and annual reviews thereafter until the loan has been fully disbursed. Further, in reviewing the financial status of borrowers, loan officers must obtain current credit reports (i.e., Credit Bureau reports and/or Dun & Bradstreet reports), updated financial statements, and Federal tax returns (IRS Form 8821) if the previous tax filing period has expired. If an adverse change in the borrower's financial condition has occurred, SBA must take appropriate measures to cancel the undisbursed portion of the loan.

To further safeguard against disbursing funds without reviewing the financial status of borrowers, disbursement deadlines are recorded in DCMS that serve as a trigger for determining when credit reviews are needed. When loan disbursement deadlines expire, loan officials are required to issue a loan modification to extend the deadlines and to update information on the borrower's financial status.

RESULTS

SBA Did Not Review the Financial Status of Borrowers Before Disbursing Additional Loan Funds

SBA's monitoring efforts were not adequate to ensure that the financial status of borrowers had not deteriorated to levels that would adversely impact their loan repayment ability. Generally, ODA did not: (1) perform annual credit reviews, as required by the Agency's standard operating procedures, before making

distributions of loan proceeds; (2) obtain updated financial information; and (3) cancel loans where the borrower had no repayment ability. As a result, SBA disbursed over \$1 billion in loans 1 year or more after loan approval without assurance that borrowers had repayment ability.

Even when reviews should have been conducted, ODA disbursed \$4.9 million on 110 (or about 70 percent) of the 159 sampled loans without verifying the creditworthiness of loan recipients. Projecting the sample results to the universe, we estimate¹ that SBA disbursed at least \$29.2 million in loan proceeds that have a higher risk of defaulting. We found no evidence showing that reviews were performed for 86 of the 110 loans. For the other 24 loans, we found evidence of partial credit reviews. For each of these loans, ODA collected only one of the three required financial reports needed to determine the financial status of borrowers. These documents included updated credit reports, current financial statements, and Federal tax return forms. However, because the reviews were not complete, ODA did not collect sufficient financial information to fully assess the financial condition of borrowers.

Although SBA originally established credit reviews as a management control to prevent ODA from making further disbursements to borrowers who no longer had repayment ability, in 2006 and 2007 ODA issued policy memoranda that relaxed the requirements for these reviews. On November 9, 2006, ODA issued Notice 06-61, *Credit Review for Hurricanes Katrina, Rita and Wilma*, which extended the time period for credit reviews of Gulf Coast Hurricane loans from 12 to 18 months from loan authorization. On September 14, 2007, ODA issued Notice 07-53, *Revised Credit Review for Hurricanes Katrina, Rita, and Wilma*, which further extended the review period to 24 months. These extensions effectively eliminated credit reviews for 10,100 loans totaling over \$1 billion² in total disbursements. Consequently, ODA circumvented a critical management control, disbursing additional funds on these loans without first determining whether adverse changes had occurred in the financial condition of borrowers that would have impacted their ability to repay the additional loan proceeds that were disbursed.

Further, both extensions were made outside of the normal process for amending standard operating procedures, which requires clearance by senior Agency executives external to ODA. Instead of amending SOP 50 30, ODA simply issued notices to its employees extending the period for credit review. While the Associate Administrator of ODA can approve exceptions to disaster loan policy

¹ The estimate was based on a 95-percent confidence level.

² This amount represents the total gross disbursements, and not the amount of subsequent disbursements that are at risk. We did not determine the total value of subsequent disbursements made on the 10,100 loans. However, based on prior audits, we believe that a significant portion of the \$1 billion was disbursed a year or more after loan authorization and; therefore, was subject to the original credit review requirement.

established by SOP 50 30, ODA was unable to provide a written justification or analysis of why the policy changes were so urgently needed that they could not be executed through a revised SOP. Because extensions of the credit review period represented a significant deviation from policy established by the SOP and ultimately placed a significant amount of loan funds at risk, we believe they should have been approved by the highest levels of SBA.

