MATERIAL DEFICIENCIES IDENTIFIED IN EARLY-DEFAULTED AND EARLY-PROBLEM RECOVERY ACT LOANS

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Office of Inspector General
U. S. Small Business Administration

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Memorandum

To: Eric R. Zarnikow
Associate Administrator for Capital Access

Date: September 24, 2010

/s/ Original Signed
From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Report on Material Deficiencies Identified in Early-Defaulted and Early-Problem Recovery Act Loans
ROM 10-19

This report presents the results of our audit of early-defaulted and early-problem 7(a) loans disbursed pursuant to the American Recovery and Reinvestment Act of 2009 (Recovery Act). Early-defaulted loans are those loans that default or are made to businesses that fail within 18 months of final disbursement. Early-problem loans are those loans that experience payment problems prior to final disbursement or within the first 18 months after final disbursement.[1] The Recovery Act provided the Small Business Administration (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, SBA temporarily eliminated the upfront guaranty fees and increased the maximum guaranty percentage to 90 percent for most 7(a) loans.[2]

The audit objectives were to determine (1) whether early-defaulted or early-problem 7(a) Recovery Act loans were originated and closed in accordance with SBA's rules and regulations and commercially prudent lending standards, and (2) if not, whether the noncompliance with SBA requirements or commercially prudent lending standards led to the loan problem, default, or unnecessary losses.

To answer these objectives, we judgmentally selected 39 loans for review from the 65 Recovery Act loans that had been purchased by SBA or placed in liquidation status by lenders as of December 31, 2009. Some of these loans defaulted within

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1 SBA defines payment problems as a pattern of late or partial payments, payments funded through the sale of collateral, or two or more deferments of consecutively scheduled payments. Loans that fund lines of credit are considered (1) early-defaulted when they default or are made to businesses that fail, within 18 months of *initial* disbursement, and (2) early-problem loans when they experience a pattern of late or partial payments, or when monthly payments are funded through the sale of collateral, within 18 months of *initial* disbursement.

2 Under the Recovery Act, the maximum guaranty for SBA*Express* loans remained at 50 percent.

3 months of disbursement. See Appendix I for further details on our sampling methodology and Appendix II for a list of the sampled loans.

We reviewed SBA and lender loan files and interviewed SBA and lender officials as necessary. For all loans examined, we also reviewed information contained in SBA's Loan Accounting System, Guaranty Purchase Tracking System, and the Centralized Loan Chron System. We conducted our audit from January 2010 to May 2010, 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 7(a) loans are made by participating lenders under an agreement to originate, service, and liquidate loans in accordance with SBA's rules and regulations. SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any of the provisions of the regulations or the loan authorization; or does not make, close, service or liquidate the loan in a prudent manner.

As of December 31, 2009, 27 Recovery Act loans had been purchased by SBA and 38 others had been transferred to liquidation status by lenders, indicating early loan default or early payment problems. These 65 loans were approved for nearly $8.2 million and represent 0.2 percent of the 34,040 Recovery Act loans made. As of June 30, 2010, there were a total of 484 early-defaulted or early-problem Recovery Act loans approved for $69,205,600.

Previous Office of Inspector General (OIG) audits identified material lender noncompliance in originating, closing, and servicing early-defaulted loans in accordance with SBA requirements and prudent lending practices, which resulted in an increased risk of loss to SBA.[3] Furthermore, a recent OIG audit of Recovery Act loans also identified material origination and closing deficiencies.[4]

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[3] OIG Report 7-23, *Audit of the Guarantee Purchase Process for Section 7(a) Loans at the National Guaranty Purchase Center*, May 8, 2007; OIG Report 8-18, *Audit of Six SBA Guaranteed Loans*, September 8, 2008; OIG Report 9-16, *The Small Business Administration's Fiscal Year 2008 Improper Payment Rate for the 7(a) Guaranty Loan Program*, July 10, 2009; and OIG Report 9-18, *SBA's Management of the Backlog of Post-Purchase Reviews at the National Guaranty Purchase Center*, August 25, 2009.

[4] OIG ROM 10-03, *Notice of Finding and Recommendation on Recovery Act Loans Involving Change of Ownership Transactions*, December 2, 2009; OIG ROM 10-05, *Notice of Finding and Recommendation on Recovery Act Loans Disbursed Without the Required Borrower Immigration Certifications*, December 10, 2009; OIG ROM 10-11, *Notice of Finding and Recommendation on Ineligible Lender-Approved Recovery Act Loans*, January 22, 2010; and OIG ROM 10-12, *Notice of Finding and Recommendation on Material Origination and Closing Deficiencies Identified in SBA and Lender-Approved Recovery Act Loans*, March 31, 2010.

