AUDIT REPORT ON

BUSINESS LOAN GUARANTEE PURCHASES

Report No. 7-5-H-011-26

September 30, 1997

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

AUDIT REPORT
Issue Date: September 30, 1997
Number: 7-5-H-011-26

TO: Aida Alvarez, Administrator
Jane P. Butler, Acting Associate Administrator for Financial Assistance

FROM: Peter L. McClintock, Assistant Inspector General for Auditing

SUBJECT: Audit Report on Business Loan Guarantee Purchases

We performed an audit of business loan guarantee purchases made during fiscal year 1995. The Summary on pages iii and iv of the report provides a synopsis of the audit findings and recommendations.

The findings included in this report are the conclusions of the Office of Inspector General's Auditing Division based upon the auditors' testing of loan files. The findings and recommendations are subject to review and procedures for audit follow-up and resolution.

Please provide us your management decisions for the recommendations addressed to you within 30 days. Record your management decision on the attached SBA Forms 1824, Recommendation Action Sheet, and show either your proposed corrective action and target date for completion, or an explanation of your disagreement with our recommendations. For those recommendations which you have already provided your proposed actions and, target dates, you need only sign the attached SBA Form 1824, Recommendation Action Sheet.

Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Headquarters Operations at (202) 205-7204.

AUDIT OF BUSINESS LOAN GUARANTEE PURCHASES

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SUMMARY

In fiscal year 1995, SBA purchased loan guarantees totaling $434.6 million on 2,819 defaulted business loans. We audited a statistical sample of 58 purchased loans, totaling $7.8 million, to determine whether SBA's decisions to purchase guaranteed business loans were appropriate. Appropriate decisions are those where (1) SBA has obtained all the necessary documentation to determine whether the lender has complied with SBA's loan making and servicing requirements (documentation), and (2) the lender has complied with these requirements (lender compliance).

The audit found that 17 of the 58 sampled purchase decisions (29 percent), valued at $2.1 million, were inappropriate. Ten loan files reviewed contained insufficient documentation to make a purchase decision and seven files had documentation that showed the lender did not comply with SBA's loan making or servicing requirements. Based on a statistical projection of these results, we estimate that 826 guarantee purchase decisions in fiscal year 1995, representing $102.9 million, were inappropriate. District Office officials attributed purchase decisions being made without sufficient documentation in the files to inexperienced District Office staff not fully understanding the purchase decision process.

We requested District Offices to provide additional documentation and explanations for the ten files where documentation was insufficient to make a purchase decision. After reviewing the provided documentation and explanations on these ten loans, we concluded that

- in one instance, the lender did not comply with requirements, therefore the purchase decision was inappropriate;
- in four instances, documentation was still insufficient to determine whether SBA should have purchased each of these loans; and
- in five instances, the documentation showed that the purchase decisions were appropriate.

SBA inappropriately paid $333,730 for guarantees on eight loans (seven based on our initial review of the loan files and one after reviewing the District Office explanation). As a result, SBA should not have purchased the guarantees, some in part and some in full. Based on a statistical projection of these results, we estimate SBA should not have honored $16.2 million in guarantees on 389 loans that it purchased. These inappropriate purchase decisions occurred because SBA District Offices either made mistakes or were lenient when evaluating documentation on defaulted loans having lender loan servicing and origination errors. Lenient evaluations may stem from the District Offices' dual conflicting roles: to market SBA's loan programs and to provide oversight for lenders making loans. District Offices are forced to balance a favorable working relationship with lenders and the need to impose sanctions if SBA regulations are violated.

SBA lacked timeframes for completing purchase reviews for secondary market loans which default. Additionally, several other recurring matters - - the lack of borrowers' financial statements, the incorrect calculation of SBA's guarantee, the purchase of excessive accrued interest, and a lack of documentation on personal guarantees - - could have affected the amount of the guarantee SBA purchased. Although SBA had policies and procedures regarding all but the first of these matters, District Office officials did not always follow them.

We recommend that the Administrator centralize the guarantee purchase process to eliminate the conflict of roles in the District Offices, improve the consistency and quality of the purchase decision, and ensure SBA denies liability or reduces the guarantee when a lender has not complied with SBA requirements. We further recommend that the Associate Administrator for Financial Assistance take the following actions: (1) obtain missing documents on the four loans where there was still insufficient information to make a purchase decision; (2) seek recovery of $333,730 on the eight loans where a full purchase should not have been made; (3) provide additional guidance on the types of information that should be obtained and reviewed to protect SBA's interests; (4) establish time frames for completing purchase reviews of loans sold in the secondary market which later default; (5) develop guidelines for charging and collecting interest from the lender for any undue delay on their part in providing SBA information to conduct purchase reviews resulting in denial of liability; and (6) notify District Offices of SBA policies related to various recurring matters noted.

