U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
ISSUE DATE: **JANUARY 11, 2000**
REPORT NUMBER: 0-03

TO: Jane Butler, Associate Administrator for Financial Assistance
Robert Baskin, Associate Administrator for Field Operations

FROM: Robert G. Seabrooks, Assistant Inspector General for Auditing

SUBJECT: Summary Audit of 7(a) Loan Processing

Attached is a copy of the subject audit report. The report contains one finding and three recommendations addressed to your offices. As a result of discussions with senior Small Business Administration (SBA) management officials, we made changes to the draft report including dropping two loans from the statistical projections. Corrective actions addressing the recommendations are in process or are planned for the near future.

The finding included in this report is the conclusion of the Office of Inspector General Auditing Division based upon the auditors testing of the auditee's operations. The finding and recommendations are subject to review and implementation of corrective action by your offices in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide your management response to the recommendations within 30 days from the date of this report on the attached SBA Forms 1824, Recommendation and Action Sheet.

Should you or your staff have any questions or want to discuss the issues further, please contact Garry Duncan, Director, Credit Programs Group at 202-205-7732.

Attachment

SUMMARY AUDIT OF 7(a) LOAN PROCESSING

AUDIT REPORT NUMBER 0-03

January 11, 2000

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.

SUMMARY AUDIT OF
7(a) LOAN PROCESSING

Table of Contents

Page

SUMMARY i

INTRODUCTION

A. Background 1

B. Objectives and Scope 1

RESULTS OF AUDIT

Finding and Recommendations

7(a) Loans were not always Processed, Disbursed, and Used in Accordance with SBA Requirements 3

APPENDICIES

A- Statistical Sampling Techniques and Results
B- Comparison of 7(a) and LowDoc Audit Results
C- Loans that were Inappropriately Approved and Disbursed
D- Loans that Need Corrective Action
E- Number of Non-Compliance by Procedure and District Office
F- Management Response
G- Audit Report Distribution

Summary

The Associate Administrator for Financial Assistance requested this audit to determine the level of compliance with SBA's requirements for loans made under the general 7(a) loan program and to compare the results to previously conducted similar audits of the Low Documentation Loan program (LowDoc), a sub-program of 7(a). From a universe of 32,462 loans valued at $10.3 billion, we selected a statistical sample of 240 loans valued at $74 million approved between March 1, 1996, and June 30, 1997. The objective of the audit was to determine whether loans were processed, disbursed, and used in accordance with SBA requirements.

We concluded that 7(a) loans were not always processed, disbursed and used in accordance with SBA requirements, and that the rate of non-compliance was about half that of the two LowDoc audits that preceded it. Based on a statistical projection of the sample results, we estimate that 3,505 loans, valued at $405 million, have a deficiency that resulted from non-compliance with SBA requirements.

The auditors evaluated lender compliance with 22 required procedures considered material to the loan approval process. Non-compliances were evaluated to determine whether they resulted in an actual deficiency that impacted the guarantee or required other corrective action to protect the Government's interest. Twenty-six loans (11 percent) valued at $7 million had deficiencies in this category. Another 92 loans (38 percent) had non-compliances in which the impact could not be determined during the audit, or had non-compliances that did not result in deficiencies.

SBA's oversight of lenders needs improvement. We noted that:

- Four out of five non-compliances occurred when SBA had limited or no oversight of the lender's processing and disbursing actions.
- SBA did not make lender oversight reviews, as required.
- A baseline goal had not been developed to measure and evaluate the adequacy of lender loan processing performance.
- Procedures for tracking guarantee repairs had not been developed by SBA district offices.

During the audit, SBA began to improve lender oversight by conducting Preferred Lender Program (PLP) Lender Reviews and Small Business Lending Company examinations and developing a guide for district offices to use for monitoring lenders. SBA also is in the process of establishing a lender oversight office.

We recommended that the Associate Administrator for Financial Assistance (AA/FA) set goals and measures to evaluate lender performance. The AA/FA advised that a lender review system, established in October 1999, would result in lenders being rated for their compliance with SBA lending procedures. The AA/FA's proposal is only partially responsive to the recommendation since lender goals and measures were not established. The AA/FA agreed to establish a centralized quality review process over the purchase of loans with material deficiencies. We also recommended and the Associate Administrator for Field Operations agreed to establish a procedure to track repairs and report the results to the AA/FA.

