

**UPS CAPITAL BUSINESS CREDIT'S
COMPLIANCE WITH SELECTED 7(A)
LENDING REQUIREMENTS**

Report Number: 8-08

Date Issued: March 21, 2008



U.S. Small Business Administration
Office Inspector General

Memorandum

To: Grady B. Hedgespeth
Director, Office of Financial Assistance
/S/ original signed
Date: March 21, 2008

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: UPS Capital Business Credit's (UPSC) Compliance with Selected 7(a) Lending Requirements
Report No. 8-08

This report presents the results of our audit of UPSC's compliance with selected Small Business Administration (SBA) lending requirements. We initiated the audit as a result of deficiencies identified by SBA personnel during their reviews of defaulted loans originated by UPSC. SBA guarantees portions of loans made by participating lenders and purchases the guarantees upon loan default. Lenders are required to comply with SBA's program regulations when originating, servicing, and liquidating the loans. When a loan defaults, the lender submits a request that SBA honor the guaranty along with relevant documentation. SBA reviews the documentation to evaluate the lender's compliance. Reviews of 7(a) loans (excluding SBA Express and Community Express loans) are centralized at SBA's National Guaranty Purchase Center in Herndon, Virginia.

The objective of the audit was to determine whether UPSC materially complied with SBA's requirements for documenting: borrower equity injection, use of loan proceeds and qualifications for debt refinancing. We had also planned to assess UPSC's compliance with SBA's requirement for reporting liquidation expenses. However, after initiating the audit, the Herndon Center began a review of the lender's liquidation expenses. Therefore, we excluded this component from the scope of our audit.

To answer the audit objective, we statistically sampled 36 of 103 loans that SBA purchased for \$11.9 million between October 1, 2003, and March 31, 2007. A listing of the sampled loans is presented in Appendix I, and our sampling methodology is provided in Appendix II. The sampled loans comprise more than one-third of the \$30.8 million SBA paid for the 103 loans. As of March 31, 2007, the outstanding SBA guaranty balance for the 36 loans had been reduced to about

\$7.3 million based on recoveries from liquidation actions. We reviewed SBA's files for 35 of the 36 loans to determine if the required documents had been submitted by the lender and requested documents from the lender for those items not found in SBA's files. SBA personnel could not locate one file. Additionally, we interviewed personnel at the Herndon Center and analyzed the results of pre- and post-purchase reviews the Center completed on 22 of the 35 loans. There was no evidence in the files of pre- or post-purchase reviews for the remaining 13 loans. We conducted our audit between May and November 2007 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

BACKGROUND

UPSC is a subsidiary of UPS Capital Corporation, which in turn is a subsidiary of United Parcel Service of America, Inc. UPSC became an SBA lender in May 2003. Since fiscal year (FY) 2004, UPSC has been one of SBA's largest lenders in the 7(a) guaranteed loan program, and has operated as a preferred lender. As of June 30, 2007, UPSC had 885 guaranteed loans outstanding with an SBA guaranteed balance of \$345 million. The lender's June 30, 2007, 12-month purchase rate for defaulted 7(a) loans was 3.7 percent—one of the highest for SBA lenders that have \$100 million or more in SBA-guaranteed loan portfolios.

RESULTS

Loans Were Purchased Without Adequate Support Showing How Loan Proceeds Were Used

SBA Policy Notice 5000-831 and Standard Operating Procedure 50 51 2B require lenders to document the borrower's disbursement of loan proceeds through the issuance of joint payee checks, except for working capital and cash. When joint payee checks are not available, the lender should maintain copies of receipts, invoices or other documentation that clearly shows that proceeds were used in accordance with the loan authorization.

Our audit disclosed that 16, or about 44 percent, of the 36 loan files in our sample did not have adequate supporting documentation to show how borrowers used the loan proceeds. These loans had an outstanding balance of about \$4.3 million. The Herndon Center conducted purchase reviews for 7 of the 16 loans, but had approved the purchases despite their deficiencies. The other nine loans were awaiting a post-purchase review.

