AUDIT OF THE GUARANTEE PURCHASE PROCESS FOR SECTION 7(A) LOANS AT THE NATIONAL GUARANTY PURCHASE CENTER

Report Number: 7-23
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Memorandum

U.S. Small Business Administration
Office Inspector General

To: Janet A. Tasker
Acting Director, Office of Financial Assistance

Date: May 8, 2007

Jennifer E. Main
Chief Financial Officer

/S/ original signed

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of the Guarantee Purchase Process for Section 7(a) Loans at the National Guaranty Purchase Center
Report No. 7-23

This report presents the results of our audit of the guarantee purchase process for section 7(a) loans at the National Guaranty Purchase Center. The Small Business Administration (SBA) guarantees loans that are made by participating lenders and purchases the guarantees upon loan default. The guarantee purchase process involves a review of the purchase request and relevant documentation to evaluate whether the lender materially complied with program rules and regulations to determine whether to honor the guarantee. This review, which is intended to minimize erroneous payments, is generally performed before purchases are made but may occur post purchase when the loan has been sold on the secondary market. Prior Office of Inspector General (OIG) audits[1] found that the guarantee purchase process did not adequately protect SBA from making erroneous payments. To improve the quality of the purchase process, SBA centralized section 7(a) loan purchase reviews (excluding Express and Community Express loans) by establishing the National Guaranty Purchase center in Herndon, VA.

The purpose of this audit was to examine purchase procedures used by the Herndon Center to determine whether they were effective in identifying lender deficiencies to prevent erroneous payments. We statistically sampled 58 loans

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[1] *Audit of the Guaranty Purchase Process*, Report No. 3-15, March 17, 2003
Audit Report on Business Loan Guarantee Purchases, Report No. 7-5-H-011-26, September 30, 1997

purchased for over $5 million from a universe of 1,803 loans purchased for $214.5 million, which were reviewed by the Center between October 1, 2004, and May 31, 2005. A listing of sampled loans is presented in Appendix I, and our sampling methodology is provided in Appendix II. Lender files for three of the sampled loans could not be located, and therefore, we relied on documentation in SBA's loan files to assess the purchase reviews of these loans. We reviewed SBA and lender loan files and interviewed lender and SBA officials as necessary. We conducted our audit at the Herndon National Guaranty Purchase Center from July 2005 to June 2006, in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

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. SBA guarantees loans that are made by participating lenders under a Guaranty Agreement to originate, service, and liquidate loans in accordance with SBA rules and regulations. SBA, in its sole discretion, may purchase the guaranteed portion of a loan at any time. Lenders may also demand in writing that SBA honor its loan guarantee if a borrower is in default on any loan installment for more than 60 days (or less if SBA agrees), and the default has not been cured.

In making the purchase decision, SBA reviews each request to determine whether the lender materially complied with program rules and regulations. In the event of noncompliance, SBA may be released from its liability on a loan guarantee, in full or in part. If SBA has already purchased the guarantee from a secondary market holder, it may seek recovery from the lender.

The guarantee purchase review is SBA's primary control for ensuring lender compliance and preventing improper/erroneous payments. Improper payments are expenditures that either should not have been made or were made in incorrect amounts. Improper payments in the guaranty purchase process arise from the failure of a purchase processor to identify material lender deficiencies in the handling of an SBA guaranteed loan. Under the Improper Payments Information Act,[2] SBA must annually examine and report the rate of improper payments. In FY 2006, SBA estimated this rate to be 1.56 percent.

In recent years the volume of section 7(a) loans in SBA's portfolio has grown by 88 percent, from 51,667 in fiscal year (FY) 2002 to 97,291 in FY 2006. As of September 2006, SBA's section 7(a) loan portfolio included 310,460 loans totaling over $60 billion, with an SBA-guaranteed share of more than $42.7 billion.

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[2] P.L. 107-300.

The OIG has conducted several audits of purchased loans over the years and reported that the guarantee purchase process does not adequately protect SBA from making erroneous payments. To improve the quality, consistency and timeliness of guarantee purchase decisions, SBA centralized the 7(a) guarantee purchase process at the Herndon Center and implemented quality assurance reviews. In FY 2006, the Center purchased 4,052 loans but, completed purchase reviews of only 2,962, or 73 percent of the purchased loans. As a result, the Center's post purchase review backlog increased by 1,090 during FY 2006.

SBA's purchase reviews have identified a number of recurring deficiencies in lender compliance with SBA rules and regulations. These include the lender's failure to: (1) verify the borrower's financial information using IRS Form 4506, use of loan proceeds and equity injection; (2) request purchase of the guarantee within 120 calendar days after loan maturity; (3) identify collateral at loan inception; (4) obtain the proper lien position on collateral; and (5) perform a timely site visit to properly inspect and secure collateral. SBA has provided specific guidance to purchase reviewers to improve their evaluations of these requirements.

RESULTS IN BRIEF

The audit disclosed that SBA purchased guarantees for 25, or 43 percent, of the 58 loans reviewed without adequately analyzing available documentation or obtaining sufficient information needed to assess whether lenders originated, serviced and liquidated loans in accordance with SBA requirements and prudent lending practices. These deficiencies resulted in $904,901 of erroneous payments[3] on 17 of the 25 deficient loans, and another $290,807 in unsupported purchases. Based on the large number of erroneous payments identified in our sample, we estimate that SBA made approximately $36 million[4] in erroneous payments on loans with purchase reviews completed between October 1, 2004 and May 31, 2005. This equates to an improper payment rate of 17 percent,[5] which is significantly higher than the 1.56 percent reported by SBA for all 7(a) loans in FY 2006.