Introduction

A. Background

Section 7(a) of the Small Business Act of 1958, as amended, authorizes SBA to provide financial assistance to small businesses in the form of government-guaranteed loans. SBA guarantees loans made by lenders who agree to process loans in accordance with the law and SBA regulations, policies and procedures. If lenders fail to comply with the terms of the agreement, depending on the severity of the non-compliance, SBA maybe released from the guarantee and is not obligated to purchase defaulted loans.

The trend in recent years is increasing delegation of duties by SBA to lenders. The Preferred Loan Program (PLP), wherein experienced lenders are authorized to make SBA-guaranteed loans without prior credit approval by the Agency, as of June 30, 1999, accounted for about 34 percent of all 7(a) loan approvals and more than half of the dollars. The Low Documentation Loan Program (LowDoc), introduced in 1993, authorizes loans up to $150,000, and increases the number of loans that are approved by lenders with limited SBA review. In all, the Agency estimates that in FY 1999, more than 75 percent of the Agency's loan volume will occur in programs with very limited up-front SBA credit reviews.

B. Objectives and Scope

The audit objective was to determine whether 7(a) general business loans were processed and proceeds disbursed and used in accordance with SBA requirements.

The audit covered 7(a) loans approved between March 1, 1996, and June 30, 1997, a universe of 32,462 loans valued at $10.3 billion. A sample of 240 loans from eight SBA districts was drawn using the Rowe-Hartley-Cochran method with RATSTATS, statistical sampling software developed by the Office of Inspector General, U.S. Department of Health and Human Services (see Appendix A). Based on weights for number and dollar volume of loans processed, RATSTATS selected eight districts: Atlanta GA, Buffalo NY, Denver CO, Madison WI, Newark NJ, Kansas City MO, Charlotte NC, and Glendale CA. Thirty loans were randomly selected from each district for a total sample of 240 loans valued at $74 million.

Each loan was reviewed for compliance with 22 requirements in the law, SBA regulations, and the SBA-lender guarantee agreements. When non-compliances were identified, they were evaluated for impact – i.e., did a deficiency result from the non-compliance?

Deficiencies were determined to include ineligible loans or partially ineligible loans, and actual deviations from the loan agreement such as not using proceeds correctly or injecting equity. For statistical sampling projections, we related the deficiency with the inappropriate portion of the loan. In terms of ineligible loans, the total guarantee was deemed inappropriately issued. In cases where only a part of the loan was deficient, the corresponding amount of the guarantee was deemed inappropriately issued. Audits of the LowDoc program in 1996 and 1997

showed that loans were not always processed, disbursed, and used in accordance with SBA policies and procedures. While the methodologies between those audits and this audit differed, we have included a comparison of both in Appendix B.

The auditors reviewed documentation and conducted interviews at offices of lenders, borrowers, and SBA. Fieldwork was performed from September 1997 through March 1999. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Eleven percent of the loans reviewed had a deficiency due to non-compliance with SBA's requirements. While another 92 loans or 38 percent of the loans had at least one non-compliance with SBA procedures, there was no correlated impact on the loan. The number of loans processed without SBA's involvement had increased over time but SBA's reviews of lenders were not being performed as required. In addition, SBA had not developed base line standards and systemic information gathering to measure lender loan processing performance.

The rate of non-compliance found in the 7(a) audit was about half that of the two LowDoc audits that preceded it. Although compliance was better in the 7(a) audit, the rate of non-compliance was still significant and the risk of loss higher due to much larger average loan values for 7(a) loans. The value of the 7(a) loans audited averaged $309,170 compared to $61,700 and $53,522 for the LowDoc audits.

Finding – 7(a) Loans not Always Processed, Disbursed, and Used in Accordance with SBA Requirements

SBA requirements for the 7(a) loan program were not always followed. Additional SBA lender oversight is needed to improve the level of compliance with established procedures.

a. Loans should not have been approved or disbursed

Non-compliances resulted in 12 loans totaling $2.7 million being inappropriately approved or disbursed (see Appendix C). SBA was not aware of non-compliances for 8 of the 12 loans because these processes are not normally reviewed by SBA and were not reported by the lenders. These deficiencies were violations of Title 13, Code of Federal Regulations (CFR), Part 120 or SBA standard operating procedures. Based on a statistical projection of the sample results, we estimate the 7(a) portfolio included 1,724 loans valued at $266 million that did not meet the requirement for a SBA guarantee. The prohibited conditions included:

