

**Audit Report on  
Sources of Credit Elsewhere  
for 7(a) Business Loans**

**Washington, D.C.**

**AUDIT REPORT NO. 5-3-W-010-018**

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

**AUDIT  
REPORT**

**Issue Date: Sept. 18, 1995**

**Number: 5-3-W-010-018**

To: John Cox,  
Associate Administrator for Financial Assistance

From: *Peter L. McClintock*  
Peter L. McClintock, Assistant Inspector General  
for Auditing

Subject: Audit Report on Sources of Credit Elsewhere  
for 7(a) Business Loans

We performed an audit of Sources of Credit Elsewhere for 7(a) Business Loans for the period October 1992 through June 1994. The summary section on page I of the report provides a synopsis of the audit finding and recommendations.

The findings included in this report are the conclusions of the 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 office following existing Agency procedures for audit follow-up and resolution.

Please provide us your management decisions for the recommendations with 80 days. Record your management decision on the attached SBA form 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.

Should you or your staff have any questions, please contact Garry L. Duncan at (202) 205-7732.

Attachment (1)

AUDIT REPORT ON  
SOURCES OF CREDIT ELSEWHERE FOR  
7(a) BUSINESS LOANS  
Washington, D.C.

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## SUMMARY

Section 7(a) of the Small Business Act authorizes the general business loan program of the Small Business Administration (SBA). This program provides assistance to new or ongoing small businesses, primarily in the form of SBA-guaranteed loans made by private lenders. The objective of the audit was to determine how SBA applies the rule that 7(a) loans are not to be made to borrowers who have credit elsewhere (CE).

Questionnaires were sent to SBA loan specialists and district office managers throughout the country. The responses showed that for a variety of reasons the loan specialists and district office managers tolerate loans to borrowers who could get credit elsewhere. Based on the estimates of those responding to the questionnaires, from \$244 million to \$316 million a year is loaned to borrowers who have credit elsewhere and are, therefore, ineligible for an SBA-guaranteed loan. This diverts funds from eligible borrowers and gives an unfair competitive advantage to SBA lenders.

To assure the best use of 7(a) business loan funds, the Associate Administrator for Financial Assistance should:

- Reemphasize the credit elsewhere rule to district offices and participating lenders.
- Reemphasize the requirement that lenders certify conventional credit was not available for loan refinancing from other sources at reasonable terms.
- Require district offices to consider the availability of credit elsewhere when they review applications for SBA loan guarantees.
- Require district offices to include an evaluation of credit elsewhere practices in periodic reviews of lenders and verify that such evaluations are accomplished through the Computerized Internal Control Review process.
- Obtain a legal opinion from the Office of General Counsel on the practice of permitting lenders to make SBA loans if the lender has a regulatory restriction that precludes a conventional loan.

The Associate Administrator for Financial Assistance agreed with the report's conclusions. With regard to the recommendations, he stated that three of the five would be implemented, and proposed acceptable alternative procedures for two.

The findings included in this report are the conclusion of the OIG's Auditing Division based upon the auditors testing of the auditee's operations. **The findings and recommendations are subject to review, management decision, and corrective action by your Office in accordance with existing Agency procedures for follow-up and resolution.**

## INTRODUCTION

### **A. BACKGROUND**

Section 7(a) of the Small Business Act authorizes the Small Business Administration (SBA) to guarantee loans to small businesses who cannot get credit elsewhere. The program enabled banks and other SBA-certified lenders to make nearly 36,000 loans totaling \$8.1 billion during Fiscal Year 1994, an all-time high and a 36 percent increase over 1993.

The "credit elsewhere" rule is established by Section 7(a)(1) of the Act, which states, "No financial assistance shall be extended pursuant to this subsection if the applicant can obtain credit elsewhere." Credit elsewhere (CE) is defined in Section 3(h) as follows:

For purposes of this Act, the term "credit elsewhere" means the availability of credit from non-Federal sources on reasonable terms and conditions taking into consideration the prevailing rates and terms in the community in or near where the concern transacts business, or the homeowner resides, for similar purposes and periods of time.

