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

AUDIT REPORT
ISSUE DATE: MAY 28, 2002
REPORT NUMBER: 2-19

TO: Jane Palsgrove Butler
Associate Administrator for Financial Assistance

David Frederickson
Associate Administrator for Field Operations

Robert G Seabrooks

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

SUBJECT: Audit of Borrowers with Prior Defaulted Loans

Attached is a copy of the subject audit report. The report contains one finding with three recommendations for the AA/OFA and two recommendations for the AA/OFO. The AA/OFA agreed with one recommendation and disagreed with two. The AA/OFO agreed with one recommendation and offered an alternative solution to the other. The recommendation that was not agreed to will be resolved during the audit resolution process. Your comments have been synopsized in the report and included as attachments.

The finding in this report is the conclusion of the Office of Inspector General's Auditing Division. The finding and recommendations are subject to review and corrective action by your office 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 Action Sheet. The SBA Forms 1824 should be sent to:

Audit Manager
SBA OIG / Auditing Division, Suite 1803
233 Peachtree Street, NE
Atlanta, Georgia 30303

Any questions you may have regarding this report may be directed to Garry Duncan, Director, Credit Programs Group, at 202-205-7732.

AUDIT REPORT

BORROWERS WITH PRIOR DEFAULTED LOANS

AUDIT REPORT NUMBER 2-19

May 28, 2002

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA 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.

AUDIT REPORT

BORROWERS WITH PRIOR DEFAULTED LOANS

Table of Contents

Page

SUMMARY i

INTRODUCTION

A. Background 1

B. Objectives and Scope 1

C. Statement of Management Controls 2

D. Prior Audit Advisory Report 2

RESULTS OF AUDIT

Finding and Recommendations

Ineligible Applicants Received Loan Guarantees 3

APPENDICES

A- Management Responses
B- Report Distribution

SUMMARY

Our audit is a follow up review to a January 2000 audit report (A1-02) which identified 31 loans in SBA's loan accounting system as committed where principals had a prior defaulted SBA guaranteed loan. We recommended SBA investigate the 31 loans to verify that the principals were eligible for the subsequent assistance. As a result, SBA cancelled guarantees totaling $3 million and requested or received payments on loans totaling $176,000.

SBA regulations state that applicants who have previously defaulted on Federally assisted financing that resulted in a loss to the Government are not eligible for SBA guaranteed loans. The audit was made to determine if SBA loans were inappropriately guaranteed to applicants who had previously defaulted on a loan resulting in a loss to the Federal Government. The SBA loan database was used to compare social security numbers (SSNs) of principals whose loans defaulted to SSNs of principals who received loans between October 1995 and April 2001.

After eliminating prior loans with no losses, subsequent disaster loans, and other inappropriate loan matches, there were 168 prior and subsequent loans made to borrowers with prior defaults. For the 168 loans, we confirmed that 42 had principals who had prior Federal losses and two had SSN input errors. The eligibility of the remaining 124 was not determined because the age of the prior loan files exceeded the file retention dates and testing indicated they probably no longer existed. As of January 2002, SBA had honored guarantees totaling $2.3 million for 9 of the 168 loans and had remaining guarantees in effect totaling about $20.1 million for 98 other loans. Fifty-nine of the loans were cancelled or paid in full at the review date.

It was disclosed that applicants were not truthful when certifying to the existence and status of their prior debts. Further, SBA did not have a specific requirement to check the SBA database and the Credit Alert Interactive Voice Response System (CAIVRS) for borrowers who caused the Government to suffer losses from prior Federal financial assistance.

