

**MATERIAL DEFICIENCIES IDENTIFIED IN FIVE 7(A) RECOVERY
ACT LOANS RESULTED IN \$2.7 MILLION OF QUESTIONED COSTS**

**Report Number: ROM 11-06
Date Issued: August 22, 2011**

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



U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Grady Hedgespeth
Director, Office of Financial Assistance

Date: August 22, 2011

John A. Miller
Director, Office of Financial Program Operations
/s/ Original Signed

From: John K. Needham
Assistant Inspector General for Auditing

Subject: Material Deficiencies Identified in Five 7(a) Recovery Act Loans Resulted in \$2.7 Million of Questioned Costs
ROM 11-06

This is the second in a series of reports resulting from our ongoing audit of purchased 7(a) Recovery Act¹ loans. The objective of the audit is to determine whether purchased 7(a) Recovery Act loans were originated, closed, and purchased in accordance with Small Business Administration (SBA) rules and regulations, and commercially prudent lending standards. Our first report identified four early-defaulted loans that we believe warrant recovery of approximately \$3.2 million. This report identifies five additional early-defaulted loans that resulted in questioned costs of \$2.7 million, and warrant immediate attention by the SBA. These loans are part of a judgmental sample of 25 Recovery Act loans, approved for \$500,000 or more, that had been purchased as of September 30, 2010. Of the total \$2.7 million questioned in this report, we are recommending recovery of approximately \$1 million, while the remaining \$1.7 million cannot be recovered due to deficiencies in the SBA's origination of these loans.

Early-defaulted loans are those loans that default within 18 months of initial loan disbursement. An early default can be an indication of material loan origination deficiencies and as a result, the SBA requires the highest degree of scrutiny to be imposed during the pre and post purchase reviews of these loans.

To assess the internal controls relevant to our audit objective, we reviewed the SBA's policies and procedures regarding loan origination, closing and

¹ American Recovery and Reinvestment Act of 2009, Public Law 111-5

purchasing. To answer the objective, we reviewed all origination, closing and purchase actions as documented in the SBA and lender loan files. We also reviewed information in the SBA's Loan Accounting System for all loans examined. We conducted the audit of these five loans from December 2010 to April 2011 in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States.

The 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. These loans are made by participating lenders under an agreement with the SBA to originate, service, and liquidate loans in accordance with SBA regulations, policies, and procedures. Some of these loans are made by lenders using delegated authority, which undergo very limited review by the SBA prior to loan disbursement, and others are subject to more extensive underwriting, eligibility review, and approval by the SBA. If a lender fails to comply materially with SBA regulations, the loan agreement, or does not make, close, service, or liquidate a loan in a prudent manner, the SBA has exclusive discretion to release itself, in whole or in part, from liability on the loan guaranty.

The Recovery Act provided the SBA with \$730 million to expand the agency's lending and investment programs, and create new programs to stimulate lending to small businesses. Under the provisions of the Recovery Act, the SBA temporarily eliminated the upfront guaranty fees and increased the maximum guaranty percentage to 90 percent for most 7(a) loans.²

For three of the loans presented in this report, the SBA completed its purchase or post purchase reviews and improperly honored its guaranty when repair or partial denial of the guaranty should have been pursued due to the material noncompliance³ we identified with SBA requirements. One of these three loans, which had been approved by the SBA, resulted in an additional loss that cannot be recovered due to the SBA's noncompliance in underwriting the loan. For a fourth loan, the SBA completed a purchase review and fully honored its guaranty; however, we identified noncompliance by the SBA, which prevented recovery of the purchased guaranty. Finally, the SBA performed its post purchase review on a fifth loan, subsequent to the issuance of the draft report, and concurred with our finding.

The deficiencies identified in the five loans, as fully described in the appendices of this report, included:

- Inadequate assurance of repayment ability;
- Ineligible use of proceeds;
- Questionable eligibility; and/or
- Improper guaranty amount.

² Under the Recovery Act, the maximum guaranty for SBAExpress loans remained at 50 percent.

³ For purposes of this report, noncompliance which resulted in or may result in improper payments is considered material.