ODA officials explained that the credit review extensions were justified since economic conditions in the hurricane-hit areas had negatively impacted borrower repayment ability in many cases, through no fault of the borrowers. Therefore, they intended to disburse the full amount of the approved loans regardless of whether borrowers could repay their loans. We believe that by disregarding borrower repayment ability, ODA was negligent in carrying out its fiduciary responsibilities. By law, SBA is authorized to make disaster loans, not grants. Further, SBA's regulations for the disaster loan program require that there be reasonable assurance that borrowers can repay their loans. Therefore, by disregarding borrower repayment ability, ODA has established procedures that are contrary to its regulations and contrary to prudent lending procedures and which could result in significantly higher loan defaults and losses.

Additionally, the 2007 ODA policy notice eliminated the requirement to review borrowers' updated financial statements and Federal tax return forms when evaluating the financial status of borrowers. Under the September 2007 notice, credit reviews are to be based solely on borrower credit reports. We believe that relying solely on credit reports is imprudent because these reports only provide information on borrower monthly debt payments, and contain no income data needed to establish whether the borrower has sufficient income to repay the loan.

Lastly, although DCMS contained disbursement deadlines that should have served as a trigger for determining when credit reviews were needed, loan officers and their supervisors ignored this information, disbursing funds without reviewing the financial status of borrowers. When loan disbursement deadlines expire, loan officials are required to issue a loan modification to extend the deadlines. However, disbursements were made on 74 of the 159 loans after the disbursement deadlines. To prevent this override from occurring in the future, SBA should build a control into DCMS in future upgrades of the system that prevents disbursements from being made after established deadlines without loan modifications.

In conclusion, ODA's revision of its credit review policies and the lack of controls in DCMS have resulted in the disbursement of loan funds that have a higher risk that the loan cannot be repaid. In our opinion, ODA's processing of subsequent loan disbursements was not only imprudent, but will likely lead to a greater

number of loan defaults, and future adverse changes in borrower credit records and property losses, should foreclosures occur.

SBA Identified No Adverse Changes in the Financial Status of Borrowers

Of the 49 loans in our sample meeting the credit review requirement, SBA did not identify adverse changes in the financial status of borrowers; therefore, the Agency did not cancel any of these loans. However, we determined that six loans involved additional disbursements to borrowers who lacked repayment ability and one involved a borrower who was over 60-days delinquent on child support payments. SOP 50 30 prohibits disbursements to borrowers who are more than 60-days delinquent on child support payments.

Six of the seven loans we identified had been approved under expedited procedures that did not require an analysis of the applicant's repayment ability. As discussed in a previous audit,³ under the Expedited Loan Program, SBA awarded an estimated \$1.5 billion to individuals who lacked repayment ability. This occurred because borrower repayment ability was not considered during the approval process.

Although SBA did not previously identify these deficiencies at the time of disbursement, ODA officials agreed with our conclusion regarding repayment ability when presented with our findings. However, officials noted that it would be inappropriate to withhold remaining loan payments for borrowers on the six loans who were not required to undergo a repayment analysis when their loans were initially approved. We disagree with this view as extending loan funds to borrowers who cannot afford to repay them will cause their loans to ultimately default, impair the future credit standing of borrowers and potentially result in foreclosures on their properties. Therefore, such action would ultimately harm borrowers.

RECOMMENDATIONS

We recommend that the Associate Administrator for Disaster Assistance:

1. Reinstitute the requirement that updated income tax returns and financial documents be collected along with updated credit reports during annual credit reviews.
2. Rescind Notice 07-53 to ensure that credit reviews are performed for loans that are disbursed 12 months beyond the original loan authorization date.

³ *Quality of Loans Processed Under the Expedited Disaster Loan Program*, OIG Report Number 07-34, September 28, 2007.

3. Require written justification for disaster assistance policy that is made outside of the Agency's SOP clearance process.
4. Implement internal system controls into DCMS that ensure disbursements do not occur after expired deadlines. As part of these controls, required credit reviews must be performed to justify extensions.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On February 28, 2008, we provided SBA with a draft of the report for comment. On March 21, 2008, SBA submitted its formal response, which is contained in its entirety in the Appendix. ODA generally concurred with the audit findings, but did not concur with three of the four recommendations, and commented on several issues raised in the report. ODA provided a partial response to the fourth recommendation. The Agency agreed that not all credit reviews were completed as required, but did not agree with our opinion of the credit review policies. The following response summarizes management's comments and our response.