Major deficiencies we noted that should have impacted SBA's purchase decision involved lenders not:

- verifying equity injection from the borrower;
- adequately documenting the borrower's use of loans proceeds;

[3] Guarantee payment amounts identified by the OIG to be in excess of amounts lenders should have received.
[4] This number was rounded. The projected amount is actually $35,643,334.
[5] The improper rate of 17 percent was calculated by dividing the projected erroneous payments of $35,643,334 by the $214.5 million purchase value of loans in the universe.

- properly securing collateral; or

- verifying borrower repayment ability.

These requirements are important controls to ensure that loan proceeds support viable, qualified businesses. Performing these steps not only helps validate the viability of the business, it also helps prevent and detect fraud. For example, borrowers are usually required to inject some of their own equity into the business. A common scheme has been for borrowers to falsify documents showing their equity injection. If the lender does not properly verify that the equity injection actually occurred, the business is denied the cash or asset it needed to operate. To illustrate, a recent OIG investigation resulted in the arrest of 19 individuals involved with SBA-guaranteed loans originated by Business Loan Express (BLX) for allegedly defrauding SBA of over $76 million. According to accompanying indictments, virtually all of these loans involved falsifying equity injections. When lender documents do not adequately demonstrate compliance with SBA requirements, requesting additional support for the areas of deficiencies can be an important control in detecting fraud.

Staffing problems and an overly aggressive emphasis on expediting and increasing purchase production at the Center has adversely impacted the quality of purchase decisions. For example, the high rate of staff turnover in FY 2006 left the Center with unfilled vacancies and largely inexperienced loan officers to review purchase requests. Because supervisor vacancies were not filled, the Center had three individuals to perform supervisory oversight of nearly 3,000 purchase reviews. Consequently, supervisors either did not review purchase requests performed by inexperienced loan officers or did not identify deficiencies the officers missed.

The level of erroneous payments will likely increase given that SBA has not fully resolved staffing issues at the Center and has launched a major initiative to grow the 7(a) loan portfolio by 15 percent in FY 2007. Increasing the guarantee loan portfolio, without identifying how the existing and additional workloads will be accommodated places government funds at increased risk.

Due to the inability of the Center to meet its purchase review demand, SBA is considering streamlining the purchase review process by using a sample-based approach to reduce the Center's current workload. However, purchasing guarantees without reviewing them may expose the Agency to increased risk, especially on requests made by PLP[6] lenders, as their credit decisions are not subject to scrutiny until the purchase request is reviewed.

To mitigate the risk, SBA will need to (1) ensure that purchase decisions receive the proper supervisory review, (2) employ a sampling plan that considers each lender's performance, the volume and size of loans in lender portfolios, the risk of loan defaults in each lender's portfolio, and the level of material lender deficiencies noted in previous purchase reviews and is projectable to the lenders universe of loans as a basis for repair of the guarantees for all of the lender's loans in that universe, and (3) evaluate the quality of decisions made under the new process to assess the level of risk associated with streamlining efforts and its impact on the improper payment rate reported in the Agency's budget.

Management was generally non-responsive to the audit findings and recommendations, neither concurring nor non-concurring with recommendations 2 and 6, disagreeing with recommendations 3 and 4 and concurring with recommendations 1 and 5. Management believes that no additional actions were needed beyond steps already taken to strengthen the guaranty purchase process as it was significantly strengthened subsequent to the purchase of the audited loans, and lender certifications for each purchase demand are unnecessary because certifications are required in Loan Guaranty Agreements. Management's comments are discussed in more detail in the Agency Comments section of the report and the response is presented in its entirety in Appendix V. Our corresponding comments are presented in the OIG Response section of this report. We will pursue resolution of recommendations 2, 3, 4 and 6 through the audit resolution process.

THE GUARANTEE PURCHASE PROCESS DID NOT DETECT MATERIAL LENDER DEFICIENCIES

SBA's guarantee purchase process did not identify material lender noncompliance for 25 of 58, or 43 percent, of the loans reviewed. Deficiencies associated with 17 of the 25 loans resulted in erroneous payments totaling $904,901. Of this amount, $850,279 was previously recommended for recovery in OIG reports issued as a result of this audit, an additional $18,215 has been recovered as a result of our audit and SBA's Quality Assurance Review (QAR) process, and $36,407 on 6 loans is recommended for recovery in this report. A summary of loans with deficiencies is provided in Appendix III and a listing of the six loans we are recommending for recovery and their deficiencies is provided in Appendix IV.

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[6] The Preferred Lenders Program (PLP) streamlines the procedures necessary to provide financial assistance to the small business community. Under PLP, SBA delegates loan approval, closing, and most servicing and liquidation authority and responsibility to selected lenders that demonstrate a proficiency in processing and servicing SBA guaranteed loans.

The remaining 8 deficient loans had purchases totaling $290,807 that were not supported by documents in SBA's files. However, we were able to obtain additional documentation from the lenders to support SBA's purchase decisions. When projected, the results show that 777 of the 1,803 loans in the universe had purchase review deficiencies that resulted in $36 million of erroneous payments being made to lenders over an 8-month period, October 1, 2004 to May 31, 2005.

As shown in Table 1 below, lender deficiencies that should have impacted SBA's purchase decisions primarily involved inadequate or incomplete documentation supporting equity injection, use of proceeds, collateral, and applicant repayment ability. For example, the audit disclosed that SBA accepted inadequate evidence to show that borrowers properly used loan proceeds on 10 percent of reviewed loans and did not ensure that lenders properly inspected and secured collateral on another 14 percent of the loans. We also found that SBA loan officers did not always correctly calculate the purchase amount, identify early default and early problem loans, and reconcile lender and Fiscal Transfer Agent transcripts to identify any differences, or properly determine the default date.

