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

Management Advisory
Report Number: 19-19

DATE: September 19, 2019

TO: Christopher M. Pilkerton
Acting Administrator and General Counsel

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: Office of Inspector General High Risk 7(a) Loan Review Program

This management advisory presents the evaluation results of a 7(a) loan as part of our ongoing High Risk 7(a) Loan Review Program. This is the third in a series of advisories for 7(a) loans we reviewed in fiscal year (FY) 2019. We presented four loans in our first two advisories and will consolidate the results of our FY 2019 loan reviews in our upcoming consolidated report. The objectives of our evaluation were to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with the Small Business Administration's (SBA's) rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

This advisory contains one recommendation that SBA agreed to implement. Please provide us your progress in implementing the recommendation within 90 days.

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.[1] Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures. When a 7(a) loan goes into default and the lender requests guaranty payment, SBA reviews loan documentation to determine whether the lender made, closed, serviced, and liquidated the loan in accordance with prudent lending standards and SBA requirements. SBA is released from liability on the guaranty, in whole or in part, at the Agency's discretion, if the lender fails to comply with any material SBA loan program requirements.

Previous audits indicated that some lenders failed to comply with SBA loan requirements; therefore, we established the High Risk 7(a) Loan Review Program in FY 2014. This program evaluates lender compliance with SBA requirements for high-dollar/early-defaulted 7(a) loans (loans approved for $500,000 or more that defaulted within the first 18 months of the initial disbursement). We use an internal scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance or suspicious activity by loan participants.

[1] 15 U.S.C. § 636(a).

Results

This memorandum includes the results of our review of a 7(a) loan as part of our ongoing High Risk 7(a) Loan Review Program. This is the third in a series of advisories covering the 7(a) loans we selected for review in FY 2019. We reviewed this high-dollar/early-defaulted 7(a) loan approved by a lender using their delegated authority. SBA honored its guaranty on the loan, resulting in a total purchase amount of $1,379,774. We found that the lender did not provide sufficient evidence to support that it originated and closed the loan in accordance with SBA's requirements. Specifically, the lender did not appropriately use its delegated authority. (See appendix II for details.)

SBA's standard operating procedure (SOP) 50 10 5 states that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. Consequently, the lender's material noncompliance with SBA requirements while originating and closing the loan resulted in a potential loss to SBA of $1,267,223.[2] (See appendix III for a schedule of questioned costs.)

Recommendation

We recommend that the Administrator require the Director for the Office of Financial Program Operations to:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $1,267,223 plus interest on the guaranty paid by SBA.

Analysis of Agency Response

SBA management agreed with the recommendation, stating that they conducted a preliminary review, and unless the lender provides additional information, deficiencies appear to exist. If the lender cannot provide information that would bring the loan into compliance, SBA will seek recovery from the lender. Management's planned corrective actions are sufficient to address the recommendation. (See appendix IV for SBA management's formal comments, which are included in their entirety.)

Summary of Actions Necessary to Close the Recommendation

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

1. **Resolved.** Management will contact the lender to obtain additional information to bring the loan into compliance. They stated that if the issues are not resolved, SBA will seek recovery from the lender. This recommendation can be closed when SBA provides evidence that the lender provided information to mitigate the finding or recovered the appropriate amount from the lender, if necessary.

[2] Proceeds from the liquidation process after purchase reduced SBA's loss on this loan. Additional proceeds from the liquidation process could further reduce this amount.

We appreciate the courtesies and cooperation extended to us during this evaluation. If you have any questions, please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616.

cc: William M. Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Jihoon Kim, Director, Office of Financial Program Operations
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Dorrice Roth, Acting Chief Financial Officer and Associate Administrator for Performance Management
Kyong Chae, Internal Control Analyst, Office of Internal Controls

Appendix I: Objectives, Scope, and Methodology

This management advisory presents the results of our evaluation of a loan as part of our ongoing High Risk 7(a) Loan Review Program. This is the third in a series of advisories covering a total of eight loans we selected for review in FY 2019. We presented four loans in our first two advisories and will consolidate the results of our FY 2019 loan reviews in our upcoming consolidated report. Our objectives were to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

To accomplish our objectives, we used an internal loan scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance or suspicious activity by loan participants. These attributes include, but are not limited to, the time lapse between loan approval and its transfer to liquidation, loan amount, equity injection, loan packager involvement, and use of loan proceeds. We obtained a universe of 190 high-dollar/early-defaulted 7(a) loans that were approved by lenders under the Preferred Lenders Program. Under this program, lenders are delegated the authority to process, close, service, and liquidate most SBA-guaranteed loans without prior SBA review. SBA honored its guaranty on these loans between October 1, 2015, and September 30, 2018. We eliminated loans for which SBA had not completed a purchase review. We then selected eight loans based on their assigned score and considered other factors, such as the outstanding balance and the period to default. This management advisory contains our review of one of these loans.