We recommended that the Associate Administrator for Financial Assistance (AA/OFA) establish procedures to require the use of the loan accounting database and CAIVRS to determine whether a borrower has had prior defaulted loans, and for lenders to access the SBA database before completing the loan application to identify borrowers with prior defaults that caused losses. We also recommended recovery from borrowers with a prior loan loss whose subsequent loan defaulted as the result of evidence of a false statement regarding the disclosure of such prior losses. We recommended that the Associate Administrator for Field Operations (AA/OFO) use the Guaranty Tracking System to annotate loan files of principals whose current loan file do not disclose prior loan losses and reiterate to field offices the retention requirements for charged-off loan files.

The AA/OFA responded that the condition identified did not rise to the level that would justify corrective action and that allowing lenders access to SBA's database raised concerns about Privacy Act issues. She agreed to pursue recovery action against borrowers whose subsequent loans default and who failed to disclose prior losses. The AA/OFO responded by offering an alternative method in lieu of the Guaranty Tracking System for alerting SBA personnel of borrowers who failed to disclose losses on prior loans. Field office personnel would also be reminded of the retention requirements for charged-off loan files.

INTRODUCTION

A. Background

When applying for an SBA guaranteed loan, applicants are required to provide information about prior Federal assistance and any losses that may have resulted from that assistance. A loss incurred by the Federal Government on a prior loan does not automatically preclude the applicant from assistance. Applicants can obtain a waiver when there is good cause or compelling circumstances.

Title 13 of the Code of Federal Regulations, Section 120.110(q) states that, unless waived by SBA for good reason, businesses and applicants who have previously defaulted on a Federal loan or assisted financing resulting in the Government sustaining a loss are ineligible for SBA business loans. For the purposes of this section, a compromise agreement is considered a loss. Standard Operating Procedure 50-10(4)(E) defines a loss as the dollar amount of any deficiency which has been incurred and recognized by a Federal agency after it has written off or otherwise closed out an account.

Office of Management and Budget Circular A-129 (Policy for Federal Credit Programs and Non-tax Receivables) states that, as part of the loan applicant screening process, agencies shall use the CAIVRS to identify Federal delinquencies. CAIVRS, an automated database maintained by the Department of Housing and Urban Development, identifies individuals who are delinquent on Federal debts. Its purpose is to improve credit management on a Government-wide basis by preventing delinquent Federal debtors from receiving additional Federal credit.

A review of lender loan files during a prior audit disclosed a principal who had obtained multiple guaranteed loans after defaulting on a prior SBA loan. Our review of these loan files showed that the principal's defaulted loans were not disclosed on subsequent loan applications. To evaluate the existence of this type problem, we compared social security numbers (SSNs) for all principals whose loans had defaulted to the SSN of those receiving loans between October 1995 and April 2001. There were SSN matches where principals with prior defaults had obtained new SBA loans totaling $132 million.

B. Objectives and Scope

The objective of the audit was to determine if and why guaranteed loans were made to applicants who had previously defaulted on an SBA loan resulting in a loss to the Government.

To identify borrowers with prior defaults, the SBA's loan accounting system was queried to compare SSNs applicable to all purchased loans to SSNs of loans approved during the period October 1995 to April 2001. We reviewed regulations and operating procedures to identify existing controls and interviewed SBA and lender personnel. The accuracy of the January 2002 data in the loan accounting system was assessed by comparing it with data in SBA's and lenders' loan files. The data was accurate for 42 of 44 pairs of loan files reviewed.

The system showed 447 loans for which the principals had prior SBA guaranteed loans that were transferred to liquidation or were purchased by SBA. We eliminated prior loans paid

in full, not charged off, charged off prior to 1989 or subsequent disaster loans. This reduced the number of loans to 168. Data in subsequent and prior loan files were then compared to ascertain whether the applicants for both loans were the same and if full disclosure was made about the prior Federal debt.

Audit fieldwork was performed from January through October 2001 and the audit was conducted in accordance with generally accepted Government Auditing Standards.