Table 1. Material Deficiencies Noted on 25 Loans

Type	Description	No. of loans in sample of 58	No. of loans with erroneous payments in sample of 58	$ value of erroneous payments in sample	$ value of unsupported purchases in sample	Projected number of loans in universe of 1,803 with purchase deficiencies	Projected $ value of erroneous payments in universe ($ in millions)
Equity Injection	SBA did not verify equity injection or did not obtain proper documentation prior to disbursing loan proceeds.	7	4	$265,620	$150,745	218	$11
Use of Proceeds	SBA accepted inadequate evidence or did not ensure lenders verified use of proceeds before reimbursing borrower for evidenced expenditures.	6	3	$293,216	$89,547	186	$12
Collateral	SBA did not ensure lenders provided an explanation for missing collateral, properly secured collateral, or properly abandoned or released collateral.	8	6	$72,902	$49,806	249	$3
Eligibility/ Origin.	Unsupported repayment ability, Poor borrower character, loan guarantor not taken, Form 912s not obtained, no IRS verification, inadequate business evaluation and borrower charged an improper broker fee.	4	2	$224,614	$0	124	$8
Other	SBA did not (1) obtain legible credit documents when required, (2) identify early default/early problem loans, (3) calculate the proper purchase amount, (4) determine the correct default date, or (5) reconcile transcripts.	13	6	$48,549	$709	404	$2
TOTALS		**25 ***	**17 ***	**$904,901**	**$290,807**	**777 ***	**$36**

* Some loans had multiple deficiencies

Our audit identified seven loans for which SBA did not properly assess lender verification of equity injection. For example, one lender claimed that the required equity injection was evidenced by bank statements from the operating checking account for the business. However, the initial funds deposited into the account were from loan proceeds; and therefore, did not provide evidence that the borrower injected funds into the business prior to loan disbursement as required by the loan authorization. On four of these loans, the deficiencies resulted in erroneous payments totaling $265,620. When projected to the universe, we estimate the Center did not enforce equity injection requirements for 218 loans, resulting in $10.6 million of erroneous payments made to lenders during an 8-month period.

When lender documents do not adequately demonstrate compliance with SBA requirements, requesting additional support for the deficient areas can be an important control in protecting SBA from making erroneous guarantee purchase payments and detecting fraud. By not securing the proper documentation, the Center may have missed opportunities to prevent or recover improper disbursements for lender noncompliance and to refer potential fraudulent activity to the OIG for investigation.

Based on the high level of deficiencies we identified in the audit, we believe the guarantee purchase process is susceptible to significant erroneous payments. In FY 2006, SBA estimated the rate of erroneous payments at 1.56 percent. However, this rate was calculated using a different sampling method than prescribed by OMB in its current Improper Payment Information Act guidance,[7] As a result, the 2006 improper payment rate may not have been estimated at the level of precision required under current OMB guidance. Because the Center's guarantee purchases comprise a significant component of the improper payment rate, and the rate of improper payments on the 7(a) loans reviewed was 17 percent, SBA will need to more closely examine whether it is properly estimating erroneous payments.

INADEQUATE CENTER RESOURCES CONTINUE TO IMPACT THE QUALITY OF PURCHASE REVIEWS

According to Center officials, lender deficiencies were not detected due to the inexperience of purchase reviewers as a result of the high turnover of loan officers at the Center. For example, in FY 2006, 10 employees resigned, retired or transferred to other agencies, leaving the Center with between 19 and 24 employees during FY 2006 to process nearly 3,000 purchase decisions.[8]

As the OIG reported in its *FY 2007 Report on the Most Serious Management Challenges Facing the Small Business Administration*, adequate resources have not been devoted to the 7(a) purchase process at the Center. The Center has announced vacancies to hire additional loan officers and loan servicing assistants and recognizes that the turnover of experienced loan officers has been a significant challenge. To address this issue, in March 2006, SBA completed the Herndon Work Process and Staffing Review that made several recommendations to remedy staffing issues at the Center, including increasing the Center's staffing from 58 to 67 people. These recommendations; however, were contingent upon the Agency obtaining approval of certain actions, such as increasing the loan officer pay ladder to a GS-13, streamlining the purchase process by increasing the threshold

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[7] OMB Circular A-123, Appendix C.

[8] During FY 2006, the Center received approximately 4,000 purchase requests, but only made decisions on about 3,000.

for expedited processing, and using a sample-based review system. To date, none of these actions have been approved.

Furthermore, supervisors were either not reviewing or were performing inadequate reviews of purchase decisions made by loan officers. We identified numerous instances where supervisors approved purchase reviews based on inaccurate or incomplete information. For example, on one loan, a supervisor did not identify that the underwriting section of the purchase review template had been removed by the loan officer, and for another loan a supervisor did not question the loan officer's contradictory response to a question on the purchase review template. The problems noted with supervisory reviews of loan officer purchase decisions were also attributable to staffing shortfalls. The Center had five supervisor positions in FY 2006; however, only three of these positions were filled for most of FY 2006. Accordingly, three supervisors at the center had to review almost 3,000 purchase decisions. One Center employee we interviewed commented that one of the supervisors approved purchase decisions without reviewing them, and therefore, "rubber stamped" loan officer recommendations.

As SBA expands its loan portfolio, meeting the purchase review demand will continue to challenge the Center's limited resources. Annual section 7(a) loan production has grown from 51,667 loans in FY 2002 to 97,291 loans in FY 2006. The Agency has also established a goal to increase its loan production by 15 percent by the end of FY 2007 without identifying the additional resources to handle the increased loan production and resulting increases in purchase requests.

The Center's resources were further tested by aggressive timeframes established for completing the purchase reviews. According to one Center employee, loan officers were told to focus on quantity rather than the quality of the reviews. During a prior audit,[9] SBA officials informed us that loan officers should be completing an average of two purchases per day. Experienced loan officers indicated that SBA's expectation of two purchase reviews per loan officer per day was unreasonable. One former SBA loan officer stated that it takes, on average, 2 days to perform a quality purchase review.