CONCLUSION

The audit found that lenders and the SBA did not originate and close the five 7(a) Recovery Act loans in accordance with the SBA's rules and regulations, and commercially prudent lending standards. Furthermore, SBA loan officers did not identify the deficiencies in three of the loans during their purchase reviews. The SBA purchased its guaranty on these five loans, which resulted in approximately \$2.7 million of questioned costs. As a result of the identified deficiencies, we recommended that the SBA seek recovery of approximately \$1 million and ensure that loan officers take steps to prevent similar deficiencies from occurring in the future. A draft of this report was provided to the SBA for comment. The SBA agreed with all of the recommendations and proposed actions that were responsive.

RECOMMENDATIONS

We recommend the Director, Office of Financial Program Operations:

1. Seek recovery of \$506,250, plus interest, from Heritage Oaks Bank on the guaranty paid by the SBA for the loan to [FOIA ex. 4]
2. Seek recovery of \$191,702, plus interest, from First Coast Community Bank on the guaranty paid by the SBA for the loan to [FOIA ex. 4] and [FOIA ex. 4]
3. Seek recovery of \$193,500, plus interest, from Valley Bank on the guaranty paid by the SBA for the loan to [FOIA ex. 4] and [FOIA ex. 4]
4. Seek recovery of \$106,802, plus interest, from Foster Bank on the guaranty paid by the SBA for the loan to [FOIA ex. 4]
5. Ensure all SBA loan officers involved in the loan approval and purchase processes understand and implement the steps necessary to identify all affiliates and determine their impact on repayment ability, size, and SBA's guaranty percentage.
6. Ensure SBA loan officers involved in the purchase process are aware that Recovery Act loans may receive less than a 90 percent guaranty and should be purchased at the percentage reflected in the loan authorization.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On June 21, 2011, we provided a draft of this report to the SBA for comment. On August 4, 2011, the SBA provided written comments, which are summarized below and contained in their entirety in Appendix VI. The SBA agreed with all of the recommendations and proposed actions that were responsive.

Recommendation 1

Subsequent to the issuance of our draft audit report, the Herndon National Guaranty Purchase Center (NGPC) conducted a thorough review of the loan to [FOIA ex. 4] and concurred with the OIG's recommendation that a full recovery be requested of the lender. Unless mitigating documentation is received from the lender, the SBA will insist upon recovery of \$506,250 from the lender. If the lender refuses to pay, the loan will be forwarded to SBA headquarters for further action. The SBA's proposed actions are responsive to recommendation 1.

Recommendation 2

The SBA fully agreed with our recommendation. The NGPC conducted a thorough review of the loan to [FOIA ex. 4] and [FOIA ex. 4], and agreed with our finding. The lender was notified of the SBA's intent for full recovery, and it did not agree with the SBA's finding. As a result, the NGPC will forward the loan to SBA headquarters for further recovery action. The SBA's proposed actions are responsive to recommendation 2.

Recommendation 3

The SBA fully agreed with our recommendation. The NGPC staff met with the lender on July 18, 2011 and the lender has agreed to reimburse the SBA for the overpaid guaranty percentage pending approval from their board. The SBA will insist upon full repayment and if the lender refuses to pay, the loan will be forwarded to the SBA headquarters for further action. The SBA's proposed actions are responsive to recommendation 3.

Recommendation 4

The SBA agreed with our recommendation, but identified a correction to the recovery amount. Although the SBA cited a corrected repair amount of \$107,603 in its response, the actual amount agreed upon between the OIG and NGPC was \$106,802. Our report was modified accordingly to reflect the corrected repair amount. The SBA requested full repayment from the lender and if the lender refuses to pay, the loan will be forwarded to SBA headquarters for further action. The SBA's proposed actions are responsive to recommendation 4.

Recommendation 5

The SBA concurred with our recommendation and will begin conducting training in September based on the new guidance being issued in SOP 50 10 5(D), which is currently in clearance. The training will be held monthly and will continue until all approval and purchase staff has a complete understanding of how to identify affiliates and determine their impact on repayment ability, size, and the SBA guaranty percentage. The SBA's proposed actions are responsive to recommendation 5.

Recommendation 6

The SBA concurred with our recommendation and stated that all NGPC purchase staff will begin training in September 2011, which will review Recovery Act loan criteria and emphasize the reasons Recovery Act loans could be subject to reduced guaranty percentages. The SBA's proposed actions are responsive to recommendation 6.

ACTIONS REQUIRED

Please provide your management response for each recommendation on 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 202-205-7390 or Terry Settle, Director, Credit Programs Group at 703-487-9940.