- Ineligible borrower
- Ineligible uses of loan proceeds
- Unacceptable character
- Undisclosed conflict of interest
- Lack of creditworthiness
- Lack of repayment ability

As of August 4, 1999, 2 of the 12 loans were performing, 2 were paid-in-full, 5 were canceled, and 3 were non-performing or charged-off.

b. Loans that had other deficiencies

Non-compliances for 14 loans, valued at $4.3 million, resulted in other deficiencies such as lack of full equity injections, ineligible loan purpose, use of proceeds, and unauthorized disbursements (see Appendix D). Non-compliances included failure to (i) ensure that equity injections were made as required by the loan agreement; (ii) disburse loan proceeds as required; (iii) ensure that the use of loan proceeds complied with the loan agreement; or (iv) disclose to SBA adverse changes in the borrower's condition. Based on a statistical projection of the sample results, we estimate that the universe of 32,462 loans included 1,781 loans valued at $139 million which had deficiencies that could impact the guarantee if a purchase request is received from the lender.

As of August 4, 1999, 7 of the 14 loans were current, 1 was paid-in-full, and 6 were non-performing or charged-off.

c. Loans with non-compliances where deficiencies may exist but could not be determined

Eight loans had non-compliances with SBA policy and the loan agreement that were unresolved. For seven loans borrowers or sellers refused to assist in obtaining IRS verification of financial data. For an eighth loan, the borrower would not provide evidence of a required equity injection.

As of August 4, 1999, seven of the eight loans were performing or paid-in-full, and one was non-performing.

d. Loans with non-compliances with no dollar impact

At least one non-compliance that did not result in a deficiency was found in 84 other loans in the sample. The non-compliances involved lack of: equity injection verifications, use of proceed verifications, IRS verifications, closing forms, or credit reports. However, when we performed the verification as a part of the audit, no adverse conditions were found. Based on statistical projection of the sample results, we estimate that the loan portfolio included 11,563 loans, totaling $3.4 billion in this category.

As of August 4, 1999, 71 of these loans were performing or paid-in-full, 8 were canceled, 1 was not disbursed, and 4 were non-performing.

Improvements needed in SBA oversight

SBA has developed various 7 (a) loan sub programs that are designed to have less direct involvement by SBA and therefore need more oversight to ensure compliance. We found that SBA's oversight program did not function as required for the reasons shown below.

SBA was not aware of a majority of the non-compliances

SBA is increasingly shifting responsibility for loan underwriting to lenders. Four of every five non-compliances in our sample occurred when SBA had limited or no oversight of the lender's processing and disbursing actions. Of the 170 non-compliances identified, only 32 were detectable by SBA under the current approval process. Of the other 138 non-compliances, 130 involved procedures that are not reviewed by SBA in loan approval and 8 were approved directly by lenders as PLP loans. The primary examples of processing and disbursing actions not reviewed by SBA were verifications of equity injections, IRS tax returns, and use of loan proceeds.

The three leading non-compliances (see Appendix E) were (1) untimely or missing IRS verification (46 instances), (2) lack of credit reports or improper determinations of character/creditworthiness (27), and (3) equity injections not verified or not made (23). These accounted for 56 percent of the 170 non-compliances identified. The first and third are procedures which traditionally have not been reviewed by SBA during loan processing.

SBA needs to monitor lender actions to strengthen controls over purchase decisions

When a loan defaults and the lender requests purchase of the SBA guarantee, SBA may be released from liability if the lender fails to materially comply with SBA regulations and the loan agreement. We found, however, that SBA purchase reviews rarely resulted in denials of liability – in the past 5 years, only 9 out of 1,918 purchase requests (0.5 percent) were denied in the eight districts covered by our audit. Three districts had no denials of liability. In contrast, our audit showed that 5 percent of loans should not have been made and another 6 percent needed corrective action or repair of the guarantee. An official in one district office stated that it was the policy of the Agency to cure non-compliances by voluntary adjustment (repair) of the guarantee by lenders. The districts did not track repairs; as a result, we could not evaluate the effectiveness of this activity.

Several individual OIG 7(a) loan audits resulted in recommendations to either repair or withdraw loan guarantees because of non-compliances with SBA requirements. We were told that such recommendations could not be implemented because of the SBA long-standing policy of not denying liability until a lender purchase request was received.