RESULTS IN BRIEF

The audit identified material deficiencies in 32, or 82 percent, of the 39 early-defaulted or early-problem Recovery Act loans reviewed, which resulted in the disbursement of approximately $5 million to borrowers who could not repay or were ineligible for the loans. Twenty of these loans were made by two lenders that used credit scoring matrices that did not comply with SBA requirements. One of the lenders no longer makes SBA loans, while the other lender, who is still active, was responsible for 18 of the 20 loans. Another 12 loans had repayment ability, equity injection, and/or eligibility deficiencies. We believe that these material deficiencies caused or contributed to the early loan defaults or loan problems. Issuance of these loans that should not have been made prevented other eligible borrowers from receiving Recovery Act loans. As of June 11, 2010, SBA purchased its guaranteed share on 25 of the 32 loans resulting in an SBA loss of $375,259.

In addition to the material deficiencies identified above, our audit also determined that lenders made disbursements without the (1) required immigration certifications, (2) restricted use certifications, and/or (3) Forms 159, *Fee Disclosure Form and Compensation Agreement,* on 28 Recovery Act loans, including 24 of the loans identified above with material deficiencies. Eleven loans with missing immigration certifications were purchased at the higher 90-percent Recovery Act guaranty amount, resulting in a $7,025 loss to SBA. While 10 of these loans also had material deficiencies for which the SBA loss is already being questioned, for one loan, the only deficiency identified was a missing immigration certification. As a result, SBA should obtain the certification for this loan or recover $3,248 from the lender. Finally, our audit identified suspicious activity in 10 loans, which have been referred to our Investigations Division for further review.

In order to address the loan deficiencies, we recommended that SBA: (1) reexamine the credit scoring matrix used by 1 lender that made 18 of the 32 loans with material deficiencies to ensure it complies with SBA requirements; (2) implement a process for providing feedback to SBA employees and lenders when deficiencies are identified; (3) require the lenders to bring the 25 purchased loans with material deficiencies into compliance or recover the $375,259 in SBA guaranties paid; (4) obtain the certification for the loan missing only an immigration certification, or recover $3,248; and (5) flag the other loans that have not yet been purchased to ensure the loan deficiencies are properly addressed at the time of purchase review.

SBA either agreed or proposed actions that were responsive to all of the recommendations.

RESULTS

Material Noncompliance May Have Caused or Contributed to Early Problems, Early Defaults, and Unnecessary SBA Losses

Material origination and closing deficiencies were identified in 32 of the 39 Recovery Act loans reviewed, which were approved for $5.5 million. As of June 11, 2010, 25 of the loans had been purchased by SBA for $375,259. As shown in Table 1 below, 32 loans had creditworthiness/repayment ability and/or equity injection deficiencies. Three of the loans also had eligibility issues. We believe these material deficiencies caused or contributed to the early loan defaults or early problems. To prevent similar instances of noncompliance, SBA should implement a process for providing feedback to SBA employees and lenders when deficiencies are identified. A listing of loans with material deficiencies is provided in Appendix III and a summary of deficiencies by loan is provided in Appendix IV.

Table 1. Material Deficiencies Noted in 32 Loans

Deficiency Type	Number of deficient loans in sample of 39*	Description of Deficiency	Number of loans with deficiencies*	Loan approval amounts allocated to deficiencies**	Number of loans purchased*	SBA loss allocated to deficiencies**
Creditworthiness/ Repayment Ability	30	Credit scoring matrices did not reasonably ensure repayment	20	$230,000	20	$202,344
		Reliance on old financial information	2	$75,000	1	$12,385
		Cash flow not calculated in accordance with SBA requirements or prudent lending standards	4	$2,709,650	0	$0
		Unsupported projections	1	$50,000	0	$0
		Credit decision based on personal credit rather than business credit as required	1	$10,000	1	$5,037
		Lender used global cash flow in violation of internal loan policies	2	$225,000	2	$94,348
Equity Injection	2	Lender did not obtain proper documentation to verify the injection prior to disbursing the loan as required	2	$824,172	0	$0
Eligibility	3	Affiliation not considered in determining eligibility as required	1	$1,002,778	0	$0
		No required business valuation	2	$220,000	1	$0
		Seller did not relinquish 100% control as required	1	$120,500	1	$61,145
TOTALS	**32**		**32**	**$5,467,100**	**25**	**$375,259**

Source: Lender and SBA loan files

* Some loans had multiple deficiencies.

