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

Management Advisory Memorandum
Report No. 16-08

DATE: January 7, 2016

TO: Jihoon Kim
Acting Director, Office of Financial Program Operations

/s/
FROM: Troy M. Meyer
Assistant Inspector General for Audit

SUBJECT: [FOIA Ex. 4]

This management advisory memorandum relates to our Office of Inspector General (OIG) High-Risk 7(a) Loan Review Program and is intended to provide the Small Business Administration (SBA) with early notification of issues identified as part of our review. The objectives for this program are to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with SBA's rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovering guaranteed payments made to lenders.[1]

This memorandum includes one recommendation that SBA agreed to implement. This recommendation can be closed upon SBA providing evidence that it has recovered the recommended amount from the lender. Please provide us within 90 days your progress in implementing the recommendation.

Background

The purpose of this memorandum is to inform you of issues we identified during our ongoing review of high-dollar/early-defaulted (HD/ED) 7(a) loans purchased by the National Guaranty Purchase Center (NGPC). As part of this review, we selected HD/ED loans using a scoring system we developed to prioritize loans based on the risk of loss to SBA. We also considered other factors, such as the outstanding balance of the loan, the period to default, and whether SBA had completed all purchase review actions during the selection process.

As part of the Preferred Lender Program (PLP), SBA authorized the lender, Santander Bank (formerly Sovereign Bank, N.A), to process, close, service, and liquidate SBA-guaranteed loans with limited review by SBA.

On September 5, 2013, the lender approved [FOIA Ex. 4] for $1.3 million with a 75 percent guaranty, to finance [FOIA Ex. 4] acquisition of [FOIA Ex. 4] entered into an agreement to acquire [FOIA Ex. 4] for $1.8 million. The purchase of

[1] Appendix I describes our scope and methodology.

the business was funded by the $1.3 million SBA loan and a $500,000 equity injection. Proceeds for this change of ownership transaction were disbursed on September 26, 2013. However, after making only seven loan payments, the borrower, [FOIA Ex. 4] defaulted on May 24, 2014. SBA purchased the outstanding balance of the loan on November 19, 2014, for $903,297, and the loan was charged off for $889,814 (SBA's share) on December 2, 2014.

Results

The lender did not provide sufficient information to support that it approved the loan in accordance with SBA's origination and closing requirements. Specifically, the lender did not inspect or adequately value the significant fixed assets for this limousine and transportation service business, resulting in increased losses to SBA. As a result, a repair to the guarantee payment in the amount of $299,318 is appropriate to cure the lender's material deficiencies on this loan.[2]

[FOIA Ex. 4] entered into an agreement to acquire [FOIA Ex. 4] for $1.8 million: $1.6 million for fixed assets and $200,000 for goodwill.[3] The lender's loan authorization stated that the $1.3 million loan included $0 for the purchase of intangible assets (i.e. goodwill); thus, the full amount of SBA's loan was for the purchase of fixed assets and the borrower's equity injection financed any goodwill.

We determined that the lender inappropriately relied on a third party business valuation and information provided by the seller to complete this transaction. Further, there was no evidence in the loan files that the lender obtained a fixed asset appraisal or conducted a site visit to confirm the condition of the assets, as required. SBA procedures state that if the valuation of fixed assets is greater than their depreciated value (net book value), the lender must obtain an independent appraisal by a qualified individual to support the higher valuation. In addition, SBA procedures require the lender to conduct a site visit to inspect the assets being acquired and document its comments in the loan file.[4]

As required by SBA, the lender obtained an independent business valuation from a qualified source. While the business valuation assigned a value of approximately $1 million to the fixed assets (of which, the majority were vehicles used in the business), it did not determine the actual worth of fixed assets. In fact, this same business valuation report stated that the valuation was based on historical and prospective financial information provided by management and/or third parties. It also stated an appraisal of the fixed assets may result in a market value that is materially different than the book value of the fixed assets, which may have a material effect on the calculation of intangible assets.

In addition to this individual business valuation, the lender should have also obtained an independent appraisal of the fixed assets to determine their value and verify the business valuation was accurate. This is particularly important considering the limitations that the third-party expressed in the valuation above. Further, the seller's financial statements used in the business valuation did not include any accumulated depreciation for the fixed assets. According to the Internal Revenue Service (IRS), depreciation is an income tax deduction that allows a taxpayer to

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[2] Per SBA procedures, a repair is an agreement between SBA and a 7(a) Lender as to a specific dollar amount that will be deducted from the amount SBA pays on the Lender's SBA loan guaranty in order to fully compensate SBA for an actual or anticipated loss on the loan caused by the Lender's actions or omissions.
[3] According to the IRS, goodwill is the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor.
[4] Standard Operating Procedures (SOP) 50 10 5(E), *Lender and Development Company Loan Programs* (June 1, 2012).

recover the cost or other basis of certain property. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property. Because most of the vehicles and other fixed assets were at least four years old, depreciation of these assets should have been recorded.[5] As a result, the seller's financial statements were unreliable and the lender should have taken further measures to evaluate the condition and market value of these assets.

