

**AUDIT OF THE LIQUIDATION PROCESS AT
THE NATIONAL GUARANTY PURCHASE
CENTER**

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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: Darryl K. Hairston
Acting Administrator

Date: January 30, 2009

Eric R. Zarnikow
Acting Associate Administrator, Office of Capital
Access

John A. Miller
Director, Office of Financial Program Operations

/s/ **Original Signed**

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Final Report on the Liquidation Process at the National Guaranty Purchase Center
Report No. 9-08

This report presents the results of our audit of the liquidation process for 7(a) loans at the National Guaranty Purchase Center. The Small Business Administration (SBA) guarantees loans that are made by participating lenders. Upon loan default, SBA authorizes participating lenders to continue servicing the account and, should liquidation and/or litigation become necessary, to completely liquidate or sue upon the loan instrument. During the liquidation process, the Center reviews and approves lender actions, as necessary. When no further recovery is expected on a loan, the Center also performs a comprehensive review of the lender's wrap-up report, liquidation plan, and relevant documentation to determine if the lender materially complied with SBA's liquidation requirements.

The audit objectives were to determine if (1) the Center's liquidation process, which culminates in loan charge-off, identified and addressed lender noncompliance with SBA's procedures to mitigate losses, and (2) the Center adequately managed loans in liquidation status.

To address the first objective, we reviewed 54 loans totaling \$6.1 million. The sample was drawn from a universe of 7,120 loans totaling \$696 million that had been charged off between October 1, 2005 and July 31, 2007. We reviewed information in SBA's loan files and documentation from lenders and interviewed

SBA officials to determine whether the Center identified lender noncompliance with SBA's procedures during liquidation and/or charge-off. The loans examined had received purchase reviews prior to the Center's reengineering of the purchase process in fiscal year (FY) 2008. Because we had previously identified weaknesses in SBA's purchase review process in the district offices and at the Center before the purchase process was reengineered, we also examined lender compliance with SBA's loan origination and servicing requirements to determine whether additional repairs and denials should have been made. Any additional repairs or denials resulting from lender noncompliance in these areas would have reduced the amount to be charged off, thereby minimizing SBA's losses. While the purchase process now in place at the Center may have corrected prior deficiencies in the purchase process, it was necessary to review the origination and servicing of the sampled loans that were purchased under the old process to ensure the charged-off amounts were correct.

To address the second objective, we reviewed 60 loans totaling \$15 million that had not been charged off. These loans were statistically sampled from a universe of 9,143 loans totaling \$1.4 billion that were in liquidation between July 31, 2006 and July 31, 2007, and had not undergone a documented liquidation action by the Center during this period. We interviewed lenders and SBA officials, and reviewed SBA loan files, as necessary. For both loan samples, we reviewed data contained in SBA's Loan Accounting System, Guaranty Purchase Tracking System, Centralized Loan Chron System and the Herndon Action Tracking System.

We conducted our audit from June 2007 to September 2008, in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States. A listing of sampled loans is presented in Appendix I, and our sampling methodology is provided in Appendix II.

BACKGROUND

Under Section 7(a) of the Small Business Act, SBA is authorized to provide government-guaranteed loans to small businesses. The loans are made by participating lenders under a Guaranty Agreement that requires them to originate, service, and liquidate loans in accordance with SBA rules and regulations. When loans default, lenders are required to take all liquidation actions and make efforts to obtain the highest possible recovery. Lenders must seek prior written approval by SBA when liquidation actions:

- create a conflict of interest or confer a preference on the lender;

- compromise the principal amount due or waive any claim against a borrower, guarantor, obligor, or standby creditor;
- involve the acquisition of environmentally impaired property in the lender's name, or any property in SBA's name;
- substantially alter the terms of the loan instrument;
- transfer a loan to another lender, or sell or pledge more than 90 percent of a loan, or
- release collateral having a cumulative value exceeding 20 percent of the original loan amount.¹

When an SBA-guaranteed loan is purchased and no further recovery is expected, SBA charges off the loan so that it can recognize the loss. SBA's charge-off process includes a detailed review of the lender's actions regarding the disposition of the loan collateral and pursuit of recovery from the guarantors, along with a review of all related recoveries and expenses. The review is a critical step in the liquidation process because it is the Agency's last opportunity to identify and recover payments that were improperly made as a result of lender noncompliance. In the event of noncompliance, SBA may be released from its liability on a loan guaranty, in full or in part, and may seek recovery from the lender.

In FY 2004, SBA centralized 7(a) purchase and liquidation reviews (excluding Express and Community Express loans) at the National Guaranty Purchase Center in Herndon, VA and significantly reduced staffing for these reviews. By FY 2006, a significant backlog of 6,700 purchased loans in need of charge-off had accrued. To resolve the backlog, SBA initiated a loan charge-off project, using contractors to perform the reviews. During this effort, the Center completed charge-off reviews on 3,949 loans totaling \$372 million in SBA guaranties. Between October 2006 and July 2007, the Center charged off an additional 2,295 loans valued at \$246 million. As of May 2008, the Center had 17,051 loans in its liquidation portfolio valued at \$3 billion.

RESULTS IN BRIEF

Our audit identified \$4 million of improper payments and uncollected amounts resulting from lender noncompliance that was not addressed during purchase or liquidation. Projecting the results from our samples, we estimate that the full value of improper payments and uncollected amounts was at least \$25.6 million. For 21 of the 54 charged-off loans reviewed, the Center's purchase and liquidation

¹ Prior SBA approval for this action is only required for lenders that do not participate in the Preferred Lender Program.

processes did not identify or address lender deficiencies that merited repair or denial of the guaranties for \$1.4 million. These improper payments included \$581,773 that should have been identified during charge-off and \$798,993 that was missed in the purchase review process. We recommended recovery of all but approximately \$.2 million of these payments in a prior report, *Audit of Six SBA Guaranteed Loans*.² Based on the sample results, we estimate that SBA made at least \$23 million in improper payments on the 7,120 loans charged off between October 1, 2005 and July 31, 2007.

The \$581,773 in improper payments was associated with lender deficiencies on 9, or 17 percent, of the loans reviewed. Of this amount, deficiencies totaling \$242,130 were not identified and \$339,643 in deficiencies were not appropriately addressed. These deficiencies included (1) unsupported sales of collateral, (2) inappropriate repair decisions regarding collateral, (3) unsupported Care and Preservation of Collateral (CPC) expenses, and (4) acceptance of inadequate offers in compromise. Lenders also did not reconcile collateral at loan origination and default, making it difficult to determine SBA's losses.

When charging off the loans, the Center also did not reassess lender compliance with loan origination and servicing requirements. While these areas are normally assessed during purchase review, the OIG previously reported that significant deficiencies existed in the Agency's purchase review process.³ Consequently, the loans we reviewed also had loan origination and servicing deficiencies that resulted in \$798,993 of improper payments. Although SBA has since reengineered its purchase process to correct many of the deficiencies the OIG previously identified, approximately 4,200 loans that were purchased under the old process have yet to be charged off.

The audit also disclosed that when the purchase or charge-off reviews identified deficiencies, the Center did not always take appropriate action to mitigate its losses. For example, the Center accepted a \$206,612 repair on a \$546,255 loan guaranty that should have been denied in full based on the lender's failure to disclose that the loan was collateralized with contaminated property.

Many factors contributed to the inadequate loan reviews. Chief among them was the lack of management emphasis on oversight based on the placement of the Center under the Office of Capital Access. According to loan officers, Center management promoted honoring the guaranties rather than holding lender's accountable for noncompliance. Additionally, contract staff hired to conduct

² OIG Report Number 8-18, *Audit of Six SBA Guaranteed Loans*, May 22, 2008.

³ OIG Report Number 3-15, *Audit of the Guaranty Purchase Process*, March 17, 2003.

OIG Report Number 7-23, *Audit of the Guaranty Purchase Process for Section 7(a) Loans at the National Guaranty Purchase Center*, May 8, 2007.

charge-off reviews were not adequately trained or supervised. Because the contractors were unfamiliar with SBA's liquidation requirements, they frequently missed deficiencies and did not seek additional support from the lenders when documentation in the loan files was inadequate to demonstrate compliance.

Finally, our review of 60 inactive loans disclosed that 46, or 77 percent, were in liquidation status for an average of 3 years and were not properly monitored to determine whether (1) improper payments and liquidation proceeds due SBA had been recovered, (2) loans were charged off or removed from the portfolio when appropriate, or (3) outstanding loan balances were correct. As a result, the Center did not timely recover approximately \$2.6 million in improper payments and liquidation proceeds, timely charge-off or remove 44 loans from the liquidation portfolio, or correctly report the outstanding balances on two loans. Based on the sample results, we estimate that at least 6,034 loans in liquidation as of July 31, 2007 had overstated values of at least \$324 million.