**Dollar values are allocated to each deficiency and do not overlap.

Creditworthiness/Repayment Ability

Our audit identified 30 loans approved for approximately $3.6 million for which lenders and SBA did not properly assess creditworthiness/repayment ability. 13 CFR §120.150 states that the applicant must be creditworthy, and loans must be so sound as to reasonably assure repayment. Standard Operating Procedure (SOP) 50 10 requires lenders to analyze each application in a commercially reasonable manner, consistent with prudent lending standards. If a lender's financial analysis demonstrates that the applicant lacks reasonable repayment ability from the cash flow of the business, the loan request must be declined.

Credit Scoring Matrices

Twenty of the 30 loans were made by 2 lenders that used credit scoring matrices that did not comply with SBA requirements. Eighteen of the loans were attributed to an existing lender, and the remaining loans were made by a lender that no longer makes SBA loans. SBA policy allows the use of business scoring models that reasonably ensure repayment and have been validated as being predictive of loan performance. The scoring matrices used by the two lenders were primarily based on personal information (including home ownership and personal credit reports), and limited business factors (such as business income and age of business), which were not verified. Furthermore, lenders used these matrices to determine the size of the loans to approve for individual borrowers, which resulted in borrowers receiving smaller loans than were requested for 11 of the 20 loans. We also identified borrowers that were approved for loans even though they did not meet the matrix criteria. A recent OIG audit of the Community Express Pilot Program found similar occurrences in approximately half of the loans reviewed.[5] Borrowers made minimal payments on these loans and as a result, they defaulted and ultimately were purchased by SBA for $202,344, or 98 percent of the original SBA guaranty amount.

A July 31, 2009 *Safety and Soundness Review* of one of the two lenders identified [FOIA ex. 8] An SBA official also informed us that the lender's scoring matrix had not been validated for its predictability as required by SBA. Additionally, the lender had a high early-default rate. For example, as of May 31, 2010, the lender had made 7 percent of all Recovery Act loans, yet its loans comprised 29 percent of all Recovery Act loans transferred to liquidation. Furthermore, as of the same date, the lender had made 50 percent of all Community and Patriot Express Recovery Act loans, yet it was responsible for 65 percent of all Community and Patriot Express Recovery Act loans transferred to liquidation.

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[5] OIG Report 10-12, *Assessment of the Community Express Pilot Loan Program*, August 25, 2010.

Repayment Ability

We also found that 10 loans did not have adequate repayment ability due to reliance on old financial information, incorrect cash flow computations, unsupported projections, and reliance solely on personal credit. The following examples illustrate deficiencies identified in these 10 loans:

- Lenders relied on old financial information to conduct credit analyses.

    - One lender used 2007 personal income of $443,110 for a loan approved on April 13, 2009, even though the borrower noted annual income of only $750 on its April 1, 2009 loan application.

    - Another lender approved a loan in April 2009 based on a credit analysis performed on the borrower 8 months earlier, although current financial information showed a business loss of $67,278 and a business net worth of negative $91,200. The credit analysis was based on projections instead of actual data because the lender considered the borrower to be a "new business." However, the borrower had been in business for more than 2 years and new financial information was available. Furthermore, the lender made the loan with the knowledge that the borrower had not made substantial revenue during its time in business.

- Cash flow was miscalculated due to inappropriate adjustments and excluded expenses.

    - Although SBA requires repayment ability to be supported from the cash flow of the business, one lender inappropriately added back $209,000 of personal income and a partner's $29,000 guaranteed payment without explanation. When these items were removed from the cash flow computation, the business did not demonstrate repayment ability.

    - For another loan, SBA did not take into consideration approximately $16,800 of expenses when computing cash flow. When all applicable expenses were used, the debt service coverage was 0.59, indicating the borrower lacked repayment ability.

- Lenders did not use the actual cash flow method when appropriate.

    - For one loan approved for $976,000, a CPA-prepared statement of cash flow included in the lender's loan file demonstrated that the borrower had a cash flow of $24,350, which was insufficient to cover its debt obligations. Instead of using the prepared statement, the lender calculated repayment ability using the rule of thumb method,[6] which resulted in a cash flow estimate that was $402,650 higher than reflected in the CPA's statement. While using the rule of thumb method met SBA requirements in place at the time the loan was made, it was imprudent to ignore a professionally prepared statement and rely solely on a self-prepared rule of thumb computation to support loan approval.