Because of the credit elsewhere rule, SBA has sometimes been characterized as a lender of last resort.

SBA program regulations in the Code of Federal Regulations (CFR) paraphrase the credit elsewhere rule as follows: "Applications for Financial Assistance shall be considered only when the desired credit is not otherwise available on reasonable terms from non-Federal sources" (13 CFR 120.103-1). Credit is considered "otherwise available" if it can be obtained from a conventional loan from the participating lender, a conventional loan from another lender or from the borrower's own resources. To establish if funds are otherwise available, the regulations require SBA to consider whether the borrower could obtain money from:

- sale of securities
- disposal of assets not necessary for growth
- personal resources of the owner, management or principal shareholders

Proof that a borrower has been refused by other lenders is required for direct SBA loans, but not for guaranteed loans, which are the bulk of SBA loans. The lender applying to SBA for a loan guarantee certifies on Form 4-1, "Without the participation of SBA to the extent applied for we would not be willing to make this loan, and in our opinion the financial assistance applied for is not otherwise available on reasonable terms." The regulation at 13 CFR 120.103-1(a)(2) states that this certification "will generally be accepted as sufficient documentation in lieu of a letter(s) of decline."

SBA's internal operating policies on credit elsewhere are contained in SOP 50 10, Section 4, which states, "The extension of SBA credit is prohibited where the financial assistance

requested is otherwise available on reasonable terms." The SOP repeats the 13 CFR guidance on lender certifications, but adds, "Bank refusal should not be considered the full test of unavailability of credit. If credit appears reasonably available from other sources, an SBA loan cannot be granted."

The SOP requires consideration of personal resources of any principal with a 20 percent share in the business. The following rules apply to the family of each principal:

(1) Liquid assets are considered as credit elsewhere, but there are exemptions for:

- life insurance cash value and IRAs
- \$50,000 per family or 25% of loan value, whichever is greater
- reasonable educational expenses

The SOP states:

Excess assets which could be used to raise funds in lieu of part or all of an SBA loan request must be injected prior to SBA financing unless such use would make unreasonable demands on the principals. The maintenance of reasonable personal reserves will be permitted to provide for the livelihood of principals and for contingent needs.

(2) Sale or refinancing of real estate "may be considered" if it would supply the majority of the loan request, but owner-occupied residences and second homes are exempted.

The SOP gives loan officers discretion to make exceptions when the rules would cause a hardship, but adds, "SBA does not consider the desire to protect one's personal estate or that income taxes will accrue on capital gains resulting from the sale of assets to constitute a hardship."

Prior audits of the OIG have identified loans to borrowers who had credit elsewhere. In 11 audits conducted from 1989 through 1993, the OIG reviewed 305 loans in sufficient detail to evaluate whether there was credit elsewhere. A new review of these audits concluded that 39 of the 305 loans (12.8 percent) totaling \$15.8 million were made to borrowers who had credit elsewhere (see Appendix A for a list of the 11 audit reports).

Various types of credit elsewhere were present in the 39 loans, including:

- liquid assets and owned real estate
- ability of the borrower to qualify for a conventional loan
- refinancing of an existing conventional loan (the existing loan is credit elsewhere)

In this report, a "CE loan" is one in which the borrower had credit available elsewhere, thus, should not have been given an SBA-guaranteed loan.

## **B. AUDIT OBJECTIVE AND SCOPE**

The objective of this audit was to determine how SBA officials apply the credit elsewhere rule in the review and approval of SBA loans. This was accomplished by the use of two questionnaires to obtain the perceptions and attitudes of SBA field office personnel for the period of October 1992 through June 1994.

One questionnaire was for field office managers. The questionnaire was completed by 132 of 135 district directors and assistant district directors, a 98 percent response rate. The other questionnaire was sent to half of SBA's loan specialists selected randomly. Out of 135 questionnaires sent to loan specialists, 117 or 87 percent were completed. The loan specialists responding had an average of nine years experience reviewing 7(a) loans.

Prior to their distribution, the draft questionnaires were reviewed by the Office of Financial Assistance. They provided valuable comments that were used to complete the instruments.

