EVALUATION REPORT

CONSOLIDATED RESULTS OF THE OIG HIGH RISK 7(A) LOAN REVIEW PROGRAM

SEPTEMBER 26, 2019 REPORT NUMBER 19-22

Executive Summary

Consolidated Results of the OIG High Risk 7(a) Loan Review Program

Report No. 19-22

September 26, 2019

What OIG Reviewed

In fiscal year 2014, the Office of Inspector General (OIG) established the High Risk 7(a) Loan Review Program to minimize losses on Small Business Administration (SBA) guaranteed loans, improve the effectiveness and integrity of the 7(a) program, and protect program dollars.

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.

This report consolidates the results of our FY 2019 High Risk 7(a) Loan Review Program. Specifically, we analyzed the results of the loans we reviewed from February 2019 through August 2019.

Using an internal loan scoring system, we selected and reviewed eight early-defaulted loans to assess lender compliance with SBA's rules, regulations, and procedures. The loans were approved by lenders under SBA's 7(a) Loan Guaranty Program. SBA honored its guaranty on these eight loans for a total purchase amount of approximately $10.8 million.

What OIG Found

Our review of these eight early-defaulted loans identified material lender origination and closing deficiencies that justified denial of the guaranty for five of the eight, totaling approximately $8.7 million. Specifically, we found that the lenders did not provide adequate documentation to support that the borrowers met requirements related to eligibility, repayment ability, size standards, franchise agreements, business valuations, appraisals, equity injection, debt refinance, and delegated authority. SBA staff completed purchase and quality control reviews on these eight loans but did not identify or fully address the material deficiencies noted during our evaluation. We did not identify any material deficiencies with the remaining three loans.

We previously issued three management advisories to SBA regarding the five loans with material lender origination and closing deficiencies. For these five loans, we identified a total potential loss of approximately $8.7 million. This report consolidates the overall results for FY 2019.

Actions Taken by SBA

SBA has taken actions in response to the three management advisories we issued this fiscal year for five loans we noted with deficiencies. These advisories identified material deficiencies in each of the loans, and we recommended combined recoveries totaling approximately $8.7 million. SBA agreed with our findings and recommendations on the five loans and agreed to contact the lenders to obtain additional information to bring the loans into compliance. If that's not possible, SBA plans to seek recovery from the lenders.

Agency Response

SBA management expressed appreciation for the information provided in the report. Management stated that they recognize the importance training plays in ensuring its employees possess the knowledge and skills required to perform guaranty purchase reviews and has placed an emphasis on training needs in FY 2019. Management also stated that they will continue to make improvements by evaluating the high dollar early default review process.

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

Final Report Transmittal
Report Number: 19-22

DATE: September 26, 2019

TO: Christopher M. Pilkerton
Acting Administrator and General Counsel

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: Consolidated Results of the OIG High Risk 7(a) Loan Review Program

Attached for your review is the evaluation report consolidating the results of our ongoing High Risk 7(a) Loan Review Program. This is the fourth and last in our series of reports for the work we conducted in fiscal year (FY) 2019.

We appreciate the courtesies and cooperation extended to us during this evaluation. Please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616 if you would like to discuss this report or any related issues.

cc: William Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Jihoon Kim, Acting 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
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Introduction

The Small Business Administration (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.

The SBA OIG High Risk 7(a) Loan Review Program

In fiscal year (FY) 2014, we established the High Risk 7(a) Loan Review Program to minimize losses on SBA loans, help SBA improve the effectiveness and integrity of its 7(a) program, and protect program dollars. We established this program because previous audits of improper payments and early-defaulted loans (loans that defaulted within 18 months of initial disbursement) showed that some lenders failed to comply with SBA loan requirements. Improper payments in the guaranty purchase process arise when an SBA purchase reviewer fails to identify material lender noncompliance with these requirements.

OIG's High Risk 7(a) Loan Review Program evaluates lender compliance with SBA's requirements on 7(a) loans approved for $500,000 or more that defaulted within 18 months of 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 and suspicious activity by loan participants.

Objectives

Our objective was to consolidate the results of our ongoing High Risk 7(a) Loan Review Program. Specifically, we analyzed the results of the loans we reviewed from February 2019 through August 2019. The objectives of the program 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. (See appendix I for information on our scope and methodology.)

Results

From February 2019 through August 2019, our evaluation included eight early-defaulted loans approved by lenders. SBA honored its guarantees by paying approximately $10.8 million for the defaulted loans. However, we identified material lender origination and closing deficiencies in five of the eight loans, resulting in a combined potential loss to SBA of approximately $8.7 million. The material deficiencies, absent additional evidence, warrant full recovery from the lenders on the guarantees paid by SBA. 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.[2] Although SBA staff completed purchase and quality control reviews on these eight loans, they did not identify or fully address the material deficiencies noted during our evaluation.

[1] 15 U.S.C. § 636(a).
[2] 13 CFR, Section 120.524, Business Credit and Assistance.

