BANCO POPULAR DID NOT ADEQUATELY ASSESS BORROWER REPAYMENT ABILITY WHEN ORIGINATING HUNTINGTON LEARNING CENTER FRANCHISE LOANS

Report Number: 11-16

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Prepared by the
Office of Inspector General
U.S. Small Business Administration

U.S. Small Business Administration Office Inspector General

Memorandum

To:	Grady Hedgespeth Director, Office of Financial Assistance	Date:	July 13, 2011
	/S/ original signed		
From:	John K. Needham Assistant Inspector General for Auditing		
Subject:	Banco Popular Did Not Adequately Assess Borrower Repayment Ability When Originating Huntington Learning Center Franchise Loans Report No. 11-16		

This report presents the results of our audit of Banco Popular's assessment of borrower repayment ability when originating Huntington Learning Center (HLC) franchise loans. We conducted the audit in response to a complaint alleging that lenders improperly originated Small Business Administration (SBA) guaranteed loans made to HLCs. The complaint, which identified potential violations of 7(a) loan program rules, alleged in part that lenders approved the loans based on inflated gross revenue projections submitted by loan brokers in SBA loan applications. Accordingly, our audit objective was to determine whether the complainant's lender, Banco Popular, adequately assessed borrower repayment ability when originating HLC franchise loans. During the course of the audit, we also noted that SBA's Loan Accounting System did not accurately reflect franchise loans. We have documented this condition in the Other Matters section of the report.

To achieve our objective, we reviewed all 12 HLC loans approved by Banco Popular using Preferred Lender Program (PLP) procedures in fiscal year (FY) 2007, the year that the complainant's loan was approved.[1] To determine if the lender met SBA's requirements for assessing the repayment ability of the companies, we reviewed SBA's procedures governing loan approval and examined loan documents in the lender's loan files. To determine if the projections supporting repayment ability were realistic, we compared revenue data

[1] Under the Preferred Lender Program, SBA delegates lenders the authority to process, close, service and liquidate SBA guaranteed loans without prior SBA review. An additional 10 companion loans were made by Banco Popular to HLCs using SBA Express loan procedures. These loans were small, with individual amounts ranging from $25,000 to $54,500.

upon which the lender's approval was based to revenue data in HLC Franchisor[2] documents. We also interviewed a former representative of the Franchisor, the complainant, other HLC franchise owners, and a representative of the lender.

We conducted our review between March 2010 and April 2011 in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States.

RESULTS IN BRIEF

Banco Popular did not adequately assess repayment ability for 12 SBA-guaranteed HLC franchise loans when approving the loans. Specifically, the lender accepted unrealistic projected annual revenue figures that ranged from $483,000 to $650,025 as a basis for demonstrating the ability of the HLC franchises to repay their debts. The lender disregarded relevant and available data, which indicated that the franchises' revenue projections were unreasonable. This was due, at least in part, to the lender's perception that franchise loans required a lesser degree of due diligence because of the established business model of franchise systems. Had the lender complied with SBA's requirements to use and assess the feasibility of realistic projections, the 12 loans should have been declined. As of December 2010, there were 10 loans, with an aggregated outstanding SBA balance of $2.1 million,[3] which had been transferred to liquidation.

We also noted that SBA's loan database did not accurately track franchise loans guaranteed by the Agency. We tested 7 franchise brands among those with the highest guaranty purchase[4] rates and number of franchise loans made as of March 2010, and determined that the number of loans for these franchises was inaccurately reported by an average of 17 percent. Program officials acknowledged the limitations of the existing database and attributed the discrepancies to lenders not entering the codes for franchise loans during the loan application process. The incomplete nature of franchise loan data negatively affected the Agency's ability to assess whether franchise loans presented a higher than average risk of financial loss and identify potential risks within certain franchise brands. This data reliability issue could also negatively impact decisions made by lenders for loan approval and prospective borrowers that are considering franchise opportunities, as well as the ability of franchisors to attract new investors.

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[2] Huntington Learning Centers, Incorporated, a Delaware Corporation

[3] $2.1 million represents SBA's share of the outstanding balance. The gross amount outstanding was $2.8 million.

[4] SOP 50 51 2B; Chapter 13 (an SOP that applied to the loans at the time that they were approved) discusses in detail SBA's obligation to honor its guaranty and purchase the guaranteed portion of defaulted loans.

We recommend that the Agency: (1) seek recovery of the loan guaranties, less any recoveries, paid in connection with the 10 defaulted loans; (2) flag all Banco Popular HLC loans in SBA's Loan Accounting System to ensure the identified underwriting deficiencies are considered in the event of future default; and (3) implement a plan to ensure the completeness and accuracy of data pertaining to existing franchise loans and those made in the future.