C. Statement on Management Controls

Our assessment of management controls, policies, procedures, and practices was limited to those applicable to the identification of applicants with prior loan defaults that caused the Government to suffer a loss. The audit was performed to determine why applicants with prior loan losses were approved for subsequent loans. A study and evaluation made for the limited purpose described above would not necessarily disclose all material weaknesses in the management controls. However, our assessment disclosed management control weaknesses that could result in undetected losses to the 7(a) loan program. These weaknesses included a lack of formal operating procedures requiring SBA personnel to check the loan accounting system and CAIVRS for prior losses and the premature destruction of charged-off loan files. These weaknesses and their effects are fully discussed in the audit results section of this report.

D. Prior Audit Advisory Memorandum Report

While conducting an audit of the PLP Oversight Process, we identified a borrower with three current loans who had sustained a loss on a prior SBA loan. A query of the SBA loan accounting system using the SSNs of borrowers showed that this was not a unique situation. As a result, advisory audit report A1-02 was issued on January 9, 2001, on the identification of possible ineligible borrowers within the Section 7(a) Business Loan Program.

We found 180 loans made during fiscal years 1998 through 2000 whose principals had previously defaulted on SBA loans. Of the 180 loans, 31 were loan commitments valued at about $12.5 million. These commitments involved the Fastrack, Section 504, International Trade, and general business loan programs processed under preferred, express, and regular loan procedures.

We recommended that the Associate Deputy Administrator for Capital Access suspend loan disbursement until a determination was made whether the borrowers were the same, whether they disclosed the prior default on the loan application, and whether a waiver had been granted. In the event a waiver was not granted, we recommended the loan commitment be cancelled. Management concurred with these recommendations.

RESULTS OF AUDIT

FINDING 1 – Ineligible Applicants Received Loan Guarantees

SBA provided loan guarantees to applicants who were ineligible. We identified 168 loans that may be ineligible and confirmed that 42 had principals with prior defaulted loans that resulted in losses. Of the remaining 126 loans, two were SSN input errors, and 124 could not be confirmed because one of the pair of loan files was presumed to no longer exist. Loan guarantees were inappropriately provided because:

- the borrowers failed to properly disclose losses incurred on prior loans, and
- SBA did not have operating procedures requiring loan officers to check for prior losses.

Providing loan guarantees to such applicants caused SBA to honor or be at risk to honor guarantees totaling about $22.4 million.

Impact of lending to borrowers with prior defaults

By not identifying borrowers with prior loan defaults and losses before loan approval, SBA initially put itself at risk to honor guarantees totaling about $34.8 million when the 168 loans were originated. The passage of time reduced the amount of dollars at risk due to 59 loans being paid in full or cancelled, but also resulted in losses on some defaulted loans. As of January 2002, SBA had honored guarantees totaling about $2.3 million for nine loans that were either in liquidation status or were charged off and still had risk of about $20.1 million for 98 loans in committed, current, or troubled status.

Premature Destruction of Loan Files

We were unable to verify that the borrowers were the same for the remaining 124 loan pairs because both SBA and the lenders had destroyed either the subsequent or prior charged-off loan files. Our review was beyond the established records retention period as the loans had been charged off more than 10 years earlier. Standard Operating Procedure 00 41 2, paragraph 50:04, states that charged-off loans that are closed will be retained at the district office for 3 years and retained at the Federal Records Center for an additional 7 years. A charged-off loan is considered closed when all collection action has ceased.

We determined that 30 of the prior loan files had been charged off for less than 10 years when they were destroyed. These records were destroyed between 3.4 and 9 years after their charge-off dates. While we cannot determine that the destroyed records would have verified that the principals for both loans were the same, our review of available records showed 95 percent of the loans had ineligible borrowers. We also found that subsequent loan files for 30 of the 34 loans had no disclosure of the prior SBA loan loss.

