



U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Eric R. Zarnikow
Associate Administrator, Office of Capital Access
/s/ Original Signed

Date: January 22, 2010

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Notice of Finding and Recommendation on Ineligible Lender-Approved Recovery Act Loans
ROM-10-11

The OIG is conducting an audit of 7(a) loans disbursed pursuant to the American Recovery and Reinvestment Act of 2009 (Recovery Act) to determine if the loans made under the Act were originated and closed in compliance with SBA's policies and procedures and to identify any evidence of suspicious activity. This is the third in a series of finding notices related to our ongoing audit and is intended to provide the Agency with early notification of findings and recommendations related to material deficiencies in Recovery Act loans and with the loan approval process. The first Notice of Finding and Recommendation (NFR) identified four SBA-approved loans involving deficiencies in change of ownership transactions. The second NFR identified 14 lender-approved loans disbursed without the required borrower immigration certification. This NFR identifies eligibility issues in three lender-approved Recovery Act loans. We made two recommendations to the Associate Administrator for Capital Access to: (1) require the lenders to bring each of the loans listed in Appendix I into compliance, or, if not possible, cancel or adjust the SBA guaranties accordingly; and (2) provide training to the lenders identified in Appendix I to prevent similar instances of noncompliance identified in this NFR.

On December 15, 2009, we provided a draft of this NFR to SBA for comment. On January 13, 2010, SBA submitted its formal comments, which are contained in their entirety in Appendix II. SBA agreed that all three loans have issues that may affect their eligibility under SBA policies and procedures. SBA stated that it would work with the lenders listed in Appendix I to determine if any adjustments are necessary and would provide training to the lenders on the issues identified in this NFR.

Specifically, SBA agreed that system controls should have rejected the first loan. However, the filter SBA put in place was unable to recognize a partial cancellation. SBA will re-examine the eligibility of this loan and reduce the guaranty amount if necessary. To ensure partial loan cancellations were not resubmitted as Recovery Act loans, SBA stated it will review loan data for all loans made between April 10, 2009 and September 30, 2009. While SBA agreed that the second loan may not have been made in compliance with SBA policy concerning loan limits for Community Express loans because of an outstanding *SBAExpress* loan, it stated the SOP is ambiguous as to whether the loan limit applies to *SBAExpress* and Pilot Loan Program loans made more than 90 days apart. SBA also agreed that the lender exceeded SBA policy on the interest rate applied to this loan, but again noted an ambiguity in the SOP requirements. SBA stated that the ambiguity in the requirements for Pilot Loan Program interest rates has been addressed in the current version of the SOP. SBA also stated that it is working to update the pricing filter in E-Tran to reflect the new lower maximum interest rate.

SBA agreed that one lender did not obtain an independent business valuation as required by the SOP. Given the small loan size (\$18,000) and the potentially high cost of an independent business valuation, SBA stated that if the lender had verified the seller's income and provided that as a justification for requesting a waiver of the request for a business valuation, it would have been considered. Nevertheless, SBA stated the issues identified in this NFR will be addressed.

We appreciate the courtesies and cooperation of the Office of Capital Access. If you have any questions concerning this NFR, please call me at 202-205-[FOIA ex. 2] or Debra Mayer, Director, Recovery Oversight Group, at 202-205-[FOIA ex. 2]

Attachment

U.S. Small Business Administration

Office of Inspector General

Notice of Finding and Recommendation

Audit Location/Division	Office of Capital Access
Date	January 22, 2010
Description of Issue	Lenders approved Recovery Act loans that did not meet SBA eligibility requirements.

BACKGROUND:

The purpose of this Notice of Finding and Recommendation (NFR) is to inform you of an issue that was identified during our ongoing audit of 7(a) loans disbursed under the American Recovery and Reinvestment Act of 2009 (Recovery Act). As part of this audit, we reviewed 30 lender-approved loans for compliance with SBA's loan origination and closing requirements.

