



**U.S. Small Business Administration
Office of Inspector General
Washington, DC 20416**

AUDIT MEMORANDUM

Issue Date: July 29, 1999

Report Number: 9-14

TO: Jane P. Butler, Associate Administrator Office of Financial Assistance

FROM: John Dye, Acting Assistant Inspector General for Auditing

SUBJECT: Audit Memorandum, Portion of a 7(a) Loan Ineligible for SBA Guarantee

INTRODUCTION

The Auditing Division performed a survey of the management of the Preferred Lender Program (PLP) review process. During our survey, we visited the Kansas City Review Branch to analyze documentation on completed reviews. We reviewed six SBA guaranteed loans approved through PLP, and one of these was partially ineligible for an SBA guarantee.

BACKGROUND

SBA has authority to guarantee up to 80 percent on loans made to small businesses. SBA lenders having PLP status are given full authority to make SBA guaranteed loans, subject to an SBA eligibility review. When a PLP lender determines that a loan is eligible, the lender completes a checklist providing evidence of eligibility for review by SBA's Sacramento Loan Processing Center (the Center). If the Center notes any problems on the checklist, the lender is asked to resolve the issue.

FINDING

SBA and PLP Lender Approved Partially Ineligible Loan.

SBA and a PLP lender approved an \$82,000 SBA guaranteed loan, of which \$49,993 was ineligible for the guarantee because the borrower had credit available elsewhere. SBA and The Bank of Castile (Castile), a PLP lender,

approved the loan for 5 years with a 10.5 percent interest rate. This loan was to (1) refinance a \$50,000 line of credit approved by the applicant's current lender (\$49,993 of the proceeds from the SBA guaranteed loan were used to pay off the line of credit), and (2) purchase \$32,000 of new computer equipment. According to the SBA application, the terms of the line of credit were prime plus 1 percent (8.5 percent plus 1 percent, or 9.5 percent as of September 17, 1997), accrued interest payable monthly. The loan was originated in 1993 and was current as of September 17, 1997. The applicant told our auditor that their bank had not demanded payment in full on the existing loan. Moreover, the bank informed our auditor that their records do not show any reason they would have demanded payment in full. Although the existing loan had terms more favorable than the SBA guaranteed loan, the applicant told Castile that they wanted to switch lenders because their loan officer had been changed twice in 3 months.

In obtaining SBA's approval, however, Castile misinformed SBA about the status of the applicant's existing loan. In their September 17, 1997, checklist submitted to the Center, Castile stated that financing with reasonable terms was not available elsewhere. In Castile's September 23, 1997, response to a question raised by the Center, Castile stated that, while the existing loan appeared to be on reasonable terms, the lender was demanding payment in full. After receiving that statement, the Center approved the SBA guaranteed loan as eligible for SBA guarantee.

Title 13 CFR 120.101 states that SBA can only guarantee loans to applicants for whom credit is not otherwise available on reasonable terms from non-Federal sources and the lender must certify to or otherwise show SBA that the credit is not otherwise available. According to Title 13 CFR 120.524, SBA is released from liability on its guarantee when a PLP lender has failed to comply materially with SBA regulations.

Castile's loan officer informed us they accepted the application because it appeared to be in the borrower's best interest to refinance their existing loans. As a result, an SBA guarantee was issued for an \$82,000 loan, of which \$49,993 was ineligible.

Recommendations

- A01 Notify the Bank of Castile that a record of this finding (ineligible refinancing) will be placed in its lender file for review during consideration of lender's request for PLP renewal or expansion, and place a record of this finding in that file.
- A02 Notify The Bank of Castile in writing that if the SBA guaranteed loan defaults, the lender will be called upon to explain why the refinancing was eligible and why SBA should not deny liability on at least the portion of the

loan used to refinance the \$49,993 line of credit, and place a copy of SBA's notification in the applicant's (Integration, Inc.) loan file.

The Bank of Castile responded to the draft report and disagreed with our finding. The full text of these comments and our evaluation of them are found in Appendices 1 and 2, respectively. The Associate Administrator for Financial Assistance also responded to the draft report and we incorporated her comments in this report.

The recommendations in this memorandum are based on the conclusions of the Auditing Division. **The recommendations are subject to review, management decision, and action by your office in accordance with existing Agency procedures for audit followup and resolution.**

Please provide us your management decision for the recommendations within 80 days. Your management decision should be recorded 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.

This report may contain proprietary information subject to the provisions of 18 USC 1905. Do not release to the public or another agency without permission of the Office of Inspector General.

Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Business Development Programs Group, at (202) 205-7204.



The Bank of Castile

CREDIT DEPARTMENT
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April 21, 1999

[EX. 6]
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Office of the Inspector General
409 Third Street SW
Washington Office Center
Suite 5600
Washington, DC 20416

Re: Audit Memorandum - [EX. 4]

Dear [EX. 6]

I am writing, per your request, in response to your draft audit memorandum issued in regards to The Bank of Castile's SBA guaranteed loan to [EX. 4] Your findings state that the Bank misinformed SBA about the applicant's previous line of credit which was requested to be refinanced. You also state that the customer's previous bank informed your office that the loan in question was not, at the time, on demand for payment in full.

