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

| **AUDIT REPORT** |
| --- |
| **Issue Date: March 20, 2006** |
| **Report Number: 6-16** |

**To:** James E. Rivera
Associate Administrator for Financial Assistance

**/S/ original signed**
**From:** Robert G. Seabrooks
Assistant Inspector General for Auditing

**Subject:** Audit of an SBA Guarantied Loan to [FOIA Ex. 6]

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to you. Your response and the response of the lender have been synopsized and included in the report. Based on these responses, we have removed the sections regarding the poor character of the borrower and ineligible use of proceeds from our final audit report. We have also reduced the recommended recovery amount from $155,651 to $18,992.

The recommendation in this report is subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for audit follow-up. Please provide your management decision for the recommendation to our office within 30 days of the date of this report using the attached SBA Form 1824, Recommendation Action Sheet.

Should you or your staff have any questions, please contact Stephen Seifert, Director, Credit Programs Group, at 703-487-[FOIA Ex. 2].

Attachment

cc: Acting IG

# AUDIT OF AN SBA GUARANTIED LOAN TO

**[FOIA Ex. 6]**

**North Little Rock, Arkansas**

**March 20, 2006**

**The finding in this report is the conclusion of the Office of Inspector General's Auditing Division based on testing of SBA operations. The finding and recommendation 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 OF AN SBA GUARANTIED LOAN TO**
**[FOIA EX.6]**

**North Little Rock, Arkansas**

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## BACKGROUND

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-guarantied loans. SBA loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with SBA regulations, policies, and procedures. SBA is released from liability on a loan guaranty, in whole, or in part, within SBA's exclusive discretion, if a lender (i) failed to comply materially with SBA regulations, the loan guaranty agreement, or the loan authorization, (ii) did not make, close, service, or liquidate a loan in a prudent manner, or (iii) did not disclose a material fact to SBA regarding a guarantied loan in a timely manner.

During an on-going review of the guaranty purchase process at the National Guaranty Purchase Center (Center) in Herndon, Virginia, we identified a problematic loan made by First Commercial Bank to [FOIA Ex. 6] (borrower), which is the subject of this audit report. In November 1998, First Commercial Bank was acquired by Regions Bank and Regions Bank became responsible for servicing and liquidating SBA guarantied loans approved by First Commercial Bank (lender).

The loan was part of a sample selected from a universe of 7(a) loan purchase requests processed at the Center by Headquarters personnel from the Office of Financial Assistance (OFA). The loan was processed as a regular 7(a) guarantied loan; therefore, SBA was responsible for determining if the borrower met eligibility and credit requirements based on documentation submitted by the lender. The lender was required to service and liquidate the loan in accordance with SBA regulations, policies, and procedures.

The loan (loan number 150-380-4006) was a $175,000 Contract CAPLines loan that was approved on August 22, 1997. The purpose of the loan was to pay for labor and materials on contracts that were assigned as security for the loan. The loan was disbursed from November 21, 1997 through August 28, 1998. The borrower defaulted on September 4, 1998, one week after the final loan disbursement. The lender requested purchase of the loan on June 10, 2001 from the Arkansas District Office after completing loan liquidation. As of October 7, 2003, the district office had not received sufficient documentation from the lender for purchase. The loan was transferred to the Center on February 12, 2004 and the guaranty was purchased for $113,221 on April 29, 2004.

## AUDIT OBJECTIVE AND SCOPE

The objective of the audit was to determine if the lender originated, serviced, and liquidated the purchased loan in accordance with SBA rules and regulations. During the audit, we examined loan files maintained by SBA and the lender, interviewed SBA officials in OFA, and interviewed lender officials. The audit was conducted during June and July 2005 in Herndon, Virginia, in accordance with Government Auditing Standards.

## RESULTS OF AUDIT

### Finding 1 – The Lender Over Disbursed a CAPLines Loan and Received an Overpayment of the Guaranty

The lender over disbursed the CAPLines loan on two occasions and SBA used the incorrect transcript to determine the purchase amount. These deficiencies were not detected during the guaranty purchase process and, as a consequence, SBA erroneously paid the lender $18,992 when it purchased the guaranty for $113,221.

The loan authorization stated that no advance shall be made if, as a result of such advance, the total principal amount outstanding would exceed $175,000. On two occasions, however, the lender made advances that resulted in an outstanding principal balance that exceeded $175,000. As a result, the outstanding principal balance at the time of purchase was $138,260 rather than $121,604, or $16,656 higher than it should have been.

