



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

Management Advisory
Report Number: 18-23

DATE: September 13, 2018

TO: Linda E. McMahon
Administrator

FROM: Hannibal "Mike" Ware 
Inspector General

SUBJECT: Office of Inspector General High Risk 7(a) Loan Review Program

This management advisory presents the evaluation results of two 7(a) loans as part of our ongoing High Risk 7(a) Loan Review Program. This is the second in a series of advisories for 7(a) loans that we reviewed in fiscal year (FY) 2018 and one loan identified in a previous review. We presented two loans in our first advisory. The remaining four loans will be presented in our capping report. The objectives of our evaluation were to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with the Small Business Administration's (SBA's) rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

This advisory contains two recommendations that SBA agreed to implement. Please provide us your progress in implementing the recommendations within 90 days.

Background

SBA is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guaranteed loans.¹ Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures. When a 7(a) loan goes into default and the lender requests guaranty payment, SBA reviews loan documentation to determine whether the lender made, closed, serviced, and liquidated the loan in accordance with prudent lending standards and SBA requirements. Further, when a lender requests guaranty payment on a defaulted secondary market loan, SBA must purchase the loan from the secondary market investor. After purchase of the secondary market loan, SBA reviews loan documentation to evaluate the lender's compliance with program rules and regulations. SBA is released from liability on the guaranty, in whole or in part, at the Agency's discretion, if the lender fails to comply with any material SBA loan program requirements.

Previous audits indicated that some lenders failed to comply with SBA loan requirements; therefore we established the High Risk 7(a) Loan Review Program in FY 2014. This program evaluates lender compliance with SBA requirements for high-dollar/early-defaulted 7(a) loans (loans approved for \$500,000 or more that defaulted within the first 18 months of the initial disbursement). We use an

¹ 15 U.S.C. 636(a).

internal scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance or suspicious activity by loan participants.

Results

This memorandum includes the results of our review of two 7(a) loans as part of our ongoing High Risk 7(a) Loan Review Program. This is the second in a series of advisories covering a total of eight loans—seven 7(a) loans we selected for review in FY 2018, and one loan identified during a previous High Risk 7(a) loan review. We reviewed these two high-dollar/early-defaulted 7(a) loans approved by lenders using their delegated authority. SBA honored its guaranty on each loan, resulting in a total purchase amount of \$2,190,843. (See Appendix IV for a schedule of questioned costs.) We found that the lenders for both loans did not provide sufficient evidence to support that they originated and closed the loans in accordance with SBA's requirements. Specifically, the lenders did not provide adequate documentation to substantiate reasonable assurance that the borrowers met requirements for repayment ability, size eligibility, and equity injection. (See Appendixes II and III for details.)

SBA's standard operating procedure (SOP) 50 10 5(H) states that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. Consequently, the lenders' material noncompliance with SBA requirements while originating and closing the loans resulted in a combined potential loss to SBA of \$1,303,403.² (See Appendix IV for a schedule of questioned costs.)

Recommendations

We recommend that the Administrator require the Acting Director for the Office of Financial Program Operations:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of \$448,287 plus interest on the guaranty paid by SBA.
2. Require the lender to bring the loan into compliance or, if not possible, seek recovery of \$855,116 plus interest on the guaranty paid by SBA.

Analysis of Agency Response

SBA management agreed with the report findings and both recommendations, stating that they conducted a preliminary review, and absent additional information from the lenders, deficiencies appear to exist. The lenders have been notified of the deficiencies and are currently conducting research. The Office of Financial Program Operations will work with the lenders to obtain documentation to bring the loan into compliance. If the issues are not overcome, recovery will be sought from the lenders. Management's planned corrective actions are sufficient to address the recommendations. (See Appendix V for SBA management's formal comments in their entirety.)

² Proceeds from the liquidation process after purchase reduced SBA's loss on these two loans. Additional proceeds from the liquidation process could further reduce this amount.

Summary of Actions Necessary to Close the Recommendations

This section provides the status of the recommendations and the actions necessary to close them.

1. **Resolved.** Management contacted the lender to obtain additional information to bring the loan into compliance and stated that if the issues are not overcome, recovery will be sought from the lender. This recommendation can be closed when SBA provides evidence that the lender provided information to bring the loan into compliance or that management recovered the appropriate amount from the lender.
2. **Resolved.** Management contacted the lender to obtain additional information to bring the loan into compliance and stated that if the issues are not overcome, recovery will be sought from the lender. This recommendation can be closed when SBA provides evidence that the lender provided information to bring the loan into compliance or that management recovered the appropriate amount from the lender.