Lender oversight was not accomplished during the timeframes, as required. According to guidelines, district offices should have visited each lender annually unless a waiver was justified. Out of 147 lenders in our sample, only 18 (12 percent) received field visits by district personnel during fiscal year 1996, and 26 (18 percent) were visited during 1997. Districts said the required visits were not made because of personnel shortages, travel budget restrictions, or low volume of loans at the lender.

In June 1999, SBA announced that it was creating a new Office of Lender Oversight to improve monitoring of lenders. The responsibilities of the Office will include:

- promulgating regulations, policies, and procedures,
- coordinating preferred lender, Small Business Lending Company, and district office reviews with respect to lender oversight, and
- evaluating changes to existing loan programs to assess their risk potential and required oversight.

The creation of this office should lead to improvements in SBA's oversight of lenders when it's fully operational, and therefore, no recommendation will be made to address the aforementioned conditions.

Baseline goals for lender loan processing

The Government Performance and Results Act of 1993 requires establishment of performance goals to define the level of performance to be achieved by a program activity. Such indicators can be used to measure or assess the efficiency of the program activity and make necessary changes if improvements are not demonstrated. SBA has no process to measure 7(a) loan processing performance. Establishment of measures, with appropriate lender monitoring and information gathering and analysis, will place emphasis on quality loan making.

Recommendations

We recommend that the Associate Administrator for Financial Assistance take the following action:

1A. Establish goals and measures for lender loan processing errors and periodically compare performance to the goals.

1B. Centralize the purchase process for all loans identified during any review as having material deficiencies.

We recommend that the Associate Administrator for Field Operations take the following action:

1C. Establish a procedure to record repairs and report those results to the Office of Capital Access and the Office of Financial Assistance.

Management Comments

The Associate Administrator for Financial Assistance stated that she partially agreed with recommendations 1A and 1B but will not implement them exactly as presented.

- The lender review system, which became effective October 1, 1999, established a scoring mechanism based on the results of loan reviews by SBA personnel for each lender. This system will result in lenders being rated as substantially in compliance, generally in compliance, minimally in compliance, or in non-compliance.
- An October 26, 1999, meeting attended by the Deputy Administrator, the Chief Operating Officer, the AA/FA, AA/FO, and General Counsel resulted in an alternate proposal to the OIG centralization recommendation. Under the proposal, the Offices of Field Operations and General Counsel will review a sample of 10 percent of all loan purchases each year, including the loans identified as problematic by the OIG or SBA lender reviews. A summary of this proposal has been drafted and is currently in the SBA clearance process.

The Office of Field Operations agreed with recommendation 1C and stated that a new system to track and provide reports on loan repairs is estimated to be implemented in the beginning of FY 2001.

The Office of Financial Assistance agreed that 11 of the 12 sample loans shown in Appendix C should not have been approved and disbursed. For one loan [FOIA EX. 4] they disagreed and provided the following rationale.

> *"The purpose of the loan was to purchase an existing business. The seller used sale proceeds to pay a debt of the business to the participating lender that financed the purchase by a PLP loan. The OIG considers this an ineligible reduction of the lender's exposure under 13 CFR Section 120.140(j)(3). OFA does not concur with this.*
>
> *OFA believes this rule is applicable only to a reduction of the lender's exposure with a borrower obtaining a SBA guaranteed loan, not the debts of a third party. 13 CFR section 120.452(a)(2) supports this position. It says, in part, that a lender may not make a PLP business loan that reduces its existing credit exposure for any Borrower. The lender did not violate this rule."*

Evaluation of Management's Comments

The AA/FA's proposal for recommendation 1A is only partially responsive to our recommendation.

- The proposed process for recommendation 1A will provide some measure of individual lender performance but does not set a baseline goal for lenders nor compare lender performance, individually or collectively, to a goal.

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- For recommendation 1B, the planned review of 10 percent of all loans purchased,

including all loans with possible problems, will be an improvement in the control over the guarantee purchase process. This alternative may be sufficient if a quality review process is implemented to: (i) recover funds inappropriately paid for loan purchases, and (ii) ensure appropriate actions are taken against district offices making bad purchase decisions. We will evaluate the effectiveness of this control in the future.

- The proposed actions are responsive to recommendation 1C.