Loans in liquidation status were not properly managed because the Center focused most of its resources on purchase activities as it was insufficiently staffed and under pressure by lenders to expediently pay guaranties. Further, SBA did not have a portfolio management system to identify when actions were needed on loans. Center officials have recently developed an in-house application to identify and address loans requiring liquidation action. However, it excludes loans that have not been purchased and lacks the proper controls to ensure data integrity. Furthermore, adequate resources were not assigned to address loans needing action.

We recommended that SBA establish a separate office outside of the Office of Capital Access to be responsible for all lender oversight functions, including the purchase and liquidation activities performed at the Center, or transfer these responsibilities to the Office of the Chief Financial Officer. Additionally, we recommended that SBA recover improper payments and uncollected liquidation proceeds identified by the audit, ensure charge-off reviews are properly supervised and all required documentation is obtained from lenders, and revise its SOP to provide clearer guidance on collateral valuations. To better manage its liquidation portfolio, we recommended that SBA further enhance the Center's newly designed portfolio management system to include the appropriate controls and ensure the appropriate resources are assigned to address loans needing action. Finally, we recommended that SBA perform periodic reviews of non-purchased loans in liquidation to ensure they are removed from the portfolio when appropriate and their outstanding balances are correct.

Management strongly disagreed with our recommendation to establish a separate office for oversight outside of the Office of Capital Access. In addition, they disagreed that removing non-purchased loans from the portfolio merited sufficient

priority to redirect resources. They also made no commitment to recover the improper payments identified by the audit, did not acknowledge insufficient contractor oversight, and only partially agreed with our other recommendations.

RESULTS

The Center's Liquidation Process Did Not Adequately Identify or Address Lender Deficiencies

The charge-off review, which focuses on lender liquidation actions, is a critical step in the liquidation process because it is the Center's last opportunity to identify improper payments made as a result of lender noncompliance. The Center staff, however, missed liquidation deficiencies on 17 percent of the 54 loans we reviewed, resulting in \$581,773 in improper payments. Of this amount, \$242,130 was not identified or addressed prior to loan charge-off and \$339,643 resulted from an inadequate repair on one loan. Further, when charging off these loans, the Center did not identify \$798,993 of improper payments associated with loan origination and servicing deficiencies that were missed during the purchase reviews of these loans. In total, approximately \$1.4 million in deficiencies was not identified during the charge-off reviews. Based on these results, we estimated that at least \$23 million in improper payments occurred on the 7,120 loans charged off between October 1, 2005 and July 31, 2007. A listing of loans with lender deficiencies is provided in Appendix III.

\$242,130 in Material Lender Liquidation Deficiencies Were Not Identified or Addressed Prior to Loan Charge-off

The audit disclosed that 8, or 15 percent, of the loans we reviewed had liquidation deficiencies that should have resulted in repairs or denials totaling \$242,130. As shown in Table 1, the majority of deficiencies involved collateral sales that were not adequately documented or supported in the SBA loan files.

Table 1. Material Liquidation Deficiencies in 8 Loans

Deficiency Area	Improper Payments Associated with Deficiency*
Collateral Sale	\$217,525
Application of Care and Preservation of Collateral Expenses	\$1,520
Offers in Compromise	\$23,085
Total Liquidation Deficiencies	\$242,130

Source: SBA loan files

*Because loans had deficiencies in multiple areas, improper payments have been quantified for each deficiency and have not been double counted.

When an SBA loan defaults, the lender must make every effort to obtain the highest possible recovery. In doing so, the lender must inventory, assess, and properly justify the disposition of the loan collateral to ensure that the highest possible recovery was achieved. However, we identified five loans where the lender did not maximize recovery from the sale of collateral, causing \$217,525 of losses to SBA. This occurred, in part, because Center loan officers were reluctant to challenge collateral recoveries obtained by lenders as SOP 50 51 2 does not provide accurate liquidation values for many types of collateral. For example, the SOP establishes that all machinery and equipment be assessed at 50 percent of the fair market value, regardless of the actual rate of recovery on the foreclosed collateral. Consequently, motor vehicles and restaurant equipment were equally assessed at a 50-percent recovery rate, even though restaurant equipment generally has a much lower actual rate of recovery. Taking this into account, it was difficult for loan officers to determine whether lenders maximized recoveries and to identify amounts that should have been repaired. Therefore, SBA will need to revise liquidation recovery rates in the SOP to reflect the forced sale liquidation values related to the various types of collateral used to secure SBA loans.

The Center Did Not Take Appropriate Action to Address Liquidation Deficiencies on One Loan

The Center also did not make the appropriate repair decision on one loan, resulting in a \$339,643 loss to SBA. SOP 50 51 (2) states that SBA should not agree to a repair if the settlement amount is insufficient to compensate the Agency for its losses or if the lender's actions are sufficiently serious that a full denial of liability is warranted. Despite this requirement, the Center accepted a repair that was insufficient to compensate the Agency for its loss.

The \$546,255 loan guaranty should have been denied in full because the lender did not disclose that the loan was collateralized by contaminated property. While the initial purchase review conducted in an SBA District Office recommended full denial of the guaranty, in the spirit of cooperation with the lender, the Center accepted a repair of \$206,612, resulting in a \$339,643 loss to SBA. During the post-purchase and charge-off reviews, the Center did not seek recovery of the entire guaranty from the lender. Therefore, we are considering this to be a deficiency in the Center's liquidation process.

The Center's Loan Charge-Off Reviews Did Not Revisit Lender Origination and Servicing Actions

In March 2003 and May 2007,⁴ the OIG reported that the purchase process that was in place at the district offices and the Center when it was first established did not identify many lender compliance issues, which resulted in significant losses due to improper payments. Despite the Center's awareness of the deficiencies, it did not reassess lender compliance with loan origination and servicing requirements at loan charge-off for loans purchased prior to the reengineering of the Center's purchase process. Consequently, the Center missed \$798,993 in improper payments that were associated with 13, or 24 percent, of the 54 charged-off loans reviewed. For example:

- One loan, which defaulted less than 6 months after disbursement, exhibited obvious indications of fraud that went undetected by the lender and SBA. The support accepted by the lender for equity injection consisted of cashier checks that were issued after loan disbursement and a bank-issued letter that appeared to have been altered. Additionally, the appraisal of the real property collateral appeared to be significantly overstated. Had these issues been further investigated during charge-off, a \$639,717 loss to SBA would have been prevented.
- One lender provided documentation that only supported \$21,000 of the required \$61,750 of the borrower's equity injection. However, the loan officer gave the lender credit for an additional \$20,000 equity injection based on a document that did not show the source of the deposit or identify the account to which the funds had been deposited.
- Another lender disbursed \$21,000 of loan proceeds for the purchase of inventory directly to the borrower rather than the vendors via joint payee checks, as required by SBA Form 1050, *Settlement Sheet*. There was no evidence that the inventory was ever purchased.

Had the Center implemented the appropriate controls to revisit common origination and servicing risk areas during the charge-off reviews, improper payments could have been identified and recovered.

Management Promotes Honoring Guaranties Rather than Holding Lenders Accountable for Noncompliance

Management placed a higher priority on its lender relations by honoring guaranties rather than holding lenders accountable for compliance with SBA requirements.

⁴ OIG Report Number 3-15, *Audit of the Guaranty Purchase Process*, March 17, 2003; and OIG Report Number 7-23, *Audit of the Guarantee Purchase Process for Section 7(a) Loans at the National Guaranty Purchase Center*, May 8, 2007.

This and prior OIG audits have identified multiple instances where the Center was reluctant to deny or repair guaranties when lenders were clearly in violation of Agency requirements. Management's focus on lender relations also resulted in the Center directing the majority of its resources to purchase activities. For example, the Center allowed loans that were purchased from the secondary market to sit for many years without a post-purchase review, until the backlog of loans awaiting review had grown to 3,500 by the end of March 2007. As discussed later in this report, loans also sat in liquidation for several years without being monitored or properly managed by the Center.

The Center's priorities are determined by the Office of Financial Assistance, (OFA), which resides within the Office of Capital Access (OCA). These two offices, however, have responsibilities that conflict with the oversight role of the Center. OFA and OCA act as advocates for small businesses and the lending companies that provide SBA guaranteed loans. Its primary goal is to grow the Agency's loan portfolio and to maintain good lender relationships.

In contrast, the Center is responsible for timely processing guaranty purchase requests, providing oversight of lenders during loan liquidation, and timely charging off loans. Both the guaranty purchase and charge-off processes are oversight activities that involve evaluating lender compliance with SBA's requirements and pursuing the denial or repair of guaranties when noncompliance is found. However, these activities have been adversely influenced in the past by OCA's emphasis on maintaining lender participation and responding timely to lenders' purchase requests. The recent decline in lender participation will only serve to increase the conflict between OCA's role as an advocate for lenders and the Center's mission of providing oversight and enforcing lender compliance. Therefore, the Center's placement within OFA, and ultimately OCA, has left it without the organizational independence needed to effectively execute its oversight responsibilities.