APPENDIX I. [FOIA ex. 4]

The deficiency on this loan resulted in questioned costs of \$506,250 that should be recovered by the SBA. During our ongoing audit of purchased 7(a) Recovery Act loans, we identified a problematic loan ([FOIA ex. 4]) made by Heritage Oaks Bank (lender) to [FOIA ex. 4] dba [FOIA ex. 4] (borrower).

BACKGROUND

Heritage Oaks Bank was authorized by the SBA to make guaranteed loans under the Preferred Lenders Program (PLP). As a PLP lender, Heritage Oaks Bank was permitted to process, close, service, and liquidate loans with limited documentation and review by the SBA.

On February 26, 2009, using PLP procedures, the lender approved a \$675,000 loan to the borrower for the purchase of an existing business known as [FOIA ex. 4]. The first loan disbursement was made on March 20, 2009 and the borrower defaulted approximately twelve months later on April 1, 2010. Therefore, this loan is considered an early default loan in accordance with SBA policy. On September 27, 2010, the SBA purchased the principal guaranty for \$506,250 from the secondary market, and completed its post purchase review subsequent to issuance of the draft report.

RESULTS

Inadequate Assurance of Repayment Ability

The lender's cash flow analysis did not consider the impact the two affiliated businesses would have on the borrower's repayment ability. In accordance with Title 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. According to the SBA's Standard Operating Procedure (SOP) 50 10 5, the cash flow of the business is the primary source of repayment. Thus, if the lender's financial analysis demonstrates that the business lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined. The SOP also requires the lender to retain affiliate and subsidiary financial statements in its loan file.

According to the lender, the principal purchased [FOIA ex. 4] to improve his overall cash flow position and support his personal cash flow needs which could no longer be maintained by the other businesses he owned. The lender explained that the principal was overextended on his personal debt and that his other business interests were not strong so he intended to sell them.

The principal's personal financial statements showed personal cash flow for 2007 was negative. The lender, however, claimed the principal's debt service position should improve with the acquisition of [FOIA ex. 4]

In order to demonstrate repayment ability for this loan, the lender only considered the financial information for [FOIA ex. 4]. The lender's loan file did not include any financial information for the borrower's two affiliated businesses to determine the effect they may have had on the borrower's repayment ability and there was no evidence to support the lender's claim that these businesses were operating at break-even. Only 8 months after loan approval, the lender revised the loan's risk rating from "acceptable" to "watch" due to the *global situation of the principal* (emphasis added), indicating the principal's personal debt and affiliated businesses were negatively impacting [FOIA ex. 4]. Approximately 5 months later, the loan defaulted. We believe the lender's lack of consideration of the effect of the two affiliates on the borrower's repayment ability resulted in the default of this loan.

CONCLUSION

Based on the above identified deficiency, this loan should not have been made and the SBA should seek recovery of \$506,250 from the lender.

APPENDIX II. [FOIA ex. 4]

AND [FOIA ex. 4]

The deficiency on this loan resulted in a \$191,702 improper payment that should be recovered. During our ongoing audit of purchased 7(a) Recovery Act loans, we identified a problematic loan ([FOIA ex. 4]) made by First Coast Community Bank (lender) to [FOIA ex. 4] and [FOIA ex. 4] (borrower).

BACKGROUND

First Coast Community Bank was authorized by the SBA to make guaranteed loans under the Certified Lender Program (CLP). For CLP loans, the SBA makes both the credit and eligibility decisions, but the SBA reviewer relies heavily on information the lender provides.

On October 13, 2009 the SBA approved a \$1,073,000 loan to [FOIA ex. 4] and [FOIA ex. 4], to pay outstanding debt, make renovations, purchase inventory and equipment, and for working capital. The loan amount subsequently increased to \$1,074,000. The first disbursement was on October 23, 2009 and the borrower defaulted five months later on March 23, 2010. Therefore, this loan is considered an early default loan in accordance with SBA policy. A purchase review was completed by the SBA and on September 10, 2010, the SBA honored its principal guaranty for \$877,859.

RESULTS

Ineligible Use of Proceeds

Our audit determined that a portion of the loan was used to refinance debt originally used for floor plan financing. Floor plan financing is a line of credit that funds the purchase of retail goods, and is collateralized by those goods. According to SOP 50 10 5(B), loan proceeds may not be used for floor plan financing. Further, loan proceeds also may not be used to refinance debt originally used for a loan purpose that would have been ineligible for SBA financing at the time it was incurred.

