U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

Management Advisory
Report Number: 19-16

DATE: August 14, 2019

TO: Christopher M. Pilkerton
Acting Administrator and General Counsel

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: Office of Inspector General High Risk 7(a) Loan Review Program

This management advisory presents the evaluation results of two 7(a) loans as part of our ongoing High Risk 7(a) Loan Review Program. This is the second in a series of advisories for 7(a) loans we reviewed in fiscal year (FY) 2019. We presented two loans in our first advisory. The remaining loans will be presented in a future report. The objectives of our evaluation were to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with the Small Business Administration's (SBA's) rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

This advisory contains two recommendations that SBA agreed to implement. Please provide us your progress in implementing the recommendations within 90 days.

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.[1] Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures. When a 7(a) loan goes into default and the lender requests guaranty payment, SBA reviews loan documentation to determine whether the lender made, closed, serviced, and liquidated the loan in accordance with prudent lending standards and SBA requirements. Further, when a loan sold on the secondary market defaults and is placed in a liquidation status, either the lender or SBA must purchase the guaranteed portion of the loan from the secondary market investor. After SBA's purchase of the secondary market loan, SBA reviews loan documentation to evaluate the lender's compliance with program rules and regulations. SBA is released from liability on the guaranty, in whole or in part, at the Agency's discretion, if the lender fails to comply with any material SBA loan program requirements.

Previous audits indicated that some lenders failed to comply with SBA loan requirements; therefore, we established the High Risk 7(a) Loan Review Program in FY 2014. This program evaluates lender compliance with SBA requirements for high-dollar/early-defaulted 7(a) loans (loans approved for $500,000 or more that defaulted within the first 18 months of the initial disbursement). We use an internal scoring system to prioritize loans for review based on known

[1] 15 U.S.C. § 636(a).

risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance or suspicious activity by loan participants.

Results

This memorandum includes the results of our review of two 7(a) loans as part of our ongoing High Risk 7(a) Loan Review Program. This is the second in a series of advisories covering the 7(a) loans we selected for review in FY 2019. We reviewed these two high-dollar/early-defaulted 7(a) loans approved by lenders using their delegated authority. SBA honored its guaranty on each loan, resulting in a total purchase amount of $2,100,448. We found that the lenders for both loans did not provide sufficient evidence to support that they originated and closed the loans in accordance with SBA's requirements. Specifically, the lenders did not provide adequate documentation to substantiate reasonable assurance that the borrowers met requirements for eligibility, repayment ability, and equity injection. (See appendixes II and III for details.)

SBA's standard operating procedure (SOP) 50 10 5 states that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. Consequently, the lenders' material noncompliance with SBA requirements while originating and closing the loans resulted in a combined potential loss to SBA of $2,059,132.[2] (See appendix IV for a schedule of questioned costs.)

Recommendations

We recommend that the Administrator require the Director for the Office of Financial Program Operations:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $1,367,417 plus interest on the guaranty paid by SBA.

2. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $691,715 plus interest on the guaranty paid by SBA.

Analysis of Agency Response

SBA management agreed with both recommendations, stating that they conducted a preliminary review, and absent additional information from the lenders, deficiencies appear to exist. SBA will work with the lenders to obtain documentation to bring the loans into compliance. If the issues are not overcome, SBA will seek recovery from the lenders. Management's planned corrective actions are sufficient to address the recommendations. (See appendix V for SBA management's formal comments, which are included in their entirety.)

Summary of Actions Necessary to Close the Recommendations

The following provides the status of the recommendations and the necessary actions to close them.

1. **Resolved.** Management will contact the lender to obtain additional information to bring the loan into compliance. They stated if the issues are not overcome, SBA will seek recovery from the lender. This recommendation can be closed when SBA provides evidence that the

[2] Proceeds from the liquidation process after purchase reduced SBA's loss on one of these two loans. Additional proceeds from the liquidation process could further reduce this amount.

lender provided information to mitigate the finding or that SBA recovered the appropriate amount from the lender.

2. **Resolved.** Management will contact the lender to obtain additional information to bring the loan into compliance. They stated if the issues are not overcome, SBA will seek recovery from the lender. This recommendation can be closed when SBA provides evidence that the lender provided information to mitigate the finding or that SBA recovered the appropriate amount from the lender.