General Comments

ODA believes that the report fails to recognize the devastating effects of the Gulf Coast hurricanes on the financial condition of borrowers, and does not acknowledge the need to adjust SBA's lending policies accordingly. Specifically, ODA argues that because the hurricanes negatively impacted borrowers' credit, the Agency must give the borrowers additional opportunities to explain poor credit history and derogatory credit bureau reports. Additionally, ODA noted that disaster-related derogatory credit issues may be beyond the borrowers' control and that continuing to enforce the standard credit review policies would have created additional hardships for borrowers.

OIG Response

We acknowledge the Gulf Coast hurricanes created hardships for SBA loan applicants. However, we do not believe that ODA was justified, or, more importantly, had the authority to circumvent regulatory requirements that loan disbursements be made only to individuals who have repayment ability. While the Agency SOP may authorize the Associate Administrator to change policies and procedures governing the disaster loan program, it does not allow him to create policies that violate Agency regulations. Regulations always govern over SOPs. Further, ODA does not have the authority to impose its will over that of the Congress. Congress intended that the disaster funds be distributed as loans that

would be repaid, and not as grants. Therefore, by relaxing annual credit review requirements designed to establish repayment ability, ODA not only violated Agency regulations, but undermined Congress' intent in establishing the disaster assistance program.

ODA's comments do not acknowledge that disbursing money, which borrowers cannot repay, only serves to weaken the financial condition of borrowers and create greater hardships for them. If the disaster loans default, resulting in foreclosures, borrowers will not only lose their homes but their credit history will also be negatively impacted. It takes 7 years on average after foreclosure for an individual to fully repair his/her credit standing.

Additionally, by relaxing its annual credit review policy, ODA may have disbursed additional funds to individuals that should never have been approved for their loans. Our September 27, 2008, report on *The Quality of Loans Processed Under the Expedited Disaster Loan Program*, estimated that \$1.5 billion in loans processed under expedited procedures were awarded to applicants who lacked repayment ability. Many of these individuals received subsequent disbursements on their loans because ODA waived the annual credit reviews.

Recommendation 1

Management Comments

Management did not indicate whether it agreed that credit review requirements should be reinstated for Gulf Coast loans. ODA stated that current guidance (Memo 07-53) for Gulf Coast hurricane loans will stay in effect until September 30, 2008, but that updated tax returns, financial data, and credit reports are currently required for all other disaster assistance loans. Memo 07-53 does not subject Gulf Coast hurricane victims to the standard credit review requirements. Additionally, ODA will implement procedures to ensure the memo is followed, including: issuing specific credit review instruction to loan officers and case managers; establishing points of contacts for case managers to obtain guidance on when a complete credit review is required on Gulf Coast loans; and training loan officers on the credit review requirements for Gulf Coast loans. Loan officers will also now be required to follow up with borrowers when credit reports indicate adverse financial changes.

OIG Response

We consider ODA's comments to be unresponsive as it did not indicate whether it agreed to implement the recommendation. ODA stated that it intends to maintain the current policy for Gulf Coast loans until September 30, 2008, when all remaining Gulf Coast loan proceeds must be disbursed. Further, although

management stated it would implement specific credit review procedures, it is unclear whether the procedures will require annual credit reviews. Accordingly, we are requesting that ODA clarify its intentions with respect to the recommendation. We will also seek a management decision on the recommendation through the audit resolution process.

Recommendation 2

Management Comments

In lieu of rescinding Memo 07-53 as recommended, ODA indicated it would implement additional instructions to ensure the guidance in the memo is followed. It will also follow up with borrowers when credit reports indicate adverse financial changes.

OIG Response

Because ODA did not agree to rescind Memo 07-53, and it is unclear whether the alternative actions ODA proposed include an analysis of borrower repayment ability prior to disbursing funds, we consider management's comments to be unresponsive to the recommendation. Accordingly, we are requesting that ODA clarify its intentions with respect to the recommendation, and we will pursue a management decision on the recommendation through the audit resolution process.