We received written comments from the Acting Associate Administrator for Financial Assistance, who reviewed a draft of this report and generally agreed with the recommendations. The Acting Associate Administrator's response is included in this report as Appendix A.

The findings included in this report are the conclusions of the Auditing Division based on the auditors' testing of operations. **The findings and recommendations are subject to review, management decision and corrective action in accordance with existing Agency procedures for audit follow-up and resolution.**

INTRODUCTION

A. Background

Section 7(a) of the Small Business Act, as amended, grants SBA the authority to provide financial assistance to small businesses through its loan guarantee program. Lenders are responsible for disbursing and servicing the loans and may sell the loan's guaranteed portion on the secondary market.

If a borrower defaults on the loan, the lender (or the registered holder for a secondary market sale) may request that SBA purchase the guaranteed percentage of the outstanding loan balance. SBA generally honors the guarantee unless the lender failed to (1) comply materially with the provisions of SBA regulations (13 Code of Federal Regulations [CFR], Part 120), the Loan Guarantee Agreement (LGA), or the Authorization and Loan Agreement (ALA); (2) close or service the loan in a prudent manner; (3) disclose a material fact to the SBA in a timely manner; (4) represent a material fact properly; (5) disclose full loan payment; or (6) pay the guarantee fee. If the lender has not fully complied with the requirements, SBA may deny liability or partially deny liability based on the materiality of the lender's non-compliance. On loans not sold in the secondary market, SBA determines whether it should honor the guarantee prior to paying the lender the guaranteed portion that defaulted. On loans sold in the secondary market, SBA ordinarily reimburses the registered holder the guaranteed portion prior to determining whether the guarantee should be honored. This is because the guaranteed portion of these loans is backed by the full faith and credit of the Federal Government. SBA demands the lender repay any funds it paid to a registered holder if SBA determines it should not have honored the guarantee.

B. Objective and Scope

The audit objective was to determine whether SBA's decisions to purchase guaranteed business loans were appropriate. Appropriate decisions are those where (1) SBA has obtained all the necessary documentation to make an informed decision whether the lender has complied with SBA's loan making and servicing requirements (documentation), and (2) the lender has complied with these requirements (lender compliance). The audit was based on a statistical sample of loans where SBA honored the guarantee during fiscal year 1995. From a universe of 2,819 purchased business loans, valued at $434.6 million, we selected 58 loans with a purchase value of $7.8 million for detailed analysis. Descriptions of the statistical sampling methodology and the projected audit results are provided in Appendix B. Appendix C lists the 58 loans.

We conducted fieldwork from April 1996 through November 1996. Audit procedures included interviewing SBA headquarters and District Office personnel, and reviewing documentation included in SBA District Office loan files. We performed the audit in accordance with Government Auditing Standards.

C. Prior Audit Resolution

This was the Auditing Division's first audit of business loan guarantee purchases.

RESULTS OF AUDIT

A. Findings and Recommendations

Finding 1 Inappropriate Purchase Decisions

Of the 58 sampled purchase decisions, SBA District Offices made 17 inappropriate purchase decisions (29 percent). Inappropriate decisions are those decisions where there was a problem with documentation and/or lender compliance. Specifically, SBA District Offices made (1) ten purchase decisions when the loan files contained insufficient information to make an informed decision, and (2) seven purchase decisions when the loan files contained information that should have precluded a full purchase decision.[1]

We requested District Offices to provide additional documentation and explanations for the ten files where documentation was insufficient to make a purchase decision. After reviewing the provided documentation and explanations on these ten loans, we concluded that

- in one instance, the lender did not comply with requirements and the purchase should not have been made;
- in four instances, there was still insufficient documentation to determine whether SBA should have purchased each of these loans; and
- in five instances, the documentation supported the purchase decisions.

SBA paid $333,730 on the eight loans which it should not have fully honored. These eight loans are the seven loans where the loan files contained information that should have precluded a full purchase decision and the one loan we determined that the purchase decision should not have been made after reviewing the District Office's explanation.