We appreciate the courtesies and cooperation extended to us during this evaluation. If you have any questions, please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616.

cc: William M. Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Jihoon Kim, Director, Office of Financial Program Operations
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Dorrice Roth, Acting Chief Financial Officer and Associate Administrator for Performance Management
LaNae Twite, Director, Office of Internal Controls

Appendix I: Objectives, Scope, and Methodology

This management advisory presents the results of our evaluation of two loans, as part of our ongoing High Risk 7(a) Loan Review Program. This is the second in a series of advisories covering a total of eight loans we selected for review in FY 2019. We presented two loans in our first advisory. We are completing the review of the remaining four loans, and the results will be presented in a future report. Our objectives were to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

To accomplish our objectives, we used an internal loan scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance or suspicious activity by loan participants. These attributes include, but are not limited to, the time lapse between loan approval and its transfer to liquidation, loan amount, equity injection, loan packager involvement, and use of loan proceeds. We obtained a universe of 190 high-dollar/early-defaulted 7(a) loans that were approved by lenders under the Preferred Lenders Program. Under this program, lenders are delegated the authority to process, close, service, and liquidate most SBA-guaranteed loans without prior SBA review. SBA honored its guaranty on these loans between October 1, 2015, and September 30, 2018. We eliminated loans for which SBA had not completed a purchase review. We then selected eight loans based on their assigned score and considered other factors, such as the outstanding balance and the period to default. The outcome of our review on two of these loans is included in this management advisory.

We also reviewed origination and closing actions as documented in SBA loan files. We assessed these actions against all applicable SBA requirements and reviewed information in SBA's loan accounting system for all loans examined.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's quality standards for inspection and evaluation. These standards require that we adequately plan inspections, present all factual data accurately, fairly, and objectively, and that we present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objectives.

Use of Computer-Processed Data

We relied on information from SBA's loan accounting system to score loans using an internal scoring system developed by OIG. Previous OIG engagements have verified that the information maintained in this system is reasonably reliable. Further, data elements associated with reviewed loans were verified against source documentation maintained in SBA's purchased loan files. As a result, we believe the information is reliable for the purposes of this program.

Appendix II: Evaluation of a $2,355,000 7(a) Loan Used to Purchase Equipment, Purchase Fixtures, Finance Leasehold Improvements, and Provide Working Capital

Background

We reviewed a $2,355,000 early-defaulted loan approved by a lender under its delegated authority for purchasing equipment, purchasing fixtures, financing leasehold improvements, and providing working capital. The borrower made 11 loan payments before defaulting on the loan. SBA honored its guaranty and purchased the loan for $1,367,417.

Results

We identified material lender noncompliance with SBA's loan origination and closing requirements. Specifically, the lender inappropriately used its delegated authority and did not adequately assess the borrower's eligibility. Also, the lender did not provide adequate assurance of the borrower's repayment ability or verify the source of the equity injection in accordance with SBA requirements.

Inappropriate Use of Delegated Authority

SOP 50 10 5(E) states that a lender may not knowingly submit a loan guaranty request under delegated authority after the applicant has already submitted a request from a different lender.[3] However, the lender approved the loan knowing the borrower already had an existing approval from another lender. Further, in order to approve the loan, the lender reduced the loan amount to stay within SBA's maximum guaranty threshold. Due to the outstanding obligation between the borrower and another lender, this loan should not have been approved.

Inadequate Assessment of Borrower's Eligibility

SOP 50 10 5(E) states that the applicant business alone (without affiliates) must not exceed the size standard for the industry in which the applicant is primarily engaged and the applicant business combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is higher. 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. SBA considers factors such as ownership, management, previous relationships with or ties to another entity, and contractual relationships when determining whether affiliation exists.[4]

According to the credit memorandum, an affiliate of the borrower advanced funds to establish an overseas company for the purpose of assisting the borrower with development of medical referrals to hospitals and specialists in Japan. However, the lender did not consider the overseas company in the borrower's size determination. Based on our review, the lender did not adequately determine if the applicant business combined with its affiliates met the size standard.

[3] SOP 50 10 5(E), Lender and Development Company Loan Programs, June 1, 2012, Subpart A, Chapter 1, Section IV.B.6.c.
[4] SOP 50 10 5(E), Lender and Development Company Loan Programs, June 1, 2012, Subpart B, Chapter 2, Section III.B.

Inadequate Assurance of Repayment Ability

SOP 50 10 5(E) states that the cash flow of the small business applicant is the primary source of repayment, not the liquidation of collateral. If the lender's financial analysis demonstrates that the small business applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available.[5] Further, the lender's credit memorandum must include an analysis of the reasonableness of the assumptions supporting the projected cash flow. It must also include a ratio analysis of the financial statements including comments on any trends and a comparison with industry averages.[6] Also, the lender's analysis must include the effect any affiliates may have on the ultimate repayment ability of the applicant.[7]

The borrower's business plan was to establish a medical imaging center inside a hospital that was planning to privatize its imaging services. However, the hospital decided against the outsourcing of services, so the borrower was not able to secure a contract to operate within the hospital. Although the borrower used the loan proceeds to establish a medical imaging center outside the hospital, the lender used projections that were based on financials from the hospital. We did not find evidence that these projections, which assumed a large market share of hospital patients using the borrower's services, were supported by a contract.