Contractor Staff Conducting the Charge-Off Reviews Were Not Properly Trained or Supervised

In addition to the lack of management emphasis on oversight, we found that appropriate management attention was not given to training and supervising the contractors performing the majority of the charge-off reviews to ensure that lender compliance was appropriately evaluated, as required by Agency procedures. In March 2006, SBA began using an outside firm to perform reviews of loans awaiting charge-off. The contractors reviewed many of the 7,120 loans in our audit universe. These inexperienced contractors did not receive formal training and learned about SBA's liquidation requirements by reading Agency procedures and asking questions of Center officials as they reviewed files. Interpreting

Agency procedures was also difficult given that the procedures were extensive, complex, and not always clearly conveyed.

While the Center realized that the contractor staff was unfamiliar with the Agency's requirements, it did not properly review their work to correct mistakes. Contractors were assigned to senior SBA loan officers who acted as mentors, but the contractors stated that these mentors had their own responsibilities and sometimes were not helpful. Additionally, our audit did not find evidence that contractor's charge-off findings were questioned or reversed by Center officials, even when material lender noncompliance was apparent. Because the contractors were not properly supervised, charge-off findings were sometimes based on incomplete documentation and unsupported lender statements. To address these issues, the Center will need to ensure that charge-off reviews are properly supervised and all required documentation is obtained.

The Center Did Not Adequately Manage its Liquidation Portfolio

SOP 50 51 (2) requires quarterly reviews of loans more than 180 days in liquidation status. These reviews help ensure that (1) improper payments and liquidation proceeds due SBA have been recovered, (2) loans are charged off or removed from the portfolio when appropriate, and (3) outstanding loan balances are correct. However, since the liquidation function was centralized in FY 2004, the Center has not adequately monitored loans in liquidation. For instance, the Center had not documented a liquidation action for 1 year or more on 9,143 loans that were in liquidation status as of July 31, 2007. These loans had been in liquidation for an average of 3 years with many of the loans in liquidation for 6 years or more.

Additionally, many of the loans purchased from the secondary market had not received post-purchase reviews, even though as much as 7 years had passed since the date of purchase. This review must take place before SBA can charge-off the loan. As of March 2007, the Center had a backlog of approximately 3,500 loans requiring post-purchase reviews. Since that time, the Center has significantly reduced the backlog, and expects it to soon be resolved.

Of the 60 loans we reviewed, 46, or 77 percent, were in liquidation status for an average of 3 years and were not properly monitored. Also, 19 of the 25 loans purchased from the secondary market did not receive timely post-purchase reviews. As a result, the Center did not:

- Timely recover \$2.6 million in improper payments and liquidation proceeds;

- Timely charge-off or remove 44 of the 60 loans from the liquidation portfolio; or
- Correctly report the outstanding balances on two loans.

Based on the sample results, we estimate that at least 6,034 of the 9,143 inactive loans, valued at \$1.4 billion, that were in liquidation as of July 31, 2007, had overstated values of at least \$324 million in SBA's Loan Accounting System.

The Center Did Not Timely Pursue Over \$2.6 Million in Recoveries of Improper Payments and Liquidation Proceeds

As shown in Table 2 below, the Center did not recover over \$2.5 million of improper payments made on 5 loans or pursue almost \$68,000 of liquidation proceeds owed to SBA on 4 loans.

Table 2. Loans Needing Recovery

Loan Number	Amount
Improper Payments	
[FOIA Ex. 2]	\$79,622
[FOIA Ex. 2]	\$810,518
[FOIA Ex. 2]	\$41,697
[FOIA Ex. 2]	\$733,231
[FOIA Ex. 2]	\$881,333
Subtotal	\$2,546,401
Liquidation Proceeds Owed	
[FOIA Ex. 2]	\$670
[FOIA Ex. 2]	\$26,328
[FOIA Ex. 2]	\$30,000
[FOIA Ex. 2]	\$10,785
Subtotal	\$67,783
Total	2,614,184

Source: SBA's Guaranty Purchase Tracking System, Centralized Loan Chron System, and Loan Accounting System

Loan officers had documented material lender deficiencies justifying repair or denial of the SBA guaranty on the five loans, but the Center did not adequately pursue recovery from lenders for many years. For example, the Center did not timely complete a post-purchase review and pursue an \$881,333 improper payment made on one loan because the lender was uncooperative in submitting requested documents.

The Center also did not collect outstanding liquidation proceeds on four loans. For example, the Center documented that lenders had not submitted SBA's share of liquidation proceeds totaling \$56,328 on two loans, but did not enforce collection. In one case, the liquidation proceeds remained uncollected for over 4

years. In response to our audit, however, the lender submitted the proceeds to SBA. For the remaining two loans, the Center neither identified nor collected \$11,455 of liquidation proceeds.

The Center Did Not Timely Charge Off or Remove Loans from the Liquidation Portfolio

The Center did not timely charge off or remove 44 of the 60 loans we reviewed from the liquidation portfolio and incorrectly reported the balances on two additional loans. Of the 44 loans, 23 loans were not charged off after lenders determined that no further recoveries were expected. For nearly 75 percent of these loans, charge-off was delayed by 3 or more years. When charge-off occurs, SBA makes an accounting adjustment, removing the loan balance from accounts receivable and recognizing it as a loss. However, because these 23 loans were reported as being in liquidation, SBA's accounts receivable balance was overstated, and losses were understated, by \$5.1 million as of July 31, 2007. Additionally, untimely charge-offs can result in delayed referral of borrowers to the Department of Treasury, in violation of the Debt Collection Improvement Act.

We also identified another 21 loans that should not have been included in the liquidation portfolio. These were loans that had not been purchased and either exceeded their maturity by 180 days,⁵ had been fully paid by the borrowers, or the lenders had no intention of requesting guaranty purchase. As a result, the inclusion of these loans distorts the accuracy of the number and value of loans in the liquidation portfolio. Furthermore, because lender risk ratings are calculated using the "loan status" and "outstanding loan balance" reported in the Loan Accounting System, lender risk ratios may be distorted and Agency responses to Congressional and Freedom of Information Act requests may be inaccurate. Therefore, the balances of these loans should be removed from SBA's accounting records. Finally, the Center did not identify overstated balances on two loans that occurred as a result of the misapplication of loan payments.

Based on the untimely charge-offs and inaccurate reporting of loan status and balances identified in the sample, we estimate that 6,034 of the 9,143 inactive loans, valued at \$1.4 billion, that were in liquidation as of July 31, 2007, had overstated values of at least \$324 million in SBA's Loan Accounting System.

⁵ 13 CFR 120.524(a)(8) states that SBA is released from its guaranty if the lender failed to request purchase within 180 days after maturity of the loan.

SBA Lacked Adequate Staffing and a Portfolio Management System to Identify Actions Needed on Loans in Liquidation

The Center did not take action on the loans in liquidation primarily because staffing had been reduced by 85 percent when the liquidation activity was centralized. When purchase and liquidation operations were transferred to the Center, only 40 of the 266 individuals performing these functions were assigned to the Center. Staffing levels remained low until the FY 2008 reengineering of the purchase process. The staff reduction, combined with pressure from the lenders to expediently pay guaranties, resulted in the Center devoting the majority of its resources to guaranty purchase activities. Because fewer staff worked on liquidation activities, loans were not assigned to a single loan officer for monitoring throughout the loan's liquidation cycle as they had been in the past. This made monitoring of the Center's liquidation portfolio more difficult and increased the opportunity for loans to be overlooked.

Additionally, the Center lacked an adequate automated system to alert managers of actions needed on loans. While the Center maintained a database to track actions taken on loans in liquidation, it only accounted for purchased loans and did not adequately track or report on actions needed. Center officials acknowledged that they lacked the tools and resources necessary to manage the liquidation portfolio and have recently developed an in-house application to identify and address loans requiring liquidation actions. We believe the new application could provide the Center with the information needed to manage its liquidation portfolio, but the application does not include non-purchased loans and needs proper controls to ensure data integrity. Furthermore, the appropriate resources need to be assigned in order to address loans needing action.

In May 2007, SBA issued a regulation directing lenders to liquidate loans prior to requesting guaranty purchase, which would require the Center to review most liquidation actions at the time of purchase. However, many loans are exempt from this requirement, including those purchased from the secondary market, those with real property collateral, and those involving borrowers that have filed for bankruptcy protection and at least 60 days has elapsed since the last full installment payment. Consequently, management of the liquidation portfolio will continue to be an important function of the Center.