We attempted to obtain from the lender the appropriate supporting documentation to show how proceeds were used for the 16 loans. The lender told us that

obtaining the requested information would be difficult as loan agents were used to close the loans. The lender provided copies of Uniform Commercial Code (UCC) searches for loan proceeds used to refinance prior debt for eight loans. The UCC data showed that prior debtors had released their liens on the assets financed by SBA loan proceeds. These documents were provided by the lender as evidence of the use of loan proceeds. Because this evidence does not state how much the prior debtors were paid, we could not determine whether loan proceeds associated with the eight loans had been used appropriately. The lender also did not provide documentation to show that proceeds were used appropriately for the remaining eight loans.

For example, the loan authorization for a loan¹ showed that \$1.5 million was to be used to repay prior debt and \$162,787 was to be used for working capital and closing costs. The lender did not provide the required supporting documentation for the use of the loan proceeds, but submitted a settlement sheet and closing statement indicating that the borrower paid an origination fee of \$17,000 that was intended for a third party. Title 13 of the Code of Federal Regulations, Part 120.222, states that a lender may not require the borrower to pay any fees as a condition of obtaining the loan, or charge a commitment, broker, commission, referral or similar fee. Despite this restriction, Herndon Center personnel did not challenge the lender's loan origination fee during the pre-purchase review and honored the guaranty. When we brought this matter to their attention, they agreed that this was an ineligible use of loan proceeds that it would address during a post-purchase review.

When presented with a copy of our draft finding, stating that SBA did not challenge the lender's lack of appropriate support for the use of proceeds for each loan, a loan purchase review supervisor did not provide an explanation other than to state that the loans may not have received a purchase review. However, as mentioned previously, 7 of the 16 loans had been reviewed and purchased without adequate proof of how the borrowers used the loan proceeds. A listing of the 16 loans is provided in Appendix III.

Projecting our sample results to the population, we estimate that 44 percent of the 103 purchased loans and \$11.2 million in guarantees purchased by SBA as of March 31, 2007, were made without the appropriate documentation showing how the borrower used the loan proceeds.

Regarding the other audit objectives concerning debt refinancing and equity injection, we found that the lender complied with SBA's qualification requirements for debt refinancing, when appropriate, for the 35 loans. However, we did not have a sufficient basis for assessing the lender's compliance with

¹ Loan number [Exemption 2]

equity injection requirements as only one loan in our sample required an equity injection.

On May 8, 2007,² we reported that, within the time period of our audit, the Herndon Center had purchased guarantees without obtaining sufficient information needed to assess whether lenders were in full compliance with SBA requirements and prudent lending practices. One of the major deficiencies noted in the report was that the Center was not ensuring that lenders had adequately documented the borrowers' use of loan proceeds. We reported that lender deficiencies were not detected due to the inexperience of purchase reviewers and inadequate Center resources. Review deficiencies were also attributed to an overly aggressive emphasis on expediting and increasing purchase production at the Center.

In response to the May 2007 report, SBA agreed to develop a plan for improving the quality of purchase reviews. However, SBA will need to take steps to remedy problems we noted with UPSC loans.

RECOMMENDATIONS

We recommend that the Director, Office of Financial Assistance, take the following actions to protect SBA's interests:

1. Obtain the appropriate use of loan proceeds documentation for the 16 loans reviewed, or repair the guarantees for up to \$4.3 million where appropriate documentation cannot be obtained.
2. Repair by \$17,000 the guaranty purchase amount for the loan proceeds that were used to pay the lender's loan origination fee.
3. Establish a corrective action plan that requires the lender to demonstrate that it has implemented a process for ensuring that it has secured adequate documentation from borrowers to include, at a minimum, showing how loan proceeds have been used.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On February 12, 2008, we provided the Director, Office of Financial Assistance, with a draft of this report for his review and comment. On March 14, 2008, he

² OIG Report No. 7-23, *Audit of the Guaranty Purchase Process for Section 7(A) Loans at the National Guaranty Purchase Center*, issued May 8, 2007. OIG reports can be found on our website: www.sba.gov/ig.

