SBA'S MANAGEMENT OF THE BACKLOG OF POST-PURCHASE REVIEWS 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: John A. Miller
Director, Office of Financial Program Operations

Date: August 25, 2009

/s/ Original Signed

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: SBA's Management of the Backlog of Post-Purchase Reviews at the National Guaranty Purchase Center
Report No. 9-18

This report presents the results of our audit of SBA's management of the backlog of post-purchase reviews at the National Guaranty Purchase Center (Center). By the end of fiscal year (FY) 2007, the Center had accumulated a backlog of approximately 3,500 loans valued at over $1 billion that had been purchased from the secondary market. The Center was required to perform a post-purchase review on each loan to evaluate whether the lender materially complied with SBA's rules and regulations in originating, servicing, and liquidating the loans and to recover improper payments for any losses incurred as a result of lender noncompliance.

During FY 2007, the former SBA Administrator established an initiative to eliminate the backlog of loans at the Center by May 2008. As part of this initiative, SBA contracted with Washington Products and Services, Inc. (WPS) to conduct post-purchase and charge-off reviews of the backlogged loans to identify lender compliance issues. The Center also charged off 313 loans that were purchased prior to 2002 without evaluating lender compliance with origination and closing requirements because the Office of Capital Access (OCA) believed the statute of limitations[1] had been exceeded, which prevented recovery from lenders.

Production reports prepared by the Center in November and December 2007 showed that WPS reviews had been completed three times faster than the Center's

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[1] 28 USC 2416 states that every action for money damages brought by an Agency of the United States, which is founded upon any contract, express or implied in law or fact, shall be barred unless the complaint is filed within 6 years after the right of action accrues or within 1 year after final decisions have been rendered in applicable administrative proceedings required by contract or law, whichever is later. The discovery provision of 28 USC 2416(c), however, extends this statute of limitations if facts material to the right of action are not known and reasonably could not be known by an official of the United States charged with responsibility to act in the circumstances.

standard purchase reviews, raising concerns that SBA was not providing adequate oversight of the contractor and its reviews. In response to these concerns, the audit determined whether (1) post-purchase reviews performed by WPS were effective in identifying lender noncompliance, (2) reviews of charged-off loans performed by WPS and the Center appropriately identified lender noncompliance, and (3) SBA's decision to charge off older loans without performing post-purchase reviews was appropriate.

To address the first objective, we reviewed 30 statistically sampled loans, including 15 charged-off loans, from a universe of 786 loans reviewed by WPS between August 23, 2007 and December 14, 2007. We also reviewed an additional judgmentally selected early-defaulted loan. To address the second objective, we examined the 15 charged-off loans to determine if WPS or the Center identified lender noncompliance issues during the charge-off process. Finally, we reviewed seven loans – five that were randomly selected and 2 that were judgmentally selected – which had been charged off without a post-purchase review to determine if lenders complied with SBA's origination and closing requirements.

We reviewed information in SBA's loan files, and interviewed SBA officials and former WPS staff to determine whether WPS and/or the Center identified lender noncompliance during the post-purchase and charge-off reviews and whether lenders complied with SBA requirements on loans that were charged off without review. For all loans examined, we also reviewed loan information contained in SBA's Loan Accounting System, Guaranty Purchase Tracking System (GPTS), and the Centralized Loan Chron System.

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

BACKGROUND

SBA is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guaranteed loans. SBA guarantees loans that are made by participating lenders under a Guaranty Agreement to originate, service, and liquidate loans in accordance with SBA's rules and regulations. Prior to the recent credit slump, up to half of all 7(a) loans were sold on the secondary market. Lenders retain servicing responsibilities for the sold portion of their loans.

When a lender requests guaranty payment on a defaulted secondary market loan, SBA must purchase the loan from the secondary market investor within 30 days. After purchase, SBA reviews loan documentation to evaluate the lender's compliance with program rules and regulations. This review is SBA's primary control for ensuring lender compliance and preventing improper payments. In the event of noncompliance, SBA may be released from its liability on a loan guaranty, in full or in part, and must seek recovery from the lender for improper payments.

The Center inherited a backlog of approximately 1,700 purchased secondary market loans needing reviews from the district offices when 7(a) purchase and liquidation activities were centralized at the Center in 2004. Insufficient staffing at the Center after centralization resulted in a steady increase in the backlog, and by July 2007, it reached approximately 3,500 loans. In August 2007, WPS began performing limited post-purchase reviews on 3,200 of the 3,500 backlogged loans.[2] These reviews focused only on loan origination and closing requirements, omitting servicing and liquidation actions that are typically included in standard post-purchase reviews.

As of January 2008, WPS had completed 1,566 post-purchase reviews and were redirected to conduct charge-off and pre-purchase reviews to augment Center staff resources. The remaining loans were transferred to another contractor in Fort Worth, Texas. As of March 31, 2009, there were 542 loans still awaiting post-purchase reviews and 1,310 loans awaiting charge-off that had liquidation actions pending.

RESULTS IN BRIEF

The audit identified $1.25 million of improper payments, consisting of: $1,055,455 that was missed in post-purchase reviews; $37,624 that was inappropriately charged off; and $157,009 of liquidation proceeds that were inappropriately applied on a loan that has not yet been charged off and will need to be reviewed. Based on our sample results, we estimate that limited post-purchase reviews performed by WPS on 786 loans did not identify at least $7.6 million[3] of improper payments resulting from lender noncompliance with loan origination and closing requirements. A listing of loans with improper payments is provided in Appendix III, a listing of loans needing recovery is provided in Appendix IV, and a summary of the loan deficiencies is provided in Appendix V.