A portion of the SBA loan proceeds was used to refinance \$191,702 of same institution debt, which was originally used for floor plan financing. The purchase package submitted by the lender to the SBA included the original note for this debt, which was dated April 9, 2004, and listed the purpose as floor plan inventory. Although this debt was renewed several times, the lender did not provide any evidence that the loans were used for anything other than floor plan inventory. Furthermore, a renewal dated July 26, 2009 stated the purpose was to amend and restate the original note dated April 9, 2004, indicating all of the

renewals were also used for floor plan inventory. The SOP in effect at the time the original debt was incurred also disallowed floor plan financing.

Nevertheless, in the credit memo and eligibility documentation submitted to the SBA at the time of loan origination, the lender claimed the purpose of the same institution debt was a “second mortgage for [FOIA ex. 4]” Since this was same institution debt, the lender would have been aware that the actual original purpose of the loan was floor plan financing. However, given the description provided in the information submitted by the lender, the SBA would have had no knowledge that the original purpose of this loan was ineligible for SBA financing when it approved the loan. Based on the above, the \$191,702 debt refinance should not have been disbursed by the lender.

CONCLUSION

Based on the above identified deficiency, this loan resulted in an improper payment of \$191,702 that should be recovered.

APPENDIX III. [FOIA ex. 4] **AND** [FOIA ex. 4]

The deficiencies on this loan resulted in a \$967,500 improper payment that cannot be recovered and a \$193,500 improper payment that should be recovered. During our ongoing audit of purchased 7(a) Recovery Act loans, we identified a problematic loan ([FOIA ex. 4]) made by Valley Bank (lender) to [FOIA ex. 4] and [FOIA ex. 4] (co-borrowers).

BACKGROUND

On September 29, 2009, the SBA approved a \$1,290,000 loan to the borrowers to pay same institution debt and for working capital. This loan was made under the Standard 7(a) program in which the SBA makes both credit and eligibility determinations. The first disbursement was on November 6, 2009 and the borrowers defaulted approximately four months later on March 4, 2010. Therefore, this loan is considered an early default loan in accordance with SBA policy. On July 26, 2010, the SBA purchased the principal guaranty for \$1,161,000 from the secondary market and on August 11, 2010, completed its post purchase review fully honoring its loan guaranty.

RESULTS

Questionable Eligibility

The effects of the borrowers' affiliated businesses were not fully considered in determining the size and repayment ability of the borrowers. In accordance with Title 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. As defined by SOP 50 10 5(A), affiliation exists when one individual or entity controls or has the power to control another or a third party or parties controls or has the power to control both. The SBA considers factors such as ownership, management, previous relationships with or ties to another entity, and contractual relationships when determining whether affiliation exists. The SOP requires disclosure of all affiliates and a determination of the effect they may have on meeting the SBA's size standards, and whether the SBA's maximum \$1.5 million guaranty limit has been exceeded. The SOP also requires the lender to retain affiliate and subsidiary financial statements in its loan file.

The SBA did not consider the effect an affiliate, [FOIA ex. 4] , had on the borrowers' repayment ability. The lender disclosed this affiliate and provided its financial information, but the SBA only considered its impact on size and the SBA guaranty percentage, and not on repayment ability. [FOIA ex. 4] 2008 tax return showed a net loss of \$257,538, indicating that it may have had a negative impact on the borrowers' repayment ability if it had been considered.

The principal's 2008 personal tax return, which was submitted to the SBA, showed that he also owned [FOIA ex. 4]. This business, however, was not considered in determining the size, repayment ability, or SBA's guaranty percentage. The personal tax return showed this affiliate had a business loss indicating a possible negative impact on the borrowers' repayment ability.

Additionally, the borrowers received financial and management support from [FOIA ex. 4], which was owned by the principal's father, at no charge. Furthermore, the principal's father provided the \$200,000 required equity injection in the form of debt, which was placed on interest only standby, but the interest payments were ultimately deferred. Also, the borrowers were going to move into office space owned by the principal's father. Based on the above factors, we believe [FOIA ex. 4] should have been considered an affiliate. Nevertheless, [FOIA ex. 4] was not treated as an affiliate and the lender did not provide any financial information. Therefore, its effect on the borrowers' repayment ability, size, and SBA's guaranty percentage could not be determined.

Since this loan was approved by the SBA, this deficiency does not warrant recovery of the guaranty from the lender. However, the SBA should ensure that all SBA loan officers involved in the loan approval and purchase processes understand and implement the steps necessary to identify all affiliates and determine their impact on repayment ability, size, and SBA's guaranty percentage.