Recommendation 3

Management Comments

ODA stated that all changes to disaster policy are analyzed extensively prior to implementation, and that the memos relaxing credit review requirements were carefully considered before being implemented.

OIG Response

Because ODA did not indicate whether it agreed to ensure that future policy established outside of the Agency's SOP process is justified in writing, we do not consider its comments to responsive to the recommendation. Instead, ODA commented that its decision to relax annual credit review requirements resulted from a detailed analysis. However, it could not produce evidence of its analysis or justification for deviating from stated policy. We also maintain that regardless of whether an analysis was performed, ODA lacked authority to establish policy that deviated from Agency regulations. As stated previously, SBA's regulations, which take precedence over its procedures, require that there be reasonable assurance that borrowers can repay their loans.

Accordingly, we are requesting that ODA clarify its intentions with respect to the recommendation, and will pursue a management decision through the audit resolution process.

Recommendation 4

Management Comments

The Agency agreed with our recommendation to install edits in DCMS that will alert case managers at the time disbursements are ordered if the disbursement period has expired. However, we also recommended that the Agency implement internal control systems into DCMS to ensure that disbursements do not occur after expired deadlines and that credit reviews are performed to justify extensions.

OIG Response

We do not consider the action proposed by ODA to be fully responsive to the recommendation. While an alert system will reduce the likelihood of disbursements occurring outside the disbursement period, we believe that an actual business rule, that would prevent the disbursement, would be more effective and satisfy the requirement to establish needed internal controls. Simply alerting case managers when a disbursement is ordered outside the disbursement period does not guarantee that the disbursement will be stopped. Further, the recommended internal control was intended to ensure that loan officers perform credit reviews, when required, prior to extending disbursement periods, and ultimately approving disbursements. ODA's proposal included no specific action that requires the completion of credit reviews when extending the disbursement period.

Accordingly, we will seek further action through the audit resolution process. Also, ODA did not provide a target date for implementing internal controls in DCMS, we are requesting a target date for this action be provided by April 25, 2008.

ACTIONS REQUIRED

Because your comments do not clearly indicate concurrence/nonconcurrence with recommendations 1 through 3, we request that you provide a written response by April 25, 2008 clarifying your management decision. Your comments should indicate whether you concur/nonconcur with each of the recommendations. If you concur, please state the specific action taken or planned and the target date for completion. If you do not concur, please provide your rationale. You may also provide alternative courses of action that you believe would resolve the issues presented in this report.

We appreciate the courtesies and cooperation of the Office of Disaster Assistance representatives during this audit. If you have any questions concerning this report, please call me at (202) 205-7203 or Pamela Steele-Nelson, Director, Disaster Programs Group, at (202) 205-[Exemption 2].



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

Date: March 21, 2008

To: Debra S. Ritt
Assistant Inspector General for Auditing

From: Herbert L. Mitchell
Associate Administrator
For Disaster Assistance

Subject: OIG Draft Report – Annual Credit Reviews For Gulf Coast Hurricane Disaster Loan Disbursements (Project No. 8304)

We have reviewed the draft audit report on Annual Credit Reviews for Gulf Coast Hurricane Disaster Loan Disbursements prepared by your office. While we disagree with your opinion of the revised KRW credit review procedures, we agree not all credit reviews were completed as required.

The report summarized the results of the audit of disaster loan disbursements to borrower's of the Gulf Coast Hurricanes. The basis of the audit was to determine if the SBA followed credit review procedures for KRW files as defined in SOP paragraph 96 d and ODA numbered memo's 06-61 and 07-53.