## **C. FOLLOW-UP ON PRIOR AUDITS**

OIG Audit Report No. 1-2-1-003-317, "National Audit Report -- Preferred Lenders Program," contained a finding that credit elsewhere was not being considered consistently by 7(a) lenders. Lenders were ignoring personal resources of borrowers and marketing SBA loans when conventional credit was available. Lenders were also using their own policies against long-term conventional loans or a low cash reserve position as a basis for certifying that funds were "not otherwise available" to the borrower without the SBA guarantee.

SBA's Office of Financial Assistance (OFA) supported the lenders' position that low cash reserves by the lending bank can satisfy the credit elsewhere rule. In response to the audit, the Assistant Administrator for Financial Assistance wrote on April 1, 1992:

The Office of Financial Assistance maintains, and has always maintained, that an otherwise eligible small business, that is denied a loan solely because its bank account is in an illiquid position, is fully eligible to receive an SBA guaranty.

Under this premise, an otherwise creditworthy borrower is eligible to receive the guaranty if the lender has insufficient funds to make the loan; must sell the major portion in the secondary market; and, must have an SBA guaranty in order to effect the sale.

In addition, SBA has always ruled that a guaranty is eligible if needed to approve a loan in an amount beyond the bank's legal lending limit for an otherwise creditworthy and eligible borrower.

The audit recommendation to obtain Congressional clarification of the credit elsewhere rule was resolved by OIG/OFA agreement to seek an opinion from SBA's Office of General Counsel. However, that opinion has not been obtained.

## **RESULTS OF AUDIT**

**FINDING**            SBA field managers and loan specialists tolerate loans to borrowers who could get credit elsewhere.

Based on the questionnaires, a significant percentage of SBA field managers and loan specialists think CE loans are submitted by lenders and approved by SBA despite the statutory prohibition. This is caused by a combination of SBA attitudes and lender incentives. If the estimates of the managers and loan specialists are correct, from \$244 million to \$316 million of CE loans were approved in 1994, depriving eligible borrowers of SBA loan assistance.

### **Local Office Managers Think the Credit Elsewhere Rule is Diluted in Practice**

Nearly half of the managers polled thought the 7(a) program was not necessarily viewed by their local office as a lender of last resort. When asked whether their local office views the 7(a) program as only for small businesses who cannot get credit elsewhere, only 66 of 130 local office managers answered "definitely." Eleven answered "no" and 53 answered "qualified yes." Reasons for the managers' opinions are given later in this report.

### **CE Indicators Ignored by 9 to 35 Percent of Loan Specialists**

In reviewing loan applications, some loan specialists ignore credit elsewhere indicators. The following table shows the results of a questionnaire item which said, "Please indicate for each condition, whether you do or do not consider it in your loan eligibility determination."

| <b>Condition</b>                             | <b>Number of Respondents</b> | <b>Number Who Don't Consider</b> | <b>Percent Who Don't Consider</b> |
|--|------------------------------|----------------------------------|-----------------------------------|
| Excess liquid assets                         | 115                          | 11                               | 9.6                               |
| Equity in real estate                        | 116                          | 28                               | 24.1                              |
| Borrower could qualify for conventional loan | 115                          | 41                               | 35.6                              |
| Lender would make a conventional loan        | 114                          | 18                               | 15.8                              |
| Refinancing                                  | 114                          | 13                               | 11.4                              |

Neither Managers Nor Loan Specialists Think Lenders Are Diligent on CE

Both questionnaire groups were asked if lenders adequately consider and address applicants' access to credit elsewhere when it appears they may not need SBA guarantee assistance. More than half of the loan specialists and 28 percent of the managers answered "seldom" or "never," as shown by the following table.

| <b>Do Lenders Adequately Address Credit Elsewhere?</b> | <b>Loan Specialists</b> | <b>Managers</b> |
|--|-------------------------|-----------------|
| Always   | 2                       | 15              |
| Usually  | 52                      | 83              |
| Seldom   | 62                      | 29              |
| Never  | 2                       | 1               |
| Total  | 118                     | 128             |

PLP Loans Are Not Adequately Reviewed for Credit Elsewhere

SBA approves some banks for the Preferred Lender Program (PLP) where the bank makes the credit analysis for SBA. The questionnaires showed a substantial belief that PLP loans are thereby shielded from SBA analysis of credit elsewhere. Nearly half of the loan specialists who review PLP loans, or 29 out of 64, said they did not consider credit elsewhere in their PLP loan review. Managers were asked whether their office's PLP review process was sufficient to disclose indications of credit elsewhere; 53 managers answered "no," 46 answered "yes," and 22 were not sure. By contrast, 123 of 128 managers answered "yes" for non-PLP loans.