SBA needs better controls

Existing controls for identification of borrowers with prior losses need improvement. At the time the loans in the sample were processed, SBA's controls consisted of: (1) certification by the applicant as to the status of prior Federal debt or that no loss was incurred on prior Federal debt, and (2) a prohibition against providing a loan to a borrower with a loss on prior Federal debt. In March 2000, SBA provided access codes to field offices to facilitate the use of CAIVRS. These controls were not adequate to prevent loans to applicants with prior losses for the reasons discussed below.

Applicant certification

Certification by borrowers is not reliable. Our review of loan applications showed that only 14 of 42 applicants (33 percent) disclosed the prior loan, and only 2 of these stated that there had been a loss. Most of the remaining applicants who declared the prior loan indicated it was paid in full. Borrowers may have been confused about the status of their prior debt due to compromised agreements with SBA. At least four borrowers, whose prior SBA loans were compromised, received correspondence from lenders stating that the prior debt had been paid in full.

No supporting operating procedures

SBA's prohibition against providing loans to applicants with prior losses was not supported by specific procedures requiring loan officers to check for this condition. SOP 50 10 (4) (e) states the prohibition, defines the term "loss," states what obligations qualify, and provides instructions on how to obtain a waiver of the rule. It does not require the SBA loan officer to check SBA's loan database or CAIVRS for prior losses.

We interviewed supervisory personnel at six SBA district offices who claimed their personnel checked loan applicants for prior SBA assistance. However, they were not aware of specific SBA procedures requiring this practice. We noted that each district office used a different combination of sources to check for prior SBA and Federal assistance. We also interviewed personnel at three loan processing centers. At the LowDoc Loan Processing Center, the director stated that his personnel looked for prior losses in the SBA database as well as using CAIVRS to identify losses on other Federal debt. The Director of the Sacramento Loan Processing Center stated that his personnel do not look for prior losses due to their workload.

The following table shows the percentage of loans in our sample applicable to the district offices or processing centers and the percentage of all SBA loans processed in recent fiscal years by these locations. The table shows that the PLP and Express Loan Processing Centers processed the majority of loans originated in the past 2 years. Based on these statistics, more than half of SBA's guaranteed loan applications are not reviewed for prior losses. This percentage will increase as the percentage of loans processed by the PLP and Express Loan Processing Centers increases.

Location	% of OIG sample	% of FY 00 loans	% of FY 01 loans
District Offices	38	22	21
LowDoc Centers	9	22	20
PLP and Express Centers	53	56	59

RECOMMENDATIONS

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

1.A Issue an SBA procedural notice and amend SOP 50 10 (4) to require a determination of whether loan applicants have caused the Federal government to suffer a loss from prior Federal financial assistance. Require the loan accounting database and CAIVRS be used to make this determination and document the results in the loan file to ensure compliance with SBA and Federal requirements.

1.B Develop a procedure to allow lenders to access the SBA database to identify principals who have prior defaults that caused SBA to suffer a loss before completing loan application processing.

1.C Seek recovery from borrowers of guarantees honored for subsequent loans when both the prior and subsequent loan files support evidence of intentional false statements concerning prior loan losses, and notify the Office of Inspector General of the intentional false statements.

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

1.D Annotate current loan files in the Guaranty Tracking System to identify borrowers who failed to disclose losses on prior loans.

1.E Reiterate to field offices the requirements for retention of charged-off loan files.

Management Comments

Associate Administrator for Financial Assistance

The Associate Administrator for Financial Assistance disagrees with recommendations 1.A. and 1.B. In response to recommendation 1.A., she stated that the 447 loans we identified represent considerably under one percent of the number of loans approved for the same period. Further, while the associate administrator stated that she agreed that this is an important issue, she stated that it does not appear to rise to the level that would justify creating new processing requirements that would require substantial additional effort. She added that the issue was addressed as part of the loan monitoring system (LMS) data collection and workflow procedure and that this will correct the problem.

Concerning recommendation 1.B., she stated that there are concerns about Privacy Act issues and the LMS included a proposed mechanism that would allow an automated procedure for alerting SBA staff. She recommended that the OIG forward the recommendation to the Office of the Chief Information Officer and the Office of General Counsel.