RECOMMENDATIONS

We recommend that the Acting Administrator:

1. Establish an office within the Agency that is separate from the Office of Capital Access to be responsible for all lender oversight functions,

including those performed at the National Guaranty Purchase Center, or transfer these responsibilities to the Office of the Chief Financial Officer.

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

2. Recover approximately \$2.8 million of improper payments and liquidation proceeds from lenders on the 24 loans identified in Appendices IV and V.
3. Direct the Center to ensure that charge-off reviews are properly supervised and all required documentation is obtained from lenders.
4. Revise liquidation recovery rates in SOP 50 51 (2) to reflect the forced sale liquidation values related to the various types of collateral used to secure SBA loans.
5. Further enhance the Center's newly designed portfolio management system to include the appropriate controls and ensure the appropriate resources are assigned to address loans needing action.
6. Perform periodic reviews of non-purchased loans in liquidation to ensure they are removed from the portfolio when appropriate and their outstanding balances are correct.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On December 17, 2008, we provided a draft of this report to SBA for comment. On January 16, 2009, SBA submitted its formal comments, which are contained in their entirety in Appendix VI. Management disagreed with several of the report findings and emphasized that improvements made in the purchase process have addressed many of the issues identified in the report. Additionally, OCA disagreed with recommendations 1 and 5, but proposed alternative actions; neither agreed nor disagreed with recommendations 2 and 4; and partially agreed with recommendations 3 and 6. Specific management comments on the report findings and recommendations, and our evaluation of them, are summarized below.

Management Comments

Comment 1

Management stated that the findings and recommendations in the report were similar to those mentioned in six other audits of the Center, did not reflect the state of the Center today, and revealed nothing new that OCA and OFA management

had not already acknowledged and set about to correct. OCA believes it took significant and successful steps to address staffing and management issues at the Center, with a reengineering effort focused on transforming the Center's processes and operations that began in July 2007.

OIG Response

We disagree with management's assessment that the audit was similar to previous OIG audits and did not identify new issues. Previous audits of the Center focused on the purchase review process, while this audit evaluated the Center's liquidation process. As a result, the audit revealed issues with the Center's liquidation process, including improper payments resulting from inappropriate collateral sales, unsupported CPC expenses, and acceptance of an inadequate offer in compromise. Furthermore, our audit revealed that SBA did not properly supervise contractor liquidation reviews, monitor loans in liquidation to determine whether recoveries due SBA had been submitted, and timely charge off or remove loans from the portfolio when appropriate to ensure outstanding loan balances were correct. None of these issues were discussed in previous reports.

Although this report addresses the liquidation process, management directed its comments almost exclusively to improvements made in purchase operations, which was outside the scope of the audit. Consequently, management incorrectly believes that it has corrected many of the problems identified by the audit. While we understand that some of the issues we identified can be addressed through an improved purchase process, others are specific to the liquidation process, such as collateral liquidation, and need to be addressed through stricter vigilance in managing the liquidation portfolio and conducting charge-off reviews.

What we believe may be similar to previous audits is our ongoing concern with lender oversight functions being organizationally placed within OCA, whose mission is to increase small business access to capital through expanding lender participation. We previously reported our concern that the placement of the Office of Credit Risk Management under OCA presented a potential conflict between the desire to encourage lender participation in SBA loan programs and the need to evaluate lender performance and take enforcement action. The Center's placement under OFA presents a similar conflict of interest issue.

Comment 2

OCA took exception to several statements in the report that assert that management does not emphasize oversight and promotes honoring guaranties over compliance and accountability. It also believes the assertion is based on anecdotal evidence rather than fact. Management stated that OCA recently reorganized, separating financial program operations (including Center operations) from OFA, and believes that communication between these key offices can only be achieved

if housed within OCA. Management also believes that the OIG made an unsubstantiated inference that a different organizational location for these functions would overcome problems that fundamentally arose from a lack of adequate resources.

OIG Response

We disagree that our statements are based on anecdotal evidence. Instead they stem from the Center's continued reluctance to pursue recovery of improper payments when there is clear evidence of lender noncompliance, and the investment of resources in pre-purchase activities that provide lenders with increased capital at the expense of enforcing lender compliance. For example, from 2003 to 2008, we recommended that that SBA recover over \$15 million based on lender noncompliance. OCA delayed resolution of many of these cases. In one case, OCA's delay caused the statute of limitations to be exceeded, thereby eliminating the opportunity for recovery. In our audit, we also reported that although an SBA loan officer originally recommended full denial of a loan guaranty, in the spirit of cooperation with the lender, the Center accepted an inadequate repair, resulting in a \$339,643 loss to SBA. Additionally, loan officers had documented material lender deficiencies justifying repair or denial of guaranties on five loans, but did not pursue recoveries from the lenders.

Furthermore, when faced with staffing constraints, management placed a higher priority on conducting pre-purchase loan reviews rather than post-purchase reviews of loans that were at higher risk of improper payments. This approach ensured that SBA guaranties were honored timely so that lenders could be promptly paid, but delayed reviews of loans purchased from the secondary market to identify improper payments.

Comment 3

Management stated that our report encouraged SBA to focus significant recovery efforts on old cases where many of the lenders believed any obligation to SBA had been satisfied. Management believes that recent reengineering of the purchase process at the Center demonstrates OCA's commitment to quality standards. They indicated that the last phase of this effort was completed in November 2008 and included a thorough review of every loan in the liquidation inventory to assess current status, identify loans eligible for charge-off, and record information in the Liquidation Management System.

OIG Response

We agree that our report encourages SBA to seek recovery of improper payments on guaranties which were purchased inappropriately. Many of these loans are old because they sat for years at the Center without a purchase or charge-off review.

The Improper Payment Act of 2002 and OMB's implementation guidance requires all Federal agencies to identify improper payments and to take actions to recover them. In its comments, OCA recognized it must balance the need for lender supervision with providing access to capital for small businesses. However, if management was achieving this balance, we would expect to see a more concerted effort by OCA to recover improper payments and less of a focus on meeting lender demands. OCA's reluctance to pursue improper payments supports our position that OCA sees its primary role as that of lender advocate, rather than a steward of taxpayer funds.

We commend management for recently completing a thorough review of every loan in the Center's liquidation inventory. This is an important first step in ensuring compliance. However, the achievement, in itself, is not sufficient. We hope that, if improper payments are identified, OCA would take the appropriate steps to recover them, despite the age of the loans, especially where the improper payment is significant.

Comment 4

Management stated that it secured funding for several contractor loan specialists with liquidation experience to work on-site at the center and used personnel with extensive liquidation experience from two centers and several district offices to perform charge-off reviews. Management has stated that it provided both classroom instruction and hands-on training to contractors and closely monitored their progress. Therefore, management believes it is not accurate to say the staff was inadequately trained or supervised.

OIG Response

We disagree that management provided appropriate oversight and training of contractor employees. According to the contract staff we interviewed, many of the contractors did not have commercial lending or financial backgrounds and claimed they learned how to perform charge-off reviews by reading Agency procedures and asking questions as they reviewed files. Contractors also told us that while mentors were assigned to assist them, these mentors were not always helpful. If management had properly supervised the contractors, it would have identified the deficiencies we noted in the audit. Finally, we saw no evidence that charge-off findings made by the contract staff were ever questioned or reversed by Center officials, even when material lender noncompliance was apparent.

Comment 5

Management stated that it was aware of the importance of accurately classifying loans and complying with the Debt Collection Improvement Act and therefore, in

October 2005, began a concerted effort to review and properly classify all purchased loans that were considered ready for charge-off.

OIG Response

While we commend OCA on its effort to properly classify all purchased loans that were ready for charge-off between October 2005 and September 2006, we reviewed 60 loans in liquidation as of July 2007, and found that most were not properly classified. Additionally, we found that loans were not timely charged off and recoveries and improper payments remained uncollected. Therefore, we continue to support our position that OCA has not rectified the problem and that loans in liquidation must be regularly monitored to ensure proper loan classification and compliance with the Debt Collection Improvement Act.

Recommendation 1

Management's Comments

Management strongly disagreed and offered an alternative action for this recommendation. It believes the recent reorganization of OCA helps to bolster management and leadership in its operations and oversight functions by separating the Center from OFA and placing it within the newly established Office of Financial Program Operations (OFPO).

OIG Response

We commend OCA for removing Center operations from OFA, where it clearly conflicted with OFA's mission. While we have reservations about whether OCA will provide the resources and management direction needed to recover improper payments where warranted, OCA's action is sufficient to address this recommendation at this time. We will review Center activities in the future to determine whether placement of the Center under OFPO provides the organizational resources and independence needed to effectively execute the oversight responsibilities of the Center.

Recommendation 2

Management Comments

Management stated it would review the underlying loans and obtain recoveries where appropriate, and will provide the OIG a summary of its decisions.