CE Indicators Identified by 77 of 117 Loan Specialists

Loan applications with indicators of credit elsewhere had been identified by 77 out of 117 loan specialists. These 77 loan specialists were asked to estimate the rate of occurrence of the five types of indicators used in this audit. The results are shown on the following table.

| <b>Indicator That Borrower Has Credit Elsewhere</b> | <b>Number Who Said It Occurs</b> | <b>Average Estimate of Rate of Occurrence</b> |
|---|----------------------------------|---|
| Excess liquid assets                                | 58                               | 32.1 %  |
| Equity in real estate                               | 65                               | 34.0  |
| Borrower could qualify for conventional loan        | 52                               | 26.3  |
| Lender would make conventional loan                 | 33                               | 12.7  |
| Refinancing   | 53                               | 34.5  |

### Reasons for Tolerance of CE Loans

Managers and loan specialists attributed the tolerance of CE loans to a variety of factors, including lender incentives and attitudes of both lenders and SBA officials about the nature of the 7(a) program.

#### Reasons Lenders Submit Loan Applications Showing Credit Elsewhere

Managers and loan specialists were each asked to check a list of possible reasons for lenders to submit SBA loan applications even though the borrower had credit elsewhere. The question was answered by 113 managers who did not think lenders always adequately consider CE and 77 loan specialists who had seen loan applications with CE indicators. The results are shown on the following table.

| Reasons for Lenders to Submit Loan Applications Although Borrower Had Credit Elsewhere   | Number Who Checked This Reason |                                  |
|--|--------------------------------|----------------------------------|
|  | Managers<br>(Total = 113)      | Loan Specialists<br>(Total = 77) |
| Lender does not view SBA loans as loans of last resort.  | 65                             | 50                               |
| Lender believes it is unlikely SBA would question credit elsewhere as an eligibility requirement.  | 17                             | 48                               |
| Lender primarily does business with applicants that qualify for conventional credit.   | 43                             | 50                               |
| Applicants with credit elsewhere are better credit risks, which minimizes defaults and improves the lender's standing with SBA.                                    | 37                             | 38                               |
| Profits in SBA's secondary market provide incentives to make larger long-term loans; borrowers with credit elsewhere give the best opportunity to use this market. | 34                             | 38                               |
| Because of the secondary market incentive, the lender influences applicants to include unnecessary real estate financing in loan requests.                         | 13                             | 27                               |
| Regulatory concerns such as loss reserve limits cause the lender to want an SBA guarantee even when the applicant qualifies for conventional credit.               | 49                             | 40                               |

See the Follow-up on Prior Audits section above for a discussion of lender actions on credit elsewhere.

**Reasons Managers Don't Think 7(a) Program Is Lender of Last Resort**

The 64 managers who did not think their local office "definitely" prohibits CE loans were asked to check a list of possible reasons for their opinion. The results on the following table show that a variety of policy considerations are being given priority over the credit elsewhere rule.

| Reasons Why Local Office Does Not View 7(a) Program as Only a Lender of Last Resort   | Managers Checking This Reason (Total = 64) |         |
|---|--|---------|
|   | Number                                     | Percent |
| The program has evolved into credit assistance to small businesses regardless of need.  | 22   | 34 %    |
| Headquarters does not emphasize enforcement of the credit elsewhere rule.   | 20   | 31      |
| Because of pressure to minimize losses from guarantees, SBA and lenders need to approve some high-quality, low-risk loans, even if credit is available elsewhere.   | 27   | 42      |
| Lenders might not actively participate in the program if they could only make SBA-guaranteed loans to borrowers who have no credit elsewhere.   | 26   | 41      |
| Lenders prefer SBA-guaranteed loans because of profits on secondary market sales and they might not actively participate if these profits were curtailed by enforcement of the credit elsewhere rule.                                     | 25   | 39      |
| Regulatory concerns, such as loss reserve rules, cause some lenders to use SBA-guaranteed loans to applicants who have credit elsewhere. These lenders might not actively participate if they were not allowed to make this type of loan. | 28   | 44      |