Due to the inability of the Center to meet its purchase review demand, SBA is considering streamlining the purchase review process by using a sample-based approach to reduce the Center's current workload. However, purchasing guarantees without reviewing them exposes the Agency to increased risk, especially on PLP loans. Under the PLP program, credit decisions by lenders are not subject to scrutiny until the purchase request is reviewed. SBA's

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[9] *Management Advisory Report on the Transfer of Operations to the National Guaranty Purchase Center*, Report No. 4-39, August 31, 2004.

implementation of a sample-based approach for its purchase reviews would require consideration of each lender's performance including (1) the volume and size of loans in their portfolio, (2) the risk of loan defaults in the portfolio, and (3) the level of material lender deficiencies noted in previous purchase reviews. Furthermore, SBA must consider the ability to repair guarantees relating to the lender's universe of purchased loans based on the projections of errors derived from the sample.

ADDITIONAL PROCEDURES COULD STRENGTHEN THE PURCHASE PROCESS AND REDUCE IMPROPER PAYMENTS

While SBA revised its policies and procedures to ensure more consistent reviews are performed by loan officers, the Center did not document the information they relied on to reach purchase decisions. Current procedures require that loan officers only complete a checklist to document whether the lender properly originated, closed, serviced or liquidated the loan. As a result, supervisors did not have the information necessary to determine if loan officers properly verified lender compliance with loan requirements. For example, SBA loan officers did not explain their bases for concluding that lenders had verified that equity injections specified in loan authorizations were made prior to the first disbursement. Additionally, SBA loan officers did not explain their bases for determining that collateral was properly liquidated. Consequently, there is no assurance that purchase decisions were based on accurate and complete information, thus increasing the potential for erroneous payments.

Under current procedures, lenders are not required to certify compliance with applicable laws, regulations and policies when requesting purchase of guarantees. OIG audits have found evidence that lenders knew they were not in compliance with all SBA requirements when requesting purchase of guarantees and believed SBA would not identify the deficiencies. To prevent this from occurring, SBA should require lender certifications. Doing so would enhance lender accountability and provide greater assurance that lenders request guarantee purchases for only those loans that were originated, closed, serviced or liquidated in accordance with SBA requirements.

CONCLUSIONS

Due to the high number of deficiencies identified, we believe the guarantee purchase process was not effective in identifying lender noncompliance with SBA lending requirements and that the Center was clearly unable to meet its purchase review demand. With the continued growth in the number of 7(a) loan approvals spurred by the Agency's 2007 initiative to grow the loan portfolio by 15 percent, SBA can expect a growth in 7(a) purchase requests from lenders. However, it has not determined how it will meet current purchase demands nor has it identified the staffing levels required to accommodate the growth in the loan portfolio. While SBA is attempting to address its resource issues and accommodate the expected growth in guarantee purchases by considering a sample-based approach to reduce the Center's workload, SBA's approach may expose the Agency to higher risk and more significant levels of erroneous payments, unless it ensures adequate safeguards are in place. If SBA can perform more thorough reviews on selected purchase requests, a sample-based approach could work. SBA's sampling plan, however, will need to consider each lender's performance, including the volume and dollar value of loans in their portfolio, the risk of loan defaults, and the deficiencies identified in previous lender purchase reviews. Furthermore, the dollar value of errors found in the sample will need to be projectable to the lender's portfolio as a basis for recovery for all loans in the lender's universe. It will also need to ensure that purchase decisions receive the proper supervisory review. As an alternative, SBA could explore processes to segment loans into risk categories and scrutinize loans based on risk. While all loans would receive some level of review, the riskier loans could have sufficient time and effort devoted to provide reasonable assurance that the guarantee payment was proper.

Further, we believe it is management's responsibility to properly determine the level of risk associated with the purchase review process and to accurately report this risk in both its A-123 report on internal controls and its estimate of improper payments in the Agency's budget. Based on the 17 percent improper payment rate and projected $36 million of erroneous payments identified in our audit, we believe adequate safeguards currently do not exist to combat this risk. Therefore, SBA will need to ensure it has adequately assessed the level of risk in the purchase review process in its A-123 assessment for 2007, and address how streamlining efforts will impact controls over this process.

Finally, because the process SBA used for estimating erroneous payments in 2006 may not have generated the level of precision required in OMB guidance, SBA should revise its sampling plan for FY 2007 to ensure compliance with OMB requirements. If SBA's 2007 rate of improper payments is significantly higher than previous reported, SBA will need to implement a plan to reduce erroneous payments, and report this information in its Performance and Accountability Report in accordance with OMB Circular A-123 Appendix C.

RECOMMENDATIONS

We recommend that the Acting Director, Office of Financial Assistance:

1. Seek recovery of $36,407 on the guarantees paid on the 6 loans listed in Appendix IV.

2. Develop a plan to improve the quality of purchase reviews performed by the National Guaranty Purchase Center and ensure purchase decisions undergo adequate supervisory review.

3. Revise the purchase review template to require loan officers to list the supporting documentation relied upon when making their guarantee purchase decisions, and ensure the template is "write-protected" to prohibit unauthorized modification.

4. Require lenders to submit certifications of compliance with applicable laws, rules and regulations with each purchase demand.

5. Revise the sampling plan for calculating the rate of improper payments in FY 2007 to ensure OMB sampling requirements are met.

We recommend that the Chief Financial Officer, in conjunction with the Associate Administrator for Capital Access:

6. Include in its A-123 report on management controls the level of risk associated with the purchase review process and describe the risk in reporting its estimate of improper payments in the Agency's budget.