SBA agreed to (1) review the 10 defaulted loans and seek recovery as appropriate, and (2) flag all HLC franchise loans originated by Banco Popular so they will receive heightened scrutiny if they are submitted for purchase. With regard to implementing a plan to ensure the completeness and accuracy of franchise data, the Agency stated it would issue an Information Notice reminding lenders of the need to provide accurate data, and would incorporate our findings into its quality control procedures. SBA, however, did not address a plan to improve the quality of franchise loan data and therefore its response was not sufficient to fully address our last recommendation.

BACKGROUND

Section 7(a) of the Small Business Act authorizes SBA to guarantee loans made by lenders to small businesses. Existing SBA regulations require lenders to comply with Agency loan program requirements. 13 CFR 120.10 defines loan program requirements as those imposed upon lenders by statute, SBA regulations, any agreement the lender has executed with SBA, SBA's Standard Operating Procedures (SOP), official SBA notices and forms applicable to 7(a) and 504 programs, and loan authorizations. Many of the small businesses that receive SBA loans are franchise-based companies which include various industry types (e.g., fast food restaurants, automotive shops, and health and fitness centers). These companies are independently operated by franchisees that have been granted the right to distribute the products or use the trademarks of franchisors in exchange for franchisor fees.

The Agency's Office of Capital Access (OCA) is responsible for delivering SBA's loan programs and monitoring the performance of lenders. Within OCA, the Office of Financial Assistance (OFA) is responsible for loan processing, servicing and liquidation functions, and for providing the policies and procedures that lenders use to accomplish these tasks.

The Agency's Loan Accounting System captures data on all of its guaranteed loans including franchise loan activity. The Agency's franchise loan statistics are made available to the lending community and ultimately to the general public. Consequently, this data may impact decisions made by lenders and prospective owners regarding franchise investments.

In FY 2007, there were 12 lenders that originated 25 SBA-guaranteed loans for the acquisition of HLC franchises using PLP procedures. Banco Popular approved 12 of those loans, 10 of which had been transferred to liquidation as of December 2010. The Agency paid $2.1 million to honor its guaranties on the 10 defaulted loans.

RESULTS

Banco Popular Used Unrealistic Revenue Projections in Assessing Borrower Repayment Ability

Banco Popular did not adequately assess whether 12 HLC franchise borrowers had the ability to repay loans totaling $3.8 million.[5] All 12 loans had unrealistic revenue projections. As a result, most of the HLC borrowers defaulted on their loans and SBA paid $2.1 million when it purchased its guaranties. With one exception, these loans were made to fund newly formed franchises. The one remaining loan was for the purchase of an existing HLC franchise.

In accordance with 13 CFR 120.150, applicants must be creditworthy and loans must be so sound as to reasonably assure repayment considering past earnings, projected cash flow, future prospects, the ability to repay the loan with earnings from the business, and the effects of any affiliates.[6] Guidance in effect at the time of the loans in question, SBA's SOP 50 10 4, required lenders to use realistic projections of future earnings when historical financial information did not demonstrate borrower repayment ability. The SOP further required lenders to test the feasibility of projections against industry averages and historical information with an explanation for significant deviations.

In FY 2007, a total of 12 HLC franchises received SBA guaranteed loans from Banco Popular for the acquisition of their businesses. The loans ranged in amounts from $196,500 to $379,900. Banco Popular approved these loans based on first- year projections that showed that the franchises would generate revenues ranging from $483,000 to $650,025. This level of performance is questionable given that the HLCs, Inc. *Franchise Offering Circular*,[7] which was effective April 1, 2006, and reviewed by the lender, showed that the average revenue of

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[5] The Agency's guaranty on the loans was 75 percent, for an aggregate SBA share of $2.9 million.

[6] Other considerations include character, reputation, and credit history; management experience; strength of the business; sufficient invested equity; potential for long-term success; and the nature and value of collateral.

[7] Uniform Franchise Offering Circulars (UFOC) are used by franchisors to provide pre-purchase information to franchise buyers as required by the Federal Trade Commission's Franchise Rule (16 CFR, §436 and §437). Currently known as the "Franchise Disclosure Document" based on a 2007 ruling by the Federal Trade Commission.

franchises in operation for one or more years was $468,442 in 2005.[8] Nevertheless, the lender expected the newly formed franchises to not only meet this average, but to exceed it, with generally no explanation for how the businesses would achieve this level of performance.