Equity Injection

Our audit disclosed that lenders made two loans without verifying that the required borrower equity was injected into the business. SOP 50 10 states that lenders must verify the equity injection prior to disbursing loan proceeds. Verification of a cash injection requires documentation, such as a copy of a check along with evidence, such as a recent bank statement, showing that the funds were deposited into the borrower's account, or a copy of an escrow settlement statement accompanied by a bank account statement showing that injection into the business was made prior to disbursement. However, as support for $713,000 in equity injection, one lender provided an invoice dated 11 days *after* loan disbursement showing a deposit was made for the equipment to be purchased with loan proceeds. Furthermore, there was no processed check or bank statement to prove the deposit was actually made, and evidence in the loan file showed the equipment vendor was a partial owner of the business, which posed a conflict of interest between the two parties.

Eligibility

We also found that lenders and SBA did not ensure that borrowers on three loans met SBA's eligibility requirements regarding affiliation, business valuation, and seller control. For example, one loan was approved for $120,500 even though the seller did not relinquish control of the business as required. This resulted in business failure, loan default, and a $61,145 loss to SBA.

OTHER MATTERS

Noncompliance With Recovery Act Documentation Requirements

Our audit identified that lenders did not comply with Recovery Act documentation requirements on 18 loans, 14 of which also had material deficiencies. Under the

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[6] The traditional "rule of thumb" method of determining cash flow for the repayment of an SBA loan is to add non-cash expenses, such as depreciation and amortization, to the firm's net profit.

Recovery Act, a guaranty cannot be made for a loan to any entity that hired, recruited or referred for a fee, an unauthorized alien for employment. To implement this requirement, SBA issued Policy Notice 5000-1098, *Implementation of Section 502 of the Recovery Act - Up to a 90 Percent Guaranty on 7(a) Loans,* which requires lenders to obtain certifications from borrowers. However, we determined that lenders did not obtain immigration certifications for 16 of the 18 loans that were required to have them. Eleven loans with missing immigration certifications were purchased at the higher 90-percent Recovery Act guaranty amount,[7] resulting in a $7,025 loss to SBA. While 10 of these loans also had material deficiencies for which the SBA loss is already being questioned, for one loan, the only deficiency identified was a missing immigration certification. As a result, SBA should obtain the certification for this loan or recover $3,248 from the lender. The remaining four loans have not yet been purchased.

We also found that lenders did not obtain restricted use certifications for the two Recovery Act loans required to have them. Under Section 1604 of the Recovery Act, appropriated funds cannot be used by any State or local government or any private entity for a casino or other gambling establishment, aquarium, zoo, golf course, or swimming pool. To implement this requirement, SBA issued Policy Notice 5000-1105, *Recovery Act–Restricted Uses of Funds*, which requires lenders to have the borrower and operating company certify prior to the first disbursement that working capital loan proceeds will not be used for any prohibited use. These two loans have not yet been purchased by SBA.

Recovery Act Loans Were Disbursed Without the Required Form 159

We identified 21 loans for which it appeared lenders had charged packaging fees, without obtaining the required Form 159, *Fee Disclosure Form and Compensation Agreement*. SBA requires completion of a Form 159 if a packager or referral agent has been used or the lender has charged a fee associated with the application. Furthermore, if a lender has paid a referral fee in connection with an SBA*Express* loan, the lender must complete a Form 159. The form is important as it documents the lender's certification that: (1) the services rendered and amounts charged are reasonable and satisfactory; (2) they have no knowledge that any other agent was engaged by, represented, or worked on behalf of the applicant other than in another executed compensation agreement; and (3) referral fees were not charged directly or indirectly to the applicant.

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[7] The 11 loans were purchased prior to changes SBA made to its purchase process in response to a previous OIG Recovery Oversight Memorandum, ROM 10-05, *Recovery Act Loans Disbursed Without the Required Immigration Certifications*, December 10, 2009.

Suspicious Activity Was Identified in Recovery Act Loans

We identified suspicious activity in 10 of the 39 loans we reviewed. These loans have been referred to the OIG Investigations Division.

RECOMMENDATIONS

We recommend that the Associate Administrator for Capital Access:

1. Reexamine the credit scoring matrix used by 1 lender that made 18 of the 32 loans with material deficiencies to ensure it complies with SBA requirements.

2. Implement a process for providing feedback to SBA employees and lenders when deficiencies are identified.

3. For the 25 purchased loans with material deficiencies, require the lenders to bring the loans into compliance or recover the $375,259 in guaranties paid.