Improper Guaranty Amount

The SBA purchased this loan at a higher guaranty percentage than authorized. According to SOP 50 10 5(A), the maximum SBA guaranty amount outstanding to any one business (including affiliates) shall not exceed \$1,500,000. The SBA Policy Notice 5000-1098 specified that the Recovery Act did not change the maximum SBA guaranteed amount of \$1,500,000 and required the guaranty percentage for new loans to be less than 90 percent when necessary to comply with the \$1,500,000 limit.

At the time of loan approval, the SBA identified an outstanding SBA loan to one of the borrowers' affiliates and therefore, appropriately approved this \$1,290,000 loan on September 29, 2009 with a reduced SBA guaranty of 75 percent. The loan, however, was recorded in the SBA's loan accounting system with a 90 percent guaranty and the lender subsequently sold the loan on the secondary market at a 90 percent guaranty. During the post purchase review, the SBA noted the guaranty percentage discrepancy, but believed the purchase at 90 percent was appropriate because the loan was a Recovery Act loan. Furthermore, the SBA's Guaranty Purchase Tracking System required the loan to be purchased at the percentage recorded in the loan accounting system unless the system was updated by the Denver Finance Center. As a result, the SBA incorrectly applied a 90 percent guaranty to the outstanding balance and purchased its principal share from the

secondary market in the amount of \$1,161,000 (90 percent of \$1,290,000), which resulted in a \$193,500 principal overpayment that should be recovered.⁴

CONCLUSION

Based on the above identified deficiencies, this loan resulted in an improper payment of \$967,500 that cannot be recovered and an improper payment of \$193,500 that should be recovered from the lender. Furthermore, the SBA should (1) ensure that all SBA loan officers involved in the loan approval and purchase processes understand and implement the steps necessary to identify all affiliates and determine their impact on repayment ability, size, and SBA's guaranty percentage, and (2) ensure SBA loan officers involved in the purchase process are aware that Recovery Act loans may receive less than a 90 percent guaranty and should be purchased at the percentage reflected in the loan authorization.

⁴ This amount was calculated as follows: (\$1,290,000 multiplied by 90 percent) minus (\$1,290,000 multiplied by 75 percent) equals \$193,500.

APPENDIX IV. [FOIA ex. 4]

The deficiency on this loan resulted in a \$106,802 improper payment that should be recovered. During our ongoing audit of purchased 7(a) Recovery Act loans, we identified a problematic loan ([FOIA ex. 4]) made by Foster Bank (lender) to [FOIA ex. 4] (borrower).

BACKGROUND

On August 24, 2009, the SBA approved a \$1,000,000 transaction-based revolving Export Working Capital loan to renew a \$1,000,000 SBA guaranteed Export Working Capital loan held by Foster Bank. The first loan disbursement after renewal was made on September 16, 2009 and the borrower defaulted approximately 3 months later on December 11, 2009. Therefore, this loan is considered an early default loan in accordance with SBA policy. A purchase review was completed by the SBA and on May 12, 2010, the SBA honored its principal guaranty for \$426,150.

RESULTS**Ineligible Use of Proceeds**

The lender did not take appropriate measures to ensure that the loan proceeds were used as required in the loan authorization. The SBA's SOP 50 10 5(A) states that on a transaction-based revolving line of credit where draws are made against foreign purchase orders or contracts, the advance rate shall not exceed 90 percent of the purchase order/contract or the borrower's costs (including overhead), whichever is less. Furthermore, the loan authorization states that the lender must assure the funds advanced for each transaction do not exceed 90 percent of purchase orders, letters of credit, and outstanding foreign receivables.

Our audit found that the borrower requested more than 90 percent of the amount listed on the letters of credit for 11 of the 15 transactions funded by the line of credit pre and post renewal. For example, on September 16, 2009, the borrower requested funds from the lender in the amount of \$77,400 for the corresponding \$82,080 letter of credit. This loan advance represents 94.3 percent of the letter of credit, which exceeded the 90 percent maximum allowed by the SBA. When all of the draws made against the 11 letters of credit were considered, they exceeded the maximum amount allowed by \$106,802. The outstanding principal balance purchased by the SBA included these transactions, and therefore, we are questioning the entire ineligible amount.

CONCLUSION

Based on the above identified deficiency, this loan resulted in an improper payment of \$106,802 that should be recovered.