We appreciate the courtesies and cooperation extended to us during this evaluation. If you have any questions, please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616.

cc: Pradeep Belur, Chief of Staff

William M. Manger, Associate Administrator, Office of Capital Access

John Miller, Deputy Associate Administrator, Office of Capital Access

Jihoon Kim, Acting Director, Office of Financial Program Operations

Christopher Pilkerton, General Counsel

Martin Conrey, Attorney Advisor, Legislation and Appropriations

Timothy E. Gribben, Chief Financial Officer and Associate Administrator for Performance Management

LaNae Twite, Director, Office of Internal Controls

Appendix I: Objectives, Scope, and Methodology

This management advisory presents the results of our evaluation of two loans, as part of our ongoing High Risk 7(a) Loan Review Program. This is the second in a series of advisories covering a total of eight loans we reviewed; including the seven 7(a) loans we selected for review in FY 2018 and one loan identified during a previous High Risk 7(a) loan review. We presented two loans in our first advisory and the remaining four loans will be presented in our capping report. Our objectives were to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

To accomplish our objectives, we used an internal loan scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance or suspicious activity by loan participants. These attributes include, but are not limited to, the time lapse between loan approval and its transfer to liquidation, loan amount, equity injection, loan packager involvement, and use of loan proceeds. We obtained a universe of 97 high-dollar/early-defaulted 7(a) loans that were approved by lenders under the Preferred Lenders Program. Under this program, lenders are delegated the authority to process, close, service, and liquidate most SBA-guaranteed loans without prior SBA review. SBA honored its guaranty on these loans between October 1, 2015, and September 30, 2017. We eliminated loans for which SBA had not completed a purchase review. We then selected seven loans based on their assigned score and considered other factors, such as the outstanding balance and the period to default. The outcome of our review on two of these loans is included in this management advisory.

We also reviewed origination and closing actions as documented in SBA loan files. When applicable, we contacted lenders to obtain additional documentation for review. We assessed these actions against all applicable SBA requirements and reviewed information in SBA's loan accounting system for all loans examined.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's quality standards for inspection and evaluation. These standards require that we adequately plan inspections, present all factual data accurately, fairly, and objectively, and that we present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objectives.

Use of Computer-Processed Data

We relied on information from SBA's loan accounting system to score loans using an internal scoring system developed by OIG. Previous OIG engagements have verified that the information maintained in this system is reasonably reliable. Further, data elements associated with reviewed loans were verified against source documentation maintained in SBA's purchased loan files. As a result, we believe the information is reliable for the purposes of this program.

Appendix II: Evaluation of a \$1,968,000 7(a) Loan Used to Refinance Debt and Provide Working Capital

Background

We reviewed a \$1,968,000 early-defaulted loan approved by a lender under its delegated authority for refinancing existing debt and providing working capital. The borrower made nine payments before defaulting on the loan. SBA honored its guaranty and purchased the loan from the secondary market for \$1,305,710. However, SBA's share of the balance was reduced to \$448,287 due to recoveries during liquidation.

Results

We determined that the lender did not originate the loan in accordance with SBA's requirements. Specifically, the lender did not provide adequate assurance of the borrower's repayment ability.

Inadequate Assurance of Repayment Ability

SOP 50 10 5(H) states that the cash flow of the small business applicant is the primary source of repayment, not the liquidation of collateral.³ Thus, if the lender's financial analysis demonstrates that the small business applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available or outside sources of cash.⁴ For standard 7(a) loans greater than \$350,000, the SOP also states that the small business applicant's debt service coverage ratio must be equal to or greater than 1.15 on a historical and/or projected cash flow basis.⁵

The lender based its cash flow analysis on a consolidated income statement derived from accrual-based financial statements. However, we did not find evidence that the lender obtained a cash flow statement, which would have shown the operating company's ability to generate cash flow. Instead, the lender used the eligible passive company and operating company consolidated income statement to calculate the borrowers' ability to repay the loan. The consolidated income statement did not provide the cash flow for the borrowers. The lender noted in its credit analysis that the operating company's payments to suppliers were slow due to the liquidity crunch resulting from the number of days it took to collect receivables. It is also important to note that the income statement for the operating company showed debt coverage ratios of 0.08 and 1.11 for the 2 years prior to loan approval, which was less than the required 1.15. Further, the operating company's retained earnings changed from -\$444,245 in 2012 to -\$1,053,517 in 2014.

Based on our evaluation of the loan file, we concluded that the lender's financial analysis did not demonstrate a reasonable assurance of repayment.

Conclusion

Our evaluation found that the lender did not provide sufficient evidence in the loan file to support that it had conducted an adequate financial analysis to ensure the borrower had repayment ability. As a result, the lender did not comply with material SBA requirements related to the origination of

³ SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015.

⁴ SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.

⁵ SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.2.d.

the loan. Because the loan was sold on the secondary market, SBA was obligated to purchase the loan. However, due to lender noncompliance with SBA requirements, SBA should require the lender to bring the loan into compliance, or if not possible, seek recovery of \$448,287 plus interest on the guaranty paid by SBA.⁶

⁶ Proceeds from the liquidation process may further reduce this amount.

Appendix III: Evaluation of a \$1,188,000 7(a) Loan Used to Finance Leasehold Improvements, Purchases, and Working Capital

Background

We reviewed a \$1,188,000 early-defaulted loan approved by a lender under its delegated authority for financing leasehold improvements, equipment, fixtures, inventory, working capital, and providing for a contingency and interest reserve. The borrower made nine loan payments before defaulting on the loan. SBA honored its guaranty and purchased the loan from the secondary market for \$885,133. However, SBA's share of the balance was reduced to \$855,116 due to recoveries during liquidation.