provided formal written comments concurring with our recommendations, and stated that actions are being taken to satisfactorily address the three report recommendations. The full text of the comments can be found in Appendix IV of this report. The actions planned by SBA are responsive to our recommendations. His comments indicated that staff will be directed to re-review the 16 loans discussed in the report to ensure that sufficient documentation and information exists to sustain the purchase decisions. The Director further stated that with respect to lender origination fees that were paid from loan proceeds, staff will review the documentation to ensure the lender makes the appropriate restitution for the \$17,000. He will also advise all processing staff that this practice is prohibited.

To address open purchase and liquidation issues, both SBA and UPS agreed to designate specific personnel and resources to bring them to resolution. SBA has assigned all of the lender's backlogged loans requiring a post purchase review to experienced personnel. SBA will also outline deficiencies found and insist that action be taken by UPSC to educate its staff of the SOP requirements and SBA's expectations. Additionally, SBA will establish a screening/tracking method to affirmatively ensure continued UPSC compliance and take immediate corrective action should the Herndon Center encounter continued non-compliance.

The Director also commented that after Herndon Center staff noticed a pattern of closing, servicing and liquidation issues on UPSC loans, UPSC was notified of potential violations of SBA policy in September 2005. He stated that UPSC had misapplied liquidation proceeds that should have been applied to SBA guaranteed loans to other non-guaranteed UPSC loans as well as reimbursing themselves for non-SBA loan care and preservation of collateral expenses. UPSC was also found to have sold notes and compromised debt without SBA approval over the years. The Director further stated that these matters were brought to the attention of the OIG. Shortly after the audit began, we found that both UPSC and Herndon Center personnel had initiated actions to resolve the issues as well as their causes. Therefore, we excluded these liquidation issues from our audit.

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) 205-7203 or Robert Hultberg, Director, Credit Programs Group, at (202) 205-[Exemption 2]

APPENDIX I. SAMPLE OF LOANS AUDITED

| Sample Number | Loan Number |
|---------------|---------------|
| 1 | [Exemption 2] |
| 2 | [Exemption 2] |
| 3 | [Exemption 2] |
| 4 | [Exemption 2] |
| 5 | [Exemption 2] |
| 6 | [Exemption 2] |
| 7 | [Exemption 2] |
| 8 | [Exemption 2] |
| 9 | [Exemption 2] |
| 10 | [Exemption 2] |
| 11 | [Exemption 2] |
| 12 | [Exemption 2] |
| 13 | [Exemption 2] |
| 14 | [Exemption 2] |
| 15 | [Exemption 2] |
| 16 | [Exemption 2] |
| 17 | [Exemption 2] |
| 18 | [Exemption 2] |
| 19 | [Exemption 2] |
| 20 | [Exemption 2] |
| 21 | [Exemption 2] |
| 22 | [Exemption 2] |
| 23 | [Exemption 2] |
| 24 | [Exemption 2] |
| 25 | [Exemption 2] |
| 26 | [Exemption 2] |
| 27 | [Exemption 2] |
| 28 | [Exemption 2] |
| 29 | [Exemption 2] |
| 30 | [Exemption 2] |
| 31 | [Exemption 2] |
| 32 | [Exemption 2] |
| 33 | [Exemption 2] |
| 34 | [Exemption 2] |
| 35 | [Exemption 2] |
| 36 | [Exemption 2] |

* Loan file could not be located by SBA

APPENDIX II. STATISTICAL SAMPLING PROJECTION

The universe consisted of 103 loans purchased between October 1, 2003, and March 31, 2007. From the population universe, we selected a statistical sample of 36 loans to determine whether UPS Capital Business Credit materially complied with SBA's lending policies and procedures. 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. Estimating 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 likely amounts.

Using the Defense Contract Audit Agency's "EZ Quant" software program, we determined that a sample size of 36 loans was required based on the universe size, a confidence level of 90 percent and a 10 percent error rate. We used the "EZ Quant" sample number generator to select the sample records from the universe.