OIG Response

Management's comments were not responsive to this recommendation. On October 21, 2008, we provided the Center detailed deficiency summaries of the 24

loans, which we believe permitted it sufficient time to make a recovery determination on the loans. We also conducted numerous meetings with Center officials to discuss our findings and answer questions, and revised our report where necessary. Based on these discussions, the Center agreed with the majority of our findings and to pursue recoveries. Therefore, it is unclear why management now believes it needs more time to make a decision. We also believe that OCA's response exemplifies its reluctance to pursue recovery when there is clear evidence of noncompliance and its continuing emphasis on honoring guaranties over accountability. Management also needs to provide a target date for taking recovery actions.

Recommendation 3

Management Comments

Management indicated that actions have already been taken to ensure charge-offs are properly supervised and that the required documentation is obtained from lenders.

OIG Response

While management has trained Center staff, as discussed previously, it has not taken sufficient actions to ensure that contract staff are properly supervised. Therefore, we do not believe that management's comments fully address the recommendation. Management also needs to provide a target date to sufficiently address this recommendation.

Recommendation 4

Management Comments

Management stated that it will consider revising forced sale liquidation recovery rates in SOP 50 51, which is currently being re-written.

OIG Response

Although management agreed to this recommendation during the exit conference, its formal comments do not address what actions it plans to take to address the recommendation. Consequently, we consider management's comments to be unresponsive. Management also needs to provide a target date to sufficiently address this recommendation.

Recommendation 5

Management Comments

Management stated there would not be a significant development effort on the Herndon portfolio management system because it is reengineering its Loan Liquidation Tracking System (LLTS) through the Loan Management Accounting System (LMAS) project. However, management agreed to add additional security protocols to the current system. As an interim measure, management stated it is improving its lender liquidation portfolio reporting process through a new project started in January 2009, which will help place the reporting burden on the servicing lenders instead of Center staff.

OIG Response

Management disagreed with the recommendation to further enhance the current system, but proposed an alternative solution. As the LMAS project is not expected to be completed until 2012, waiting for the modernization of LLTS does not address the current system's shortcomings. While management offered an interim measure, it did not provide sufficient detail on how this measure will correct the identified problems. Furthermore, target dates for completion were not provided.

Recommendation 6

Management Comments

Management agreed to perform periodic data analysis on non-purchased loans in its portfolio to check for loans that should be removed. However, management stated it would be a lower priority activity and loans will be removed as resources allow.

OIG Response

Management partially agreed with the recommendation, but did not specify how and when the periodic reviews will be performed and loans removed from the portfolio. Management needs to provide a target date to sufficiently address this recommendation.

ACTIONS REQUIRED

Because your comments did not fully address recommendations 2, 3, 4, 5, and 6, we request that you provide a written response providing additional details and target dates for implementing the recommendations within 2 weeks from issuance of this report. If a timely response is not received, these recommendations will be

pursued through the audit resolution process and reported in our Semiannual Report to Congress as lacking a management decision.

We appreciate the courtesies and cooperation of the OCA, OFA, and Center officials during the audit. If you have any questions concerning this report, please call me at (202) 205-[FOIA Ex. 2], or Debra Mayer at (202) 205-[FOIA Ex. 2].

APPENDIX I. SAMPLED LOANS

Loans Charged Off

#	Loan Number	Borrower	Guaranty Paid	Amount Charged Off	Charge-Off Fiscal Year
1	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$74,254	\$51,249	2006
2	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$72,047	\$2,360	2006
3	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$749,701	\$339,643	2006
4	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$182,635	\$161,935	2006
5	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$174,132	\$174,132	2007
6	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$537,217	\$534,110	2007
7	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$29,321	\$29,321	2007
8	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$51,982	\$51,982	2006
9	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$29,693	\$23,085	2006
10	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$106,831	\$61,261	2006
11	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$65,874	\$65,874	2006
12	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$87,373	\$87,373	2006
13	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$172,241	\$172,241	2006
14	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$96,429	\$53,334	2006
15	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$102,336	\$102,336	2006
16	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$81,738	\$91,846	2007
17	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$51,287	\$51,287	2007
18	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$63,175	\$54,241	2007
19	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$140,827	\$60,543	2006
20	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$16,302	\$16,302	2007
21	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$96,259	\$89,767	2006
22	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$8,045	\$8,045	2006
23	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$50,577	\$50,577	2006
24	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$133,713	\$133,713	2006
25	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$38,714	\$38,714	2006
26	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$224,512	\$224,512	2006
27	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$25,385	\$22,148	2006
28	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$65,101	\$65,101	2006
29	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$145,006	\$123,065	2006
30	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$3,950	\$3,950	2006

#	Loan Number	Borrower	Guaranty Paid	Amount Charged Off	Charge-Off Fiscal Year
31	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$139,831	\$139,831	2006
32	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$62,329	\$62,329	2006
33	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$54,572	\$54,572	2006
34	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$77,121	\$77,242	2006
35	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$156,929	\$156,929	2006
36	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$26,094	\$26,094	2007
37	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$40,000	\$40,000	2006
38	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$101,078	\$87,799	2006
39	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$558,003	\$550,950	2006
40	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$193,330	\$42,703	2007
41	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$79,944	\$79,944	2006
42	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$48,361	\$48,361	2006
43	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$127,015	\$127,015	2006
44	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$415,014	\$415,014	2006
45	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$749,412	\$639,717	2007
46	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$10,693	\$4,085	2006
47	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$44,944	\$44,944	2006
48	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$22,616	\$22,616	2007
49	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$371,472	\$267,656	2007
50	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$41,776	\$41,776	2006
51	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$176,377	\$107,754	2007
52	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$52,816	\$52,816	2006
53	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$33,258	\$33,258	2006
54	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$84,773	\$64,292	2007
	Totals		\$7,344,415	\$6,131,744	

Loans in Liquidation

#	Loan Number	Date Transferred to Liquidation	# of Years Spent In-Liquidation as of 7/31/2007	SBA Share of Outstanding Gross Amount as of 7/31/2007
1	[FOIA Ex. 2]	1/12/2000	7.6	\$46,133
2	[FOIA Ex. 2]	4/6/2000	7.3	\$260,677
3	[FOIA Ex. 2]	9/11/2000	6.9	\$45,559
4	[FOIA Ex. 2]	3/23/2000	7.4	\$483,689
5	[FOIA Ex. 2]	5/3/1999	8.2	\$656,935
6	[FOIA Ex. 2]	11/16/1999	7.7	\$10,722
7	[FOIA Ex. 2]	8/11/1997	10.0	\$10,284
8	[FOIA Ex. 2]	8/10/2000	7.0	\$13,406
9	[FOIA Ex. 2]	9/7/1999	7.9	\$37,139

#	Loan Number	Date Transferred to Liquidation	# of Years Spent In-Liquidation as of 7/31/2007	SBA Share of Outstanding Gross Amount 7/31/2007
10	[FOIA Ex. 2]	11/10/1999	7.7	\$22,800
11	[FOIA Ex. 2]	7/5/2000	7.1	\$125,033
12	[FOIA Ex. 2]	5/14/1998	9.2	\$57,498
13	[FOIA Ex. 2]	12/14/2000	6.6	\$748,037
14	[FOIA Ex. 2]	12/15/1998	8.6	\$35,927
15	[FOIA Ex. 2]	8/8/2000	7.0	\$26,497
16	[FOIA Ex. 2]	11/8/2000	6.7	\$16,714
17	[FOIA Ex. 2]	9/30/1999	7.8	\$62,006
18	[FOIA Ex. 2]	3/31/1998	9.3	\$171,773
19	[FOIA Ex. 2]	1/29/1997	10.5	\$178,627
20	[FOIA Ex. 2]	7/10/2000	7.1	\$63,290
21	[FOIA Ex. 2]	1/26/2000	7.5	\$79,622
22	[FOIA Ex. 2]	4/28/2000	7.3	\$15,000
23	[FOIA Ex. 2]	5/10/1999	8.2	\$66,250
24	[FOIA Ex. 2]	12/15/1999	7.6	\$810,518
25	[FOIA Ex. 2]	10/25/2000	6.8	\$674,279
26	[FOIA Ex. 2]	7/20/2000	7.0	\$743,285
27	[FOIA Ex. 2]	8/18/2000	7.0	\$693,892
28	[FOIA Ex. 2]	5/8/2000	7.2	\$506,196
29	[FOIA Ex. 2]	8/11/2000	7.0	\$613,338
30	[FOIA Ex. 2]	4/21/2003	4.3	\$70,136
31	[FOIA Ex. 2]	3/12/2004	3.4	\$22,541
32	[FOIA Ex. 2]	5/10/2005	2.2	\$19,846
33	[FOIA Ex. 2]	7/28/2006	1.0	\$70,840
34	[FOIA Ex. 2]	5/8/2006	1.2	\$1
35	[FOIA Ex. 2]	3/16/2005	2.4	\$162,315
36	[FOIA Ex. 2]	3/2/2005	2.4	\$120,232
37	[FOIA Ex. 2]	4/18/2006	1.3	\$141,077
38	[FOIA Ex. 2]	12/12/2005	1.6	\$480,576
39	[FOIA Ex. 2]	10/24/2005	1.8	\$24,115
40	[FOIA Ex. 2]	7/20/2004	3.0	\$103,889
41	[FOIA Ex. 2]	10/22/2002	4.8	\$32,317
42	[FOIA Ex. 2]	1/26/2006	1.5	\$84,205
43	[FOIA Ex. 2]	12/26/2002	4.6	\$14,939
44	[FOIA Ex. 2]	5/7/2001	6.2	\$16,565
45	[FOIA Ex. 2]	9/27/2002	4.8	\$190,244
46	[FOIA Ex. 2]	11/4/2005	1.7	\$492,347
47	[FOIA Ex. 2]	1/17/2001	6.5	\$30,821
48	[FOIA Ex. 2]	4/26/2005	2.3	\$66,020
49	[FOIA Ex. 2]	12/1/2003	3.7	\$62,801
50	[FOIA Ex. 2]	2/5/2001	6.5	\$44,418
51	[FOIA Ex. 2]	9/17/2001	5.9	\$41,697
52	[FOIA Ex. 2]	10/1/2004	2.8	\$367,769
53	[FOIA Ex. 2]	8/31/2005	1.9	\$113,650
54	[FOIA Ex. 2]	3/23/2006	1.4	\$47,969
55	[FOIA Ex. 2]	3/8/2005	2.4	\$932,141
56	[FOIA Ex. 2]	4/27/2006	1.3	\$818,279
57	[FOIA Ex. 2]	1/21/2003	4.5	\$760,160