Similarly, information the lender relied upon to approve the loan further supported that the vehicles' book values did not reflect their true market values.[6] Specifically, documents in the loan file showed that many of the aged vehicles also had high mileage. For example, one vehicle was manufactured in 2003 (Lincoln Towncar) and had approximately 250,000 miles reflected on its 2012 title. These assets served as the primary collateral to reduce SBA's exposure in the event of loan default. A site visit and inspection of the vehicles could have provided further insight into determining the actual worth of the limousine business' fixed assets and overall worth of the business. In addition, the lender did not justify the value for the other fixed assets purchased with SBA loan proceeds. Notably, the value of the remaining fixed assets provided in the purchase agreement was only $58,395, while the lender's credit memorandum valued these assets at $431,116 without any additional support or explanation.

As previously stated, the borrower only made seven payments against the SBA loan before defaulting on May 24, 2014. A post-default appraisal valued the fixed assets of the business, which included 28 vehicles, at less than $57,000.[7] The lender allowed the borrower to sell the assets to a third party for $56,000 on September 17, 2014 and did not explain the significant decrease in the value of the assets. Table 1 below provides a comparison of the origination value used by the lender to the liquidation value of the assets.

Table 1. Value of Fixed Assets

Asset Description	Market Value as of May 2013	Liquidation Value as of August 2014
Vehicles	$575,884	$53,400
Dispatch System	$192,760	$500
Office Furniture/Tools	$119,347	$1,520
Car Parts	$119,009	$1,250
Totals	$1,007,000	$56,670

Source: SBA and Lender Loan Files

SBA requirements state that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards.[8] In addition, SBA will not purchase the guaranteed portion of a loan when a lender does not provide sufficient credible evidence to support it made the loan in accordance with SBA loan program requirements and prudent lending practices.[9] In accordance with SBA requirements and prudent lending standards, the lender should have conducted a site visit and obtained an asset appraisal to ensure that the business valuation was appropriate. SBA is released from liability on the guaranty (in whole or in part) if the lender fails to comply with any material SBA loan program requirement; failed to make, close, service, or

[5] According to IRS standards, the estimated useful life of automobiles is 3 to 5 years.

[6] According to the IRS, book value is the net amount at which an asset or group of assets is carried on the books of account. It equals the gross amount of any asset minus any depreciation, amortization, or impairment costs made against the asset. The fair market value is the price at which property would change hands between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of relevant facts.

[7] The lender obtained this post-default appraisal in August 2014.

[8] SOP 50 10 5(E), *Lender and Development Company Loan Programs* (June 1, 2012).

[9] SOP 50 57, *7(a) Loan Servicing and Liquidation* (March 1, 2013).

liquidate a loan in a prudent manner; or the lender's improper action or inaction has placed SBA at risk.[10] Consequently, the lender's material noncompliance with SBA requirements on this loan resulted in an increased risk and subsequent loss to SBA. Using the unsubstantiated values of the fixed assets at origination (shown in Table 1) and the forced sale equivalent rates (liquidation values) previously recommended by SBA, we determined that the lender's negligence increased SBA's loss on the subject loan by $299,318.[11]

Recommendation

We recommended that the Director of the Office of Financial Program Operations:

1. Require Santander Bank to bring the loan into compliance and, if not possible, seek recovery of $299,318 from Santander Bank on the guaranty paid by SBA for the loan to [FOIA Ex. 4] [FOIA Ex. 4]

Management's Response

Please indicate your response by checking the appropriate box below and providing the appropriate supporting documentation to the OIG within 30 days from the date of this memorandum.

☒ Management substantially concurs with the memorandum and recommendation.

☐ Management does not concur with the memorandum and recommendation. Please give reasons for management's non-concurrence.

<u>Explanation of proposed action and target date for final action</u>:

After a thorough review, with no additional documentation submitted by the lender, OFPO concurs with the recommendation to recover funds from the lender. The lender has been notified and the loan has been forwarded to HQ for denial review process.

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Please contact us if you would like to discuss this memorandum or any related issues.

[10] Title 13 Code of Federal Regulations Part 120.524, Business Credit and Assistance.
[11] This amount was calculated using the asset market values at origination and SBA liquidation values as follows: (($887,653 multiplied by 50 percent) plus ($119,347 multiplied by 10 percent)) minus ($56,670 to deduct proceeds from the sale of the collateral) multiplied by SBA's 75 percent guaranty equals $299,318.

Appendix I: Scope and Methodology

This memorandum presents the results of our review of [FOIA Ex. 4] [FOIA Ex. 4] as part of our ongoing High-Risk 7(a) Loan Review Program. Our objectives for this program are to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with SBA's rules, regulations, policies, and procedures and (2) material deficiencies exist that warrant recovering guaranteed payments made to lenders. To answer the objectives, we reviewed origination and closing actions as documented in SBA and lender loan files. We assessed these actions against all applicable SBA requirements. We also reviewed information in SBA's Loan Accounting System.

We used an internally developed and evolving OIG 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 and 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 the use of loan proceeds.

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 Mainframe 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 to 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.