Concerning recommendation 1.C., she stated that she agreed and would continue to reinforce the practice of referring such cases to OIG for action.

Associate Administrator for Field Operations

In response to Recommendation 1.D., the Associate Administrator for Field Operations offered an alternative method for alerting SBA personnel of borrowers who failed to disclose losses on prior loans. He stated that the Guaranty Repair Tracking System was inappropriate for this type of use; however, he will have field offices annotate the Portfolio Management Query Display (PMQD) Screen 26 in the Delinquent Collection Loan System and the Loan Liquidation Tracking System for borrowers who failed to disclose losses on prior SBA loans.

Concerning recommendation 1.E., a notice will be issued to the field requiring that charged-off loan files are to be retained at the field office for 3 years before being sent to the Federal Records Center.

Evaluation of Management's Comments

Associate Administrator for Financial Assistance

The cited condition is an internal control weakness whose financial impact to SBA could increase significantly in the future if not corrected. It is also an element of erroneous payments that SBA will have to consider in its annual reporting. Failure to correct this condition could materially impact SBA's attempt to reduce the level of erroneous payments. An example of the impact of this condition is sample number 24 [FOIA Ex. 4 & 6] which defaulted after issuance of the draft report. The principals failed to disclose that they had defaulted on three prior SBA guaranteed loans and a disaster loan which resulted in a charge-off of about $440,000. The district office has estimated that this subsequent default will result in a loss of about $667,500 to SBA. This matter has been referred to OIG/Investigations for possible prosecution. SBA cannot afford unnecessary losses of this magnitude.

Additionally, the scope of this condition may be much larger than the audit sample. Our audit effort did not consider borrowers who were ineligible due to non-SBA delinquent debt and we did not attempt to identify the eligibility of the large number of borrowers with invalid social security numbers in SBA's database.

We disagree that corrective action for this condition would require substantial additional effort. As noted in the audit report, district offices claim to be routinely reviewing the loan accounting system database to identify borrowers with prior debt even though there is no stated requirement to do so, and some have started to use CAIVRS. Corrective action would merely

consist of incorporating current practice in the standard operating procedures and directing the one location that admittedly is not following this practice, the Sacramento Loan Processing Center, to comply with the revised SOP.

Concerning recommendation 1.B., if properly implemented, there would be no violation of the Privacy Act or compromise of SBA's database. Additionally, this procedure would reduce the loan processing burden on SBA personnel and save loan processing time for lenders through the early identification of those applicants who make false statements about prior Federal assistance.

Associate Administrator for Field Operations

For recommendation 1.D., the associate administrator's proposed alternative action is acceptable. For recommendation 1.E., the notice to be sent to field offices should also state that charged off loan files must be held at the Federal Records Center for an additional 7 years.

Appendix A

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

DATE: May 9, 2002

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

FROM: Calvin Jenkins, Associate Administrator for Field Operations

SUBJECT: Draft Audit Report - Borrowers with Prior Defaulted Loans

We have reviewed your draft management letter dated March 7, 2002, and have the following comments:

Recommendation 1.D.
Annotate current loan files in the Guaranty Tracking System to identify borrowers who failed to disclose losses on prior loans.

OFO Response:
The Guaranty Repair Tracking System is a system which is used to track lender guaranty repair issues and trends. There is not currently a system in place to track things like failure to disclose. It is our understanding that the PIMS system would be able to be flagged once it is up and running. In the interim, we will have the field notate the failure to disclose on the PMDQ26 (chronological record) which is in the DCLS and LLTS systems. (Can you please furnish an electronic copy of the listing to Melinda Williamson in the Office of Field Operations?)

Recommendation 1.E.
Reiterate to field offices the requirements for retention of charged-off loan files.