Results

We identified material lender noncompliance with SBA's loan origination and closing requirements. Specifically, the lender did not provide adequate assurance of the borrower's repayment ability and size eligibility in accordance with SBA's requirements. Further, the lender did not properly verify the source of the required equity injection.

Affiliates Not Fully Considered for Repayment Ability and Size Eligibility

SOP 50 10 5(H) states that the cash flow of the small business applicant is the primary source of repayment, not the liquidation of collateral.⁷ Thus, if the lender's financial analysis demonstrates that the small business applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available or outside sources of cash.⁸ Further, the lender's financial analysis must include an assessment of impact on cash flow from any affiliates.⁹ It also states that the applicant business combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is higher. Affiliation exists when one individual or entity controls or has the power to control another or a third party or parties controls or has the power to control both. SBA considers factors such as ownership, management, previous relationships with or ties to another entity, and contractual relationships when determining whether affiliation exists.¹⁰

An individual with 90 percent ownership in the business disclosed more than 10 additional entities on his personal financial statements that the lender did not adequately consider for affiliation, including an entity that was used to inject funds into the business. There was no evidence in the loan file that the borrower provided a full list of affiliated businesses, their relationship with the borrower, and all financial data required for the lender to fully assess the affiliate's impact on the borrower's repayment ability and size eligibility. Therefore, the lender did not demonstrate that the borrower met SBA requirements for repayment ability and size eligibility.

⁷ SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015.

⁸ SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.

⁹ SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.2.c.

¹⁰ SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 2, Section III.B.1.

Inadequate Support for Equity Injection

SOP 50 10 5(H) states that adequate equity is important to ensure the long term survival of a business. The lender must determine if the equity injection and the pro forma debt-to-worth are acceptable based on the factors related to that type of business, experience of the management, and the level of competition in the market area. Further, the equity injection cannot be borrowed funds. It also states that lenders must verify the equity injection prior to disbursing loan proceeds and must maintain evidence of such verification in the loan files.¹¹

The borrower's loan file included statements for the business accounts to support the required \$325,000 equity injection; however, the file did not contain sufficient documentation to support the source of the funds. For example, the loan file included business account statements and invoices that supported the use of the equity injection, but it did not include evidence for the source of multiple deposits. Further, the lender improperly considered the borrower's use of a revolving line of credit as equity, which was ineligible because the funds were borrowed. Based on our review, the lender did not adequately verify the source of the equity injection.

Conclusion

Our evaluation found that the lender did not provide sufficient evidence in the loan file to support that it conducted an adequate financial analysis to ensure the borrower met requirements for repayment ability, size eligibility, and equity injection. As a result, the lender did not comply with material SBA requirements related to the origination and closing of the loan. Because the loan was sold on the secondary market, SBA was obligated to purchase the loan. However, due to lender noncompliance with SBA requirements, SBA should require the lender to bring the loan into compliance or, if not possible, seek recovery of \$855,116 plus interest on the guaranty paid by SBA.¹²

¹¹ SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.E.

¹² Proceeds from the liquidation process may further reduce this amount.

Appendix IV: Questioned Costs

Table 1: Questioned Costs for OIG High Risk 7(a) Loan Review Sample

Sample	Approval Amount	Purchased Amount	OIG Questioned Costs
1	\$1,968,000	\$1,305,710	\$448,287
2	\$1,188,000	\$885,133	\$855,116
Totals	\$3,156,000	\$2,190,843	\$1,303,403

Source: Generated from evaluation results.

SBA

OFFICE OF FINANCIAL PROGRAM OPERATIONS

RESPONSE TO EVALUATION REPORT



TO: Hannibal M. Ware, Inspector General
Office of Inspector General (OIG)

FROM: Jihoon Kim
Acting Director, Office of Financial Program Operations

SUBJECT: Response to Draft Report on The OIG High Risk 7(a) Loan Review Program – 18002A

We appreciate the role the Office of Inspector General (OIG) plays in working with management in ensuring that our programs are effectively managed, and for the feedback provided in this draft report.

The 2018 draft report outlines the OIG's concerns regarding its review of High Risk 7(a) loans purchased in the NGPC and identified deficiencies in 2 loans with following recommendations:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of \$448,287 on the guaranty paid by SBA.
2. Require the lender to bring the loan into compliance or, if not possible, seek recovery of \$855,116 on the guaranty paid by SBA.

Management's response to the recommendations in the draft report is noted as follows:

Management substantially concurs with the report and recommendations.

After conducting a preliminary review, and absent additional information from the lender, deficiencies appear to exist. The lender has been notified of the deficiencies and is currently conducting research. OFPO will work with the lender to obtain documentation to bring the loan into compliance. If the issues are not overcome, recovery will be sought from the lender.