#	Loan Number	Date Transferred to Liquidation	# of Years Spent In-Liquidation as of 7/31/2007	SBA Share of Outstanding Gross Amount 7/31/2007
58	[FOIA Ex. 2]	1/16/2003	4.5	\$733,231
59	[FOIA Ex. 2]	7/20/2004	3.0	\$960,386
60	[FOIA Ex. 2]	2/7/2002	5.5	\$881,333
	Total			\$15,154,481

APPENDIX II. SAMPLING METHODOLOGY

Objective 1 – Sampling Methodology

The universe consisted of 7,120 loans with charge-off reviews completed by the National Guaranty Purchase Center from October 1, 2005 through July 31, 2007. The population universe was established from charge-off information in SBA's Loan Accounting System (LAS). Upon consultation with a statistician, we selected a statistical random sample of 54 loans to evaluate the liquidation and charge-off process. In statistical sampling, the projected estimates in the population universe have a measurable precision or sampling error. The precision is a measure of the expected difference between the value found in the sample and the value of the same characteristics that would have been found if a 100-percent review had been completed using the same techniques.

Sampling precision is indicated by ranges, or confidence intervals, that have upper and lower limits and a certain confidence level. Calculating at a 95-percent confidence level means the chances are 9.5 out of 10 that, if we reviewed all of the loans in the total population, the resulting values would be between the lower and upper limits, with the population point estimates being the most likely amounts.

Using the Defense Contract Audit Agency's 'EZ Quant' software program, we determined that based on the universe size and resource limitations, a sample size of 54 loans was required. We used Interactive Data Extraction and Analysis (IDEA) software to select the sample records from the universe.

We calculated the following lower limit projections using the Defense Contract Audit Agency's 'EZ Quant' software program's difference method at a 95-percent confidence level.

Type	Number of loans with questioned costs	SBA portion of questioned dollars charged-off	Projected number of loans in the universe of 7,120 with questioned costs	Lower limit \$ overall projection
Collateral Sale	5	\$217,525	263	
CPC Expenses	3	\$1,520	107	
Offer in Compromise	1	\$23,085	7	
Repair/Denial	1	\$339,643	7	
Other Charge-Off & Purchase Deficiencies	13	\$798,993	1,061	
Total*	21	\$1,380,766	1,979	\$22,836,886

*Two loans had more than one deficiency

Objective 2 – Sampling Methodology

The universe consisted of 9,143 loans transferred to liquidation on or before July 31, 2006 that were still in liquidation as of July 31, 2007 and had not received a completed liquidation action by the Center during that timeframe. The population universe was established from loan information in SBA's Loan Accounting System (LAS) and information within the Center's Herndon Action Tracking System (HATS).

The universe was separated into four strata for sampling purposes. The division of the universe strata was based upon liquidation year pre-2001 and post-2001⁶ and the gross amount of dollars outstanding per loan. Based on resource limitations, we determined that a sample of 60 loans would be reviewed. The universe and sample information by strata is presented in the table below.

Universe	Strata Size	SBA share of \$ outstanding	Sample Size	Sample SBA share of \$ outstanding
Pre-2001 outstanding liquidations over \$1 million	6	\$4,041,506	6	\$4,041,506
Pre-2001 outstanding liquidations less than \$1 million	409	\$54,300,099	23	\$3,233,616
Post-2001 outstanding liquidations over \$1 million	198	\$159,558,398	6	\$5,085,529
Post-2001 outstanding liquidations less than \$1 million	8,530	\$1,157,609,519	25	\$2,821,329
Totals	9,143	\$1,375,509,523	60	\$15,181,979

In statistical sampling, the projected estimates in the population universe have a measurable precision or sampling error. The precision is a measure of the expected difference between the value found in the sample and the value of the same characteristics that would have been found if a 100-percent review had been completed using the same techniques.

Sampling precision is indicated by ranges, or confidence intervals, that have upper and lower limits and a certain confidence level. Calculating at a 95-percent confidence level means the chances are 9.5 out of 10 that, if we reviewed all of the loans in the total population, the resulting values would be between the lower and upper limits, with the population point estimates being the most likely amounts. We used Interactive Data Extraction and Analysis (IDEA) software to select the sample records for each strata. We calculated the following lower limit

⁶ A date of January 1, 2001 was used to determine whether loans fell into the strata of pre-2001 or post-2001. Loans transferred to liquidation before January 1, 2001 are considered pre-2001 loans. Loans transferred to liquidation on or after January 1, 2001 are considered post-2001 loans.

projections using the Defense Contract Audit Agency's 'EZ Quant' software program's difference method at a 95-percent confidence level.

Universe Strata	Sample Size	# Overstated	\$ Overstated	Lower Limit # Projection	Lower Limit \$ Projection
Pre-2001 outstanding liquidations over \$1 million	6	4	\$2,734,277	4	\$2,734,277
Pre-2001 outstanding liquidations less than \$1 million	23	21	\$2,382,390	309	\$14,618,655
Post-2001 outstanding liquidations over \$1 million	6	4	\$2,718,829	55	\$18,680,840
Post-2001 outstanding liquidations less than \$1 million	25	17	\$1,269,193	4,239	\$196,738,536
Summary Projection	60	46	\$9,104,681	6,034	\$323,566,720

APPENDIX III. LOANS WITH LENDER DEFICIENCIES

Loan Number	Liquidation Action Deficiencies Not Corrected in Charge-Off				Purchase Review Deficiencies Not Corrected in Charge-Off	Totals
	Collateral Sale	CPC Expense Review	Repair & Denial	Offer in Compromise		
[FOIA Ex. 2]			\$339,643			\$339,643
[FOIA Ex. 2]	\$12,270					\$12,270
[FOIA Ex. 2]					\$970	\$970
[FOIA Ex. 2]					\$13,449	\$13,449
[FOIA Ex. 2]				23,085		\$23,085
[FOIA Ex. 2]	\$26,150	\$4,045				\$30,195
[FOIA Ex. 2]	\$5,391				\$27,225	\$32,616
[FOIA Ex. 2]		\$726				\$726
[FOIA Ex. 2]	\$133,714					\$133,714
[FOIA Ex. 2]					\$3,680	\$3,680
[FOIA Ex. 2]	\$40,000					\$40,000
[FOIA Ex. 2]					\$12,809	\$12,809
[FOIA Ex. 2]					\$643	\$643
[FOIA Ex. 2]		-\$3,251				-\$3,251
[FOIA Ex. 2]					\$639,717	\$639,717
[FOIA Ex. 2]					-\$3,863	-\$3,863
[FOIA Ex. 2]					\$41,776	\$41,776
[FOIA Ex. 2]					\$12,576	\$12,576
[FOIA Ex. 2]					\$19,754	\$19,754
[FOIA Ex. 2]					\$21,000	\$21,000
[FOIA Ex. 2]					\$9,257	\$9,257
Totals	\$217,525	\$1,520	\$339,643	\$23,085	\$798,993	\$1,380,766