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[2] The remaining 300 loans were originated by one lender and were separated for review by another contractor.
[3] This amount was rounded up from $7,550,918.

WPS missed lender deficiencies because its employees were not adequately trained, and the Center lacked adequate resources to sufficiently supervise the work of contractor staff. On average, only two SBA approvers were assigned to manage 3,200 post-purchase reviews. According to former WPS employees, they were not sufficiently instructed on SBA's lending requirements and relied on published Agency procedures and support from SBA team leaders when reviewing the loan files. More formal training and supervision might have improved the quality of the reviews, since some contractor staff had no experience in commercial lending and SBA's procedures were extensive, complex, and difficult to interpret. Further, SBA's contract with WPS did not include a detailed scope of work, measurable performance metrics, deliverables, or adequate acceptance criteria to assist the contractor staff in performing the reviews and the Center in supervising them.

Our review also identified $744,481 of improper payments on 5 loans that were charged off without post-purchase reviews. While the Center performed charge-off reviews on these loans, it did not identify the deficiencies nor recover the improper payments. The Agency mismanaged the post-purchase reviews of these loans by allowing them to sit for more than 6 years. Had the Agency taken timely action, the $744,481 of improper payments could have been recovered.

We recommended that SBA recover $1.25 million of improper payments identified by the audit. We also recommended that SBA: (1) develop a purchase review manual to provide assistance on analyzing documentation and identifying fraud when purchase reviews are contracted out; (2) include detailed scopes of work, measurable performance metrics, deliverables, and adequate acceptance criteria in service contracts to assist the contractor staff in performing the reviews and the Center in supervising them; (3) devote adequate resources to contractor oversight to allow for thorough reviews of contractor purchase and charge-off decisions; and (4) take timely action to perform adequate post-purchase and charge-off reviews to ensure the recovery of improper payments.

Management agreed to seek recovery of, or request additional documentation from lenders for, about $1.1 million of the $1.25 million in improper payments identified for recovery. Management did not agree that recovery should be pursued on the remaining balance due to either the age of the loans or prior settlements reached. Management agreed to (1) develop performance and measurement criteria for contractor staff, (2) devote adequate resources to contractor oversight, and (3) take timely action to perform adequate post-purchase and charge-off reviews. Management did not agree to develop a purchase review manual for contractors because the Center had already developed and distributed a comprehensive purchase review manual for all SBA employees and contractors.

RESULTS

Material Lender Noncompliance Was Not Detected on Backlogged Loans

While the Agency made progress, post-purchase reviews performed by WPS and approved by SBA officials did not identify material lender noncompliance with loan origination and closing requirements in 3 of the 30 loans we reviewed. Two of these loans also had obvious indications of fraud that were not appropriately addressed. Reviewers accepted inadequate evidence to support use of proceeds and equity injections.

For example:

- A $165,354 improper payment went undetected on an early-defaulted loan because inadequate evidence of equity injection and use of proceeds was accepted, and indications of fraud were not detected. The source of the equity injection could not be verified and no evidence existed that it was used for business purposes. Additionally, loan proceeds of $200,000 disbursed for inventory were not supported by joint payee checks or paid invoices dated after loan approval, as required. Lastly, we found several indications of suspicious activity that occurred during loan origination that the lender overlooked and WPS did not identify.

- WPS inappropriately recommended a $180,000 repair on another loan that warranted a full denial of $351,340. This repair amount was insufficient to mitigate SBA's loss given fraud indicators and the material lender noncompliance issues identified. Furthermore, the Center had previously reviewed the loan and recommended full denial of the SBA guaranty. We question why the Center accepted an inadequate repair amount that resulted in a $171,340 loss to SBA.

As a result, improper payments totaling $467,845 were not identified or recovered. When projecting the sample results to the 786 loans in the universe, we estimate at least $7.6 million of improper payments were made. Additionally, our review of an early-defaulted loan that an SBA loan officer previously recommended for full denial identified a $587,610 improper payment. The guaranty should have been denied in full based on a less than arm's-length change of ownership, inadequate proof of equity injection, and several indications of fraud that went undetected by the lender during loan origination. We found no assurance that loan proceeds were used for the intended purpose and only $7,500 of the required $242,500 injection could be verified. The post-purchase review for this loan was completed and approved by the same individuals who inappropriately accepted the $180,000 repair described above in lieu of the prior denial recommendation. This is an indication that there is inadequate oversight to prevent reviewers and approvers from inappropriately overturning prior denial recommendations made in compliance with the Agency's policies and procedures.

Charge-off Reviews Did Not Identify a Liquidation Deficiency

WPS did not identify a $37,624 improper payment related to a liquidation deficiency in 1 of the 15 charged-off loans in our sample. The lender did not obtain and reconcile collateral lists at origination and default. Because SBA omitted servicing and liquidation actions from the WPS post-purchase reviews, these actions were reviewed for the first time during charge-off. This reduced the amount of oversight provided during standard post-purchase and charge-off reviews and increased the risk of improper payments.