- The OIG disagrees with management's position concerning loan number [FOIA EX. 4]. The CFR cite and management's interpretation are not supportive or applicable to the circumstances of this loan.

  Proceeds were used to pay off a loan owed by the ***seller*** *of the business to the lender making the SBA loan. SBA was not informed of this fact. Section 120.140(j)(3) of 13 CFR, which applies to all lenders, states that a participant may not fail to disclose to the SBA whether the loan will repay or refinance a debt due a Participantor an Associate of a Participant.*

  OFA management appears to be inappropriately using a narrowly focused prohibition to support their disagreement. Section 120.452(a)(2) of 13 CFR provides an exception to 13 CFR 120.140 (j)(3) only when the lender has an interim non-real estate loan to a borrower which is refinanced by a PLP loan within 90 days after the issuance of the interim loan. This provision—13 CFR 120.452 (a)(2) does not address any other situation and therefore, does not provide any other exception to the 120.140(j)(3) provision. Discussions with legal counsel support our conclusion.

Appendix A

Statistical Sampling Techniques and Results

We reviewed data from a statistical sample of 7(a) loans approved during the period March 1, 1996 to June 30, 1997, to develop our estimates of population values. The statistical sample was a multi-stage sample based on the following data.

UNIVERSE	32,462 loans valued at $10.3 billion							
1st Stage	240 loans valued at $74 million							
2nd Stage	Atlanta 30 loans	Buffalo 30 loans	Charlotte 30 loans	Denver 30 loans	Glendale 30 loans	Kansas City 30 loans	Madison 30 loans	Newark 30 loans

The estimates of population values have measurable precision or sampling errors. The precision is a measure of the expected difference between the values found in the sample and the values of the same characteristic that would have been found if a 100 percent review had been made using the same techniques. Sampling precision is indicated by ranges or confidence intervals that have upper and lower limits and a certain level of confidence. Calculating at a 90 percent confidence level means the chances are 9 out of 10 that if we reviewed all of the 7(a) loans in the populations, the resulting values would be between the lower and upper limits, with the population mid-point estimates being the most likely number of non-compliances.

The following population estimates and lower and upper limits were calculated using the Department of Health and Human Services OIG's RATSTATS program at a 90 percent confidence level. We used the population mid-point estimates as the statistical projections for this report. These projections are applicable solely to the 7(a) loans processed during the period of our review.

SAMPLE RESULTS	**PROJECTIONS TO POPULATION**					
	Dollar Amount			**Number of Loans**		
	Point Estimate	**Lower Limit**	**Upper Limit**	**Point Estimate**	**Lower**	**Upper**
26 loans with dollar impact	$404,684,221	$273,686,826	$535,681,616	3,505	2,901	4,109
12 loans that should not have been made	$266,162,243	$148,257,035	$384,067,451	1,724	1,231	2,217
14 loans that may need adjustment if purchased by SBA	$138,521,978	$49,556,083	$227,487,873	1,781	844	2,718
118 loans with at least one non-compliance	$4,570,742,851	$4,042,146,846	$5,099,338,856	16,192	14,092	18,292
8 loans with unresolved dollar impact	$218,666,753	$64,637,064	$372,696,442	1,124	349	1,898
84 loans with no dollar impact	$3,404,361,873	2,526,913,292	4,281,810,455	11,563	8,411	14,715

Appendix B

Comparison of 7(a) and LowDoc Audit Results

ELEMENT	7(A)	LOWDOC II	LOWDOC I
a —Number of loans	240	120	70
b—Number of loans with non-compliances	120	84	55
c—Non-compliances/loans (b÷a)	50%	70%	77%
d—Number of loans which should not have been made	12	13	7
e—Material Non-compliances/loans	5 %	11%	10%
f—Material non-compliances/dollars	6 %	9%	10%
g—Total non-compliances	170	171	110
h —Average number of non-compliances to loans with non-compliances (d÷b)	1.42	2.04	2.04
Dollar impact – gross loan amount	$2,735,000	$673,805	$390,000
Gross amount of sampled loans	$74,010,093	$7,404,024	$3,746,540