**Reasons Loan Specialists Approve CE Loans**

Forty loan specialists said they approved loans even though the borrower had credit elsewhere. These 40 loan specialists were asked to check off a list of reasons why they approved CE loans, with the results shown on the following table.

| Reasons for Loan Specialists to Approve Loans to Borrowers Who Have Credit Elsewhere   | Number of Specialists Citing This Reason<br>(Total = 40) |                |
|--|--|----------------|
|  | A Reason   | Primary Reason |
| The SBA loan specialist is expected to rely primarily on the representations and certifications made by the lender.                      | 30   | 16             |
| Guidelines in SOP 50 10 are not adequate to serve as a basis for questioning the lender's judgment on credit elsewhere.                  | 18   | 13             |
| CE loans afford minimal risk of loss and are needed to strengthen SBA's loan portfolio.  | 17   | 4              |
| CE loans assist the local office and SBA in meeting or exceeding loan production goals.  | 23   | 17             |
| Because of higher profits to lenders on 7(a) loans, many lenders might not participate in the program if precluded from making CE loans. | 12   | 3              |
| SBA management does not view 7(a) loans as loans of last resort and, generally, does not expect CE loans to be turned down.              | 21   | 8              |

As noted earlier (Background), the program regulations and SOP create a presumption in favor of the lender certification that credit is not otherwise available. No documentation is required to support the lender certification, especially for PLP loans.

**Impact of SBA Tolerance of CE Loans**

SBA's tolerant attitude on credit elsewhere affects the 7(a) loan market in several ways, including (1) approval of an estimated \$244.5 to \$316 million a year of loan guarantees for borrowers who are ineligible because they have credit elsewhere, (2) diversion of funds from needy applicants, and (3) unfair competition for banks making conventional loans.

**A Significant Amount of CE Loans Are Approved**

Loan specialists estimated that CE indicators were present in 6.7 percent of PLP loan

applications and 8.2 percent of other loan applications. Further, an estimated 37.5 percent of these applications were nevertheless approved despite the CE indicators.

Managers were asked to estimate the percentage of loan approvals that were CE loans. The average of 71 respondents, including 37 who said no CE loans were approved, was 3.9 percent.

If these estimates are valid, CE loans totaled \$244.5 million to \$316 million in 1994, out of the \$8.1 billion in total 7(a) loans in 1994. The calculations are shown below.

**Loan Specialist Estimate:**

*PLP Loans*

$$\begin{array}{rcl}
 \text{CE rate in applications} & \times & \text{Loan Approval Rate} = \text{Overall CE Loan Rate} \\
 .067 & \times & .375 = .025 \\
 \text{CE Loan Rate (.025)} & \times & \$1.1 \text{ Billion} = \$27.5 \text{ Million of PLP CE Loans}
 \end{array}$$

*Non-PLP Loans*

$$\begin{array}{rcl}
 \text{CE rate in applications} & \times & \text{Loan Approval Rate} = \text{Overall CE Loan Rate} \\
 .082 & \times & .375 = .031 \\
 \text{CE Loan Rate (.031)} & \times & \$7 \text{ Billion} = \$217 \text{ Million of Non-PLP CE Loans}
 \end{array}$$

Amount of CE Loans Per Loan Specialist Estimate: \$244.5 million

**Managers Estimate:**

$$\begin{array}{rcl}
 \text{CE Loan Approval Rate} & \times & \text{Total Loans} = \text{CE Loan Estimate} \\
 .039 & \times & \$8.1 \text{ billion} = \underline{\$316 \text{ million}}
 \end{array}$$

Based on the current subsidy rate of 2.7 percent, the budget impact of the loan specialist and manager estimates would be \$6.6 and \$8.5 million, respectively.