WPS Reviewers Were Not Adequately Trained or Supervised

Lender noncompliance went undetected because WPS reviewers were not adequately trained to perform post-purchase and charge-off reviews, and the Center lacked adequate resources to sufficiently supervise their work. WPS staff lacked experience in conducting these reviews and were provided only limited on-the-job training. No formal classroom instruction was provided covering the extensive and complex standard operating procedures (SOP) and lending requirements. One former WPS employee stated she had to learn by reading SOPs, asking questions as she reviewed the files, and making mistakes that were corrected by her peers. An instruction manual was not available on how to analyze documentation to verify equity injection, use of proceeds, and collateral. In addition, the WPS service contract did not contain a detailed scope of work for contractor staff to use in performing post-purchase or charge-off reviews.

The Center's supervision of the contractor's work did not show evidence that SBA approvers challenged any of the contractor's purchase decisions even when the Center had previously recommended denial of loan guaranties. On average, only two SBA approvers were assigned to manage 3,200 post-purchase reviews. Further, SBA's contract with WPS lacked measurable performance metrics, deliverables, and acceptance criteria for the Center to effectively monitor the adequacy of the contractor's work.

Loans Charged Off Without a Post-Purchase Review Are at Risk for Significant Improper Payments

The Center charged off 313 of the backlogged loans with an outstanding balance of approximately $70 million without performing post-purchase reviews to determine whether the lenders originated and closed the loans in accordance with

SBA's requirements. These loans had been purchased more than 6 years prior to undergoing charge-off reviews and Headquarter officials believed a statute of limitations had been exceeded, preventing the Agency from pursuing recovery from lenders.

For 5 of the 7 loans reviewed, we identified material deficiencies related to the verification of equity injection, use of proceeds, repayment ability calculation, IRS tax verification, site visit performance, and collateral valuation. While the Center performed charge-off reviews which focused on servicing and liquidation actions on these loans, it did not identify the deficiencies or recover $744,481 of improper payments. The Agency mismanaged the post-purchase reviews of these loans by allowing them to sit for more than 6 years. Had the Agency taken timely action, the $744,481 of improper payments could have been recovered. Based on our audit results, we believe the 313 loans charged off without a post-purchase review resulted in significant improper payments and overstated SBA losses.

Loan Recovery Needed Prior to Charge-off

As another matter, we identified a $157,009 improper payment on one loan that has not yet been charged off. This issue is being brought to the attention of the Agency to ensure appropriate recovery is sought during the charge-off review. The improper payment occurred because WPS did not identify that the lender inappropriately applied liquidation proceeds to a standby note provided by the seller rather than to the SBA loan. The lender misled SBA to believe the standby agreement no longer applied or had been overcome by events. Without knowledge of the standby agreement terms (which remained in place regardless of the maturity of the note that was on standby), SBA relied on information provided by the lender and concurred with the lender's request to allow the borrower to pay down the standby agreement versus the SBA loan. 13 CFR 120.524 states that SBA is released from liability on its guaranty when the lender has misrepresented a material fact to SBA regarding a guaranteed loan. The lender's misrepresentation resulted in a $157,009 improper payment that should be recovered.

RECOMMENDATIONS

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

1. Seek recovery of $1,250,088 on the guaranties paid on the 6 loans listed in Appendix IV.

2. Develop a purchase review manual for contractors that explains the different types of documentation that could be submitted and methods to analyze the

data to identify lender deficiencies and potential indications of fraud during a purchase review.

3. Include detailed scopes of work, measurable performance metrics, deliverables, and adequate acceptance criteria in service contracts to assist the contractor staff in performing the reviews and the Center in supervising them.

4. Devote adequate resources to contractor oversight to allow for thorough reviews of contractor purchase and charge-off decisions, along with supporting statements and documentation.

5. Take timely action to perform adequate post-purchase and charge-off reviews to ensure the recovery of improper payments.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On June 10, 2009, we provided a draft of this report to SBA for comment. On July 17, 2009, SBA submitted its formal comments, which are contained in their entirety in Appendix VI. Management agreed with recommendations 4 and 5, but did not identify actions planned or taken which are needed to be considered fully responsive. Management partially agreed with recommendations 1 and 3, but did not provide target dates for implementation. Finally, management disagreed with recommendation 2, but had taken the corrective action needed to satisfy the recommendation. 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 this report focused on the earlier history of the center before major efforts to reengineer the purchase reviews process were completed. It said that many of the cases in the audit resulted from secondary market purchases processed in the district offices prior to centralization that were sent to the center without completed post-purchase reviews.

Management further stated that a comprehensive purchase review manual was implemented in February 2008, after the August 23, 2007 to December 14, 2007 period covered by the audit. According to management, the cases reviewed in the audit do not reflect the current state of the Center as significant process improvements have been made, and much of the large backlog of cases inherited from the district offices has been eliminated. Management stated they were fully aware of the issues raised in this and other audits that focused on the earlier history of the center and have taken many steps to address them.

Management took issue with the audit's assertion about the lack of training and oversight provided to contract loan specialists and stated that prior to the audit, the Center undertook a considerable effort to train and fully integrate contract personnel into the work of the Center, including the processing of post-purchase reviews. Further, Management said that this training process was standardized and strengthened after the implementation of the purchase review manual in February 2008.

OIG Response

Due to the scope of our audit, our statistical sample included secondary market purchases that were processed in the district offices and sent to the center without completed post-purchase reviews. Nevertheless, 6 of the 8 loans identified in our draft report with deficiencies warranting recovery were purchased by the Center. We have revised the final report and are no longer seeking recovery on the two older loans.