AGENCY COMMENTS

The Agency provided written comments on a draft of this report. These comments are summarized below and the full text of the comments can be found in Appendix V. Management agreed with recommendations 1 and 5, disagreed with recommendations 3 and 4 and neither agreed nor disagreed with recommendations 2 and 6. However, management provided responses to recommendations 2 through 4 indicating that no additional actions were needed beyond steps the Agency had already taken.

Management was unclear as to whether it agreed with recommendation 2 that a plan be developed to improve the quality of purchase reviews by the Center and that purchase decisions undergo adequate supervisory review. Management stated that significant changes have been implemented to strengthen the purchase review process since the audited loans were purchased. The changes described included adding Senior Loan Specialists to the staff, standardizing documentation that lenders are required to provide with the purchase package, creating a data base of lender deficiencies in purchase packages, bar-coding purchase packages and having administrative staff review the initial purchase package for completeness of documents needed to conduct a review.

Management disagreed with recommendation 3 that the purchase review template be revised to require loan officers to list the supporting documentation relied upon when making their guarantee purchase decisions, and that the template be "write-protected" to prohibit unauthorized modification. Management stated that the existing 327 action form is adequate to document the purchase recommendation, legal concurrence and final approval. In addition, management noted that the Center has developed new Tabs for use by the lenders in an effort to standardize the documents reviewed during the purchase process. Management believes this enhanced system should improve the overall quality of the purchase packages and the purchase reviews as well as make it easier to track the supporting documentation received from lenders.

Management also disagreed with recommendation 4 that lender certifications of compliance with applicable laws, rules and regulations be required with each purchase demand. Management stated that a Loan Guaranty Agreement (Deferred Participation), SBA Form 750, must be executed between the lender and SBA for a lender to participate in the 7(a) loan program. This agreement requires the lender to certify that the loans have been disbursed and serviced in compliance with the agreement and all applicable rules and regulations. Management believes this certification addresses the recommendation.

Management was unclear as to whether it agreed with recommendation 6 that the level of risk associated with the purchase review process be included in SBA's A-123 report on management controls and that the risk be described in estimating improper payments in the Agency's budget. Management stated it will work with the Senior Assessment Team to identify what is most appropriate to include in the A-123 report on management controls.

Management also commented on the audit methodology used in developing the audit findings. For example, management took exception with the statistical sample we used because it was not representative of the 7(a) portfolio. Agency comments also indicated that comparing the improper payment rate for FY 2006 to the rate we calculated for the audit period does not allow for a fair and equitable comparison and conclusion. Additionally, management disagreed with the anecdotal comments in the report regarding the management of the loan guaranty purchase process. Management did not believe the comments were backed up by any audit findings and are simply a recitation of comments made to auditors.

OFFICE OF INSPECTOR GENERAL RESPONSE

The actions being taken by SBA on recommendations 1 and 5 are responsive to our recommendations. However for recommendation 1, we believe the Agency should set a target date for completing the review of the 6 loans and recovering any guarantees paid to the affected lenders, as appropriate.

Management comments were not responsive to recommendation 2. According to management, significant changes have been implemented since the audited loans were purchased to strengthen the purchase review process. The Center has developed a set of self-guided tabs to guide lenders step by step through the documents needed for a proper guarantee purchase review, added additional loan specialists, and created a database of lender deficiencies among other things. While these steps will improve the quality of purchase reviews, we do not believe they are sufficient to fully address lender deficiencies. For example, SBA has not addressed how it will ensure that purchase decisions undergo adequate supervisory review. Also, at SBA's April 2007 Management Meeting, the Agency acknowledged that 90 percent of guarantee purchase requests still lack some required documentation and charged the Office of Capital Access to develop a plan for improving the process by the end of April. We believe that the plan, which we recommended be developed, will address the recommendation. Therefore, we are requesting that management send us a copy of the plan to close the recommendation, and plan to pursue this action through the audit resolution process.

Management's comments were not responsive to recommendation 3. The comments did not address the issues of requiring loan officers to identify the supporting documentation they relied upon in making a guarantee purchase decision or ensuring write-protection of the template. Management indicated that action has been taken to standardize the documents reviewed during the purchase process through development of new Tabs for lenders in preparing their purchase packages. While this process should improve the purchase documentation received from lenders, it will not result in implementation of the recommendation. To enable supervisors to adequately review a loan officer's purchase decision, the documentation used in making a purchase decision should be specifically identified. Likewise the template should be "write-protected" to prevent loan officers from making unauthorized changes. This recommendation will be resolved through the audit resolution process.

Management's comments were also not responsive to recommendation 4. Management stated that the Loan Guaranty Agreement requires the lender to certify that a loan has been disbursed and serviced in compliance with the agreement and all applicable rules and regulations, which satisfies the recommendation. The Loan Guaranty Agreement states that the lender's written demand that SBA purchase the guaranteed portion of a loan serves as the lender's certification that the loan has been disbursed and serviced in compliance with this agreement. Audits have continually shown that lenders have submitted guarantee purchase demands for loans that did not comply with laws, rules, and regulations, and that SBA has paid many of the guarantees. Requiring lenders to certify that they have complied with laws, rules and regulations on each guarantee purchase request should result in lenders demanding purchases of only those loans for which they have complied with all laws, regulations and rules. More importantly, by certifying compliance on each purchase demand, lenders acknowledge that if SBA finds noncompliance, SBA may repair or deny the purchase request. We plan to pursue a management decision on this recommendation through the audit resolution process.

Management's comments also were not responsive to recommendation 6. Management stated it will work with the Senior Assessment Team to identify what is most appropriate to include in the A-123 report on management controls. However, it did not specify the actions it will take to properly determine the level of risk associated with the purchase review process and accurately report this risk in both its A-123 report on internal controls and its estimate of improper payments in the Agency's budget. Consequently, we plan to pursue resolution of this recommendation through the audit resolution process.