Additionally, the lender did not adequately consider other factors impacting the franchises' first year of performance. For example, one prospective borrower had nine other tutoring services within a 10-mile radius of the proposed center and yet the lender still expected the center to exceed the earnings of more established HLC franchises.

Through interviews and the review of loan files, we further validated the unrealistic nature of the first-year revenue projections. These sources provided first-year revenue figures ranging from $262,272 to $360,000. For example, we noted that one of the applicants was a change of ownership in an existing franchise that averaged revenues of $265,475 for 2005 and 2006. In addition, we reviewed literature published by the Franchisor that showed that the actual average first-year revenue for HLC franchises in 2007 was $262,272.[9] The projected revenues of the 12 HLCs approved by Banco Popular exceeded this average by as much as 148 percent. We further substantiated the unrealistic nature of the projections when we interviewed a former operations manager for the HLC Franchisor who told us that the targeted level of performance for new HLC franchises in FY 2007 was $360,000 in the first year. See Appendix I for a list of the 12 HLC borrowers with their projected first-year revenues and the percentage by which their projections exceeded the actual average revenue for start-up HLC franchises.

Furthermore, the 12 HLCs' projected expenses were generally significantly higher than the more realistic first-year revenue figures that we identified. These expenses ranged from $415,585 to $563,032, with fixed expenses averaging more than $400,000.[10] This means that if the lender had used more realistic first-year revenue projections, it should have projected that the franchises would operate at a loss and be unable to repay their SBA guaranteed debts from business cash flow.

We spoke with a vice president at Banco Popular who stated that the only data obtained from the Franchisor was the UFOC[11] — and as such — the lender was limited to the data reported in that document. According to the vice president,

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[8] The lender had access to the HLCs, Inc. *Franchise Offering Circular*, effective April 1, 2006, that showed the actual average revenues for existing HLC franchises was $468,442 in 2005. A Franchise Offering Circular is the typical document used by franchisors for disclosing revenue information pertaining to franchises. The HLCs, Inc. *Franchise Offering Circular* effective April 1, 2006, was the most recent circular available when the 12 HLC franchise loans were made.

[9] Huntington Franchise Headlines Volume 88, February 2008.

[10] Fixed expenses ranged from $348,064 to $526,504.

[11] The Uniform Franchise Offering Circular (UFOC) that the vice president was referring to was the HLCs, Inc. *Franchise Offering Circular*, effective April 1, 2006.

franchise loans require a lesser degree of due diligence because of the established business model of franchise systems. The vice president further stated that the upfront training and marketing assistance in franchise businesses increases the likelihood that businesses will achieve their projections. Banco Popular ultimately relied on the borrowers' own statements that their revenue projections had been vetted against the operations of other HLC franchises. Moreover, the lender's internal policy did not require that the revenue projections be supported by calculations or compared to the revenues of similar businesses. The vice president believed the latter was the responsibility of the borrowers.

If Banco Popular had complied with SBA's requirements and used revenue projections that were realistic, the 12 HLC franchise loans should have been declined due to lack of repayment ability. Of the 12 loans approved, 10 loans with an aggregated outstanding SBA balance of $2.1 million had been transferred to liquidation as of December 2010. Four of the 10 loans defaulted within 18 months of disbursement, and as such, are considered early defaults by SBA's definition.[12] The two remaining loans[13] were current as of May 2011.

During the time that the 12 loans were approved, the lender's loans to start-up companies were only made under the SBA program. Since that time, the lender discontinued the practice of making loans to any start-up franchises with or without an SBA guaranty.

OTHER MATTER

Incomplete Data Impairs SBA's Ability to Monitor Franchise Loans

In our efforts to test the completeness and accuracy of SBA's HLC franchise data, we queried the name *Huntington* in the FY 2006 through FY 2009 data that we obtained from the Agency's loan database. As a result of our analysis, we concluded that the HLC loan universe was understated by 16 loans, or 17 percent. We expanded our scope to include six additional franchise brands among those with the highest purchase rates and number of loans made as of March 2010. We determined that the number of franchises for these brands was similarly underreported, as shown in Table 1.

SBA releases its franchise loan data to an industry organization that publishes reports on SBA's annual franchise performance. This information is made available to the lending community and the general public. For example, CNN

[12] According to SOP 50 51 2(b) "early default" means a default that occurred either prior to final disbursement of the loan, or within 18 months from the date of the final disbursement. A default includes an unremedied failure to make one or more payments as required by the terms of the note, as well as events that would place a loan in liquidation status.