We presented the five loans with material deficiencies in three separate management advisories issued this fiscal year. We reported that the lenders did not provide adequate documentation to support their use of their delegated authority and that the borrowers met requirements related to eligibility, repayment ability, size standards, franchise agreements, business valuations, appraisals, equity injection, and debt refinance. We recommended combined recoveries totaling approximately $8.7 million. The issues we found in our FY 2019 reviews were similar to those identified in previous evaluations, such as business valuations, affiliates, equity injection, and repayment ability. We did not identify any new systemic issues during FY 2019; therefore, we are not making any recommendations in this report. The following table depicts the loan number, transaction type, issue, purchase amount, and recommended recovery for the eight loans reviewed in FY 2019.

Lender-Approved Loans Reviewed by OIG in FY 2019

Loan Number	Transaction Type	Issue Description	Purchase Amount	Recommended Recovery
1	Change of Ownership	(1) Inadequate review of franchise agreement, (2) Did not obtain business valuation, (3) Inadequate support for equity injection, (4) Inadequate appraisal, (5) Unsupported projections	$3,024,679	$3,000,297
2	Purchase Land	(1) Inadequate support for equity injection, (2) Inadequate support for debt refinance	$2,506,612	$2,335,492
3	Change of Ownership	No reportable deficiencies	$735,048	N/A
4	Business Startup	(1) Inappropriate use of delegated authority, (2) Affiliate not considered for size, (3) Inadequate support for equity injection, (4) Inadequate assurance of repayment ability	$1,367,417	$1,367,417
5	Change of Ownership	No reportable deficiencies	$607,904	N/A
6	Change of Ownership	(1) Inadequate support for equity injection	$733,031	$691,715
7	Change of Ownership	No reportable deficiencies	$491,383	N/A
8	Change of Ownership	(1) Inappropriate use of delegated authority	$1,379,774	$1,267,223
Totals			**$10,845,848**	**$8,662,144**

Source: SBA loan files and results of OIG's reviews.

Actions Taken by SBA

SBA has taken actions in response to the three management advisories we issued this fiscal year for five loans we noted with deficiencies totaling $8.7 million in questioned costs. These advisories identified material deficiencies in each of the loans, and we recommended combined recoveries totaling approximately $8.7 million. SBA agreed with our findings and recommendations on the five loans and agreed to contact the lenders to obtain additional information to bring the loans into compliance. If that's not possible, SBA plans to seek recovery from the lenders.

Analysis of Agency Response

SBA management expressed appreciation for the information provided in the report. Management stated that they recognize the importance training plays in ensuring its employees possess the knowledge and skills required to perform guaranty purchase reviews and has placed a large emphasis on training needs in FY 2019. Management also stated that they will continue to make improvements by evaluating the high dollar early default review process. (See appendix III for SBA management's formal comments in their entirety.)

Appendix I: Objective, Scope, and Methodology

This report presents the consolidated results of our ongoing High Risk 7(a) Loan Review Program from February 2019 through August 2019. Our program 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 and 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 the 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 defaulted 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.

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 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 was 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: Prior OIG Reports

SBA OIG issued the following OIG High Risk 7(a) Loan Review Program reports during FY 2019.

SBA OIG Report No.	Report Name	Date Issued
19-15	Office of Inspector General High Risk 7(a) Loan Review Program	July 10, 2019
19-16	Office of Inspector General High Risk 7(a) Loan Review Program	August 14, 2019
19-19	Office of Inspector General High Risk 7(a) Loan Review Program	September 19, 2019

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 Consolidated Results of the Office of Inspector General High Risk 7(A) Loan Review

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 Small Business Administration (SBA) strives to ensure payments on guaranty purchases are consistent with SBA's rules, regulations, policies, and procedures. The Office of Financial Program Operations (OFPO) takes great pride in its continuous improvement efforts at the National Guaranty Purchase Center (NGPC) and is always looking for ways to enhance the effectiveness of the review of guaranty purchase requests. SBA also recognizes the importance training plays in ensuring its employees possess the knowledge and skills required to perform guaranty purchase reviews. SBA works diligently to ensure it provides high quality training for employees' continued improvement.

In FY 2014, OIG established the High Risk 7(a) Loan Review Program. The OIG has since continued to review and report individual loan findings to management on an ongoing basis, which allowed the NGPC to address deficiencies and continuously improve the efficiency and effectiveness of the NGPC's guaranty purchase process.

Most recently, OFPO placed a large emphasis on training needs in FY2019. At the NGPC, training that specifically targets high risk loans helps to ensure that center staff has the proper resources to conduct the complex reviews required when these loans are purchased. Training has enabled the NGPC to identify more instances where repayment ability is an issue. Training has also enabled the NGPC to refer cases to the OIG to investigate potential fraud.

In FY2020, SBA will continue to make improvements by evaluating the high dollar early default review process. This evaluation will allow us to better identify areas that can be improved upon in the future to eliminate improper payments. The continuing evaluation of process improvements has contributed to the enormous strides The National Guaranty Purchase Center has made in studying complex early default purchases.