CE loans Divert Funds from Needy Applicants

Significant proportions of both questionnaire groups believed that CE loans deprive truly needy applicants of SBA loan funds. Sixteen out of 32 loan specialists with an opinion said that cutting out CE loans would result in service to needy applicants not now being served. When asked if they believe that CE loans reduce credit assistance to truly needy borrowers, 39 of 110 managers with an opinion answered "yes" or "probably."

## SBA-Guaranteed Loans Are Unfair Competition for Conventional Lenders

When lenders offer SBA-guaranteed loans to applicants that can obtain credit elsewhere, it results in an unfair competitive advantage over non-SBA lenders. In this audit, we encountered two examples.

A Northeast banker complained that loan packagers were arranging for existing loans to be refinanced with SBA-guaranteed loans at another bank. The borrowers did not need guaranteed financing due to their credit standing; the first bank would have refinanced the conventional loans without SBA guarantees. The conventional loans were for eight or 10 years with a balloon and the SBA loans had a 25-year term. The conventional banker stated, however, that he would refinance the loans if the borrower remains credit worthy.

A West Coast lender complained to SBA that a competing lender was refinancing his loan with an SBA-guaranteed loan. The conventional lender said that the SBA lender's certification that credit was "not otherwise available" could not have been accurate because no contact was made except to ask for a payoff. In fact, the conventional lender said he was willing to refinance at the same or a better rate than offered by the SBA lender. The conventional lender stated that losing loans to the SBA lender threatened his firm's existence.

### Examples of CE Loans Identified in Prior Audits

Prior OIG audits have identified loans to borrowers who had credit elsewhere. In 11 audits conducted from 1989 through 1993, the OIG reviewed 305 loans in sufficient detail to evaluate whether there was credit elsewhere. A new review of these audits concluded that 39 of the 305 loans (12.8 percent) totaling \$15.8 million were made to borrowers who had credit elsewhere. Credit elsewhere available for these loans, included the following sources:

- liquid assets and owned real estate
- ability of the borrower to qualify for a conventional loan
- refinancing of an existing conventional loan

Examples of these types of credit elsewhere found in previous OIG reports are discussed below:

#### Liquid Assets and Owned Real Estate

- A Florida bank made a \$100,000 PLP loan to partially finance building construction costs. The applicant's reported net worth was about \$1.5 million after SBA exemptions were excluded. The personal assets of the applicant included \$300,000 in savings and real estate and \$971,000 in other investments. The SBA District Director advised us that the lender had the right to determine the applicant's eligibility but would be reminded of

the requirement regarding excess liquid assets.

- A bank in Texas made a PLP loan for \$625,000 to refinance a real estate note held by a non-SBA lender. The owners (husband and wife) of the small business reported a personal net worth of \$6.3 million on their loan application. After adjusting for allowed exemptions and value of ownership interest in the small business, the owners had unencumbered assets of approximately \$1.9 million. The assets consisted of real estate valued at about \$900,000 with the remaining assets held in various savings and trust accounts. This lender stated that the borrowers were eligible because the amount of the loan was larger than the bank's charter permitted it to make for any one customer. We were told by the borrower that a loan elsewhere was never applied for. The district office did not have sufficient information to evaluate the personal finances of this borrower before the lender approved the loan.
- A small business lending company in Texas made a \$1.45 million non-PLP loan to finance the purchase of a motel property. The applicant had a personal net worth of \$3.5 million excluding exempted assets. The net worth consisted primarily of equity in various motel properties and one unencumbered investment property located in California, valued at \$1.4 million. The loan was only secured by the real estate to be purchased. The District Director stated that investment real estate was not considered a potential source of CE because the borrower cannot be required to sell.