[13] [FOIA Ex. 4]

Money cited SBA's 10 most popular franchises by loan volume and identified a number of the best and worst performing franchises based on the Agency's franchise data. The Agency provides a disclaimer statement about the accuracy of its franchise data when it shares the data with external parties.

Table 1

Error Rates For 7 Franchise Brands with Incomplete Data In SBA's Database (FY 2006 – FY 2009)

Franchise Code	Franchise Name	Loans Coded in Database	Loans Not Coded	New Loan Totals	Error Rate
01350	AAMCO TRANSMISSIONS	105	21	126	0.17
17998	COLD STONE CREAMERY, INC.	218	42	260	0.16
21420	CURVES FOR WOMEN	104	2	106	0.02
39598	HUNTINGTON LEARNING CENTER	78	16	94	0.17
52875	MEINEKE CAR CARE	63	11	74	0.15
65140	PLANET BEACH	102	24	126	0.19
68020	QUIZNOS	448	118	566	0.21
Totals		**1,118**	**234**	**1,352**	**0.17**

Source: Generated by the OIG using SBA loan data for FY 2006 to FY 2009.

FRANdata is a franchise information and research company that maintains SBA's franchise registry. In a January 2007 report, *Study on SBA Loan Performance in Franchising*, FRANdata disclosed the incompleteness of the Agency's franchise data. Our audit work shows that the issue of under-reported franchise loan data highlighted in FRANdata's report remains an issue.

In October 2001, the Office of Management and Budget issued guidelines requiring agencies to adopt a basic standard of quality (including objectivity, utility, and integrity) as a performance goal and to take appropriate steps to incorporate information quality criteria into their information dissemination practices.[14] Furthermore, SBA's Strategic Plan for FYs 2011-2016 contains the objective of promoting the availability, analysis, and dissemination of the most current, accurate, and detailed statistics possible on small business.

Incomplete franchise loan data impairs SBA's ability to assess the risks of franchise loans as compared to non-franchise loans. It also affects the Agency's ability to identify and take actions regarding individual franchise brands that pose a risk to the Agency. Further, inaccurate statistics could negatively affect decisions made by lenders for loan approval and prospective borrowers that are

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[14] Office of Management and Budget's Guidelines for Ensuring and Maximizing the Quality, Objectivity, Utility and Integrity of Information Disseminated by Federal Agencies, October 1, 2001.

considering franchise opportunities, as well as the ability of franchisors to attract new investors. SBA management acknowledged the limitations of the existing database and attributed the errors to lenders who did not input the codes for franchise loans during the loan application process. The Agency, however, had not taken action to address this issue at the time of this report.

CONCLUSION

Banco Popular did not adequately assess borrower repayment ability when originating HLC franchise loans, and SBA paid $2.1 million when it purchased its guaranties on 10 of these loans. Furthermore SBA's franchise loan data is incomplete and impairs SBA's ability to monitor franchise loans. This data reliability issue could also negatively impact decisions made by lenders for loan approval and prospective borrowers that are considering franchise opportunities, as well as the ability of franchisors to attract new investors.

RECOMMENDATIONS

We recommend that the Associate Administrator, Office of Capital Access:

1. Seek recovery of the loan guaranties, less any recoveries, paid in connection with the 10 defaulted loans and their associated lines of credit.

2. Flag all Banco Popular HLC franchise loans in SBA's Loan Accounting System, along with any associated lines of credit, to ensure the identified underwriting deficiencies are considered in the event of future default.

3. Improve the quality of franchise loan data by implementing a plan to ensure the completeness and accuracy of data pertaining to new franchise loans made in the future and correct existing incomplete loan records.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On April 6, 2011, we provided a draft of this report to SBA for comment. On May 26, 2011, SBA provided written comments, which are summarized below and contained in their entirety in Appendix II. It is not clear from SBA's response whether it agreed or disagreed with recommendations 1 and 3, but it did agree with recommendation 2.

Recommendation 1

SBA stated that the National Guaranty Purchase Center (NGPC) will review the 10 defaulted loans by July 25, 2011 and will seek recovery of all purchase amounts disbursed if recovery is appropriate under the facts of each case and consistent with SBA loan program requirements. If the NGPC concludes that recovery is not warranted, the cases will be referred to the Office of Risk Management for resolution. These proposed actions are responsive to the recommendation. However, we also recognize that SBA typically only reviews early-defaulted loans for weaknesses in a lender's repayment ability analysis. Given the systemic issue noted in this report and the clear violation of SBA's policies and procedures by Banco Popular in originating HLC franchise loans, we believe all 10 defaulted loans should be reviewed with the same heightened scrutiny and the lender's inadequate repayment ability analysis should be considered material to the default of these loans.