Further, 4 months after the initial loan disbursement, the lender noted the addition of a contracted medical doctor into the imaging center to fulfill the requirement for accreditation by the American College of Radiology and Medicare. The lender modified its projections to incorporate the contracted doctor and an in-house pharmacy into the medical imaging center. However, we did not find evidence of the borrower's contract with the doctor.

As noted above, an affiliate of the borrower established an overseas company for the purpose of assisting the borrower with development of medical referrals to hospitals and specialists in Japan. However, the lender did not consider the effect of this overseas affiliate on the borrower's repayment ability.

The loan file did not contain financial statements or a ratio analysis to support the original and revised projections. Also, we did not find contracts with the hospital and medical doctor to support projected revenue and expenses. Since lower-than-anticipated revenues contributed to the business failure, it is imperative that such analysis be included in the loan file. Without additional justification to support the projections or consideration of all affiliates, the lender did not adequately show reasonable assurance of the borrower's repayment ability.

Inadequate Support for Equity Injection

SOP 50 10 5(E) states that adequate equity is important to ensure the long-term survival of a business. The lender must determine if the equity injection and the pro forma debt-to-worth are acceptable based on the factors related to that type of business, experience of the management, and the level of competition in the market area. Further, subject to one limited exception, the equity injection cannot be borrowed funds.[8] It also states that lenders must verify the equity injection prior to disbursing loan proceeds and maintain evidence of such verification in the loan files. Lenders are expected to use reasonable and prudent efforts to verify that equity is injected and

[5] SOP 50 10 5(E), Lender and Development Company Loan Programs, June 1, 2012, Subpart B, Chapter 4, Section I.A.
[6] SOP 50 10 5(E), Lender and Development Company Loan Programs, June 1, 2012, Subpart B, Chapter 4, Section I.A.1.f.
[7] SOP 50 10 5(E), Lender and Development Company Loan Programs, June 1, 2012, Subpart B, Chapter 4, Section I.A.1.i.
[8] SOP 50 10 5(E), Lender and Development Company Loan Programs, June 1, 2012, Subpart B, Chapter 4, Section I.B.

used as intended. Verifying a cash injection requires a copy of a check or wire transfer along with evidence showing the funds were moved into the borrower's account, a copy of the statements for the account from which the funds were withdrawn for the 2 months prior to disbursement showing that the funds were available, and an escrow settlement statement showing the use of the cash or a subsequent statement of the borrower's account showing that the funds were deposited.[9]

According to the loan authorization, the borrower was required to make an equity injection of $162,676 to purchase equipment. Ultimately, the lender provided documentation that the borrower injected $164,353. However, only $64,685 was related to the purchase of equipment. The lender's loan documentation showed that the remaining $99,668 was not used as intended, but was instead used for salaries, taxes, travel, and other miscellaneous expenses dating back almost 4 years prior to loan approval.

Further, $61,953 of the injection was paid by the borrower; however, the borrower was non-income producing since inception. While the loan file included the borrower's bank statements, we did not find sufficient evidence for the source of the deposits made into the related accounts. In addition, $97,173 of $164,353, or 59 percent, was provided by an affiliate, but according to the credit memorandum, this injection was expected to be repaid. Based on our review, the lender did not adequately support the intended use and source of the required equity injection.

Conclusion

Our evaluation found that the lender inappropriately used its delegated authority to approve the loan. Further, the lender did not provide sufficient evidence in the loan file to support that it conducted an adequate analysis to ensure the borrower met SBA requirements for eligibility, repayment ability, and equity injection. As a result, the lender did not comply with material SBA requirements related to the origination and closing of the loan. Due to lender noncompliance with SBA requirements, SBA should require the lender to bring the loan into compliance or, if not possible, seek recovery of $1,367,417 plus interest on the guaranty paid by SBA.[10]

[9] SOP 50 10 5(E), Lender and Development Company Loan Programs, June 1, 2012, Subpart B, Chapter 4, Section I.B.3.a.
[10] Proceeds from the liquidation process may further reduce this amount.

Appendix III: Evaluation of a $975,000 7(a) Loan Used to Purchase Land and Improvements, Purchase a Business, Purchase Inventory, and Provide Working Capital

Background

We reviewed a $975,000 early-defaulted loan approved by a lender under its delegated authority to finance the purchase of land and improvements, purchase a business, purchase inventory, and provide working capital. The borrower made 13 loan payments before defaulting on the loan. SBA honored its guaranty and purchased the loan from the secondary market for $733,031. However, SBA's share of the balance was reduced to $691,715 due to recoveries during liquidation.