While Management expressed concern that the OIG focused on the earlier history of the Center before major efforts to reengineer the purchase process were completed, OIG had been told, in response to a previous audit,[4] 4 months prior to the period reviewed by our audit that the Guaranty Purchase Division of the Center had been extensively reengineered, staffing was at an adequate level, and self-guided Tabs had been developed that would improve the quality of purchase reviews. Despite these reengineering efforts, the deficiencies noted in the audit occurred because Center officials did not exercise adequate oversight to ensure that purchase policies were followed.

For example, during our audit, we identified two loans where Center loan officers had recommended full denial of the SBA guaranty in compliance with SBA's policies. A WPS reviewer and an SBA approver, however, inappropriately overrode these decisions in December 2007 by fully approving a purchase and accepting an inadequate repair, resulting in $758,950 of losses to SBA.

Although management took issue with our assertion that contract loan specialists were not adequately trained or supervised, the evidence presented in our audit

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[4] *Audit of the Guarantee Purchase Process for Section 7(a) Loans at the National Guaranty Purchase Center*, Report No. 7-23, May 8, 2007

report supports our position that WPS reviewers were not adequately trained or supervised.

Recommendation 1

Management Comments

Management agreed to seek recovery of $752,964 on 2 of the 8 loans questioned in our draft report and suggested a reduction in the recommended recovery amount for one loan from $65,045 to $37,624. Management also agreed to seek additional information from the lenders on two other loans with recommended recoveries of $288,160 prior to rendering a final decision. Finally, management did not agree to seek recovery of $389,076 on the remaining 3 loans because of either the age of the loans or a prior settlement reached.

OIG Response

Management comments were generally responsive to our recommendation. We concur with SBA's decision to recover $752,964 on two of the loans and to reduce the amount of recovery for the third loan to $37,624. We also accept management's decision to seek additional information on two loans and are no longer recommending recovery for the two older loans. For the final loan, we continue to support our position that the Center's $180,000 repair was insufficient to mitigate SBA's loss and as a result, we are questioning the remaining outstanding balance of $171,340. This loan was originally recommended for full denial by the Center's legal team who concluded, "It is clear that had the lender made any effort to prudently make and close this loan that it would have discovered fraud perpetuated by the borrower/guarantor and certain third parties." Additionally, the repair amount was an "unsolicited offer" from the lender with no relevance to the amount of harm caused SBA because the lender acknowledged that "their actions on this loan were not up to their standards." It is the OIG's opinion that this repair action was clearly inappropriate and warrants recovery from the lender. Our recommendation has been modified to reflect the revised amount of questioned costs. Target dates for final action will be required for management's response to be considered fully responsive.

Recommendation 2

Management Comments

Management stated the Center has already developed and distributed a comprehensive purchase review manual for all SBA employees and contractors that covers both pre-purchase and post-purchase reviews. The manual contains detailed steps for employees/contractors to follow in the purchase review process, along with an appendix that addresses guidelines with respect to documentation needed from the lender. Management stated that the purchase review manual is fully satisfactory for use by all SBA employees and contractors, and that it would be unnecessary and duplicative to create a separate manual to be used only by contractors.

OIG Response

Although management stated disagreement with the recommendation, the development of a purchase review manual satisfies the actions recommended. Upon receipt of the Form 1824 for this recommendation, the OIG will review the revised purchase manual to ensure that it adequately explains the documents that could be submitted, methods to analyze the data to identify lender deficiencies, and potential indicators of fraud during a purchase review. If the revised manual is sufficient, this recommendation will be closed.

Recommendation 3

Management Comments

Management partially agreed with this recommendation and stated that the WPS staff is held to the same performance metrics, deliverables, and adequate acceptance criteria as those applicable to SBA employees. Management agreed to develop performance and measurement standards for WPS personnel by December 31, 2009 and work with WPS as required to implement the standards into the contract.

OIG Response

While Management agreed to develop standards by December 31, 2009, it did not provide a target date for incorporating the standards into the WPS contract. This target date is needed to fully address this recommendation.

Recommendation 4

Management Comments

Management agreed to devote adequate resources to contractor oversight to allow for thorough reviews of contractor purchase and charge-off decisions and contended that this is currently being implemented. Management stated that the Center’s oversight process includes the analysis and review of pertinent supporting lender documentation by legal counsel and approving officials as set forth in SBA's policies and procedures.

OIG Response

While management agreed to implement the recommendation, its comments did not describe whether adequate resources have been directed to contractor oversight. While the Center's current oversight policies and procedures may call for the analysis and review of pertinent supporting lender documentation, if there is not an adequate number of approving officials devoted to the process, they will not be able to devote sufficient time to thoroughly analyze the supporting documentation. As noted in our report, only 2 approving officials on average were assigned to manage 3,200 post-purchase reviews, and there was no evidence that they challenged any of the contractor's purchase decisions even when a previous denial recommendation had been made by Center officials. Management will need to identify the steps it will take to ensure staffing is adequate to manage the post-purchase review workload before we can consider management's comments to be responsive to the recommendation.

Recommendation 5

Management Comments

Management agreed with this recommendation and stated it would promptly pursue recovery if a post-purchase or charge-off review indicates there are grounds for recovery.

OIG Response

Although management agreed to the recommendation, it did not specify the process it would implement to ensure that reviews are performed adequately and timely. Therefore, management's comments were not fully responsive to this recommendation.

ACTIONS REQUIRED

Because your comments did not fully address recommendations 4 and 5, we request that you provide a written response providing additional details for implementing these recommendations within 2 weeks from issuance of this report. Furthermore, a form 1824 must be provided for all recommendations in our report, and target dates for final action must be provided for recommendations 1 and 3. If a timely response is not received, these recommendations will be pursued through the audit resolution process.