CONDITION:

Lenders approved 3 loans which were not eligible for SBA guaranties. One lender cancelled a portion of an SBA guaranteed loan approved prior to the Recovery Act and, without SBA approval, reissued it as a Recovery Act loan with a higher SBA guaranty. This practice was specifically prohibited by SBA Policy Notice 5000-1103. A second loan was ineligible for an SBA guaranty because (1) it resulted in the borrower's maximum outstanding loan balance exceeding the SBA limit,¹ and (2) the interest rate on the loan was in excess of that allowed by SBA. Finally, a third loan was not eligible for an SBA guaranty because the lender did not comply with SBA's change of ownership requirements. Specifically, the lender did not (1) perform a business valuation, (2) conduct a site visit of the assets being purchased, or (3) verify the seller's financial information. See Appendix I for deficiencies associated with each of the loans.

¹ For this loan, the borrower's maximum outstanding loan balance was a total of the outstanding balances of the borrower's SBAExpress, FA\$TRACK, Community Express, Patriot Express and Export Express loans.

CRITERIA:

SBA Policy Notice 5000-1103, *Recovery Act – Treatment of Cancellations of Loans Approved Prior to the Recovery Act*, states that a loan approved before the passage of the Recovery Act may not be cancelled and resubmitted, except in situations approved by SBA on a case-by-case basis.

SOP 50 10 5(a) states the maximum outstanding loan balance (including any SBAExpress, Community Express, Patriot Express and Export Express loans) that a Community Express loan applicant may have is \$250,000. Furthermore, SBA’s Eligibility Checklist for Community Express loans states that FA\$TRAK loans are also to be considered in the calculation of the applicant’s maximum outstanding loan balance.

SOP 50 10 5(a) states that interest rates on Community Express loans over \$50,000 with maturities of less than 7 years may not exceed the Prime Rate, LIBOR Base Rate, or the SBA Optional Peg Rate plus 2.25 percent.

SOP 50 10 5(a) lists the requirements for a change of ownership transaction. It specifies that the lender’s loan file must include a business valuation that supports the seller’s asking price and documentation of a site visit of the assets being acquired. The SOP also states that in a change of ownership transaction, the lender must obtain the seller’s tax transcripts to verify the seller’s financial information.

CAUSES:

Preferred Lender Program (PLP) and Community Express lenders did not originate loans in compliance with SBA policies and procedures.

EFFECT:

Lenders approved three loans that were ineligible for SBA guaranties. As a result, if the loans are not brought into compliance with SBA’s requirements, the lenders risk losing their SBA guaranties.

PROPOSED RECOMMENDATIONS:

We recommend that the Associate Administrator for Capital Access:

1. Require the lenders to bring each of the loans listed in Appendix I into compliance, or, if not possible, cancel or adjust the SBA guaranties accordingly.
2. Provide training to the lenders identified in Appendix I to prevent similar instances of noncompliance identified in this NFR.

ACTION REQUIRED:

Please provide your management response for each recommendation on the attached SBA Forms 1824, Recommendation Action Sheet, within 80 days from the date of this report. Your response should identify the specific action(s) taken or planned to fully address each recommendation and the target date(s) for completion.

APPENDIX I. INELIGIBLE LENDER APPROVED LOANS

Loan Number	Borrower	Lender	Loan Amount	Deficiency
[FOIA ex. 2]	[FOIA ex. 4, 6]	U.S. Bank	\$54,700	A
[FOIA ex. 2]	[FOIA ex. 4]	Redstone Federal Credit Union	\$200,000	B,C
[FOIA ex. 2]	[FOIA ex. 4, 6]	Commerce Bank	\$18,000	D
Total			\$272,700	

Deficiency Type Legend:

- A. Disallowed Loan Re-Submission
- B. Exceeded Lending Limits
- C. Exceeded Allowable Interest Rates
- D. Change of Ownership- Business Valuation, Site Visit, Financial Verification

APPENDIX II. AGENCY COMMENTS



U.S. Small Business Administration
Washington, D.C. 20416

DATE: January 13, 2010

TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: Eric R. Zarnikow
Associate Administrator for Capital Access

SUBJECT: Draft Notice of Finding and Recommendation on Ineligible Lender-Approved Recovery Act Loans Project No. 9512C

Thank you for the opportunity to comment on the Draft Notice of Finding and Recommendation (NFR) on Ineligible Lender-Approved Recovery Act Loans.