Management also commented on our audit methodology. For example, management took exception to our statistical sample of loans stating that because 38 percent of the loans in the sample were LowDoc loans, the sample does not reflect the nature of the current 7(a) portfolio. We recognize that the number of LowDoc loans in the current portfolio has decreased because LowDoc loans are no longer a delivery method for the 7(a) program. Our sample was representative of the 1,803 loans purchased by the National Guaranty Purchase Center from October 1, 2004, through May 31, 2005. A review of the delivery method for each loan in the universe showed that 695, or 38.5 percent of our sample, were LowDoc loans. However, *80 percent* of the dollar value of the lender deficiencies cited in the audit were associated with other loan delivery methods and were not LowDoc loans. Furthermore, the purchase process is the same for all loans with a principal balance of more than $10,000, regardless of delivery method.

Management acknowledged that the guarantee purchase process represents a critical internal control that requires improvement, but stated the FY 2006 improper payment rate of 1.56 percent, which is based on the period July 1, 2005, through June 30, 2006, cannot be compared to the audit results which reflect guarantee purchases in FY 2005. As indicated in the report, we cannot conclude that the FY 2006 improper payment rate was erroneous because it considered guarantee purchases for loan delivery methods, such as Express Loans, which were not included in our audit. However, the significant difference between the two percentages (17 versus 1.56 percent) also cannot be ignored as it may indicate that SBA's FY 2006 reported amount is inaccurate. Furthermore, as noted in the audit report, the FY 2006 estimate of improper payments was calculated using a different sampling method than prescribed by the Office of Management and Budget. Consequently, we believe that the report accurately portrays the possibility that SBA may have understated the improper payment rate for FY 2006.

Management also commented that staff remarks regarding management of the guarantee loan purchase process were anecdotal and do not appear to be supported by audit findings. We would like to emphasize that the audit was conducted in accordance with *Government Auditing Standards,* which recognize testimonial evidence as relevant and competent support for audit findings and conclusions. Since the testimonial evidence was provided by experienced loan officers who gave consistent responses, and the Agency has never performed a workload analysis to determine the amount of time required to complete a purchase review, we consider their responses to be a relevant and competent source of evidence appropriately included in the audit report.

ACTIONS REQUIRED

We are requesting that the Acting Director, Office of Financial Assistance provide the Office of Inspector General a target date for implementing recommendation 1 no later than May 30, 2007.

We appreciate the courtesies and cooperation of the Small Business Administration representatives during this audit. If you have any questions concerning this report, please call me at (202) 205- **[Exemption 2]** or Robert Hultberg, Director, Credit Programs Group, at (202) 205- **[Exemption 2]**.

APPENDIX I. SAMPLED LOANS

#	Loan Number	Borrower	Loan Type	Amount	
				Disbursed	Purchased [1]
1			PLP	$120,000	$102,489
2			LowDoc	$57,000	$29,069
3			LowDoc	$28,000	$7,753
4			PLP	$132,000	$70,516
5			PLP	$158,000	$51,734
6			Reg 7(a)	$257,000	$124,774
7			LowDoc	$39,998	$26,143
8			Reg 7(a)	$300,000	$162,107
9	[Exemption 2, 4 & 6]		LowDoc	$100,000	$5,157
10			Reg 7(a)	$200,624	$74,933
11			Reg 7(a)	$865,000	$322,465
12			LowDoc	$40,000	$28,004
13			PLP	$365,000	$257,743
14			PLP	$500,000	$377,802
15			PLP	$200,000	$36,797
16			PLP	$367,000	$257,723
17			PLP	$129,300	$111,941
18			LowDoc	$66,395	$42,172
19			Reg 7(a)	$100,000	$77,513
20			LowDoc	$95,000	$20,232
21			PLP	$299,000	$167,518
22			LowDoc	$150,000	$82,780
23			Reg 7(a)	$112,475	$27,168
24			Reg 7(a)	$480,000	$317,973
25			LowDoc	$77,800	$27,841
26			LowDoc	$37,000	$16,785
27			LowDoc	$40,545	$21,573
28			LowDoc	$150,000	$118,635
29			PLP	$200,000	$51,114
30			Reg 7(a)	$28,500	$16,936
31			Reg 7(a)	$258,000	$175,843
32			PLP	$483,000	$228,725
33			GP	$30,000	$15,441
34			LowDoc	$147,985	$32,370
35			Reg 7(a)	$148,100	$59,720
36			LowDoc	$35,000	$11,002
37			PLP	$128,400	$37,525
38			LowDoc	$44,600	$829
39			PLP	$494,301	$47,806
40			Reg 7(a)	$288,075	$55,196

APPENDIX I. SAMPLED LOANS

#	Loan Number	Borrower	Loan Type	Amount Disbursed	Amount Purchased [1]
41			PLP	$204,500	$142,156
42			CLP	$700,000	$65,942
43			LowDoc	$96,700	$65,819
44			Reg 7(a)	$100,000	$0
45			PLP	$240,000	$163,535
46			PLP	$1,155,000	$207,463
47			PLP	$310,000	$31,310
48			LowDoc	$150,000	$35,265
49		[Exemption 2, 4 & 6]	PLP	$103,800	$64,122
50			LowDoc	$150,000	$108,017
51			LowDoc	$97,000	$64,257
52			LowDoc	$61,000	$50,731
53			LowDoc	$100,000	$31,869
54			PLP	$280,000	$116,919
55			PLP	$750,000	$325,885
56			PLP	$265,000	$128,331
57			LowDoc	$45,625	$0
58			PLP	$72,000	$50,158
	Totals			**$12,633,723**	**$5,351,626**

[1] Amount purchased is rounded to the nearest dollar and does not include adjustments for recoveries received or expenses, such as legal fees, incurred after purchase.