APPENDIX IV. REMAINING CHARGED-OFF LOANS NEEDING RECOVERY

#	Loan Number	Borrower	Charged Off	Charge-Off Fiscal Year	Deficiency Summary	Questioned Cost
1	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$174,132	2007	A	\$12,270
2	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$534,110	2007	C	\$970
3	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$51,982	2006	C	\$13,449
4	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$51,287	2007	A,B	\$30,195
5	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$89,767	2006	A,C	\$32,616
6	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$50,577	2006	B	\$726
7	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$38,714	2006	C	\$3,680
8	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$87,799	2006	C	\$12,809
9	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$48,361	2006	C	\$643
10	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$415,014	2006	B	-\$3,251
11	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$267,656	2007	C	-\$3,863
12	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$107,754	2007	C	\$12,576
13	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$52,816	2006	C	\$19,754
14	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$33,258	2006	C	\$21,000
15	[FOIA Ex. 2]	[FOIA Ex. 4 & 6]	\$64,292	2007	C	\$9,257
	Totals		\$2,067,519			\$162,831

Deficiency Type Legend:

- A. Unsupported Collateral Sale
- B. Unsupported CPC Expense
- C. Guaranty Purchase Issues & Charge-Off Issues*

*Deficiencies related to equity injection, use of proceeds, transcript reconciliation, date of default, application of payments to interest, improper refund of the guaranty fee, lender site visits, and reconciliation of note receivables.

APPENDIX V. LOANS IN LIQUIDATION NEEDING RECOVERY

#	Loan Number	Lender	SBA Share of Outstanding Amount	Deficiency Summary	Questioned Costs
1	[FOIA Ex. 2]	Manufactures & Trader TR Co	\$125,033	A	\$670
2	[FOIA Ex. 2]	One United Bank	\$35,927	B	\$26,328
3	[FOIA Ex. 2]	Peoples National Bank	\$63,290	B	\$30,000
4	[FOIA Ex. 2]	Meridian Bank National Assoc.	\$79,622	C,D	\$79,622
5	[FOIA Ex. 2]	Business Loan Center, LLC	\$810,518	D	\$810,518
6	[FOIA Ex. 2]	Community First National Bank	\$41,697	C,D	\$41,697
7	[FOIA Ex. 2]	Business Loan Center, LLC	\$733,231	D	\$733,231
8	[FOIA Ex. 2]	Source BIDCO	\$960,386	A,B	\$10,785
9	[FOIA Ex. 2]	Business Loan Center, LLC	\$881,333	D	\$881,333
		Totals	\$3,731,037		\$2,614,184

Deficiency Type Legend:

- A. Disallowed Lender Servicing Fees
- B. Liquidation Collections Not Remitted or Correctly Accounted For
- C. Charged Off Without Post-Purchase Review
- D. Material Lender Servicing Deficiencies

APPENDIX VI. MANAGEMENT COMMENTS

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DATE: January 16, 2009

TO: Debra Ritt
Assistant Inspector General for Auditing

FROM: Eric Zarnikow, Associate Administrator for the Office of Capital Access
Grady Hedgespeth, Director, Office of Financial Assistance

THRU: Jovita Carranza, Deputy Administrator [FOIA Ex 6]

SUBJECT: Response to OIG's Draft Report Titled "The Liquidation Process at the National Guaranty Purchase Center"

The Office of Capital Access (OCA) is committed to maintaining appropriate quality standards in all of its operations. Thank you for this opportunity to respond to the Office of Inspector General (OIG) concerning the draft audit report (Report) on liquidation processes at the National Guarantee Purchase Center (NGPC).

COMMENTS ON REPORT FINDINGS

Overall, the findings and recommendations in the Report are similar to those mentioned in the six other audits of the NGPC, all of which focused on the early history of the center before major efforts to reengineer the purchase review process and add additional resources. They do not reflect the state of the centers today. The major finding in all of these audits is that the NGPC was significantly understaffed to perform all of the functions that it assumed during its first three years of operation. There is nothing new revealed in this audit that OCA and Office of Financial Assistance (OFA) management has not already acknowledged and set about to correct.

The attention to structural, management and process improvements dedicated to the NGPC in the past two years is, in fact, evidence of OCA's commitment to ensuring appropriate quality control and oversight in the operations of its financial programs. In addition, OCA has recently reorganized, placing increased emphasis on Risk Management and Financial Program Operations functions. For these reasons, OCA takes exception to OIG's statements throughout the Report that characterize OCA management as demonstrating a lack of concern for the quality and oversight functions which are a large part of the Office's mission.

SBA has Already Acknowledged and Addressed NGPC Operational Findings

Though OCA and OFA management attention to the issues at the NGPC are generally not discussed in the Report, many of the findings identified by OIG have already been addressed through focused actions. SBA has taken significant and successful steps to address staffing and management issues at the NGPC with a re-engineering effort focused on transforming the Center's processes and operations that began in July 2007.

OCA and OFA management have already taken steps toward addressing five of the six recommendations outlined in this Report, and therefore basically concur with those suggestions. Significant investments in staffing, training and technology were made in the past year and a half while reengineering the guaranty purchase submission and review processes at the NGPC. The authorized staffing level in Herndon has almost doubled and the surge staffing component added to eliminate backlogs inherited from District Offices swelled to more than three times the original authorized staffing level. Some of this staffing addition has been specifically focused on eliminating the backlog of the older loans in liquidation where SBA acknowledges its lack of sufficient attention and resource allocation in the past.

OCA Emphasizes Oversight and Operational Performance

OCA takes its lender oversight and review processes seriously, as demonstrated by the increased attention dedicated to these areas in the past two years. The Office of Capital Access is charged with a shared vision for balancing the need for lender supervision with the mission to provide access to capital for small businesses. We believe that keeping these missions tied together is the best way to ensure they are met. OCA takes exception to several statements in the Report that assert, based on anecdotal evidence rather than fact, that management does not emphasize oversight and that lender relations prioritizes honoring guarantees over compliance and accountability.

The Office of Capital Access has recently reorganized, separating Financial Program Operations (including the NGPC) (OFPO) from OFA, which focuses on policy and program development as well as lender relations. In addition, under the new structure, OCA has added a new Office of Risk Management (ORM) with a Director that will increase focus and attention to managing risk through developing an OCA-wide risk governance structure. Office Directors will have shared accountability for risk management goals, including quality assurance in financial program operations. These changes were just approved in the Fall of 2008 and need time to be fully implemented and take effect before additional reorganizations are considered.

SBA believes that housing OFA, OFPO, ORM and the Office of Credit Risk Management (OCRM) under the Office of Capital Access is critical to the Agency's success. To run a strong loan program there has to be open communication between these key offices that can only be achieved if they operate in tandem. For example, last year OFA and OCRM spent time together to review package deficiencies that most often lead to repairs and denials. OFA aggregated and analyzed trends in deficiencies, especially for our largest lenders and took pro-active steps to prevent further problems including providing a series of trainings for lenders around the country. OCRM is now using this information to help focus their lender reviews on the areas of most frequent defects. Co-location within OCA offers a number of other opportunities for collaboration toward systematically improving the quality of lender purchase packages, as well as underwriting, closing policies, servicing and documentation.

OIG's main, repeated finding is that a lack of resources in the early stages of centralization caused problems that rippled through the operations of SBA lending programs. OCA management has worked diligently to correct and improve staffing and resource issues at the NGPC. However, OIG makes an unsubstantiated inference that somehow a different organizational location for these functions would overcome problems that fundamentally arose from this lack of adequate resources.

Concrete Improvements have been made in the NGPC

Between July 2007 and the present, OCA has worked to improve the entire guarantee purchase process. This time period is unfortunately not covered in OIG's analysis. Instead, the Report encourages SBA to focus significant recovery efforts on old cases where many of the lenders believed any obligation they had to SBA had been satisfied. It provides little new information to inform or change the proactive direction in which SBA is already moving – a direction that is already having an effect on the entire industry.

The improvements to the NGPC demonstrate OCA management's commitment to quality standards. Recognizing the need for an effective system that accomplishes both appropriate accountability and timely honoring of SBA guarantees – achieving both parts of OCA's balanced mission – the office set about re-engineering processes and procedures to become both a better partner and overseer of participating lenders. SBA's efforts include the creation of an operations manual to guide the purchase review process, implementing a clearer pre- and post purchase package submission systems, improving timely responses, and better categorizing loans in liquidation.