We appreciate that the Office of the Inspector General has given us a quick feedback on Ineligible Lender-Approved Recovery Act loans. In reviewing the three loans we determined that all three loans have issues that may affect their eligibility under SBA policies and procedures. OCA will work with the lenders listed in Appendix I to determine if any adjustments are necessary and will provide training to the lenders on the issues identified in this NFR. Our response to the deficiencies is as follows:

Disallowed Loan Re-Submission (loan ending in [FOIA ex. 2]): The cancellation policy concerning Sections 501 and 502 of the Recovery Act was communicated in Policy Notice 5000-1103 (April 10, 2009). An automated filter to screen for cancellations that are then resubmitted as Recovery Act loans for the same loan/borrower was put into effect around April 17th. A review of the file shows that this loan was made after the filter was put in place. The filter should have rejected this loan from E-Tran and required manual review. However, because the new loan was only for the portion of the pre-ARRA loan that was cancelled, the filter did not treat this loan as a resubmission of a cancelled loan. The original

loan was approved for \$343,500 on February 9, 2009 and the new loan was in the amount of \$54,700. The filter interpreted this as a new loan request.

OCA will discuss this issue with the lender and if the facts surrounding the new loan meet the criteria set out in Policy Notice 5000-1103 the lender will be allowed to keep the higher guaranty. If not, OCA will advise the lender that the guaranty amount will be reduced to 75%. In addition, in order to alleviate the concerns that there may be other similar loans, the Office of Financial Assistance and the Office of Financial Program Operations will review loan data for all loans made between April 10, 2009 and September 30, 2009.

Exceeding Lending Limits and Interest Rate (loan ending in [FOIA ex. 2]): (1) *Lending Limits* - A review of the file shows that the loan may not be in compliance with SBA policy concerning loan limits for Community Express loans because of the outstanding SBA Express loan. However, the SOP is ambiguous as to whether the loan limit applies to SBA Express and Pilot Loan Program loans made more than 90 days apart. On pages 142-146 of SOP 50 10 5(A) there is guidance that indicates that when 7(a) loans are approved more than 90 days from each other the loan balances are not combined. The pertinent provision of the SOP reads as follows:

If two SBA guaranteed loans are approved within 90 days of each other, the maximum gross loan amount of all the loans made in that time frame to any one business (including affiliates) cannot exceed \$2,000,000. (See pg. 142.)

...

The 90-day rule is only for those situations where a borrower is approved for multiple 7(a) loans within a 90-day period. (See pg. 146.)

The lender could have interpreted the SOP guidance to mean it could provide multiple loans to the borrower, including SBA Express and Community Express loans, as long as the loans were not made within 90 days of each other. It should be noted that if the loan had been made under standard 7(a) or PLP procedures, the loan would have been eligible for a 90% guaranty under the Recovery Act.

(2) *Interest Rate* - OCA agrees that the lender exceeded SBA policy on the interest rate applied to this loan. The interest rate ceiling for Community Express was lowered effective October 1, 2008. However, a review of the SOP language concerning interest rates for Pilot Loan Programs indicates an ambiguity in the requirements. While the SOP includes language that states Community Express interest rates are the same as standard 7(a), there is additional language that suggests that Community Express loans are subject to the same interest rate ceilings as SBA Express loans. In addition, it appears that the pricing filter within E-Tran was not updated to reflect the new lower maximum interest rate for Community Express loans. The ambiguity in the SOP language has been

addressed in the current version of the SOP and OCA is currently working to update the pricing filter in E-Tran.

OCA intends to contact the lender to discuss this loan and its other Community Express loans in order to resolve this matter.

Change of Ownership- Business valuation, Site Visit, Financial Verification (loan ending in [FOIA ex. 2]): The borrower's loan application indicates that the loan was for the purpose of purchasing the assets of a business owned by the borrower's mother. The lender did not obtain an independent business valuation, as required by the SOP when there is a close relationship between the buyer and seller. The lender did, however, take liens on the purchased assets and, additionally, the lender also took a lien against the borrower's personal residence. Given the small size of the loan (\$18,000) and the potentially high cost of an independent business valuation, if the lender had verified the seller's income and provided that as justification to request a waiver of the requirement for a business valuation, which would have been considered.

This issue will be discussed with the lender to determine whether the lender has additional information that may affect the outcome.

As we have stated, the issues identified by OIG in this NFR will be addressed. OCA will continue to provide training on the issues that can cause a loan to be ineligible at the time they are approved by the lender and OCA will work to update the filters in E-Tran.