Title 13 CFR Part 120.524 and SOP 50 50 3 (F), require SBA's purchase decision to be based on an evaluation of the lender's overall compliance with SBA's rules and regulations and the LGA and ALA. SBA evaluates this compliance by performing a purchase review of all loans. According to SOP 50 50 3(F), documentation which must be included for SBA's purchase decision includes a written demand letter, a certified transcript of account, and any loan documents needed to fulfill the requirements made by the ALA, e.g., settlement sheets, personal guarantees, life insurance, co-loans, and capital injections.

District Offices were lenient when evaluating defaulted loans resulting from serious

[1] One of the 17 loan files did not contain sufficient information on some issues and contained information that would have precluded a full purchase decision. To avoid double counting, we only included this in the category "containing information that would have precluded a full purchase decision."

lender loan servicing and origination errors. In six of the eight instances where we determined that SBA should not have purchased the defaulted loan, the cognizant District Office disagreed that remedial action was needed. In the seventh instance, the cognizant District Office stated,
". . . further review of the file will be made to determine whether an action against the participant lender is warranted." In only one instance did a District Office put the lender on notice that if
". . . a loss is sustained, SBA may have recourse against the bank." Some of the situations and the reason for not taking action follow:

- A District Office agreed an unauthorized debt was paid with loan proceeds (a violation of the ALA and, thus, a reason for partial denial), but responded that had the lender requested a change in the use of proceeds, SBA probably would have approved it.

- While a District Office did not disagree that the lender made errors, it argued that the purchase was appropriate because the FDIC had assumed the loan from a failed lending institution and no benefit would accrue to SBA by litigating against the FDIC. This argument contradicts SOP 50 50 3(G), Paragraph 78, which states the FDIC is governed by the same rules and requirements expected of the original lender.

- An SBA loan financed a building where a personal residence was 61 percent of the structure in question, a violation of SOP 50 10, paragraph 3f(2), which states the residential portion of a structure cannot exceed 50 percent. The District Office responded that because the loan was for refinancing rather than acquisition, SOP 50 10, paragraph 3f(2) was not applicable. According to an official in the Office of General Counsel, a borrower cannot accomplish through refinancing what it cannot accomplish through an initial acquisition.

- An SBA loan involved the lender making a unilateral change impacting over 20 percent of the loan amount, which violated SOP 50 50 3(F), which grants lenders the authority to make unilateral changes up to 20 percent of the loan amount. The District Office responded that because the guaranteed portion of the unilateral change did not exceed 20 percent of the loan, no violation occurred. The SOP allows for unilateral changes up to 20 percent of the loan amount and does not discuss what the guaranteed portion of a unilateral change can be.

We concluded that the above lack of action to protect the government's interests on loan violations demonstrates SBA District Offices were lenient when evaluating purchase documentation on defaulted loans. Past audits have also resulted in observations that District Offices were lenient when evaluating documentation on defaulted loans having lender loan servicing and origination errors. Two recent examples follow:

- In one audit, we reported that the lender and the borrower made misrepresentations on

the loan application to ensure loan guarantee approval. We recommended that SBA deny liability, recover funds disbursed on a $750,000 guarantee, and rescind the lender's Preferred Lender Program (PLP) status. The District Office instead offered to "request" the lender to relinquish a share of a life insurance policy and renew the PLP status for one year instead of the customary two. After an investigation by the Office of Inspector General and the Department of Justice led to possible litigation, the lender settled with SBA for $1.6 million.

- In the second audit, we reported that the lender did not close, disburse, and service the loan as required by SBA procedures. Additionally, the lender disbursed loan proceeds in a manner which increased SBA risk and sold a portion of the loan without SBA approval. Despite this, SBA paid $740,926 when it honored its guarantee on this loan. District Office officials did not agree with our recommendation to determine if the bank's action should cause the lender's guarantee agreement to be terminated or result in other appropriate sanctions.

District Offices have dual conflicting responsibilities. They are responsible for (1) marketing and promoting SBA's loan programs, and (2) determining whether or not SBA will purchase defaulted loans based on whether the lenders making loans followed SBA rules. Active enforcement by the District Offices can jeopardize their relationship with these lenders, who could refuse to make more SBA loans, thus hurting the office's productivity.

According to a Financial Assistance official, if the purchase decisions were centralized, this conflict should be eliminated. Centralizing the function would allow SBA employees, who do not consider the lenders to be their clients, to develop the needed expertise to make appropriate, consistent decisions.