APPENDIX V. [FOIA ex. 4]

The deficiency on this loan resulted in a \$763,277 improper payment that cannot be recovered. During our ongoing audit of purchased 7(a) Recovery Act loans, we identified a problematic loan ([FOIA ex. 4]) made by American Bank of Commerce (lender) to [FOIA ex. 4] (borrower).

BACKGROUND

On April 9, 2009, the SBA approved a \$1,350,000 loan to the borrower for working capital and to refinance outstanding debt to multiple creditors. This loan was made under the Standard 7(a) program in which the SBA makes both credit and eligibility determinations. The loan was disbursed on June 22, 2009 and the borrower defaulted approximately six months later on January 1, 2010. Therefore, this loan is considered an early default loan in accordance with SBA policy. A purchase review was completed by the SBA and on August 3, 2010, the SBA honored its principal guaranty for \$769,037. As of April 29, 2011, the SBA's share of the loan balance was \$763,277, which reflected recoveries received after purchase.

RESULTS**Inadequate Assurance of Repayment Ability**

The SBA did not consider the effect the borrower's affiliated business had on repayment ability. In accordance with Title 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. As defined by SOP 50 10 5(A), affiliation exists when one individual or entity controls or has the power to control another or a third party or parties controls or has the power to control both. The SBA considers factors such as ownership, management, previous relationships with or ties to another entity, and contractual relationships when determining whether affiliation exists. The SOP requires disclosure of all affiliates and a determination of the effect any affiliates have on the applicant.

Although the lender reported an affiliate on the eligibility checklist and also made reference to the affiliate in its credit memo, the SBA did not take into consideration the impact this affiliate had on the ultimate repayment ability of the borrower. The SBA's global cash flow analysis only took into account the financial information of the borrower and one of the three guarantors who was ultimately released from the guaranty. This analysis was prepared and approved by SBA loan specialists prior to loan approval. The SBA's global cash flow provided debt service coverage of 1.12, with excess cash available of \$29,000. A December 31, 2007 cash flow statement of the affiliated business provided to

the SBA by the lender showed negative cash available of \$96,479 before consideration of debt service. Furthermore, the affiliate's December 31, 2007 balance sheet reported \$9.3 million of outstanding debt. Although, the SBA did not request 2008 financial information, it appears this affiliated business negatively impacted the repayment ability of the borrower. As a result, if the affiliate's financial information had been considered, this loan may not have been made. Since this loan was approved by the SBA, this deficiency does not warrant any recovery of the purchased guaranty.

CONCLUSION

Based on the above identified deficiency, the SBA should ensure that all SBA loan officers involved in the loan approval and purchase processes understand and implement the steps necessary to identify all affiliates and determine their impact on repayment ability.

APPENDIX VI. AGENCY COMMENTS



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

MEMORANDUM

August 4, 2011

To: Peter L. McClintock
Deputy Inspector General

From: John A. Miller
Director, Office of Financial Program Operations

Subject: Response to Draft Report: "Material Deficiencies Identified in Five 7(A) Recovery Act Loans Resulted in \$2.7 Million of Questioned Costs", Project No. 10508A

Thank you for the opportunity to review the draft report. We appreciate the role the Office of Inspector General (OIG) plays in assisting management in ensuring that these programs are effectively managed.

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Recovery Act") (P.L. 111-5). Section 501 of the Recovery Act authorized SBA to reduce or eliminate certain fees on 7(a) and 504 loans. Section 502 of the Recovery Act authorized SBA to guarantee up to 90 percent of a 7(a) loan except for SBA Express. The loans in this report were made under sections 501 and 502.

The report identifies five early-defaulted loans that OIG believes warrant immediate attention by the agency in order to recover approximately \$1 million of improper payments. OIG states that an additional \$1.7 million cannot be recovered due to deficiencies in the SBA's origination of these loans.

- One loan was purchased from the secondary market in September 2010, but a post purchase review had not been completed by SBA when the draft audit was prepared. A review has since been completed.
- Three loans were purchased from the secondary market and SBA had conducted the post purchase reviews at the time of the audit.

- One loan had received a pre-purchase review prior to the audit, however the guaranty funds cannot be recovered.

Deficiencies identified in the five loans included:

- Inadequate assurance of repayment ability;
- Ineligible use of proceeds;
- Questionable eligibility; and/or
- Improper guaranty amount.

OFPO has been in frequent communication with OIG during this process.