Additionally, when computing the guaranty purchase amount, SBA mistakenly used a September 3, 2003 transcript which showed the principal loan balance was $146,273. The lender submitted a revised transcript on October 1, 2003 which showed the principal loan balance had been reduced to $138,260. The revised transcript should have been used to compute the guaranty purchase amount.

As a result of these deficiencies, SBA overpaid the lender by $18,992 when it purchased the guaranty. This includes a principal overpayment of $18,502 (($146,273 x 75% SBA guaranty) - ($121,604 x 75% SBA guaranty)) and an interest overpayment of $490 (($18,502 x 10.75% interest rate)/365 day basis = $5.45 per day x 120 days = $653.91 x 75% SBA guaranty).

### RECOMMENDATION

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

1. Seek recovery of $18,992 from the Regions Bank on the guaranty paid for loan number 150-380-4006.

### Lender Response

The lender stated that the issues pointed out in the draft report were correct and not disputable. The lender did not specifically respond to the section in our draft audit report concerning the poor character of the borrower. With regard to the ineligible use of proceeds, the lender stated that it appears both SBA and the bank dropped the ball in the front end approval of the loan. The lender claimed there was no intentional misrepresentation by the bank on the loan request. SBA did not question how the proceeds from the existing loans being refinanced were

used and it appears the former lender did not understand that SBA loans could not be extended to cover tax obligations. The lender concluded that what should have been a primary point of discussion was missed by SBA and the bank.

The lender agreed that the over disbursement of the CAPLines loan was a mistake on its part. The lender currently does not extend CAPLines loans and does not intend to in the future due to the complications from a monitoring standpoint. The lender's response is included as Appendix A.

**SBA Management Response**

SBA Management stated that character was not an issue with respect to the loans because the borrower had cured his prior withholding taxes by paying them off with a loan obtained from the lender approximately one year before the SBA loans were made. SBA management stated, "the borrower's corrective action diminished sufficiently any character concerns related to the previously delinquent taxes." SBA Management also stated that both the lender and SBA shared the responsibility of obtaining the necessary loan information since the loan was processed as a regular 7(a) loan.

SBA Management does not consider the lender's use of proceeds to refinance a loan made to repay delinquent withholding taxes one year prior to the SBA loan to be an ineligible use of loan proceeds. SBA Management agreed that the use of loan proceeds to pay delinquent withholding taxes was prohibited in SOP 50 10 3, but stated the policy did not address the issue of direct versus indirect uses of proceeds. Since the lender did not directly repay the delinquent withholding taxes with SBA loan proceeds, but rather refinanced a loan made approximately one year earlier for this purpose, SBA Management does not support recovery of the guaranty payment. SBA Management stated "the previous loan made by the lender that was used to repay the withholding taxes was sufficiently removed in time so as not to contravene the SBA prohibition."

SBA Management agreed that SBA processed the purchase for loan 15038040-06 using the incorrect transcript of account and stated the resulting overpayment of the purchase amount was $6,202. SBA Management, however, did not identify an over disbursement of the loan by the lender and suggested that the OIG may have used the incorrect transcript of account to identify the over disbursement. SBA Management's response is included as Appendix B.

**Evaluation of Lender and SBA Management Responses**

Based on the above responses, we have removed the sections regarding the poor character of the borrower and ineligible use of proceeds from our final audit report. We believe the lender should have notified SBA of the borrower's prior withholding tax delinquencies and it should have been considered a character issue. However, since SBA procedures state such delinquencies "should be <u>considered</u> from a character standpoint" (Emphasis added) and SBA Management has taken the position that the borrower's corrective actions diminished sufficiently any character concerns, we have removed this section from the report. We also believe SBA procedures regarding ineligible uses of proceeds should apply to the indirect use of proceeds

regardless of the period of time that lapsed since the original loan was made by the lender. Since SBA procedures did not expressly state this and SBA Management has taken the position that the previous loan was sufficiently removed in time so as not to contravene SBA prohibition, we have removed this section from the report.