District Office officials attributed purchase decisions with documentation problems to inexperienced District Office staff not fully understanding the purchase decision process. While these officials need to take interim action to ensure their staffs correctly complete this process, centralizing the function could facilitate the development of experienced staff.

Making purchase decisions when there is insufficient documentation increases the risk that SBA will purchase a loan that was not properly processed or serviced. When SBA incorrectly purchases a loan, there is an inappropriate outflow of cash, and this action, coupled with the time value of money, affects the 7(a) program's overall subsidy rate. Based on a statistical projection of the $333,730 SBA should not have paid on eight of the 58 loans in our sample, we estimate in fiscal year 1995, SBA should not have honored $16.2 million in guarantees on 389 loans. Based on a statistical projection of the 17 decisions in our sample that were made with insufficient data, we estimate that in fiscal year 1995, 826 loan decisions representing $102.9 million were inappropriate.

Details on the 17 inappropriate purchase decisions follow.

(a) Insufficient information

Ten loan files contained insufficient information for SBA to make an informed purchase decision. We grouped the insufficient documentation into three categories: (a) timing and use of proceeds, (b) injection of capital, and (c) fulfillment of other specific loan requirements. On half of these files, District Offices obtained the missing information after our review of the files.

Timing and Use of Proceeds

Three loan files lacked a required settlement sheet and transcript of account to confirm timing and use of proceeds. Without these forms, SBA cannot be assured that the use of proceeds and loan balances were proper and, thus, whether the guarantee should be honored. Specifically, we found that SBA District Offices purchased -

- $118,287 of a $279,800 loan without obtaining the settlement sheet and the complete transcript of account. After our review, the District Office obtained the settlement sheet and a partial transcript of account. The District Office obtained only a partial transcript of account because the loan had been sold to a second lender, and the transcript only reflected transactions of the second lender. Hence, disbursements totaling $89,123 were not described. Subsequent to SBA purchase however, the loan was paid in full, thus, the transcript of account from the first lender is not required.

- $112,488 of a $150,000 loan without obtaining a settlement sheet or other documentation to support the use of proceeds. After our review, the District Office informed us that they believed the lack of the settlement sheet did not create a specific loss to SBA because it did not cause the business failure. While this may be true, without a settlement sheet, SBA and the lender cannot be assured that the borrower used the funds for authorized purposes. SBA either needs to obtain a settlement sheet or other documentation supporting the use of proceeds, or disallow the purchase.

- $37,183 of a $71,000 loan without obtaining a settlement sheet or acceptable transcript of account. Although the ALA requires that the lender submit a settlement sheet, SBA did not require it because SBA erroneously believed that a preferred lender was not required to submit one. The transcript of account in SBA's file was a computerized account inquiry and lacked a certification that it was correct. After our review, the District Office obtained a copy of the settlement sheet from the lenders file.

Injection of Capital

Four loan files contained no evidence of required capital injections. Without capital injections by the borrower, SBA could be providing 100 percent financing, which SBA is

prohibited from doing. Further, the failure to make promised capital injections represents a substantial alteration of the loan agreement, and this can only be done with SBA's prior written approval. SBA District Offices purchased -

- $51,638 of a $75,000 loan without support that the borrower injected $48,300 into the startup business and obtained a $50,000 concurrent loan. The borrower's internal financial statements showed injections of only $46,970, a shortage of $51,330. When requested during the audit, the District Office informed us a further inquiry of the SBA and lender files disclosed no other documentation to support the full capital injection. As a result, the District Office also informed us the lender had been notified if a loss was sustained on the loan, SBA may have recourse against it. Based on this deficiency, we questioned the entire $51,638 purchase.

- $337,042 of a $401,000 loan without sufficient support that the borrower injected $132,000 cash into the business. SBA considered a hand written financial statement signed by the borrower as evidence he had made the required injection instead of other documentation such as deposit slips, bank statements, or purchase receipts. The financial statement by itself is not sufficient evidence to substantiate that the injection occurred. SBA either needs to obtain documentation such as certified financial statements or invoices to support the capital injection, or disallow the purchase.

- $67,945 of a $88,000 loan without sufficient support that the required $59,840 cash injection was made or personal guarantees obtained. Although SBA obtained sufficient evidence of the capital injection and copies of the guarantees from the lender files after our review, receipt and verification of this type of documentation is essential at the time of the purchase decision.