APPENDIX II. STATISTICAL SAMPLING PROCESS AND PROJECTION RESULTS

The universe consisted of 1,803 loans with purchase reviews completed by the National Guaranty Purchase Center from October 1, 2004 through May 31, 2005. From the population universe provided by the National Guaranty Purchase Center, we selected a statistical sample of 58 loans to evaluate the purchase process. In statistical sampling, the projected estimates in the population universe have a measurable precision or sampling error. The precision is a measure of the expected difference between the value found in the sample and the value of the same characteristics that would have been found if a 100 percent review had been completed using the same techniques.

Sampling precision is indicated by ranges, or confidence intervals, that have upper and lower limits and a certain confidence level. 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 total population, the resulting values would be between the lower and upper limits, with the population point estimates being the most likely amounts.

Using the Defense Contract Audit Agency's 'EZ Quant' software program, we determined based on the universe size, a confidence level of 90 percent and a 10 percent error rate, that a sample size of 58 loans was required. We used IDEA (Interactive Data Extraction and Analysis) software to select the sample records from the universe.

We calculated the following population point estimates and the related lower and upper limits using the Defense Contract Audit Agency's 'EZ Quant' software program's ratio method at a 90 percent confidence level.

Value	Occurrences in Sample of 58 Loans	Population Point Estimate	Lower Limit	Upper Limit
Loans With Purchase Deficiencies	25	777	581	984
Equity Injection	7	218	106	384
Use of Proceeds	6	186	85	348
Collateral/Liquidation	8	249	130	422
Eligibility/Loan Origination	4	124	45	269
Other Issues	13	404	251	597
Improper Payments	17	$35,643,334	$19,066,957	$52,220,610

APPENDIX III. LOANS WITH DEFICIENCIES

#	Loan Number	Borrower	Amount Purchased[1]	Deficiency Type (See Legend)	Purchase Amount "Questioned"[2]	Purchase Decision "Unsupported"[3]
1			$102,489	C, E	$7,578 [4]	
2			$70,516	C	$0	$2,000
3			$124,774	A, D	$0	$100,000
4			$26,143	A, B	$26,143	
5			$74,933	E	$624 [4]	
6			$322,465	A, E	$0	$50,745
7			$257,724	B	$256,933	
8			$42,172	B	$28,660	
9	[Exemption 2, 4 & 6]		$167,518	A, D, E	$183,297	
10			$82,780	A	$82,411	
11			$27,168	E	$0	$0
12			$317,973	E	$31,463	
13			$27,841	B	$0	$15,000
14			$16,785	A, C, E	$2,840 [4]	
15			$21,573	C	$4,746 [4]	
16			$175,843	B, E	$1,273 [4]	$59,156
17			$15,441	B	$0	$15,391
18			$47,806	C	$0	$47,806
19			$55,196	E	$12,368	
20			$142,156	A, C, D	$141,689	
21			$163,535	C	$19,346 [4]	
22			$35,265	C, E	$22,000	
23			$31,869	E	$2,213	
24			$325,885	D, E	$81,317	
25			$50,158	E	$0	$709
	Totals		**$2,726,008**		**$904,901**	**$290,807**

[1] Amount purchased does not include adjustments for recoveries received or expenses such as legal fees incurred after purchase.
[2] Recommended recovery amount.
[3] Amount not supported by documentation in the SBA file.
[4] Recovery recommendation made in this report.

Deficiency Type Legend:

A. Equity Injection
B. Use of Proceeds
C. Collateral/Liquidation
D. Eligibility/Origination
E. Other Issues

APPENDIX IV. LOANS NEEDING RECOVERIES

#	Loan Number	Borrower	Amount		Purchase Amount Questioned	Deficiency Type (See Legend)
			Disbursed	Purchased[1]		
1			$120,000	$102,489	$7,578	A
2			$200,000	$74,933	$624	B
3	[Exemption 2, 4 & 6]		$37,000	$16,785	$2,840	A
4			$40,545	$21,573	$4,746	A
5			$258,000	$175,843	$1,273	B
6			$240,000	$163,535	$19,346	A
	Totals		**$895,545**	**$555,158**	**$36,407**	

[1] Amount purchased does not include adjustments for recoveries received or expenses such as legal fees incurred after purchase.

Deficiency Type Legend:

A. Collateral/Liquidation
B. Other Issues
C. Collateral/Liquidation
D. Eligibility/Origination
E. Other Issues

APPENDIX V. MANAGEMENT RESPONSE

MEMORANDUM

April 27, 2007

TO: Debra Ritt
Assistant Inspector General for Auditing

FROM: Janet A. Tasker
Acting Director
Office of Financial Assistance

SUBJ: Response to Draft Audit Report on the Guaranteed Purchase Process

Thank you for the opportunity to review the draft audit report on SBA's guaranteed purchase process. While we will address the specific recommendations made in the report, we would like to offer the following overall comments as part of our response.

While we acknowledge that the centralization of the guaranty purchase process into the Herndon National Guaranty Purchase Center (NGPC) could have been smoother, we believe that much has been done since it was established in early 2004 to improve and strengthen the process. We believe the report is misleading about the current state of affairs at the Herndon NGPC as the loans reviewed were purchased two or more years ago and a tremendous amount of progress has been made in the intervening period. Nevertheless, given the critical internal control function the guaranty purchase process serves and the dollars involved, we know we must continue to improve the process and this is a significant priority for the Office of Financial Assistance.

Further, we find the comparisons of findings resulting from loans purchased in the period from October 1, 2004 through May 31, 2005 (the first part of FY 2005), when the Center was just getting established with results and events in FY 2006 is inappropriate and inconsistent and does not allow for fair and equitable comparisons and conclusions. Different periods cannot be compared as the time periods are simply different and reflect different conditions, situations, processes and activities. The FY 2006 erroneous payment rate of 1.56% cannot be compared to the audit results which reflect guaranty purchases in FY 2005. Similarly, the report speaks about staffing issues and turnover in FY 2006, does not bear relationship to the staffing situation in FY 2005 when the loans were actually reviewed at the Herndon NGPC.