We appreciate the courtesies and cooperation of the Small Business Administration during this audit. If you have any questions concerning this report, please call me at (202) 205-[FOIA ex. 2] or Debra L. Mayer, Director, Credit Programs Group, at (202) 205-[FOIA ex. 2].

APPENDIX I. SAMPLED LOANS

Loans with Post-Purchase and Charge-Off Reviews

#	Loan Number	Borrower	SBA Outstanding Balance*
1	[FOIA ex. 2]	[FOIA ex. 4, 6]	$253,675
2			$127,222
3			$178,692
4			$131,151
5			$75,724
6			$105,002
7			$188,607
8			$36,788
9			$31,721
10			$153,273
11			$177,489
12			$156,623
13			$55,150
14			$91,715
15			$117,990
	Totals		**$1,880,822**

* SBA share of the outstanding balance as of January 24, 2008, when our sample was pulled

Loans with Post-Purchase Reviews Only

#	Loan Number	Borrower	SBA Outstanding Balance*
1	[FOIA ex. 2]	[FOIA ex. 4, 6]	$81,806
2			$237,344
3			$332,277
4			$207,688
5			$34,504
6			$87,583
7			$139,726
8			$287,374
9			$98,931
10			$351,340
11			$67,007
12			$165,355
13			$25,640
14			$211,497
15			$86,832
	Totals		**$2,414,904**

* SBA share of the outstanding balance as of January 24, 2008, when our sample was pulled

Judgmentally Sampled Loan

#	Loan Number	Borrower	SBA Outstanding Balance
1	[FOIA ex. 2]	[FOIA ex. 4, 6]	$587,610

* SBA share of the outstanding balance as of September 16, 2008

APPENDIX I. SAMPLED LOANS CONTINUED

Loans Charged Off Without a Post-Purchase Review

#	Loan Number	Borrower	SBA Outstanding Balance*
1	[FOIA ex. 2]	[FOIA ex. 4, 6]	$41,297
2			$74,984
3			$63,768
4			$37,585
5			$86,083
6			$79,622
7			$477,180
	Totals		**$860,519**

* SBA share of the outstanding balance as of January 24, 2008, when our sample was pulled

APPENDIX II. SAMPLING METHODOLOGY

Although the Guaranty Purchase Tracking System is the Agency's system of record for the guaranty purchase process, loans reviewed by Washington Products and Services, Inc. (WPS) could not be independently extracted or differentiated from loans reviewed by Center loan officers. Likewise, loans that were charged off without receiving post-purchase reviews also could not be independently extracted. As a result, we relied upon off-line spreadsheets maintained by the National Guaranty Purchase Center to derive our universes and were unable to perform formal reliability assessments of the data.

The off-line spreadsheet of loans reviewed by WPS consisted of 786 loans with an SBA outstanding balance of $25,000 or more, for which post-purchase reviews had been conducted on behalf of SBA between August 23, 2007 and December 14, 2007. We verified the sampled list against the official loan file records. The universe was broken into two strata – one with 110 loans that had been subsequently charged off and one with 676 loans that had not been charged off. Upon consultation with a statistician, we used Interactive Data Extraction and Analysis software (IDEA) to statistically select 15 loans from each strata for a total sample size of 30 loans.

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 90-percent confidence level means the chances are 9 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 calculated the following lower limit projections using the Defense Contract Audit Agency's 'EZ Quant' software program's ratio method at a 90-percent confidence level.

Deficiency to Be Projected	Loans in Sample	No. of Deficiencies in Sample	$ Value of Deficiencies in Sample	Lower Limit $ Projection
Deficiencies in WPS Post-purchase Reviews	30	3	$467,845	$7,550,918
Deficiencies in Charge-off Reviews	15	1	$37,624	$37,624
TOTALS		4	$505,469	$7,588,542

APPENDIX III. LOANS WITH DEFICIENCIES

WPS Post-Purchase Review Deficiencies

#	Loan Number	Loan Name	Deficiency Type	Questioned Cost
1	[FOIA ex. 2]	[FOIA ex. 4]	B	$131,151
2			A,B,D,E	$171,340
3			A,B	$165,354
	Total			**$467,845**

Deficiencies Not Identified During Charge-Off

#	Loan Number	Loan Name	Deficiency Type	Questioned Cost
1	[FOIA ex. 2]	[FOIA ex. 4]	C	$37,624
	Total			**$37,624**

	Totals	**Questioned Costs of $467,845 + $37,624**		**$505,469**

Judgmental Loan-Post-Purchase Review Deficiency

#	Loan Number	Loan Name	Deficiency Type	Questioned Cost
1	[FOIA ex. 2]	[FOIA ex. 4]	A,B,C,D	**$587,610**

Charge-Off Without a Post-Purchase Review

#	Loan Number	Loan Name	Deficiency Type	Improper Payment
1	[FOIA ex. 2]	[FOIA ex. 4]	B,E	$81,641
2			A,B,C,D,E	$477,180
3			C	$42,271
4			A,C,D	$79,622
5			A,B,D	$63,767
	Total			**$744,481**

Deficiency on Loan without a Charge-Off Review

#	Loan Number	Loan Name	Deficiency Type	Questioned Cost
1	[FOIA ex. 2]	[FOIA ex. 4]	C	**$157,009**

Deficiency Type Legend:

A. Equity Injection
B. Use of Proceeds
C. Collateral/Liquidation
D. Eligibility/ Origination
E. Other Issues

APPENDIX IV. LOANS NEEDING RECOVERY

#	Loan Number	Loan Name	Questioned Cost
1	[FOIA ex. 2]	[FOIA ex. 4]	$131,151
2			$171,340
3			$165,354
4			$37,624
5			$587,610
6			$157,009
	TOTAL		**$1,250,088**

APPENDIX V. SUMMARY BY LOAN

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

The lender did not provide adequate support for debt being refinanced with loan proceeds. The loan authorization allocated $144,754 to refinance a [FOIA ex. 4] note, $22,150 to purchase equipment, and $83,296 for working capital. WPS did not obtain documentation to determine if the lender complied with the debt refinancing requirements of SOP 50 10 to ensure (1) there was at least a 20-percent improvement in cash flow, (2) the new payment was at least 20-percent less than the previous payment, and (3) the refinancing did not pay off a creditor in a position to sustain a loss. We are questioning SBA's charged off amount of $131,151.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

We are questioning the entire SBA purchase amount of $171,340 on this early-default loan based on the following lender deficiencies: (1) unsupported use of proceeds, (2) unverified equity injection, and (3) undetected indications of borrower fraud. The lender did not provide adequate documentation to support that $445,000 of loan proceeds were used for the purchase of the business. The lender provided a good faith estimate dated prior to loan disbursement as support for the use of proceeds, but there was no assurance that the loan was actually disbursed as documented on the estimate. Further, there was evidence a "straw borrower" was used to obtain the loan, but this was not questioned by the lender. The secretary of the borrowing business, who was not a co-borrower or guarantor on the loan, injected the entire $160,000 of equity into the business without the required standby agreement, was the apparent sales manager, and was operating this business and another out of the same location. While these facts show this individual was significantly involved in the business and indicate she was using a "straw borrower" to obtain the loan, the lender did not require her guaranty on the loan or examine her credit history and character. The lender acknowledged that it should have further examined her credit history, which would have allowed the bank to discover her past financial difficulties and potentially rethink the disbursement of the loan. After loan default, the lender learned that this individual used a "straw borrower" because she did not have the creditworthiness to obtain the loan herself. Rather than deny this loan in full, WPS recommended a $180,000 repair which was insufficient to mitigate the SBA loss. We are recommending recovery of the SBA guaranty purchase amount of $171,340.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

We are questioning SBA's outstanding balance of $165,354 on this early-default loan due to unverified equity injection, use of proceeds, and obvious indications of borrower fraud that were not identified during the post-purchase review. The WPS reviewer accepted bank statements, a wire transfer receipt, and an affidavit signed by the borrower as sufficient evidence of the $330,000 of required equity injection. While the bank statement showed $237,081 of deposits into the business account in 1 month, it also showed $151,318 of written checks. Copies of the checks were not provided to show the funds were used for business purposes. The remaining expenditures were also questionable because $16,638 was spent on overdraft service charges and returned deposit fees. Further, personal home mortgage and car payments may have been paid from the account. The wire transfer receipt provided in support for the remainder of the equity injection was also not acceptable because it omitted the source of the funds as required.

Joint payee checks or paid receipts were not provided to support $200,000 of loan proceeds disbursed for inventory. While the lender provided invoices to support the alleged inventory purchases, many were dated months prior to loan approval, were past due, and did not show evidence of payment. Lastly, indications of fraud by one of the company's owners were overlooked during the post-purchase review. The owner, who started the business 2 years prior to the loan request, was the largest contributor of equity injection, and the company's Chief Financial Officer, was designated as only a 5-percent owner of the business. Even though there were indications of irregular activities in the business accounts he controlled, the lender did not question his business ownership percentage, and he was not required to disclose his criminal history on Form 912. After loan default, the lender discovered potential fraud on the part of this individual.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

The machinery and equipment collateral for this loan had a liquidation value of $94,120 at loan origination. Approximately 1 year later when the loan defaulted, however, the collateral had a liquidation value of only $12,785. An appraisal indicated that collateral items may have been missing, but there was no evidence that the lender questioned the borrower or attempted to locate the missing collateral. We are recommending recovery of $37,624 as agreed to by the Center based on an analysis of the type of collateral, estimated liquidation expenses, and the liquidation value assigned to the collateral remaining at loan default.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

We are questioning SBA's outstanding balance of $587,610 on this early-default loan because the change of ownership was not at arm's-length, the lender did not verify equity injection, and there were obvious indications of fraud that were not detected by the lender. A $953,000 check for the disbursement of loan proceeds was made payable to both the seller and borrower. The borrower, however, was the principal of the borrowing corporation and an officer of the seller's corporation, with financial control over both businesses. As a result, the business purchase was not an arms-length transaction.

Further, no assurance existed that $242,500 of the $250,000 of required equity was injected into the business. A $175,000 gift, representing the majority of the required injection, was provided by the borrower's mother, who was also in control of the trust that held the business being purchased. While funds totaling $269,000 were available in the principal's personal account, there was no evidence any of it was ever injected into the business.