- $166,835 of a $230,000 loan without sufficient evidence that the borrower made a $70,000 cash injection. SBA obtained evidence of the capital injection after our review, but did not have this information at the time of the purchase decision.

<u>Fulfillment of Other Specific Loan Requirements</u>

Two loan files lacked documentation to support lender compliance with ALA provisions specific to the individual loans: (1) appraisal to evidence business occupancy use, and (2) quarterly financial reports that would have identified an adverse condition on a loan. A third loan file did not contain evidence of a purchase review. SBA District Offices purchased -

- $169,778 of a $207,000 loan without obtaining the required property appraisal, which would note the amount of space allocated for residence and business. The ALA authorized 82 percent of the loan proceeds for use to refinance a first mortgage on a combined residential and business structure. The SBA loan officer's report noted that

the lender asserted the business space exceeded the 50 percent of the total space required by SBA. Without the property appraisal (which was paid for from the loan proceeds), SBA had not confirmed this assertion. Because a property appraisal exists which probably includes the amount of space allocated for the residence and building, SBA could easily confirm the amount of space devoted for a business purpose.

- $162,153 of a $500,000 loan without required quarterly financial statements. These financial statements were important because the borrower incurred substantial losses in the two years prior to loan approval and future profitability was based on projections. The District Office informed us that although not in the SBA file, the lender had in fact obtained all the quarterly statements, except for one, but none were dated. Further, they stated that because the business was seasonal, review of any individual quarterly statement would be subjective. Without the quarterly statements, however, the District Office did not have enough information to determine whether the lender properly monitored the financial condition of the borrower while making loan disbursements. SBA either needs to obtain documentation showing that the lender properly monitored the borrower's financial condition, or disallow the purchase.

- $176,097 of a $225,000 loan when a purchase review was not conducted until after we raised the issue, almost 2 years after the guarantee was honored. A purchase review performed after SBA's purchase decision was necessary because loans sold in the secondary market must be purchased immediately, but reviewed later to verify lender compliance. At the time of our review, the files contained no purchase documentation. After our review, the District Office obtained the necessary documentation and conducted the purchase review. SBA officials said that the review was not conducted until we raised the issue because of a backlog of purchases, a shortage of staff, and inexperienced staff, including a supervisory loan officer who came to the office because of downsizing at the regional level.

(b) Information that should have precluded a full purchase

Six loan files contained information that should have precluded SBA from making a full purchase decision. Documentation in two of these files should have resulted in a full denial. SBA District Offices purchased -

- $11,543 of a $13,580 loan with those proceeds being used to repay a loan to the lender. The lender did not obtain the required SBA written pre-approval. We questioned the SBA guaranteed portion of $11,543 ($13,580 x 85 percent).

- $86,093 of a $100,000 loan when information in the file revealed that the lender had not executed a first security interest on a $25,000 property and did not obtain personal guarantees or the assignment of rental income, as required by the ALA. The District Office agreed with the findings but stated the purchase was appropriate since the FDIC

had assumed the loan and no benefit would accrue to SBA by litigating against the FDIC. They also stated that since the lender had the borrowers sign the note individually and in their partnership capacity, the personal guarantees were not needed. We agreed with the latter point, but noted that SOP 50 50 3(G) states the FDIC is governed by the same rules and requirements expected of the original lender. As such, we questioned the guaranteed portion of the priority lien of $21,250 ($25,000 x 85 percent).

- $126,694 of a $150,000 loan when an appraisal in the file revealed that the personal use of the mortgaged property was 61.5 percent, while SBA requires that the residential space be less than 50 percent. Based on this deficiency, we questioned the entire $126,694 purchase.

- $224,514 of a $290,000 loan when information in the file revealed that the lender had released a third mortgage position without obtaining the required SBA approval. The lender did not obtain the required SBA consent when it released the collateral valued at $115,000 (40 percent). Based on this deficiency, we questioned $40,387 [($115,000 - priority liens of $43,200) x 75 percent lender liquidation value x 75 percent SBA guarantee] of the purchase.