Recommendation 2

SBA stated it would flag all HLC franchise loans originated by Banco Popular so they will receive heightened scrutiny if they are submitted for purchase. This proposed action is responsive to our recommendation.

Recommendation 3

SBA stated it will issue an Information Notice reminding lenders of the need to provide accurate data to SBA and will specifically mention the necessity of indicating whether a loan is being made to a franchisee. Additionally, SBA stated that our audit findings will be incorporated into the Quality Control procedures at the centers.

SBA's comments were only partially responsive to our recommendation. Specifically, the response did not address a plan to improve the quality of franchise loan data. Furthermore, issuing an Information Notice will only help to obtain more complete and accurate data for new franchise loans and will not correct the problem for existing loans. Consequently, SBA's proposed actions are not sufficient to fully address our recommendation and we will work with management to resolve this issue during the audit follow-up process.

ACTIONS REQUIRED

Please provide your management response for each recommendation on the attached SBA Forms 1824, *Recommendation Action Sheet*, within 30 days from the date of this report. Your responses should identify the specific actions taken or planned to fully address each recommendation and the target dates for completion. We appreciate the courtesies and cooperation of the Office of Capital Access during this audit. If you have any questions concerning this report, please call me at (202) 205-6586 or Terry Settle, Director, Credit Programs Group at (703) 487-9940.

APPENDIX I. PROJECTED FIRST-YEAR REVENUES OF TWELVE HUNTINGTON LEARNING CENTERS

No.	HLC Name	Projected First-Year Revenues	[redacted] Performance in Excess of Average[15]
1		$ 650,025	148%
2		$ 628,200	140%
3		$ 543,000	107%
4		$ 542,000	100%
5		$ 538,000	105%
6	[FOIA Ex. 4]	$ 533,000	103%
7		$ 523,000	99%
8		$ 514,100	96%
9		$ 511,500	95%
10		$ 501,000	91%
11		$ 490,000	87%
12		$ 483,000	84%

Source: Generated by the OIG using credit memorandums obtained from Banco Popular, and the Franchisor's Newsletter, Huntington Franchise Headlines Volume 88, obtained from the HLC Franchisor.

[15] The average revenue for new HLCs in 2007 was $262,272 according to Huntington Franchise Headlines Volume 88.

APPENDIX II. AGENCY COMMENTS

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

DATE:	May 26, 2011
TO:	Peter L. McClintock, Deputy Inspector General
	/S/ original signed
FROM:	Grady Hedgespeth, Director, OFA
SUBJECT:	Draft Report on the Audit of Franchise Loan Origination Practices Project No. 10012

Thank you for the opportunity to review this draft report. We appreciate the role that the Office of Inspector General (OIG) plays in assisting management in ensuring that SBA loan programs are effectively managed. Set forth below are our responses to the OIG recommendations in the draft audit report.

1. **Seek recovery of the loan guarantees, less any recoveries, paid in connection with the 10 defaulted loans and their associated lines of credit.**

RESPONSE: The National Guaranty Purchase Center (NGPC) will review the 10 defaulted loans within 60 days of this response, and will seek recovery from the lender of all purchase amounts disbursed if recovery is appropriate under the facts of each case and consistent with SBA loan program requirements. If NGPC concludes that recovery on any of the loans is not warranted, we will refer these loans to the Office of Risk Management for resolution in accordance with procedures previously agreed to by OIG.

2. **Flag all Banco Popular HLC (Huntington Learning Center) franchise loans, in SBA's loan accounting system, along with any associated lines of credit to recognize the identified underwriting deficiencies in the event of future default.**

RESPONSE: We will flag all HLC franchise loans originated by Banco Popular so they will receive heightened scrutiny if they are submitted to SBA for purchase. This will be done within 60 days of this response.

3. **Improve the quality of franchise loan data by implementing a plan to ensure the completeness and accuracy of data pertaining to new franchise loans made in the future and correct existing incomplete loan records.**

RESPONSE: We will issue an Information Notice reminding lenders of the need to provide accurate data to SBA in the loan origination process, and will specifically mention the necessity of indicating whether a loan is being made to a franchisee. Also, the findings of this audit will be incorporated in the Quality Control procedures at the centers.

Again, thank you for the opportunity to review the draft report. We hope to continue working with OIG to address these issues. Please let us know if you need additional information or have any questions regarding our response.