We also reviewed origination and closing actions as documented in SBA loan files. We assessed these actions against all applicable SBA requirements and reviewed information in SBA's loan accounting system for all loans examined.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's quality standards for inspection and evaluation. These standards require that we adequately plan inspections, present all factual data accurately, fairly, and objectively, and that we present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objectives.

Use of Computer-Processed Data

We relied on information from SBA's loan accounting system to score loans using an internal scoring system developed by OIG. Previous OIG engagements have verified that the information maintained in this system is reasonably reliable. Further, data elements associated with reviewed loans were verified against source documentation maintained in SBA's purchased loan files. As a result, we believe the information is reliable for the purposes of this program.

Appendix II: Evaluation of a $1,970,000 7(a) Loan Used to Purchase a Business, Refinance Debt, and Provide Working Capital

Background

We reviewed a $1,970,000 early-defaulted loan approved by a lender under its delegated authority for purchasing a business, refinancing debt, and providing working capital. The borrower made 12 loan payments before defaulting on the loan. SBA honored its guaranty and purchased the defaulted loan for $1,379,774, but SBA's share of the balance was reduced to $1,267,223 due to recoveries during liquidation.

Results

We identified material lender noncompliance with SBA's loan origination and closing requirements. Specifically, the lender did not appropriately use its delegated authority in accordance with SBA requirements.

SOP 50 10 5(H) states if the purchase price of the business includes intangible assets in excess of $500,000, and the equity contribution from the borrower and the seller combined is less than 25 percent of the purchase price of the business, the application may not be processed using delegated authority and must be sent to the Loan Guaranty Processing Center.[3] According to the business valuation for this change of ownership transaction, $2,038,442 of the value represented goodwill and other intangible assets which would require the borrower to provide a 25 percent equity injection for the lender to process the application under delegated authority. However, the loan authorization did not require an equity injection for this loan. The lender used this loan along with a companion loan, which required an equity injection in the form of a $1,000,000 standby agreement, to finance this transaction. Considering the purchase price of $4,310,832, the equity injection should have been at least $1,077,708. Because the lender did not require an equity injection of at least 25 percent of the selling price, the lender was not authorized to approve this loan under its delegated authority.

Conclusion

Our evaluation found that the lender approved a loan outside of its delegated authority. As a result, the lender did not comply with material SBA requirements related to the origination and closing of the loan. Due to lender noncompliance with SBA requirements, SBA should require the lender to bring the loan into compliance or, if not possible, seek recovery of $1,267,223 plus interest on the guaranty paid by SBA.[4]

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[3] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Subpart B, Chapter 2, Section IV.H.7.b.iii.

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

Appendix III: Questioned Costs

Questioned Costs for OIG High Risk 7(a) Loan Review Sample

Sample	Approval Amount	Purchased Amount	OIG Questioned Costs
1	$1,970,000	$1,379,774	$1,267,223

Source: Generated from evaluation results.

SBA

OFFICE OF FINANCIAL PROGRAM OPERATIONS

RESPONSE TO EVALUATION REPORT

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

TO:	Hannibal M. Ware, Inspector General Office of Inspector General (OIG)
FROM:	Jihoon Kim Director, Office of Financial Program Operations
SUBJECT:	Response to Draft Report on General High Risk 7(a) Loan Review Program
DATE:	September 13, 2019

We appreciate the role the Office of Inspector General (OIG) plays in working with management in ensuring that our programs are effectively managed, and for the feedback provided in this draft report.

The 2019 draft report lists the OIG's evaluation results of one 7(a) loan as part of the OIG's ongoing High Risk 7(a) Loan Review Program. The OIG's purpose was to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with the Small Business Administration's (SBA's) rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

The OIG found that the lender did not provide sufficient evidence to support that it originated and closed the loan in accordance with SBA's requirements. Specifically, because the lender did not require an equity injection of at least 25 percent of the selling price, the lender was not authorized to approve this loan under its delegated authority, and therefore, did not appropriately use its delegated authority.

OIG made the following recommendation:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $1,267,223 plus interest on the guaranty paid by SBA.

Management's response to the recommendations in the draft report follows:

Management substantially agrees with the recommendation listed in the report. After conducting a preliminary review, and absent additional information from the lender, deficiencies appear to exist. OFPO will notify the lender and work with the lender to obtain documentation to bring the loans into compliance. If the issues are not overcome, SBA will seek recovery from the lender.