4. Obtain the certification for the loan missing only an immigration certification, or recover $3,248 from the lender.

5. Flag the other loans that have not yet been purchased to ensure the loan deficiencies are properly addressed at the time of the purchase review.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On August 13, 2010, we provided a draft of the report to SBA for comment. On September 17, 2010, SBA provided written comments, which are contained in their entirety in Appendix V. SBA either agreed or proposed actions that were responsive to all five recommendations.

Recommendation 1

SBA agreed to reexamine the credit scoring matrix used by the one lender to ensure it complies with SBA requirements. This comment was responsive to recommendation 1.

Recommendation 2

SBA agreed that providing feedback to SBA employees and lenders when deficiencies are identified is an important internal control and stated that the

Quality Assurance Guide being developed includes a feedback and training component for SBA employees. SBA will also evaluate its practices with regard to lenders and will make appropriate adjustments. SBA's comments were responsive to recommendation 2.

Recommendation 3

SBA stated it will review the 25 purchased loans with identified deficiencies and will take appropriate action. This comment was responsive to recommendation 3.

Recommendation 4

Management stated it will review the loan missing only an immigration certification and will take appropriate action. This comment was responsive to recommendation 4.

Recommendation 5

SBA agreed to flag the loans that have not yet been purchased to ensure the loan deficiencies are properly addressed during purchase review if the loans default. SBA's proposed action was responsive to recommendation 5.

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. If you have any questions concerning this report, please call me at (202) 205-[FOIA ex. 2] or Debra Mayer, Director, Recovery Oversight Group, at (202) 205- [FOIA ex. 2]

APPENDIX I. SAMPLING METHODOLOGY

The universe consisted of 65 Recovery Act loans that had been purchased by SBA or placed in liquidation status by lenders as of December 31, 2009. From this universe, we selected a judgmental sample of 39 loans. This included the 27 loans that had been purchased by SBA, the majority of which were Community Express and Patriot Express loans; the 4 largest loans based on gross approval amount; and 8 other loans that were selected based on various judgmental factors. Specifically, we selected one Preferred Lenders Program (PLP) loan that was transferred to liquidation within 2 months after loan approval, two additional loans (one Regular 7(a) and one PLP) due to the limited representation of these loan types in the universe, two SBA*Express* companion loans approved on the same date, and three Patriot Express loans to compare to the other defaulted Patriot Express loans made by different lenders. Of the 39 sampled loans, 15 were Community Express, 8 were Patriot Express, 7 were SBA*Express*, 6 were PLP, and 3 were Regular 7(a).

APPENDIX II. SAMPLED LOANS

#	Loan Number	Loan Name	Loan Type	Deficiency Type (See Legend)	Approved Amount	Deficiency Amount*	Questioned Cost**
1	[FOIA ex. 4]		SBA*Express*	A	$25,000	$12,500	$12,385
2			Patriot Express	A, D	$50,000	$45,000	$0
3			PLP	D	$100,000	$5,000	$3,248
4			Regular 7(a)	A, B, D	$220,000	$198,000	$0
5			PLP	A	$1,345,000	$1,008,750	$0
6			SBA*Express*	A	$75,000	$37,500	$38,147
7			SBA*Express*	A	$150,000	$75,000	$56,201
8			PLP	A, C, D	$976,000	$878,400	$0
9			SBA*Express*	B	$120,500	$60,250	$61,145
10			Community Express	A, D	$5,000	$4,250	$4,232
11			Patriot Express	A, D	$5,000	$4,500	$4,476
12			Patriot Express	A, D	$5,000	$4,500	$4,498
13			Community Express	A, D	$5,000	$4,500	$4,622
14			Community Express	A, D	$5,000	$4,500	$4,631
15			Patriot Express	A, D	$7,500	$6,375	$6,516
16			Community Express	A, D	$7,500	$6,750	$6,770
17			Community Express	A, D	$7,500	$6,750	$6,853
18			Patriot Express	A, D	$10,000	$8,500	$8,445
19			Community Express	A, D	$10,000	$8,500	$8,505
20			Community Express	A, D	$10,000	$9,000	$9,149
21			Community Express	A, D	$10,000	$9,000	$9,245
22			Community Express	A, D	$10,000	$9,000	$9,294
23			Community Express	A, D	$12,500	$10,625	$10,869
24			Community Express	A, D	$12,500	$10,625	$11,114
25			Community Express	A, D	$12,500	$11,250	$11,556
26			Community Express	A, D	$20,000	$17,000	$17,328
27			Patriot Express	A, D	$25,000	$21,250	$21,838
28			Patriot Express	D	$50,000	$2,500	$0
29			Patriot Express	D	$85,800	$4,290	$0
30			Community Express	A, D	$25,000	$21,250	$21,165

* Deficiency amount for those loans with material deficiencies (A, B, C) was calculated as the SBA guaranty share of the loan approval amount. Deficiency amount for those loans with documentation deficiencies (D) only was calculated as the difference between the SBA guaranty share at the higher Recovery rate and the regular SBA guaranty share for the loan type.