Finally, the lender was not diligent in underwriting the loan, and therefore, did not identify obvious indications of borrower fraud prior to disbursing the loan. The borrower provided powers of attorney, guaranty forms, and mortgage documents in order to collateralize the loan with his sister and brother-in-law's home. Using another person's asset as collateral is very rare and should have raised questions. Further, signatures on the documents looked suspiciously similar to the applicant's signature that should also have raised questions. Nevertheless, the lender disbursed the loan, requiring a verification of signatures within 15 days after loan disbursement, which was not prudent lending. The borrower had, in fact, forged the signatures of his sister and brother-in-law on the powers of attorney, guaranty forms and mortgage documents. If the lender had performed its proper due diligence, the loan never would have been made.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

There was no evidence that $98,000 of loan proceeds disbursed for debt refinancing was actually used for legitimate business purposes. Credit card statements or invoices to show the debt was incurred for business purposes were unavailable. We are questioning $81,641, SBA's share of the outstanding balance on the loan.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

We identified numerous lender deficiencies related to IRS verification, equity injection, site visit performance, collateral abandonment, and CPC expenses. This was an early-default loan, and there was no evidence that the lender performed an IRS verification of financial information relied on for the business purchase. Additionally, approximately 30-percent of the equity injection was derived from borrowed funds without the required standby agreements. There was also no evidence that a timely site visit was performed or that collateral was properly liquidated after loan default. The collateral consisted of equipment and 5 vehicles with a liquidation value of $112,365 at loan origination. At default, the lender estimated that the equipment had a liquidation value of only $20,000. The lender abandoned the collateral, claiming that the business equipment had been assigned to the landlord who was demanding $30,000 for rent, storage and attorney fees. The landlord, however, had signed a Consent and Waiver for the lender's first lien position on the equipment. As a result, the lender could have asserted its rights to the equipment. Moreover, the disposition of the five vehicles was not addressed. The sale proceeds from the equipment and vehicle collateral would have reduced the SBA loan balance. Lastly, the lender incurred an unnecessary $24,124 expense in pursuing funds related to its second lien position on real estate collateral. Due to material lender noncompliance, full recovery of $477,180 charged off by SBA is warranted.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

The lender failed to conduct a timely site visit and collateral inspection. The lender abandoned the machinery and equipment collateral, concluding that after the September 11, 2001, tragedy, its auction value had decreased by 40 percent. As the borrower defaulted on January 1, 2000, more than 21 months prior to September 11, 2001, this event should not have impacted recovery from collateral. As a result, we are questioning $42,271 ($64,900 liquidation value at origination less $8,539 in estimated expenses = $56,361 times 75 percent).

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

We are questioning $79,622 on this early defaulted loan due to lender deficiencies related to repayment ability, equity injection, and collateral. The lender projected positive cash flow for an existing business which historically had negative cash flow. The projections included a 149-percent increase in sales that was not justified. Further, there was no evidence that the borrowers made the required equity injection of $93,000. An unsigned HUD-1 Settlement Sheet was the only evidence provided for the majority of the equity injection. The lender also did not perform a timely site visit, which may have resulted in the loss of collateral.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

We are questioning SBA's outstanding balance of $63,767 on this early-defaulted loan based on deficiencies with repayment ability, equity injection, and use of proceeds. The SBA loan file did not contain the lender's credit analysis and the IRS transcripts of the seller's financial information, as required. Additionally, the file did not contain documentation to verify that the required $57,355 of equity injection was made. Further, no evidence was available that the lender verified the use of proceeds totaling $238,000. The loan file lacked the SBA Settlement Sheet and copies of checks to support the loan disbursement.

[FOIA ex. 4] **Loan Number** [FOIA ex. 2]

An SBA servicing center allowed the lender to apply proceeds from the sale of a portion of a business to a standby note before applying the proceeds to the SBA loan. However, the servicing center's approval of this action was based on misleading information provided by the lender. The Standby Agreement required the creditor to accept interest payments only until the SBA loan was paid in full and prevented the creditor from taking action to enforce its claim against the borrower until the SBA loan was fully satisfied. Standby Agreements remain in effect regardless of the maturity of the note that is on standby. Nevertheless, the lender misled SBA into believing that the Standby Agreement no longer applied or had been overcome by events. The lender told SBA that the note had been on standby with payments allowed and that the seller had filed suit against the borrower. Furthermore, the lender claimed the seller was unwilling to provide long-term financing. Without knowledge of the Standby Agreement terms, SBA relied on the information provided by the lender and concurred with the lender's request to allow the borrower to pay down the Standby Agreement versus the SBA loan. The lender's misrepresentation resulted in a $157,009 improper payment that should be recovered.

Appendix VI. Management Comments

DATE: July 17, 2009

TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: John A. Miller, Director [FOIA ex. 6]
Office of Financial Program Operations

SUBJECT: Draft Report on SBA's Management of the Backlog of Post-Purchase Reviews at the National Guaranty Purchase Center
Project No. 8002

Thank you for the opportunity to comment on the referenced draft audit. The audit was performed on a sample of post purchase reviews and charge-offs that took place from August 23, 2007 to December 14, 2007 on the backlog of post purchase review cases in the National Guaranty Purchase Center's (NGPC) inventory.

To help clarify the context for this and several other recent OIG audits, the findings and recommendations in this report focused on the earlier history of the center before major efforts to reengineer the purchase review process were completed. Many of the cases in this audit resulted from secondary market purchases processed in district offices prior to centralization that were sent to the center without completed post purchase reviews.

As you know, the NGPC introduced in February 2008 a comprehensive purchase review manual which was implemented after completion of the audit's on-site work. Accordingly, the cases reviewed in the audit do not reflect the current state of the center. Since the time of the on-site work, NGPC has realized significant process improvements and eliminated much of a large backlog of cases inherited from district offices. The Office of Capital Access (OCA), Office of Financial Assistance (OFA) and Office of Financial Program Operations (OFPO) management have been fully aware of the issues raised in this and other audits focused on the earlier history of the center, and have taken many steps to address them.