Appendix C

Loans that were Inappropriately Approved and Disbursed

LOAN NUMBER	AUDIT REPORT #	LOAN AMOUNT	GUARANTEE AMOUNT	QUESTIONED AMOUNT	REASON
Entire column FOIA EX. 4	8-7-F-019-014	Entire column FOIA EX.4	$30,000	$30,000	Ineligible purpose of loan
	8-7-F-019-014		$283,500	$283,500	Conflict of interest
	8-7-F-020-022		$271,260	$271,260	Ineligible purpose of loan
	8-7-F-021-018		$166,500	$166,500	Adverse change in financial condition
	8-7-F-021-018		$450,000	$450,000	Size standard
	8-7-F-021-018		$251,250	$251,250	Adverse change in financial condition
	8-8-F-002-028		$120,000	$120,000	Conflict of interest
	8-8-F-002-028		$20,000	$20,000	Repayment ability, false statement, character
	8-8-F-002-028		$56,000	$56,000	Ineligible purpose of loan
	9-05		$80,000	$80,000	Lack of character/creditworthiness
	9-05		$108,000	$108,000	False statement
	9-04		$53,250	$53,250	Ineligible purpose of loan
TOTAL		$2,735,000	$1,889,760	$1,889,760	

Appendix D

Loans that Need Corrective Action

LOAN NUMBER	AUDIT REPORT #	LOAN AMOUNT	GUARANTEE AMOUNT	QUESTIONED AMOUNT	DEFICIENCY
Entire column FOIA EX.4	8-7-F-019-014	Entire column FOIA EX.4	$210,000	$10,000	Equity injection not made
	8-7-F-019-014		$386,250	$100,000	Equity injection not made
	8-7-F-019-014		$80,000	$67,000	Equity injection not made
	8-7-F-019-014		$236,250	$17,479	A portion of loan proceeds used to repay ineligible debt
	8-7-F-020-022		$172,650	$20,000	Equity injection not made
	8-7-F-020-022		$375,000	$107,715	A portion of loan proceeds used to repay an eligible debt
	8-8-F-003-019		$157,500	$13,000	Equity injection not made
	8-8-F-002-028		$151,500	$83,400	Equity injection not made
	9-05		$749,720	$390,000	A portion of loan proceeds were used to compensate an associate
	9-04		$264,375	$104,326	A portion of loan proceeds used for an unapproved business purpose
	9-16		$36,000	$18,995	Equity injection not made
	9-16		$37,500	$17,830	A portion of loan proceeds used for an unapproved business purpose
	9-16		$64,320	$23,847	Use of proceeds not verified
	9-16		$100,500	$29,567	A portion of loan proceeds used for unapproved business purposes
TOTALS		$4,267,600	$3,021,565	$1,003,159	

Appendix E

Number of Non-compliances by Procedure and District Office

PROCEDURE	ATL	MAD	BUF	NEW	GLN	DEN	CHA	KC	TOTAL
1) Inadequate evidence of repayment ability					1	1			2
2) No repayment ability calculation documented									
3) Lack of character / creditworthiness (including lack of credit reports)	4	2	2		1	1	9	8	27
4) Conflict of interest	1				1				2
5) Alternative source of funds available									
6) Size standard	1		1						2
7) Ineligible loan purpose or use of proceeds	2	1			1		2		6
8) Unallowable business type									
9) IRS verification not done	1	2	1	2	4	1	1	5	17
10) IRS verification done after loan disbursement	6	7	4	2	2		1	7	29
11) False/inaccurate information provided					1	1			2
12) 1050 Settlement sheet signed in blank		1				3			4
13) 1050 Settlement statement not prepared		2				1	2		5
14) Disbursements not made per loan authorization requirements		1	1			2		2	6
15) Joint payee checks not used		2	3			1		3	9
16) Use of proceeds not verified		1	1	2		1	7	2	14
17) Required equity injection not verified or not made	4	2	1	4	2	3	2	5	23
18) Adverse change not reported to SBA			3						3
19) All available and needed collateral not used					1				1
20) Disbursements not per the required time frame	2	1		2	2	1	1		9
21) Required standby agreement not obtained									
22) Fees not documented or not allowed					2		2	5	9
Total	21	22	17	12	18	16	27	37	170

Individual audit reports issued by district:
ATL – Atlanta, GA #8-7-F-019-014 **MAD** - Madison, WI #8-7-F-020-022; **BUF** - Buffalo, NY #8-7-F-021-018; **NEW** - Newark, NJ #8-8-F-003-019; **GLN** - Glendale, CA #8-8-F-002-028; **DEN** - Denver, CO #9-05; **CHA** – Charlotte, NC #9-04; **KC** – Kansas City, MO, #9-16

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

Appendix F

DATE: November 2, 1999

TO: Phyllis K. Fong
Inspector General

FROM: Jane Palagrove Butler
Associate Administrator
for Financial Assistance

SUBJECT: Draft Summary Report - 7(a) Loan Processing
Response to Recommendations

The Office of Financial Assistance (OFA) provides the following responses to the recommendations of the Office of the Inspector General (OIG) made in the Draft Summary Report on 7(a) Loan Processing.