**Questioned cost (with interest) does not include adjustments for recoveries received or expenses such as legal fees incurred after purchase.

#	Loan Number	Loan Name	Loan Type	Deficiency Type (See Legend)	Approved Amount	Deficiency Amount*	Questioned Cost**
31	[FOIA ex. 4]		Community Express	A, D	$25,000	$21,250	$21,238
32			SBA*Express*	-	$30,000	$0	$0
33			SBA*Express*	-	$10,000	$0	$0
34			SBA*Express*	A	$10,000	$5,000	$5,037
35			Regular 7(a)	B, C	$1,715,600	$1,286,700	$0
36			PLP	A, D	$50,000	$45,000	$0
37			PLP	A	$500,000	$375,000	$0
38			Regular 7(a)	D	$980,000	$147,000	$0
39			PLP	-	$50,000	$0	$0
	Totals				**$6,772,900**	**$4,385,265**	**$378,507**

* Deficiency amount for those loans with material deficiencies (A, B, C) was calculated as the SBA guaranty share of the loan approval amount. Deficiency amount for those loans with documentation deficiencies (D) only was calculated as the difference between the SBA guaranty share at the higher Recovery rate and the regular SBA guaranty share for the loan type.

**Questioned cost (with interest) does not include adjustments for recoveries received or expenses such as legal fees incurred after purchase.

Deficiency Type Legend:

A. Creditworthiness/Repayment Ability
B. Eligibility
C. Equity Injection
D. Documentation Deficiencies

APPENDIX III. LOANS WITH MATERIAL DEFICIENCIES

#	Loan Number	Loan Name	Loan Type	Deficiency Type (See Legend)	Approved Amount	Deficiency Amount*	Questioned Cost**
1			SBA*Express*	A	$25,000	$12,500	$12,385
2			Patriot Express	A, D	$50,000	$45,000	$0
3			Regular 7(a)	A, B, D	$220,000	$198,000	$0
4			PLP	A	$1,345,000	$1,008,750	$0
5			SBA*Express*	A	$75,000	$37,500	$38,147
6			SBA*Express*	A	$150,000	$75,000	$56,201
7			PLP	A, C, D	$976,000	$878,400	$0
8			SBA*Express*	B	$120,500	$60,250	$61,145
9			Community Express	A, D	$5,000	$4,250	$4,232
10			Patriot Express	A, D	$5,000	$4,500	$4,476
11			Patriot Express	A, D	$5,000	$4,500	$4,498
12			Community Express	A, D	$5,000	$4,500	$4,622
13	[FOIA ex. 4]		Community Express	A, D	$5,000	$4,500	$4,631
14			Patriot Express	A, D	$7,500	$6,375	$6,516
15			Community Express	A, D	$7,500	$6,750	$6,770
16			Community Express	A, D	$7,500	$6,750	$6,853
17			Patriot Express	A, D	$10,000	$8,500	$8,445
18			Community Express	A, D	$10,000	$8,500	$8,505
19			Community Express	A, D	$10,000	$9,000	$9,149
20			Community Express	A, D	$10,000	$9,000	$9,245
21			Community Express	A, D	$10,000	$9,000	$9,294
22			Community Express	A, D	$12,500	$10,625	$10,869
23			Community Express	A, D	$12,500	$10,625	$11,114
24			Community Express	A, D	$12,500	$11,250	$11,556
25			Community Express	A, D	$20,000	$17,000	$17,328
26			Patriot Express	A, D	$25,000	$21,250	$21,838
27			Community Express	A, D	$25,000	$21,250	$21,165

* Deficiency amount for those loans with material deficiencies (A, B, C) was calculated as the SBA guaranty share of the loan approval amount. Deficiency amount for those loans with documentation deficiencies (D) only was calculated as the difference between the SBA guaranty share at the higher Recovery rate and the regular SBA guaranty share for the loan type.