- $89,566 of a $100,000 loan when the file contained evidence that the lender had not obtained a required appraisal of $350,000 on the property serving as collateral on a second mortgage. Instead the appraisal was $325,000. The lender did not obtain the required SBA consent when this created an equity shortage of $25,000 (25 percent). Based on this deficiency, we questioned $3,150 of the purchase ($5,000 of the $25,000 equity shortfall) x 70 percent lender liquidation value x 90 percent SBA guarantee). We did not take exception to $20,000 of the $25,000 equity shortfall since SOP 50 50 3, Paragraph 62, permits SBA lenders to make unilateral changes to the loan that do not exceed 20 percent of its value, which in this case was $20,000 ($100,000 x 20 percent).

- $32,156 of a $47,216 disbursed loan when the lender made 11 disbursements totaling $11,441 after the borrower defaulted on the loan. A District Office official responded that the lender apprised the District Office of problems on the loan on two occasions and the District Office did not tell the lender to stop disbursements. Thus, the District Office concurred with the lender actions, including disbursements made while the loan was in default. Documentation in the file, however, is not clear on whether the default status was brought to SBA's attention by the lender on either occasion. We disagreed with the District Office because neither SBA policy nor prudent lending practices dictate notice be provided to a lender to stop disbursements on a defaulted loan. Based on this deficiency, we questioned $10,068 of the purchase ($11,441 in inappropriate disbursements x 88 percent SBA guarantee).

(c) Insufficient information and information that would preclude a full purchase

One loan file contained insufficient information for District Offices to make an informed purchase decision and also included information that should have precluded SBA from making a full purchase decision. An SBA District Office purchased -

- $69,000 of a $187,000 loan without support for the borrower's use of $108,810 proceeds. SBA purchased this loan based on a transcript of account from the Fiscal and Transfer Agent when it had not received one from the lender. SBA also purchased this loan even though the lender only obtained $75,000 of life insurance when the ALA required $150,000. When the borrower died, only $75,000 was available from insurance proceeds. Based on this deficiency, we questioned the entire purchase of $69,000.

Recommendations

We recommend that the Administrator:

1A. Centralize, and assign sufficient resources to, the guarantee purchase process, which will (1) eliminate the District Offices' conflicting responsibilities, (2) improve the consistency and quality of the purchase decision through staff specialization and economy of scale, and (3) ensure that SBA denies liability or reduces the guarantee when a lender has failed to comply with SBA requirements.

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

1B. Obtain missing documents on the remaining 4 loans noted in Appendix C and determine if purchase decisions were proper.

1C. Seek recovery of $333,730 where a full purchase decision should not have been made. SBA should first make recoveries through agency and lender liquidation efforts, and if insufficient, recover any remaining balances from lenders.

1D. Provide additional guidance on the types of information that should be obtained and reviewed to protect SBA's interests until the guarantee purchase process is centralized.

Management's Response

The Acting Associate Administrator for Financial Assistance (AA for FA) generally agreed with our finding and recommendations. The AA for FA stated she will (1) request additional documentation in those cases where we found it to be insufficient, (2) recover questioned costs from participating lenders if the General Counsel thinks the matter is serious

enough to support litigation, and (3) consider, in conjunction with the Offices of General Counsel and Field Operations, the feasibility of centralizing the guarantee purchase process. A copy of her response is included in the report as Appendix A.

Because Financial Assistance has no unilateral authority to centralize the guarantee purchase function, recommendation 1A is being addressed to the Administrator.

Evaluation of Management's Response

We agreed with the AA for FA management's response, with the exception of her statement that funds will be recovered only on those loans which the General Counsel thinks are serious enough to support litigation. The decision to recover funds is an administrative decision which should be made by the program office. Litigation is not the only tool the agency has for recovering funds, and should not be the primary basis for determining the suitability of a recovery action.

Finding 2 Other Matters

We noted other matters which did not affect SBA's decision to purchase its guarantees, but could affect the timeliness of SBA recoveries and the amount SBA purchased. These matters concern untimely secondary market purchase reviews, the lack of borrowers' financial statements, the incorrect calculation of SBA's guarantee, the purchase of excessive accrued interest, and a lack of documentation on personal guarantees.

(1) Secondary Market Purchase Reviews

On defaulted secondary market loans, SBA ordinarily paid the registered holder of the guarantee prior to determining whether it should honor the guarantee and demanded repayment from the lender if it later determined that lender error occurred. We noted two instances where SBA did not complete purchase reviews on these defaulted loans in a timely manner, i.e., one and two years, respectively, after honoring the guarantee. Further, in one of the above instances, the lender had not provided SBA with the requested documentation needed to conduct the purchase review one year after SBA paid the guarantee and requested the needed documentation. According to an Office of Financial Assistance official, SBA's unwritten policy is to conduct these reviews and to accomplish them in a timely manner because SBA may have recourse against a lender if origination and servicing deficiencies have occurred. SBA has not, however, established time frames for completing these reviews and does not penalize lenders who do not provide requested documentation in a timely manner. Delays in conducting the purchase review could adversely affect recovery attempts and ultimately the subsidy rate.