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

1. *Seek recovery of \$506,250 plus interest, from Heritage Oaks Bank on the guaranty paid by SBA for the loan to* [FOIA ex. 4]

OFPO concurs with this recommendation. The primary deficiency for this loan was inadequate assurance of repayment. OFPO recognizes that the lender did not include any financial information on the borrower's two affiliated businesses to determine repayment ability. A post-purchase review had not been conducted prior to the OIG draft report being issued. The Herndon National Guaranty Purchase Center (NGPC) has since conducted a thorough review and concurs with OIG's findings that a full recovery be requested of the lender. The NGPC staff notified the lender of the primary deficiencies found in the review. Absent sufficient mitigating documentation from the lender, OFPO will insist upon full recovery of \$506,250 from the lender by August 12, 2011. If the lender refuses to pay, the loan will be forwarded to HQ for further action.

2. *Seek recovery of \$191,702, plus interest, from First Community Bank on the guaranty paid by SBA for the loan to* [FOIA ex. 4] ***and*** [FOIA ex. 4]

OFPO concurs with this recommendation. The major deficiency for this loan was ineligible use of proceeds. After a thorough review of the case, the Herndon NGPC agrees with OIG's findings that a portion of the loan was used to refinance debt originally used for floor plan financing. Herndon NGPC staff notified the lender in July of SBA's intent for full recovery. The lender responded on August 3, 2011, stating that they do not agree with SBA's findings. Herndon NGPC will forward the loan to HQ for further recovery action.

3. *Seek recovery of \$193,500, plus interest, from Valley Bank on the guaranty paid by SBA for the loan to* [FOIA ex. 4] ***and*** [FOIA ex. 4]

OFPO concurs with this recommendation. The major deficiency for this loan was questionable eligibility and/or an improper guaranty amount. After a thorough review of

the case by the Citrus Heights Standard 7(a) Loan Processing Center and the Herndon NGPC staff, OFPO concurs that the the loan should have been purchased at a 75% guaranty rate instead of 90% and that this should have been caught at the time of post purchase review. OFPO also concurs with OIG's recommendation that affiliates should be considered in the determination of repayment ability. Herndon NGPC staff met with the lender on July 18, 2011, and the lender has agreed to reimburse SBA for the overpaid guaranty percentage pending approval from their board. OFPO will insist upon full repayment by August 15, 2011. If the lender refuses to pay, the loan will be forwarded to HQ for further action.

4. *Seek recovery of \$81,502, plus interest, from Foster Bank on the guaranty paid by SBA for the loan to* [FOIA ex. 4]

OFPO concurs with this recommendation, but has identified a correction to the recovery amount. The major issue involving this loan was ineligible use of proceeds. OFPO recognizes that the borrower requested more than 90 percent of the amount listed on the letters of credit, exceeding the maximum amount allowed. OFPO concurs that the Post Purchase Review should be adjusted to account for this material deficiency. After a thorough review of the case, the repair calculated by NGPC is higher than stated in OIG's finding. The appropriate repair is \$107,603. OIG staff met with NGPC staff on July 19, 2011, and OIG concurs with the revised amount. OFPO requested full repayment by August 15, 2011. If the lender refuses to pay, the loan will be forwarded to HQ for further action.

5. *Ensure all SBA loan officers involved in the loan approval and purchase processes understand and implement the steps necessary to identify all affiliates and determine their impact on repayment ability, size, and SBA guaranty percentage.*

OFPO concurs with this recommendation. Beginning in September, OFPO will conduct training derived from the new guidance being issued in SOP 50-10 5(D) currently in clearance at HQ. Training will be held monthly for Loan Officers, Lead and Supervisory Loan Specialists. Training will continue until all approval and purchase staff have a complete understanding of the steps on how to identify 'affiliates' and determine their impact on repayment ability, size and SBA Guaranty.

6. *Ensure SBA loan officers involved in the purchase process are aware that Recovery Act loans may receive less than a 90 percent guaranty and should be purchased at the percentage reflected in the loan authorization.*

OFPO concurs with this recommendation. All Herndon NGPC purchase staff will begin training on September 14, 2011 and continue monthly as needed. The training will review Recovery Act loan criteria and emphasize that loans made under this program are subject to a reduced guaranty percentage if this criteria is not met. The training will also focus on the reasons that would result in a reduced guaranty percentage.

Again, thank you for the opportunity to review the draft report. Please let us know if you need additional information or have any questions regarding our response.