**Questioned cost (with interest) does not include adjustments for recoveries received or expenses such as legal fees incurred after purchase.

#	Loan Number	Loan Name	Loan Type	Deficiency Type (See Legend)	Approved Amount	Deficiency Amount*	Questioned Cost**
28	[FOIA ex. 4]		Community Express	A, D	$25,000	$21,250	$21,238
29			SBA*Express*	A	$10,000	$5,000	$5,037
30			Regular 7(a)	B, C	$1,715,600	$1,286,700	$0
31			PLP	A, D	$50,000	$45,000	$0
32			PLP	A	$500,000	$375,000	$0
	Totals				**$5,467,100**	**$4,226,475**	**$375,259**

* Deficiency amount for those loans with material deficiencies (A, B, C) was calculated as the SBA guaranty share of the loan approval amount. Deficiency amount for those loans with documentation deficiencies (D) only was calculated as the difference between the SBA guaranty share at the higher Recovery rate and the regular SBA guaranty share for the loan type.

**Questioned cost (with interest) does not include adjustments for recoveries received or expenses such as legal fees incurred after purchase.

Deficiency Type Legend:

A. Creditworthiness/Repayment Ability
B. Eligibility
C. Equity Injection
D. Documentation Deficiencies

APPENDIX IV. SUMMARY OF MATERIAL DEFICIENCIES

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

The lender utilized a credit scoring model that considered the borrower's debt service coverage. While the borrower indicated on his April 1, 2009, loan application that his personal gross annual income was $750, the lender used the borrower's 2007 personal annual income in the amount of $443,110 to calculate debt service coverage. The lender verified the 2007 income using a W-2 and the 2007 1040 personal tax return, but did not obtain or verify the borrower's 2008 income, which clearly would have been known and available at the time the loan was approved.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

Despite having IRS tax transcripts for 2008 showing a business loss of $67,278 and calculating a business net worth of ($91,200), the lender approved this loan in April 2009 using a credit analysis made 8 months earlier for prior SBA loans made to the borrower. Notes in the lender's credit analysis model claimed that this was a "new business" and the credit determination was based on projections. The credit memo showed, however, that the business was established in February 2007. Furthermore, the lender made the loan with the knowledge that the borrower had not made substantial revenue during its time in business. There may also be a lender preference issue on this loan as the lender's previous SBA loans were made at a lower SBA guaranty percentage and working capital from this loan may have been used to pay down those loans.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

A business valuation was not completed for this change of ownership transaction. Further, the cash flow was not calculated properly as it did not include all applicable expenses, and the lender did not obtain IRS tax transcripts to support the financial statements used to calculate repayment ability.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

The lender did not compute repayment ability correctly. Although SBA requires repayment ability to be supported from the cash flow of the business, one lender inappropriately added back $209,000 of personal income and a partner's $29,000 guaranteed payment without explanation. When these items were removed from the cash flow computation, the business did not demonstrate repayment ability.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]
Loan Number [FOIA ex. 4]

The lender used global cash flow to calculate repayment ability, which is in violation of its internal loan policy. The business' cash flow alone did not cover the debt service. Furthermore, the lender did not obtain IRS tax transcripts to support the financial information used to calculate repayment ability.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

A CPA-prepared statement of cash flow included in the lender's loan file demonstrated that the borrower did not have repayment ability for this $976,000 loan. It appears that the lender ignored the CPA-prepared statement and instead calculated repayment ability using the rule of thumb method. While using the rule of thumb method met SBA requirements in place at the time the loan was made, it was imprudent to ignore a professionally prepared statement and rely solely on a self-prepared rule of thumb computation to support loan approval.

As support for the required $111,350 equity injection, the lender provided checks that were processed approximately 1 year before the March 27, 2009 loan approval as well as a settlement statement, which was not accompanied by a bank account statement showing the injection into the business.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

The seller did not relinquish control, and the lender did not obtain a business valuation for this change of ownership transaction. Per the sales contract, the purchase would not take effect until the liquor license was transferred from the seller to the buyer. The liquor license, however, was never transferred and instead, the borrower and seller established a "management agreement" under which the seller agreed to transfer the license at an unknown point in the future. Furthermore, the management agreement designated the borrower as an "independent contractor" rather than a buyer and designated all business income as a "management fee" payable to the borrower. The seller's control over the business was demonstrated when the seller shut down the business over a personal disagreement with the borrower.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

The lender approved this SBA*Express* loan based on the borrower's personal credit history and its personal relationship with the bank. The lender did not calculate the cash flow of the business or use a business scoring model consistent with its internal loan policies to determine repayment ability as required by SBA.