The audit included an analysis on 159 loans of 1,117 requiring reviews as of September 30, 2007. The report concluded that 70% of the loans were disbursed without performing the necessary credit review. The report also criticized SBA for revising the normal credit review procedures as defined in SOP paragraph 96 d. for KRW borrowers in numbered memo's 06-61 and 07-53. The report ignores the fact that the Gulf Coast region and the majority of Hurricane Katrina, Rita and Wilma victims suffered catastrophic physical and economic injury as a result of the Hurricanes. The economic and physical disaster recovery period for the Gulf Coast region, including businesses and individual home owners was significantly longer than experienced in other disaster declarations. As a result of these extraordinary hardships associated with the extended recovery period, SBA's made a decision to modify the credit review procedures as defined in SOP paragraph 96 d. for KRW borrowers. The decision to temporarily revise the credit review procedures was appropriate and is supported in the current SBA guidance in SOP paragraph 76 and SBA training manual #4. The physical and economic hardships that KRW borrowers were faced with were disaster related and the circumstances were beyond the borrower's control.

SOP Paragraph 76

Poor Credit History: You must give applicants with poor credit history every opportunity to provide explanations before you reach a conclusion about their overall credit worthiness. Generally, a history that consists of minor, isolated instances of poor credit or late payments is acceptable provided that:

Training Module #4

Derogatory Credit Issues

In some instances, derogatory credit may be beyond control of the applicant.

For example:

- .. Unemployment
- .. Protracted labor strikes
- .. Prolonged illness
- .. Uninsured medical costs
- .. Divorce, etc
- .. Disaster related

Continuing to enforce the standard credit review policies would have created an additional hardship on SBA's KRW borrowers.

Comments on the Recommendations:

Recommendations #1: Reinstitute the requirement that updated income tax returns and financial documents be collected along with updated credit reports during annual credit reviews.

ODA Response: For KRW files SBA numbered memo 07-53 is in affect until September 30, 2008. To ensure we adhere to the credit review policy as outlined in the memo we have initiated the following procedures:

- *Issued specific credit review instructions to the loan officers and case managers on the policy and level of review required for KRW files.*
- *Established loan processing points of contacts for case managers to obtain guidance and determine if a complete credit review is required on any KRW file prior to disbursement*
- *Completed loan officer training classes the week of 2/1/08 and covered the credit review policy and requirements for KRW loans.*

For all Non-KRW files SBA policy as defined in SOP paragraph 96 d is in effect which requires updated tax returns, financial data and credit reports when a credit review is required. Additionally we have completed the following:

- *Revised the SBA disbursement period from 12 months to 6 months from the date of the SBA loan authorization and agreement for all new disaster declarations.*
- *Issued specific credit review instructions to case managers on the policy and level of review required for Non-KRW files.*
- *Established loan processing points of contacts for case managers to obtain guidance and determine if a complete credit review is required prior to disbursement*

- Completed loan officer training classes the week of 2/1/08 and covered the credit review policy and requirements for Non-KRW loans.

Recommendation #2: Rescind Notice 07-53 to ensure that credit reviews are performed for loans that are disbursed 12 months beyond the original loan authorization date.

ODA Response: The revised credit policy covering the KRW loans is reasonable given the circumstances and we have taken additional steps to ensure that the policy is followed. If the credit report indicates an adverse change the loan officer or case manager is required to follow up, which may include obtaining updated financials and tax returns on an individual basis.

Recommendation #3: Require written justification for disaster assistance policy that is made outside the Agency's SOP clearance process.

ODA Response: Because of the nature of disasters the Agency SOP authorizes the Associate Administrator to make changes to the policies and procedures governing the disaster loan program. All changes to the Agency SOP governing the disaster loan program are thoroughly reviewed and justified prior to implementation. In this specific instance which is the subject of this audit a great deal of consideration was given to the magnitude of the disaster, the amount of devastation, its impact on the economy and the extended recovery period well beyond any other disaster in the history of the country.

Recommendation #4: Implement internal system controls in DCMS that ensure disbursements do not occur after expired deadlines. As part of the controls, required credit reviews must be performed to justify extensions."

ODA Response: We agree with the IG recommendation to have an edit installed in DCMS that will alert the case manager at the time they try to order a disbursement if the disbursement period is expired. We are currently working on automating this process.

Thank you for the opportunity to comment on this draft report and if you have any questions on this response please feel free to contact me or James Rivera.

[Exemption 6]

Herbert L. Mitchell
Associate Administrator
for Disaster Assistance