We continue to question the total overpayment of the guaranty for the CAPLines loan due to the lender's over disbursement of the loan and SBA's use of the incorrect transcript for purchase. The lender agreed that the CAPLines loan was over disbursed and contrary to SBA Management's suggestion that we used the incorrect transcript of account, the OIG correctly identified the lender's over disbursement. The transcript provided by the lender at the time of purchase reflected the disbursements and repayments for 10 sub-loans with outstanding principal loan balances at the time of default and did not reflect the disbursements and repayments for all 25 sub-loans made under the CAPLines loan. In order to identify the lender's over disbursement, we prepared a detailed spreadsheet of all chronological disbursements and repayments for the 25 sub-loans made under the CAPLines loan. No such spreadsheet was provided by the lender or prepared by SBA during the purchase review in order to identify this deficiency.

SBA Management's comments with regard to the overpayment of the guaranty that resulted from SBA's use of the incorrect transcript were responsive to the issue presented in our draft report.

Based on the above, we reduced our recommended recovery amount from $155,561 to $18,992.

REGIONS
FINANCIAL CORP.

December 14, 2005

Stephen Seifert
Office of Inspector General
1145 Herndon Parkway
Suite 900
Herndon, VA 20170

Dear Mr. Seifert:

FOIA Ex. 6

Attached is a response to the audit report for the loans extended to [ ] The first credit was extended September 26, 1997 for $170,100. The second credit was for a $175,000 CAPLine extended on November 21, 1997.

The credits referenced above were extended by First Commercial Bank which was acquired by Regions in November of 1998. The original lender is no longer with the bank. At the time the loans were extended First Commercial Bank did not have a formalized SBA approval process nor did Regions bank when they acquired First Commercial Bank. Since the lender is no longer with the bank, I can only make assumptions on her thought process on the loans. I assume she did not understand that SBA loans could not be extended to cover tax obligations. I could not tell from the file that it was discussed when the loan was submitted to the SBA for approval. There were no discussions from the SBA side on what the entire proceeds from the existing loans that were be refinanced were used for. Since this was the majority of the loan proceeds I would have thought this would have been the primary point of discussion between the SBA and our lender. I could not find anywhere in the file documentation where there was misrepresentation by our lender on what all the proceeds of our existing loans were used for. What should have been a primary point of discussion appears to have been missed by the SBA and the bank. I do understand that this is a violation of SBA policy; but it appears that both sides share in the blame for this and was not intentional on our part.

The second issue that was pointed out in the audit was the overpayment on the CAP line. After review of the documentation I would agree that this was a mistake on our part. We currently do not extend any CAP line products nor do we intend to extend them in the future. We are only participating in the SBA express and 7A (term loan) programs. This product is far to complicated from a monitoring standpoint to actively participate in.

Bill Neal was the local specials assets officer that handled the liquidation of the above referenced requests and also the request for payment of guaranty. Since the loans were originally approved by the SBA, Bill went about the process with the assumption that the

loans were closed in compliance with SBA policy. There was no intentional misrepresentation on his part on the work performed to obtain payment of the guaranty by the SBA.

We have just completed the final conversion in the merger of Union Planters Bank and Regions Bank. We currently have a fully operational SBA department located in Nashville, Tennessee. All SBA requests less than $1,000,000 are centrally approved by this unit. Any requests greater than $1,000,000 are approved by local credit units. All SBA documentation is handled by the unit in Nashville. Local lenders no longer determine SBA eligibility and as mentioned above we do not actively participate in the CAP line program. Based on our current policy and procedures the issues addressed in this audit will not occur in the future. The SBA unit also has an SBA liquidation specialist that assists the local special assets officers on SBA problem accounts. All requests for payment of guaranty are handled by the SBA liquidation specialist.

The issues pointed out in audit are correct and not disputable. It does appear that both the SBA and bank dropped the ball in the front end approval of this request. Based on review of file documentation there does not appear to be any intentional misrepresentation by the bank on this request, only lack of sound credit judgment on both sides. The liquidation was handled based on the assumption that the proceeds were used for eligible purposes. As outlined above this type error should not occur in the future.