1A. **Establish baseline goals and measures for lender loan processing errors and periodically compare performance to the goals.**

OFA partially agrees with this recommendation but will not implement it exactly as presented. We believe that the following is consistent with the spirit of the recommendation.

A Lender Review System has been established with the implementation of SOP 50 50 4(B), Appendix 30. This was effective October 1, 1999.

The system has established a scoring mechanism based on the answers provided at the time the loan is reviewed. It covers all aspects of a loan (i.e., processing, servicing, and liquidation). This will result in the lender being substantially in compliance, generally in compliance, minimally in compliance, or non-compliance.

This system is an integral component of risk management that establishes benchmarks that are used in the review system to determine the priority and frequency of the reviews.

1B. **Centralize the purchase process for all loans identified during any review as having material deficiencies.**

On August 25, 1999, a 606 requesting implementation of centralizing purchases of loan whose guarantees are in question was placed into clearance. [FOIA EX 5]

On October 26, 1999, a meeting was held with the Deputy Administrator and Chief Operating Office which included OFO, OGC, OFA, and the Office of Capital Access. At that meeting an alternate proposal was discussed. Under this proposal, OFO and OGC will review a sample of 10% of all loan purchases each year, including the cases identified by OIG or through lender reviews or otherwise as potentially problematic for

purchase. A summary of this proposal, including a recommendation to the Deputy Administrator that it be adopted, has been drafted and is currently in clearance.

2A. Establish a procedure to record repairs and report those results to the Office of Capital Access or Financial Assistance.

The Agency currently collects some of the data that is required to track repairs. A repair actually covers three areas: (1) Partial adjustments to the SBA guaranty, (2) denial of liability, and (3) lender releases SBA of its guaranty. Data from the partial adjustment and the denial of liability is currently in SBA's database. However, a program will need to be developed to generate regular reports. When the lender writes SBA and formally releases the Agency of its guaranty, the letter is placed in the borrower's file, and the lender marks the next SBA Form 1502 as paid in full. SBA's system only reflects that the loan is paid in full not that the lender releases the Agency of its liability. As a result, a check block will be developed for the field office to complete that will reflect that the guaranty was released. It is anticipated that the necessary program changes and report development should be completed in approximately one month.

The new Loan Monitoring System (LMS), which is being developed as part of the over all systems modernization of the Agency, will record loans on which a repair occurs and will provide OFA with reports. The estimated implementation date is the beginning of FY2001.

Twelve of the fourteen case files listed in Appendix C of the report were reviewed.

OFA concurs with 4 of findings, does not concur with 2, and is unable to take a position on 6 of the loans. OFA has not reviewed 2 files.

Of the 2 files not reviewed, one was requested but not received by Headquarters and the other was not the correct file. The correct file was requested after OFA's initial response but was not received as of the date of this memorandum.

OFA will continue to try to obtain these files and will provide comment when they come in from the field and are reviewed if we do not concur with the findings.

Detailed comments on the findings are attached.

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

Appendix F

DATE: December 8, 1999

TO: Phyllis Fong
Inspector General

FROM: Jane Palsgrove Butler
Associate Administrator
for Financial Assistance

SUBJECT: Draft Summary Report - 7(a) Loan Processing

The Office of Financial Assistance (OFA) is responding to additional information provided by the Office of Inspector General (OIG) on 10 of 14 loans in Appendix C of the Draft Summary Report on the 7(a) Loan Processing. OIG classifies the 14 loans in Appendix C as "Loans that should not have been made."

As a result of additional information supplied by OIG pertaining to 10 loans listed in Appendix C, OFA has reviewed 13 of the 14 total loans on that list as of this date. Although one loan file was not reviewed by OFA, the information supplied by OIG on this loan was sufficient for OFA to respond.