Our statement to the Sacramento PLP Center regarding the status of the line was based on our belief that the payments on the line of credit were to be accelerated. Accordingly, the Banks restructuring of this debt was and still is in the best interests of the borrower. Our assumption that payments on the line were to be accelerated was based on the commitment letter which was provided to the borrower by their previous lender, [EX. 4] In the commitment the lender proposed a refinance of the previous \$50,000 line of credit over a term of five years with an SBA guaranty. Based on this proposal, it was evident that payments on the line were to be accelerated or demanded.

The borrower stated, in letter form, that [b] had used proceeds from the line to purchase computer equipment. As a result, the borrower was unable to perform the line of credit as required with monthly interest only payments and a 30 day annual clear. In reviewing the customer's situation, it is apparent that the Bank of Castile would have been doing the business, [EX. 6] a disservice by financing only the new equipment purchases. The customer, at the time, was in a mode of growth which would have resulted in an anticipated need for additional working capital in the upcoming months. With the line of credit as it had previously existed, the customer had no room to borrow for operating needs to fund this new growth. In an effort to assist the business in continuing as a "going concern entity", the Bank termed out the line of credit with payment terms that were able to be met by the businesses cash flow and supplemented the operating needs of the business with a 10,000 non-SBA guaranteed line of credit. As a result, we do not believe that the SBA was misinformed nor is it our opinion that an SBA guarantee was issued for an ineligible loan.

FOIA EX. 4, 6



In closing, we would like to make reference to the SBA SOP 50-10. The policy regarding debt refinancing states, "For a business wanting to refinance a revolving line of credit, the substantial benefit lies in the ability of the business to continue to borrow once its existing line matures or its ability to stretch the payments over a longer maturity, thereby retaining its working capital for a longer period of time". With the refinance provided by the Bank, both of the above stated benefits were achieved; payments were stretched over a longer maturity and a renewed source of working capital was provided. The SOP further states that the terming out of a line of credit will frequently benefit companies experiencing significant growth and is an acceptable refinancing with any reasonable justification. Refinancing of short term debt is not subject to the 20 percent improvement to cash flow test as is required when refinancing term debt.

Further discussion and comments are welcomed. If you would like to discuss this response at greater length, please feel free to contact me at [Ex. 6] Thank you for your time with this matter.

Sincerely,

[Ex. 6]

Commercial Credit Analyst

Cc: [Ex. 6]

CASTILE'S COMMENTS AND OIG EVALUATIONS

Castile provided the following explanations as to why they believed the loan was eligible for an SBA guarantee (see Appendix 1 for full text of the response).

Auditee Comment 1. Castile informed SBA that payment of the \$50,000 line of credit was being demanded in full based on their belief that payments on the line were to be accelerated. This belief was based on a commitment letter provided by the borrower's previous lender that proposed to refinance the line over a term of 5 years with an SBA guarantee. The proposal made it evident that payments on the line were to be accelerated or demanded.

OIG Evaluation 1. We disagree that Castile had sufficient reason to believe that the loan was being demanded. While the previous lender's commitment letter proposed to refinance the line over a term of five years with an SBA guarantee, there was no evidence that the existing line would be demanded in full if the loan proposed in the commitment letter was not made. Also, as discussed in the body of this audit memorandum, there was no evidence that the previous lender had or intended to demand payment in full on the existing loan.

Auditee Comment 2. The borrower used the proceeds from the line of credit to purchase computer equipment. As a result, the borrower was unable to perform the line. In reviewing the borrower's situation, Castile determined that financing only new equipment would be a disservice to the borrower. In an effort to assist them in continuing as a "going concern entity," Castile termed out (refinanced) the line of credit with payment terms that could be met by the business' cash flow.

OIG Evaluation 2. The lender's payment history record showed that the borrower was able to perform the line. While we do not take exception to the statement that the \$82,000 SBA guaranteed loan assisted the borrower, an SBA guaranteed loan must also meet SBA eligibility requirements. As discussed previously, this portion of the loan did not meet SBA eligibility requirements.

Auditee Comment 3. Castile believed that with the refinancing loan they made, they provided the following benefits stated in SBA SOP 50-10:

For a business wanting to refinance a revolving line of credit, the substantial benefit lies in the ability of the business to continue to borrow once its existing line matures or its ability to stretch the payments over a longer maturity, thereby retaining its working capital for a longer period of time.

According to Castile, the SOP further states that:

[T]he terming out of a line of credit will frequently benefit companies experiencing significant growth and is an acceptable refinancing with any reasonable justification. Refinancing of short-term debt is not subject to the 20 percent improvement to cash flow test as is required when refinancing term debt.

OIG Evaluation 3. We do not take exception to any of these statements, but before these benefits can be realized and prior to using the cited criteria for refinancing short term debt, a loan must first be eligible for refinancing. According to SOP 50 10, "To be eligible for refinancing with 7(a) proceeds, the existing debt must not presently be on reasonable terms AND the refinancing must provide a substantial benefit to the small business." As discussed in the body of this audit memorandum, the existing loan had more favorable terms than Castile's loan, and the lender had not demanded payment in full on the existing loan. As such, this loan was ineligible for refinancing.

Appendix 3

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