The lender's policies for SBA*Express* loans states that it will take into consideration the business' financial statements and calculate historical cash flow coverage.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

The loan authorization required a $713,000 cash injection prior to loan disbursement. As evidence for this equity injection, the lender provided an invoice dated 11 days *after* loan disbursement showing a deposit was made for the equipment to be purchased with loan proceeds. Furthermore, there was no processed check, wire confirmation, or bank statement to prove the deposit was actually made, and evidence in the loan file showed the equipment vendor was a partial owner of the business. Based on the relationship between the borrower and the equipment vendor to whom loan proceeds were to be disbursed, it appears this $1,715,600 loan never should have been made.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

The lender based repayment ability on unsubstantiated cash flow projections. The lender did not provide support for its cash flow projections and acknowledged that the projections had been inaccurate at the time the loan was approved. Furthermore, the lender claimed that the projections would be validated "when the economy improves" and noted that no improvement had taken place so far. Because the lender did not provide an estimation of when improvement might occur, it is unclear how it considered the borrower to have repayment ability and justified loan approval.

[FOIA ex. 4] **Loan Number** [FOIA ex. 4]

For its credit analysis, the lender prepared both actual cash flow and rule of thumb statements. The actual cash flow statement clearly reflected the borrower's inability to repay the loan. Nevertheless, the lender approved the loan relying on the rule of thumb cash flow method for which some of the relied-upon figures could not be verified. Based on financial statements provided in the file for the 9 months ending September 30, 2008, we annualized the figures and calculated debt service coverage of 0.92. Therefore, based on our calculation and the actual cash flow statement in the file, the borrower did not have repayment ability.

We also found that the lender did not consider an affiliate of the borrower in its cash flow computations. A detailed income statement for its affiliate showed a net operating loss of $100,000 and an adjustment to retained earnings of ($385,000) for the 9 months ending September 30, 2008, indicating that the affiliate's financial status would have negatively impacted the borrower's repayment ability.

Superior and Innovative Loans

The credit scoring matrices used to approve these loans did not comply with SBA requirements. They were primarily based on personal information (including home ownership and personal credit reports), and limited business factors (such as business income and age of business), which were not verified. Furthermore, these matrices were used to determine the size of loans the lenders would approve for individual borrowers. As a result, we determined that 11 of the 20 loans were smaller than borrowers requested. We also determined that borrowers were approved for loans even though they did not meet the criteria of the credit scoring matrices. These 20 loans were purchased by SBA for $202,344 or 98 percent of the original SBA guaranty amounts.

APPENDIX V. AGENCY COMMENTS

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

MEMORANDUM

September 17, 2010

TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: Eric R. Zarnikow
Associate Administrator for Capital Access

SUBJ: Management Response to OIG Draft Report on Material Deficiencies Identified in Early-Defaulted and Early-Problem Recovery Act Loans, Project 10502

Thank you for the opportunity to review the subject report. As you know, the Recovery Act authorized increased guarantee percentages and eliminated fees for 7(a) loans. SBA is proud of its record of implementing the Recovery Act in a prudent and expeditious manner in order to support small businesses as part of the economic recovery. We appreciate the role the Office of Inspector General (OIG) plays in assisting management in ensuring that these programs are effectively managed. Management's response to the recommendations included in the draft report is as follows:

1. ***Reexamine the credit scoring matrix used by one lender that made 18 of the 32 loans with material deficiencies to ensure it complies with SBA requirements.***

   SBA agrees with the recommendation.

2. ***Implement a process for providing feedback to SBA employees and lenders when deficiencies are identified.***

   SBA agrees that providing feedback is an important internal control. Providing feedback to SBA employees is an important part of the Office of Capital Access' quality assurance program. The Quality Assurance Guide being developed includes a feedback and training component for SBA employees. SBA will evaluate its practices with regard to lenders and will make appropriate adjustments.

3. ***For the 25 loans purchased with material deficiencies, require the lenders to bring the loans into compliance or recover the $375,259 in guarantees paid.***

   SBA will review the 25 loans identified and will take appropriate action.

4. ***Obtain the certification for the loan missing only an immigration certification or recover $3,248 from the lender.***

   SBA will review the subject loan and will take appropriate action.

5. ***Flag the other loans that have not yet been purchased to ensure the loan deficiencies are properly addressed at the time of the purchase review.***

   SBA agrees with the recommendation and will flag the loans where deficiencies were identified for purchase review if the loans default.

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.