We also disagree with the anecdotal comments provided in the report regarding the management of the loan purchase guaranty process. It does not appear that these

APPENDIX V. MANAGEMENT RESPONSE

comments were backed up by any audit findings and are simply a recitation of comments made to auditors. Having production standards is an established means of measuring and managing work. Production/performance standards do not translate into instructions not to take time when needed to complete a purchase review. Similarly, stating a loan officer's opinion of how long it should take to complete a purchase review without supporting analysis of the workflow and related timelines involved in completing a purchase is not a fair representation of the process requirements nor is it supported by audit evidence.

Lastly, while the report states that a statistical sample of loans purchased was reviewed, the 38% of the sample were LowDoc loans which does not reflect the nature of the 7(a) portfolio. While the sample may have been intended to be a statistical sample, it resulted in something that is not representative of SBA's portfolio of 7(a) loans.

Management's response to the recommendations contained in the report are provided below. In addition, we are continuing to look at the specific details of individual loans reviewed. When the review is completed, we will advise you of any significant issues identified.

Recommendation 1: Seek recovery of $37,541 on the guarantees paid on the 6 loans listed in Appendix IV.

Response: NGPC will review OIG audit details on the 6 loans and make a determination whether recovery is appropriate in each case.

Recommendation 2: Develop a plan to improve quality of purchase reviews performed by the National Guaranty Purchase Center and ensure purchase decisions undergo adequate supervisory review.

Response: As mentioned above, the loans reviewed in this audit were purchased between October 1, 2004 and May 31, 2005. In the almost two years that have passed since then significant changes implemented. These changes include the following:

In FY2007, the staffing structure at the NGPC was adjusted by adding Senior Loan Specialists. This change allows for more direct, hands-on training of loan officers as well as providing additional resources to perform the supervisory reviews mentioned in the audit. The NGPC feels that the restructuring increases the Center's approval capacity to an adequate level.

APPENDIX V. MANAGEMENT RESPONSE

Also, as a result of the Administrator's initiative to increase throughput by 25%, the Center, with the assistance of Six Sigma consultants, has undergone an extensive reengineering of the entire Guaranty Purchase Division. The redesigned process includes the following:

- In an effort to improve the quality of the guaranty purchase process and to standardize the documents sent by the lenders, the Center developed a set of self-guided Tabs to assist with the compilation of the purchase request package. These tabs guide the lenders step by step through the documents needed for a proper guaranty purchase review. These new Tabs were made available on the NGPC web site in early April and have been distributed to all district offices. Ongoing training sessions in the use of the Tabs and the documentation required for purchase is currently being scheduled for both our lending partners as well as district office staff. This new initiative to address document deficiencies in the purchase process will go a long way to improving the overall quality of the purchase reviews.

- Created a data base for lender deficiencies in package which will help identify problem areas and fix them. This information is being shared with the Office of Lender Oversight and the District Offices.

- All purchase packages are barcoded when they enter the door using the 98 file system. As the package moves through the process, it is scanned and its location is always known, eliminating the possibility of lost or separated packages.

- Administration Staff performs the initial intake function of the purchase packages and ordering of the loan files from the Servicing Centers to allow LSAs in the GP Division to make better use of their time assisting with the processing of guaranty purchase reviews.

- Purchase requests are processed by the date the package was received to ensure that the banks get service in the order they made the request.

Recommendation 3: Revise the purchase review template to require loan officers to list supporting documentation relied upon when making their guarantee purchase decisions, and ensure the template is "write-protected" to prohibit unauthorized modification.

Response: The Center feels that the existing 327 Action form is adequate to document the purchase recommendation, legal concurrence and final approval. However, in an effort to standardize the documents reviewed by the loan officers prior to purchase, the

APPENDIX V. MANAGEMENT RESPONSE

Center has developed new Tabs for use by the lenders. In addition to being informative and self-guided, they also require the lender to carefully review the Loan Authorization itself and answer specific questions about required documentation. This enhanced system should improve the overall quality of the purchase packages received as well as the purchase reviews themselves. It will also make it much easier to track the supporting documentation received from the lending partners.

Recommendation 4: Require lenders to submit certifications of compliance with applicable laws, rules and regulations with each purchase demand.

Response: To enable lenders to participate in the 7(a) loan program, SBA requires the execution of a Loan Guaranty Agreement (Deferred Participation), SBA Form 750 between the lender and SBA. This agreement sets out the terms and conditions of the application, approval, closing, servicing and purchasing of 7(a) loans. Included in that document is a requirement that the lender certify that the loans have been disbursed and serviced in compliance with the agreement and all applicable rules and regulations. We feel this certification addresses the recommendation.

Recommendation 5: Revise the sampling plan for calculating the rate of improper payments in FY 2007 to ensure OMB sampling requirements are met.

Response: In coordination with OCFO, OFA developed a new sampling procedure for the selection of purchases for IPIA review for FY 2007. The purchases to be reviewed will be randomly selected by OCFO from all purchases made during the year-long period that ended March 31, 2007.

Recommendation 6: Include in its A-123 report on management controls the level of risk associated with the purchase review process and describe the risk in reporting its estimate of improper payments in the Agency's budget.

Response: Management will work with the Senior Assessment Team to identify what is most appropriate to include in the A-123 report on management controls.

Again, thank you for the opportunity to review the draft audit report on the guaranty purchase process. Please let us know if you have any questions regarding our comments.

APPENDIX VI. AUDIT REPORT DISTRIBUTION

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