#### Ability of the Borrower to Qualify for a Conventional Loan

- A Northeast bank's regular policy was to market SBA loans to small business applicants first, then make conventional credit available only when an SBA loan was unacceptable to the borrower. According to the lender, since the guaranteed portion of SBA loans was salable on the secondary market, the use of bank resources would be moderate when compared to conventional loans. District officials commented that due to the lender's liquidity position it could not adequately service small business borrowers. Further, the district office would not question the lender's judgment as to the availability of credit elsewhere.
- Customers receiving SBA loans at a Southwest bank were as creditworthy as those receiving conventional loans. For two of the twelve loans examined at this bank, the lender was willing to offer applicants either an SBA or conventional loan with comparable terms. The applicants apparently accepted the SBA loans of \$710,000 and \$200,000 because interest rate adjustments were more advantageous. This lender was clearly ready to make conventional loans to the borrowers at reasonable terms if SBA guarantees had not been readily available.
- A Wisconsin bank made a PLP loan of \$1 million to a small business borrower as part of a \$17 million loan package funded by several lenders. The lender could provide no

justification for making the SBA loan in light of the substantial financing that was extended to this business without SBA's backing.

#### Refinancing of an Existing Conventional Loan

- In February 1993 a bank loaned \$243,000 to refinance the balance of the applicant's real estate note held by the same bank. The original amount of the bank's note was \$326,000 on a loan obtained by the borrower in May 1987 to purchase business real estate. The conventional bank loan was for a term of 15 years with a fixed interest rate of 11 percent. The SBA loan was also for 15 years, but had an initial interest rate of 7.75 percent. The loan was subject to a monthly adjustment based on the movement of prime interest rates but could not exceed 12.75 percent. The SBA loan was justified on the basis that it would decrease debt service requirements for the business by \$15,000 a year and allow additional cash flow to upgrade equipment and make minor repairs to the building. We concluded that the original loan by the bank, obtained by the borrower at reasonable terms without Federal guaranty assistance, was credit elsewhere. The lender did not offer a compelling reason to convert 80 percent of its existing loan exposure to a Federal guaranteed loan. The lender did not specify the amounts needed for equipment upgrades and building upkeep nor explain why other short-term financing could not meet these requirements.

#### **RECOMMENDATIONS**

We recommend that the Office of Financial Assistance (OFA) take the following steps to prevent SBA-guaranteed loans to applicants with credit elsewhere:

- 1A. Reemphasize the credit elsewhere rule to district offices and participating lenders.
- 1B. Reemphasize the requirement that lenders certify conventional credit was not available for loan refinancing from other sources at reasonable terms.
- 1C. Require district offices to consider the availability of credit elsewhere when they review applications for SBA loan guarantees.
- 1D. Require district offices to include an evaluation of credit elsewhere practices in periodic reviews of lenders and verify that such evaluations are accomplished through the Computerized Internal Control Review process.
- 1E. Obtain a legal opinion from the Office of General Counsel on the practice of permitting lenders to make SBA loans if the lender has a regulatory restriction that precludes a conventional loan.

### Management Response

The Associate Administrator for Financial Assistance agreed with the report's conclusions (see Appendix B). He stated that recommendations 1A, 1C, and 1E would be implemented, clarified OFA requirements for 1B, and proposed an additional action for 1D.

### Evaluation of Management's Response.

Actions outlined by OFA are responsive to our recommendations. An evaluation of the comments resulted in:

- dropping a draft recommendation regarding borrower certification (paragraph 2),
- revising recommendation 1B to "reemphasize" rather than "require" lender certification (paragraph 3), and
- amending recommendation 1D to incorporate verification of district office evaluations in the Computerized Internal Control Review process (paragraph 5).