Much of this audit centered on the work product of contract loan specialists that SBA uses to process post purchase reviews, and the assertion is made in the audit that the quality of their work was substandard due to a lack of training and oversight. Prior to the time of this audit, NGPC undertook considerable effort to train and fully integrate contract personnel into the work of the center, including the processing of post purchase reviews. Accordingly, we take issue with the audit's assertion about the lack of training and oversight.

After the development of the comprehensive purchase review manual in February 2008, this training process was standardized and strengthened. Currently, all contractors and SBA employees receive comparable training, and as part of continuous process improvement, NGPC is continually building upon and refining past training processes. In fact, the center is now introducing a number of revisions to the 10-tab purchase system that will assist in purchase reviews.

Set forth below are our responses to each of the recommendations in your draft audit.

1. **Seek Recovery of $1,495,245 on the guaranties paid on the 8 loans in Appendix IV**

Response: OFPO and NGPC have reviewed the 8 loans in Appendix IV, and provide the following comments:

- [FOIA ex. 4] We agree that the lender did not provide adequate support for the $144,754 debt being refinanced and consequently we are requesting that the lender provide its refinancing analysis. If the lender cannot provide a satisfactory analysis, NGPC will require that the lender repay SBA's share of the loan proceeds that were used for the refinancing. If the lender does not do so, OFPO will seek OGC's evaluation as to the propriety of litigation to enforce collection.

- [FOIA ex. 4] We do not agree with OIG's conclusion that recovery is warranted because of a lack of evidence that $25,000 of loan proceeds was used to pay a franchise fee as required by the loan authorization. We note that the business operated for over 5 years and, accordingly, the strong presumption can be made that the franchise fee was paid. In addition, this loan was purchased over 6 years ago (3/3/03).
- [FOIA ex. 4] We do not agree with OIG's recommendation to pursue full recovery of the remaining purchase amount. In this case there was a repair in the amount of $180,000 that was negotiated in good faith with the lender and consummated to resolve the lender's deficiencies in handling the loan. This case is now closed and further collection action will not be pursued.
- [FOIA ex. 4] OFPO agrees to seek recovery from the lender in this case. If the lender will not repay the balance of the purchase amount disbursed, OFPO will request OGC's evaluation as to the propriety of litigation to enforce collection.
- [FOIA ex. 4, 6] We do not agree with OIG's suggestion that recovery of $12,736 may be appropriate. In view of the small amount involved and the remote date of the purchase (11/06/02), SBA will take no further action.
- [FOIA ex. 4] We agree that recovery from the lender is warranted in this case, but NGPC calculates the proper amount to be recovered as $37,624 based on an analysis of the collateral, rather than $65,045 as determined by OIG. If the lender will not repay the $37,624, OFPO will request OGC's evaluation as to the propriety of litigation to enforce collection.
- [FOIA ex. 4] OFPO agrees that full recovery from the lender is warranted in this case. If the lender will not repay the balance of the purchase amount, OFPO will request OGC's evaluation as to the propriety of litigation to enforce collection.
- [FOIA ex. 4] NGPC will seek additional information from the lender on this case in order to make a determination as to whether recovery is warranted and in what amount.

2. **Develop a purchase review manual for contractors that explains the different types of documentation that could be submitted and methods to analyze the data to identify lender deficiencies and potential indications of fraud during a purchase review.**

Response: We disagree with this recommendation. The NGPC has developed and distributed a comprehensive purchase review manual for all SBA employees and contractors. This manual is used for both pre-purchase and post purchase reviews and contains detailed steps for employees/contractors to follow in the purchase review process, along with an appendix that addresses guidelines with respect to documentation needed from the lender. The appendix and other portions of the manual will be supplemented with additional procedures and guidelines that are being developed through NGPC's ongoing Quality Assurance Policy Forum, which are integrated into the training process for the center. It is our position that the purchase review manual is fully satisfactory for use by all SBA employees and contractors, and that it would be unnecessary and duplicative to create a separate manual to be used only by contractors. In fact, dual manuals may lead to inconsistencies in the review process.

3. **Include detailed scopes of work, measurable performance metrics, deliverables, and adequate acceptance criteria in service contracts to assist the contractor staff in performing the reviews and the Center in supervising them.**

Response: OFPO partially agrees with the recommendation. Although the current contract does not have specific performance metrics, the WPS staff is held to the same performance metrics, deliverables, and adequate acceptance criteria in performing purchase reviews as those applicable to SBA employees. OFPO will develop performance and measurement standards for WPS personnel. These standards will be developed by 12-31-09 and OFPO will work with WPS as required to implement the standards into the contract.

4. **Devote adequate resources to contractor oversight to allow for thorough reviews of contractor purchase and charge-off decisions, along with supporting statements and documentation.**

Response: OFPO agrees with the recommendation and contends that it is currently being implemented. With respect to proper supervision, the work product of NGPC contract staff follows the same review process as for the work product of NGPC SBA employees, including the analysis and review of pertinent supporting lender documentation, and is subject to the same secondary level review standards employed by center legal counsel and approving officials as set forth in SBA's policies and procedures.

5. **Take timely action to perform adequate post-purchase and charge-off reviews to ensure the recovery of improper payments.**

Response: We agree with this recommendation. If a post-purchase or charge-off review indicates that there are grounds for recovery from the lender, such recovery will be promptly pursued.