- **Tab Submission Processes:** SBA has clarified its expectations of lenders by creating a streamlined 10 Tab submission processes for purchase packages. This up front clarification has led to improved documentation for both pre and post purchase packages and higher quality submissions from lenders. These improvements helped decrease the time SBA employees spent chasing documents from lenders, freeing up more time to focus on quality reviews.
- **Lender Requirement Clarifications:** In August 2008, we modernized procedures outlined in SOP 50 10 (5) to make SBA's requirements clearer to lenders and potential lenders.
- **Post Purchase Notifications:** In order to improve the post purchase process and help ensure that the backlog of post purchase reviews does not happen again, we send lenders timely notification of their obligation to submit a post purchase package, with warnings of the consequences of non-response.
- **Charge Offs:** The last phase of the Herndon reengineering effort, completed in November 2008, was a thorough review of every loan in the liquidation inventory to assess current status, identify loans eligible for charge-off, and

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record information in the Liquidation Management System (LMS) – driving follow up to resolve these cases.

- **Cross-Training and Integrating Functions:** Through the re-engineering process, the purchase review, liquidation and charge-off functions have been better integrated; most loan officers in Herndon are now cross-trained in both disciplines.

These initiatives are new – most were implemented after the period covered in the audit – and we continue to refine and build upon them. However, the results can already be seen in the significant improvement of package quality and the increase in voluntary withdrawals and cancellations, as lenders become used to the higher expectations of the reengineered NGPC and the consistent approach of our processes.

Staff and Contractors Dedicated to Liquidation Efforts were Properly Trained

During the time period covered in the audit, in order to process the charge off workload, the Office of Capital Access explored various options for human resources, including contract, field office, and other center personnel. OCA secured Agency funding for several contractor loan specialists with liquidation experience to work on site at the NGPC and also utilized personnel with extensive liquidation experience from two centers and several district offices in the effort. OCA disagrees with OIG's suggestions that these recognizable qualifications and documented trainings were not sufficient.

NGPC provided both classroom instruction and "hands on" training to contractors, and closely monitored their progress. In fact, one of the lead contractors was a former SBA district office Portfolio Management Chief with substantial SBA-specific liquidation guaranty purchase, and charge off experience. Contractor work was scrutinized by the NGPC legal division and approving officials, with feedback and instructional guidance provided to the contractors where necessary and rejected work returned for correction.

OCA and other Senior Agency management supported the project by providing funding for contractors, hiring of temporary attorneys for legal reviews within the NGPC, and loan file shipments to centers and district offices. It is not accurate to say that the staff performing this work was inadequately trained or supervised.

Audit Period Charge Off Strategy

In October, 2005, during the time period covered by the audit, SBA began a concerted effort to review and properly classify all purchased loans that were considered charge-off ready in the National Guaranty Purchase Center. In addition to simply good operational management, this initiative helped address two items on the President's Management Agenda: Improved Financial Management and Improved Credit Management. Prior to this date, NGPC had focused on processing a backlog of guaranty purchases it inherited

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from district offices, while at the same time attempting to process the large number of guaranty purchases that the center received after centralization.

NGPC, OFA, OCA, and other senior Agency management were aware of the importance of accurately classifying these loans and complying with the Debt Collection Improvement Act. OFA and OCA management supported the charge off project through obtaining resources and maintaining a high level of visibility for the project to Agency leadership and the lending industry. While keeping production goals in mind, NGPC, OFA, and OCA management maintained the responsibility of performing accurate reviews. The NGPC assessed and will continue to assess guaranty repairs and denials in amounts sufficient to compensate the Agency for any material loss associated with a guaranty purchase or charge-off review, as well as in areas of program integrity, such as program eligibility.

There need not be a trade-off between the timely processing of guaranty purchases or charge-off reviews and accurately assessing repairs and denials, as suggested by the OIG comments in this Report. Rather, SBA believes the two go hand in hand in supporting the Agency's mission by providing efficient guaranty claim processing while maintaining effective controls to protect the program by accurately assessing and enforcing repairs and denials.

RESPONSES TO OIG RECOMMENDATIONS:

1. **We recommend that the Deputy Administrator establish an office within the Agency that is separate from the Office of Capital Access to be responsible for all lender oversight functions, including those performed at the National Guaranty Purchase Center, or transfer these responsibilities to the Office of the Chief Financial Officer.**

The functional lapses before 2007 that OIG finds in this report stemmed from a lack of resources at the NGPC – and it is not at all clear how this recommendation flows from that finding. Since 2007, the Agency and OCA have been continually responsive to requests for additional center staffing, NGPC has since added resources, and is currently in the process of adding additional loan specialists and supervisor positions.

Housing all of the offices that are key to a strong lending program – including the Office of Risk Management, the Office of Credit Risk Management, the Office of Financial Program Operations and the Office of Financial Assistance under the Office of Capital Access is critical to ensuring that these functions communicate well and benefit from constant feedback and input – which makes for a better overall lending program.

The Office of Capital Access is charged with a shared vision for balancing the need for lender supervision with the Agency's mission to provide access to capital for small businesses. The central mission of OCA is the management of *all* of the

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program offices within OCA. SBA believes that keeping these responsibilities tied together is the best way to ensure that they are both met.

OCA has consistently disagreed with OIG's position regarding the placement of risk management and oversight functions – now including those within the National Guarantee Purchase Center. OIG's continued suggestions to organizationally divide key functions of SBA's lending programs would lead to unhealthy fragmenting in the Agency, unnecessary duplication of efforts and inefficient allocations of resources. Under a structure where operations and risk management functions do not operate in tandem, it only becomes less clear how and when the joint prioritization of improving quality and achieving balance between appropriate oversight and the Agency's mission to provide access to capital to small businesses can be achieved.

The recent structural reorganization approved for the Office of Capital Access helps to bolster management and leadership in oversight and operations functions by separating Operations from OFA and adding a new Office of Risk Management. Under the new structure, the OFPO has shared reporting to the Associate Administrator for Capital Access and the Director of the Office of Risk Management for center quality and risk management areas.

In addition, OFPO and ORM have recently begun a new Center Quality Program that is designed to improve quality assurance and control in the centers and increase transparency, accountability, and integrity in center operational processes and procedures.

2. **We recommend that the Director, Office of Financial Assistance recover approximately \$2.8 million of improper payments and liquidation proceeds from lenders on the 24 loans identified in Appendices IV and V.**

OFA and, where necessary, the Office of General Counsel, will review the underlying loans identified and recoveries will be obtained where appropriate. OFA will provide OIG with a summary of its decisions on each loan and recovery results.

3. **We recommend that the Director, Office of Financial Assistance direct the Center to ensure that charge-off reviews are properly supervised and all required documentation is obtained from lenders.**

NGPC currently supervises charge-offs properly, and there are no plans to suspend doing so. Staff have been cross-trained in both the review and the charge off function, which adds to management flexibility in the center. In addition, the center is currently in the process of adding several loan specialist and supervisor positions in anticipation of increasing workload for 2009. The addition of these

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positions will help ensure that staffing is sufficient to properly supervise charge off reviews.

The center requires documentation from lenders necessary to support the charge-off decision. Through training of lenders over the past 4 years, NGPC has improved the quality and consistency of documentation receipts for both purchase packages and charge-off/close out reports. NGPC will continue to focus on the quality and consistency of lender documentation under the Center Quality Program.

4. **We recommend that the Director, Office of Financial Assistance revise the liquidation recovery rates in SOP 50 51 (2) to reflect the forced sale liquidation values related to the various types of collateral used to secure SBA loans.**

OFA is in the process of re-writing the entire SOP 50 51, and will consider revisions to the forced sale liquidation recovery rates.

5. **We recommend that the Director, Office of Financial Assistance further enhance the Center's newly designed portfolio management system to include the appropriate security and controls and ensure the appropriate resources are assigned to address loans needing action.**

SBA is reengineering its loan liquidation tracking system (LLTS) through the LMAS project, and will modernize it to make it a more effective tool in managing loan inventories in a centralized environment. There have been recent enhancements made to the LLTS. However, there will not be a significant development effort on the Herndon portfolio management system because a more comprehensive system will be developed through LMAS that will function in all portfolio liquidation centers. Nevertheless, we will add additional security protocols to the current system.

As an interim measure, SBA is improving its lender liquidation portfolio reporting process through a new project started January, 2009. The project will focus on improving the relevancy and consistency of data elements in the lender quarterly status report for purchased loans, emphasize lender reporting compliance, provide resources in Herndon to analyze the information and follow up for missing reports, and improve the process for identifying loans that require action. This project will help to place the reporting burden on the servicing lenders, where it should be, instead of center staff following up on individual loan items, which is costly and time-consuming.

6. **We recommend that the Director, Office of Financial Assistance perform periodic reviews of non-purchased loans in liquidation to ensure they are removed from the portfolio when appropriate and their outstanding balances are correct.**

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NGPC will perform periodic data analysis on the non-purchased loans in its portfolio to check for loans that should be removed from the portfolio. As this will be a lower priority activity than those performed on the purchased loans in the portfolio - loans in which SBA has a direct ownership interest - loans will be removed as resources allow.

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