OFO Response:
The Office of Field Operations will issue a notice to remind the field that charged off loan files are to be retained at the field office for 3 years prior to shipping them to the Federal Records Center.

For additional information, contact Melinda Williamson, Field Operations Specialist, Office of Field Operations at 202-205-6598.

Appendix A

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

MEMORANDUM

DATE: March 29, 2002

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

FROM: Jane Palsgrove Butler
Associate Administrator
for Financial Assistance

RE: Draft Audit Report - Borrowers with Prior Defaulted Loans

I have reviewed your draft management letter dated March 7, 2002, and have the following comments.

Recommendation 1.A.
Issue an SBA Procedural Notice and amend SOP 50 10 4 to require a determination of whether loan applications have caused the Federal Government to suffer a loss from prior Federal financial assistance. Require the loan accounting database and CAIVERS be used to make this determination and document the results in the loan file to ensure compliance with SBA and Federal requirements.

OFA Response:
The report notes that "to identify borrowers with prior defaults, the SBA's loan accounting system was queried to compare SSNs applicable to all purchased loans to SSNs of loans approved during the period October 1995 to April 2001...The system showed 447 loans for which the principals had prior SBA guaranteed loans that were transferred to liquidation or were purchased by SBA." The report also notes that through further review of these 447 loans, the OIG "identified 168 loans that may be ineligible and confirmed that 42 had principals with prior defaulted loans that resulted in losses.

For the time period October 1995 to April 2001, approximately 287,384 loans were approved under 7(a). The 447 loans that you identified to be of concern represents considerably under one percent of the number of loans approved.

Therefore, although OFA agrees that this is an important issue, it does not appear to rise to the level that would justify creating new processing requirements that would require substantial additional effort. However, we note that this issue was addressed as part of the loan monitoring system (LMS) data collections and workflow procedure. When that effort moves forward, this problem will be corrected.

The report does not note whether you checked the 168 loan files to determine whether SBA had provided a waiver. As you know, under 13 C.F.R. 120.110 (q), SBA may waive ineligibility to businesses that had previously defaulted on a Federal loan or on Federal assisted financing.

OFA will work with the Office of Field Operations to issue an Information Notice cautioning staff and lenders regarding this problem and to notate their files, electronic and paper copies, accordingly.

Recommendation 1.B.
Develop a procedure to allow lenders to access the SBA database to identify principals who have prior defaults that caused SBA to suffer a loss before completing loan application processing.

OFA Response:
OFA has concerns about this recommendation. Privacy Act issues are of considerable concern to the Agency and considerable safeguards would be required to allow access without breaching security walls and obtaining protected data. A part of the LMS included a proposed mechanism that would allow an automated procedure that would have alerted SBA's staff, thereby avoiding the privacy issues with releasing the data directly to lender. In the interim, the OIG should forward the recommendation to the Office of the Chief Information Officer's Howard F. Bolden, Computer Security Program Manager, and OGC for their comments. In addition, OFA must refer to the above noted concern regarding expending limited resources on a problem, though serious when found, is not widespread.

Recommendation 1.C.
Seek recovery from borrowers of guarantees honored for subsequent loans when both the prior and subsequent loan files support evidence of intentional false statements concerning prior loan losses, and notify the Office of Inspector General of the intentional false statements.

OFA Response
OFA agrees with this recommendation and will continue and reinforce its practice of referring such cases to OIG for action. We note, however, that frequently the Department of Justice is unwilling to pursue these matters because of the relatively small dollar amounts involved.

For additional; information, contact Gregory L. Diercks, Assistant Administrator for Financial Program Operations, OFA, 202-205-7538.

Appendix B

REPORT DISTRIBUTION

Recipient	No. of Copies
Associate Deputy Administrator for Capital Access	1
Associate Administrator for Field Operations	1
Associate Administrator for Financial Assistance	1
Financial Administrative Staff Attention: Jeff Brown	1
General Counsel	2
General Accounting Office	1