Results

We identified material lender noncompliance with SBA's loan closing requirements. Specifically, the lender did not adequately support the source of the equity injection.

Inadequate Support for Equity Injection

SOP 50 10 5(H) states that adequate equity is important to ensure the long-term survival of a business. The lender must determine if the equity injection and the pro forma debt-to-worth are acceptable based on the factors related to that type of business, experience of the management, and the level of competition in the market area. [11] It also states that the source of the injected equity must not be cash that is borrowed unless the small business applicant can demonstrate repayment of the personal loan from sources other than the cash flow of the business.[12]

Additionally, lenders must verify the equity injection prior to disbursing loan proceeds and must maintain evidence of such verification in the loan files.[13] Verifying a cash injection requires a copy of a check or wire transfer along with evidence showing the funds were moved into the borrower's account, a copy of the statements for the account from which the funds were withdrawn for the 2 months prior to disbursement showing that the funds were available, and a statement of the borrower's account showing that funds were deposited or a copy of an escrow settlement statement showing the use of the cash.[14]

The loan authorization required a cash injection of at least $230,000. In its credit memorandum, the lender stated the source of the injection would be funds from the sale of a business previously owned by the guarantors. The credit memorandum also indicated the guarantors had a fully drawn home equity line of credit in the amount of $200,000 with another bank. The lender's file contained bank statements from this bank for a new account showing a sufficient balance to support the injection prior to disbursement. However, the lender did not fully document the source of the injection or support that the funds were not borrowed. Specifically, the sale of the prior business took place almost 2 years prior to the opening date of the new account, and the lender's file did not have support that the funds came from that sale. In addition, we did not find evidence that the guarantors had an outside source of income to support the home equity line of credit making it prudent for the lender to demonstrate the borrowed funds were not used as equity injection. Based on our review, the lender did not adequately support the source of the equity injection.

[11] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Subpart B, Chapter 4, Section I.E.1.
[12] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Subpart B, Chapter 4, Section I.E.2.a.
[13] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Subpart B, Chapter 4, Section I.E.
[14] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Subpart B, Chapter 4, Section I.E.3.a.

Conclusion

Our evaluation found that the lender did not provide sufficient evidence in the loan file to support that the borrower met SBA requirements for equity injection. As a result, the lender did not comply with material SBA requirements related to the closing of the loan. Due to lender noncompliance with SBA requirements, SBA should require the lender to bring the loan into compliance or, if not possible, seek recovery of $691,715 plus interest on the guaranty paid by SBA.[15]

[15] Proceeds from the liquidation process may further reduce this amount.

Appendix IV: Questioned Costs

Questioned Costs for OIG High Risk 7(a) Loan Review Sample

Sample	Approval Amount	Purchased Amount	OIG Questioned Costs
1	$2,355,000	$1,367,417	$1,367,417
2	$975,000	$733,031	$691,715
Totals	$3,330,000	$2,100,448	$2,059,132

Source: Generated from evaluation results.

SBA

OFFICE OF FINANCIAL PROGRAM OPERATIONS

RESPONSE TO EVALUATION REPORT

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

TO:	Hannibal M. Ware, Inspector General Office of Inspector General (OIG)
FROM:	Jihoon Kim Director, Office of Financial Program Operations
SUBJECT:	Response to Draft Report on General High Risk 7(a) Loan Review Program
DATE:	August 2, 2019

We appreciate the role the Office of Inspector General (OIG) plays in working with management in ensuring that our programs are effectively managed, and for the feedback provided in this draft report.

The 2019 draft report lists the OIG's evaluation results of two 7(a) loans as part of the OIG's ongoing High Risk 7(a) Loan Review Program. The OIG's purpose was to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with the Small Business Administration's (SBA's) rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders. The OIG determined that lenders for both loans did not provide sufficient evidence to support that they originated and closed the loans in accordance with SBA's requirements. Specifically, the lenders did not provide adequate documentation to substantiate reasonable assurance that the borrowers met requirements for eligibility, repayment ability, and equity injections.

OIG made the following recommendations:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $1,367,417 plus interest on the guaranty paid by SBA; and,
2. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $691,715 plus interest on the guaranty paid by SBA.

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

Management acknowledges the recommendations listed in the report. After conducting a preliminary review, and absent additional information from the lender, deficiencies appear to exist. OFPO will notify the lenders and work with the lenders to obtain documentation to bring the loans into compliance. If the issues are not overcome, SBA will seek recovery from the lenders.