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

| Attribute | Occurrences in Sample of 36 loans | Population Point Estimate | Lower Limit | Upper Limit |
|-------------------------------------|-----------------------------------|---------------------------|-------------|-------------|
| Use of loan proceeds not documented | 16 | 44.4 | 33 | 57.4 |

| Value | Questioned Amount | Projected Amount | Precision Amount | Lower Limit | Upper Limit |
|-------------------------------------|-------------------|------------------|------------------|-------------|--------------|
| Use of loan proceeds not documented | \$4,334,850 | \$11,244,304 | \$3,385,955 | \$7,858,349 | \$14,630,258 |

APPENDIX III. LOANS WITHOUT FULL DOCUMENTATION OF THE USE OF LOAN PROCEEDS

| Sample Number | Loan Number | Outstanding SBA Guaranty Balances On Loans With Undocumented Use Of Proceeds As Of March 31, 2007 |
|---------------|---------------|---|
| 1 | [Exemption 2] | \$121,796* |
| 3 | [Exemption 2] | \$463,740 |
| 6 | [Exemption 2] | \$265,518 |
| 8 | [Exemption 2] | \$151,604 |
| 9 | [Exemption 2] | \$187,525 |
| 12 | [Exemption 2] | \$412,618 |
| 13 | [Exemption 2] | \$546,991 |
| 15 | [Exemption 2] | \$179,790 |
| 18 | [Exemption 2] | \$568,469 |
| 19 | [Exemption 2] | \$30,305 |
| 20 | [Exemption 2] | \$255,569 |
| 23 | [Exemption 2] | \$67,719 |
| 24 | [Exemption 2] | \$125,878 |
| 31 | [Exemption 2] | \$401,556 |
| 32 | [Exemption 2] | \$45,140 |
| 33 | [Exemption 2] | \$510,632 |
| | Total | \$4,334,850 |

* The balance for this loan represents the amount charged off by SBA.

APPENDIX IV. AGENCY COMMENTS

From: Grady B. Hedgespeth
Director, Office of Financial Assistance

TO: Debra S. Ritt
Assistant Inspector General for Auditing

Date: March 14, 2008

Subject: OFA response to IG Draft Report on UPS Capital Business Credit's (UPS) Compliance with Selected 7a Lending Requirements - Project 7023

NGPC UPSC BACKGROUND:

After the establishment of the The National Guaranty Purchase Center (NGPC), staff began to notice a pattern of closing, servicing and liquidation issues on loans being serviced by UPS Capital Business Credit (UPS). A memorandum dated September 7, 2005 was sent to UPS that specifically identified these deficiency issues and potential violations of SBA policy and procedures. The issues included a variety of lender preference concerns including a unique so-called "Waterfall theory /windfall theory" method applied by UPS wherein UPS misapplied proceeds that should have been applied to SBA guaranteed loans on a lien priority basis. In essence, any monies over and above an arbitrary liquidation value were then shared with other non-SBA loans as a "windfall" regardless of lien priority loan balance. UPS instead applied some of these liquidation proceeds to non-guaranteed UPS loans as well as reimbursed themselves with SBA loan proceeds on non-SBA loan CPC expenses. Our review also identified additional practices and actions that UPS has implemented over the years regarding the sale of notes and compromising the debt without SBA approval. We also brought these matters to the attention of the Inspector General Office.

IG RESULTS and OFA CORRECTIVE ACTIONS

Of the 36 loans sampled in this report, 16 (44%) have not yet had Post Purchase Review so issues with regard to capital injection, use of proceeds, and other pertinent actions have not yet been reviewed. Use of proceeds and other actions are reviewed during the post purchase review, not prior to purchase from the secondary holder. Of the loans having had Post Purchases Review, the report cited 7 loans where the use of proceeds appeared to be undefined. Our resolution to this type of issue is to try to form a conclusion from the information available. Where a lender cannot or does not provide documentation behind a 1050, but we have access to acceptable alternative sources of evidence such as an appraisal, accounting at liquidation, etc., we will use the alternative

information. This methodology was demonstrated in some of the 36 cases reviewed. Although not specifically identified in the 1050, it was apparent that the lender had followed the loan authorization, and by review of alternative sources, we concluded that the lender complied with the loan authorization. However, in all cases cited for apparent lack of substantiation of the use of proceeds, staff will be directed to re-review with particular attention to satisfying that we have sufficient documentation and information to sustain the purchase decision.