## Appendix A

| <b>PRIOR AUDITS OF LOANS WITH CREDIT ELSEWHERE</b> |                             |                              |                           |                      |
|--|-----------------------------|------------------------------|---------------------------|----------------------|
| <b>Audit Location</b>                              | <b>Date Audit Completed</b> | <b>No. of Loans Examined</b> | <b>Applicants With CE</b> | <b>Report Number</b> |
| San Antonio District Office                        | 9/93                        | 38                           | 8                         | N/A                  |
| First Wisconsin National Bank of Sheboygan         | 11/90                       | 40                           | 3                         | 1-2-9-008-045        |
| Merchants Bank                                     | 7/90                        | 38                           | 2                         | 0-2-9-009-152        |
| ITT SBLC   | 2/92                        | 33                           | 2                         | 2-0-C-406-046        |
| Independence Mortgage                              | 5/91                        | 42                           | 2                         | 1-2-0-404-241        |
| ITT SBLC   | 3/94                        | 14                           | 2                         | 4-3-W-007-014        |
| Tx Bank of Weatherford                             | 3/94                        | 12                           | 6                         | 4-3-W-007-014        |
| Bank of the West                                   | 3/94                        | 9                            | 4                         | 4-3-W-007-014        |
| Signet   | 2/94                        | 8                            | 2                         | 4-3-E-006-010        |
| Bay Bank and Trust                                 | 3/90                        | 25                           | 3                         | 0-2-9-001-90         |
| SW Commerical Capital                              | 1/91                        | <u>46</u>                    | <u>5</u>                  | 1-2-9-010-125        |
| <b>Total</b>                                       |                             | <b><u>305</u></b>            | <b><u>39</u></b>          |                      |



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



Date: August 11, 1995

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

From: *John Cox*  
John Cox  
Associate Administrator  
Office of Financial Assistance

Subject: Draft Audit Report - Sources of Credit Elsewhere for  
7(a) Business Loans

This is in response to the referenced Draft Audit Report.

The following comments are offered in the order of the recommendations listed in your memo.

1. OFA supports and plans to implement the recommendation to reemphasize the "credit elsewhere" rule to district offices and participating lenders. Most lenders try to be diligent in this regard, but this issue is not one of significant importance to them. As a result, they tend to lose sight of its relevance to the SBA. Reemphasizing this rule to the lenders will remind them of our intent and function. OFA will develop, and issue to the field, a Notice restating the intent of our credit elsewhere policy and the importance of it. This will be accomplished this Fall.
2. Requiring loan applicants to certify that they tried and failed to obtain the requested financing from other sources before requesting an SBA loan is demoralizing to small business owners, but unenforceable by the Agency. As found when we were making direct loans, very few banks resist someone's request for a "turn down" letter, especially if the loan request is for a relatively small amount of money, is for a start-up, or if the applicant has not been a customer of the bank. And so, applicant certification that they tried and failed to obtain the requested financing would be meaningless. Furthermore, it is the lender's decision whether to request SBA's guaranty on their proposed loan, not the applicant's. At the time the small business concern submits its loan request to the bank, the applicant may or may not have considered SBA financing. Only after the lender analyzes the application, will the lender decide if it will make the loan itself, make the loan with an SBA guaranty, or decline the loan. The lender's certification that it would not make the loan without SBA's guaranty is considered sufficient.

3. Execution of the Lender's Application for Guaranty by the lender constitutes certification that the lender would not be willing to extend credit on the requested terms without SBA's guaranty. OFA deems this to include those cases involving refinancing and understands it to mean that the lender would not refinance the debt on terms comparable to the SBA loan requested or that the applicant no longer meets the lender's conventional underwriting criteria. However, OFA expects to revisit its policy on debt refinancing within the next several months and will ensure that this understanding is made clear in new policy guidance.

4. As previously stated, this is a requirement of the Agency and this Office in accordance with 13 CFR and SOP 5010 3. Reemphasis of the "credit elsewhere" rule, through the issuance of the Notice referenced at Item #1, should achieve the recommendation to require district offices to consider the availability of credit from other sources when they review applications for SBA loan guarantees.

5. Verifying that an evaluation of credit elsewhere had been accomplished is a valid recommendation with great potential benefit to SBA. Rather than field offices performing the verification, this Office shall be glad to implement it by including it as an element in the Computerized Internal Control Reviews.

6. OFA will immediately request an opinion from the Office of General Counsel on the practice of permitting lenders to make SBA loans instead of conventional loans to borrowers with credit elsewhere if a regulatory restriction exists that precludes a lender from making conventional loan shall be requested right away.

I appreciate your efforts in helping us to maintain the high level of quality that exists in our loan program and look forward to working with you in the future in a spirit of mutual cooperation.

John R. Cox  
Assistant Administrator  
for Financial Assistance

OFFICE OF INSPECTOR GENERAL  
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