(2) Financial statements

Nineteen of 58 loan files did not have current or complete financial statements. SOP 50 50 3, paragraph 24, and the ALA require financial statements. Without current financial statements, SBA cannot determine whether unauthorized distributions or other prohibited actions occurred.

(3) Calculation of SBA guarantee

In 4 of 58 loans, SBA incorrectly calculated its guarantee percentage. According to SOP 50 10 3, paragraph 5d(3), the SBA guarantee for debt refinancing shall not exceed 80 percent, and the percentage for debt refinancing from participating lenders shall be subject to an additional calculation.[2] SBA accepted an overexposure of risk when it did not calculate

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[2]The additional calculation requires that the lesser of the two percentages determined below will be the maximum guarantee percentage:

1. [(80% x amount refinanced) + (Guaranteed percent x balance of loan)] divided by Total Loan, or

2. (Total loan - amount refinanced) divided by Total Loan.

the guarantee percentage correctly. Below is a list of the four loans.

Number	Date Approved	Guarantee Percentage	Allowable Guarantee Percentage	Amount of Overexposure
1	04/22/92	80 Percent	31.8 Percent	$134,864
2	07/07/93	83 Percent	59.4 Percent	$118,000
3	01/08/93	85 Percent	32 Percent	$249,100
4	09/23/91	85 Percent	80 Percent	$43,032

(4) Accrued interest purchased

Four of the 58 loan files included no justification for the purchase of excess accrued interest. SOP 50 50 3, paragraphs 74c and 74e, state that interest in excess of 120 days must be approved by SBA. In one case, SBA purchased 687 days of accrued interest ($9,179). SBA forgave 90 days of this interest because of internal mishandling of the file, allowed the Fiscal and Transfer Agent 150 days and accepted another 166 days because of SBA processing, but provided no further justification for the remaining 281 days (3,956). Excess interest paid on the other three loans ranged from 26 days ($563) to 143 days ($1,610).

(5) Personal guarantees

Eight of the 58 loan files did not contain the required signed Form SF 148 documenting that the necessary personal guarantees were obtained. This requirement is contained in SOP 50 10 3, paragraph 16(f). As such, SBA's collateral position was weakened.

Recommendations

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

2A. Establish time frames for completing purchase reviews on loans sold in the secondary market.

2B. Develop guidelines for charging and collecting interest from the lender for any undue delay on their part in providing SBA information needed to conduct purchase reviews resulting in denial of liability on loans sold in the secondary market.

2C. Notify SBA District Offices to follow SBA procedures related to (1) obtaining financial statements, (2) calculating SBA guarantees, (3) accruing interest purchased, and (4) obtaining personal guarantees.

Management's Response

The Acting Associate Administrator for Financial Assistance concurred with the recommendations. She responded that (1) time frames will be established for purchase reviews of loans sold in the secondary market, and (2) she will issue a notice to all field offices addressing the other recurring matters noted. A copy of her response is included in the report as Appendix A.

Appendix B

Statistical Sampling Techniques and Results

From the review population of 2,819 purchased guarantee loans, we randomly selected a sample of 58 to develop our estimates of population values. Because this was a random, or statistical sample, the population estimates have a measurable precision, or sampling error. This precision is a measure of the expected difference between the value found in the sample and the value 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 loans in the population, the resulting values would be between the lower and upper limits, with the population point estimates being the most likely amounts. We used the population point estimates for the value of inappropriate guarantee purchase decisions. The amounts, however, could be as low as the lower limit or as high as the upper limit.

We calculated the following population estimates and lower and upper limits using the U.S. General Accounting Office's 'SRO-STATS' program at a 90 percent confidence level.

Inappropriate Purchase Decisions

Value	Population Point Estimate	Lower Limit	Upper Limit
Not supported when the decision was made:			
Gross Purchased Amount	$102,925,700	$63,025,070	$147,717,400
Number of Loans	826	520	1132
Should not have been purchased:			
Amount	$16,220,430	$5,195,053	$29,645,890
Number of Loans	389	152	626

Appendix D

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