With regard to the lender charging and collecting a lender's origination fee, we can offer no reason why this was not caught and adjusted. We will review the documentation to ensure the lender makes the appropriate restitution which would be either refunding monies deducted from loan proceeds to SBA or crediting the borrower for any funds paid by them outside the loan transaction. We will also advise all the processing staff that this practice is prohibited.

It should be noted that completion of the PPR does not release the lender from any subsequent repair or denial. In some cases, depending on the nature of the issue, harm to the Agency can not be adequately determined at the time of the PPR since all liquidation and collection efforts have not yet been completed by the lender. There still remains the comprehensive charge off process and this was the process where we originally identified the UPS deficiencies.

The IG report sampled loans made in the period October 2003 thru March 2007. The NGPC was started in January 2004 and since opening has undergone many issues and challenges both in personnel and operations. Some of the issues noted in this draft report as well as early reports identified areas of review that needed to be augmented or operationally enhanced. Partly as a result of these issues, as well as others, the NGPC has recently rolled out new procedures and systems that make the entire review process more visible, accountable, uniform, and effective. Coupled with a change in operating organization, increase in personnel, intensive training, and other efforts, we expect that the end product will produce the appropriate level of uniform and effective review desired.

As to UPS specifically, our overall UPS strategy includes a continuing dialogue and resolution on a case by case basis with UPS of all remaining backlogged purchase reviews and charge-off reviews. Both NGPC and UPS agreed to designate specific personnel and resources to address existing issues and bring them to resolution and to continue to coordinate corrective efforts to alleviate future problems. In conjunction with that philosophy, UPS management has indicated that effective with SBA's September 7, 2005 Memorandum, that UPS would cease and desist the so called "waterfall practice" of the Waterfall theory. A Senior Vice President and Compliance Officer was assigned by UPSC to the task of moving the remaining issues and cases to resolution. All backlogged UPS PPR loan reviews as well as charge-off reviews have been assigned to a senior and very experienced NGPC team for continuity and expertise.

OFA Action Plan as to IG Recommendations:

IG Recommendation #1: *Obtain the appropriate use of loan proceeds documentation for the 16 loans reviewed, or repair the guarantees for up to \$4.3 million where appropriate documentation cannot be obtained.*

OFA Action Plan: In all cases cited for apparent lack of substantiation of the use of proceeds, staff will be directed to re-review with particular attention to satisfying that we have sufficient documentation and information to sustain the purchase decision.

IG Recommendation #2: *Repair by \$17,000 the guaranty purchase amount for the loan proceeds that were used to pay the lender's origination fee.*

OFA Action Plan: We will review the documentation to ensure the lender makes the appropriate restitution which would be either refunding monies deducted from loan proceeds to SBA or crediting the borrower for any funds paid by them outside the loan transaction. We will also advise all the NGPC and UPS processing staff that this practice is prohibited.

IG Recommendation #3: *Establish a corrective action plan that requires the lender to demonstrate that it has implemented a process for ensuring that it has secured adequate documentation from borrowers to include, at a minimum, showing how loan proceeds were used.*

OFA Action Plan: As NGPC staff works with UPS to resolve open purchase issues, we will outline deficiencies found to lender and insist that action be taken by UPS to educate its staff of the SOP requirements and SBA expectations. This same attention and scrutiny will be applied to those open liquidation cases to ensure that this requirement was met at time of purchase. We will also acquaint the NGPC staff of the results of this report and establish a screening/tracking method to affirmatively insure continued UPS compliance and take immediate corrective action should NGPC encounter continued non-compliance.