OFA concurs with the findings on 6 out of the 14 loans listed in Appendix C but does not concur with the findings on the remaining 8 loans.

Comments explaining OFA's position on each of the 14 loans and a copy of OFA's memorandum of November 2, 1999, are attached for your convenience.

Please advise if your office desires further discussion on this review.

c. **OFA concurred with the finding on the following loan on the basis that it was improperly approved under PLP:**

7. FOIA EX 4

d. **OIG provided additional information that enabled OFA to concur with the findings on the following 3 loans:**

8. FOIA EX 4

11 FOIA EX 4

OIG stipulated that the lender did not make SBA aware of unsatisfactory credit information.

12. FOIA EX 4

OIG stipulated that the lender did not make SBA aware of unsatisfactory credit information.

e. **OFA and OIG are unable to reach concurrence on the following loan:**

2. FOIA EX 4

The purpose of the loan was to purchase an existing business. The seller used sale proceeds to pay a debt of the business to the participating lender that financed the purchase by a PLP loan. The OIG considers this an ineligible reduction of the PLP lender's exposure under 13 CFR §120.140(j) (3). OFA does not concur with this.

OFA believes this rule is applicable only to a reduction of the lender's exposure with a borrower obtaining an SBA guaranteed loan, not the debts of a third party. 13 CFR §120.452(a)(2) supports this position. It says, in part, that a lender may not make a PLP business loan that reduces its existing credit exposure for any Borrower. The lender did not violate this rule.

More information is available from the memoranda and attachments dated November 2, 1999, and December 8, 1999, issued by OFA to OIG.

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

Appendix F

DATE: December 17, 1999

TO: John Dye
Acting Assistant Inspector General
for Auditing

FROM: Jane Palsgrove Butler
Associate Administrator
for Financial Assistance

SUBJECT: Response to OIG on Draft of Summary Report on 7(a) Loan Processing

This office has had extensive discussions with OIG concerning the subject draft report and has reached agreement on the findings for all but one of the loans originally listed in Appendix C of the Draft Summary Report on 7(a) Loan Processing.

This appendix originally included 14 loans. OIG agreed to drop two loans from this list, which should significantly improve the statistical data, which substantially lowers the projected exposure of SBA to potential loss. The two loans reduced the total gross loan amount of $4,765,000 by $2, 030,000, or 43.1%.

a. The following two loans are the ones OIG agreed to drop:

10. FOIA EX 4

OIG concurred with OFA that analysis and determination of repayment ability is subjective and should not be viewed as a violation of policy and procedures.

13. FOIA EX 4

OIG concurred that use of loan proceeds to pay off interim construction loans to participating PLP lenders per policy in SOP 50-10 is not ineligible and does not create an appearance of a conflict of interest.

b. OIG also agreed to amend language in the report to indicate that some loans either should not have been approved or should not have been disbursed. This enabled OFA to concur with OIG's finding on the following three loans on which an adverse change occurred after approval:

4.

6. FOIA EX 4

9.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

Appendix F

MEMORANDUM

Date: September 23, 1999

To: John Dye, Acting Inspector General for Auditing

From: Robert Baskin, Associate Administrator for Field Operations

Subject: Summary Audit of 7 (a) Loan Processing

Thank you for the opportunity of commenting on your draft summary report on the 7(a) Loan Processing. The Office of Field Operations supports the Office of Inspector General and relies upon your office in the investigative process, especially in instances where our field offices have indicated a matter of potential fraud or other misuse of the loan programs.

We are in agreement with you that more lender oversight of our lenders is needed and are working closely with the Office of Financial Assistance on the new procedure for lender oversight. It is anticipated that our field offices will be receiving training on the new procedures within the next couple of months by a series of conference calls. OFA will be coordinating these conference calls with our office to ensure that all appropriate field staff are trained in the new lender oversight procedures.

It may be beneficial in future reports to identify issues of dispute between OIG and the field offices as to OIG's findings. This way, some of these matters may be resolved up front instead of being left as unresolved issues. For example, in your Kansas City Report 9-16 dated August 4, 1999, on page 6 Reasons for Lender Deficiencies the lender's loan officers disagreed that an error was made as to 7 of the OIG stated deficiencies. There was no elaboration or notation as to what was in dispute, and whether OIG took the lenders' or the field's responses into consideration as to those items being disputed.

Robert B. Baskin

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Appendix G

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