Sincerely,

[FOIA Ex. 6]

Pete Peterson
Senior Vice President
Regions Financial Corporation

**U.S. SMALL BUSINESS ADMINISTRATION**
**WASHINGTON, DC 20416**

DATE: January 17, 2006

TO: Robert G. Seabrooks, Assistant Inspector General for Auditing
[FOIA Ex. 6]

THROUGH: James E. Rivera, AA/FA
[FOIA Ex. 6]

FROM: James W. Hammersley, Director, Loan Programs Division

SUBJECT: OIG Draft Audit of SBA Guaranteed Loans to [FOIA Ex. 6]
SBA Loan Numbers GP 15055140-06 and CAPL 15038040-06

We have reviewed the Office of Inspector General (OIG) September 22, 2005, memorandum and accompanying draft audit report for the two subject loans that recommend full recovery of the guaranty payments of $42,340 and $113,221, for a total recovery from the lender of $155,561. The basis for the OIG recommendation is 1) the lender's failure to disclose a material fact regarding the character of the borrower for both loans, 2) disbursement of loan proceeds for an ineligible purpose for loan 15055140-06, 3) overpayment of the guaranty purchase for loan 15038040-06 due to the lender's over-disbursement of the loan and also due to SBA processing the purchase amount based on a version of the transcript of account that did not reflect updated account information.

The lender responded to OIG's findings and denied any intentional misrepresentation on its part, and raised the issue of SBA's shared responsibilities since SBA obtained the background information when it analyzed the loan for approval.

1). Character:
We do not believe character is an issue with respect to these loans because the borrower cured his delinquent withholding tax obligations by paying the taxes with a loan obtained from the lender approximately one year before the SBA loans were made. SBA loan 15055140-06 refinanced the lender's side loan of approximately $57,000 along with approximately $89,000 in other debt. The refinancing of these debts provided a substantial benefit to the borrower, as stated in the SBA loan officer's analysis. Also, because the SBA loan was processed in a district office, both the lender and SBA shared the responsibility of obtaining the loan information necessary to process the loan under SBA requirements. Had this loan been processed under expedited procedures, we would agree that the explanation and analysis of the information were primarily the responsibility of the lender. SBA policy in 50 10 3 in effect at the time this loan was approved in August 1997 did not require the lender to disclose the purpose of the loans to

be refinanced. Even though the policy did require a full explanation of the circumstances when a major part of the SBA loan proceeds was used to pay existing debt, the district office had the opportunity and obligation to request any information it deemed necessary to conduct its analysis. The SBA loan officer that recommended approval for the loan states near the end of her write-up supporting the loan, "Lender's analysis wasn't very thorough either. This is a viable business, however." The officer appears to have acknowledged some shortcomings in the lender's explanation, but nonetheless recommended approval of the loan.

The borrower's corrective actions diminished sufficiently any character concerns related to the previously delinquent taxes. Therefore, we do not support recovery of the guaranty payment for either loan due to the character issue.

2). Eligibility:
We do not consider the lender's use of proceeds to refinance a loan made to repay delinquent withholding taxes one year prior to the SBA loan to be an ineligible use of loan proceeds. OIG references the SOP prohibition against use of loan proceeds to pay delinquent withholding taxes and provides support for the policy by referring to an unidentified SBA loan official who stated that the prohibition also applied to indirect situations, such as in refinance situations. We agree that the use of loan proceeds to pay delinquent withholding taxes was prohibited in SOP 50 10 3, but the policy did not address the issue of direct versus indirect uses of proceeds. Since the lender did not directly repay delinquent withholding taxes with SBA loan proceeds, but rather refinanced a loan made approximately one year earlier for this purpose, we do not support recovery of the guaranty payment for this reason. If the loan from the lender had been made just prior to the SBA loan, then we would agree that the lender was attempting to accomplish indirectly what it was prohibited from doing directly, and thus was seeking to circumvent an SBA prohibition. In this case, however, the previous loan made by the lender that was used to repay the withholding taxes was sufficiently removed in time so as not to contravene the SBA prohibition.

3). Overpayment of Guaranty:
We agree that SBA processed the purchase for loan 15038040-06 using a transcript of account dated September 3, 2003, reflecting an outstanding principal balance of $146,273. This transcript was a revision of a prior transcript located in the file. A third revision dated September 30, 2003, was also located in the file, and should have been used to process the purchase; this transcript reflects a lower principal balance of $138,260. The resulting overpayment of the purchase in the amount of 56,202 ($6,010 principal and $192 interest) should be recovered from the lender.

We did not identify an over disbursement of the loan by the lender. OIG may have used the September 3, 2003 transcript of account when it identified a disbursement above the $175,000 loan amount. The more recent September 30, 2003 transcript reflects the maximum disbursement of the loan to be $173,883.

We recommend that the OIG adjust the draft audit to require repayment of $6,202 due to the overpayment of the guaranty purchase for loan 15038040-06 by this amount. We agree that this amount should be recovered from the lender.

Thank you for your assistance.

**Appendix C**

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