AUDIT REPORT

EARLY-DEFAULTED HURRICANE SANDY DISASTER LOANS

August 15, 2016

Report Number 16-18

EXECUTIVE SUMMARY

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What OIG Reviewed

We reviewed the Small Business Administration's (SBA) performance in mitigating the risks of Hurricane Sandy disaster loans from defaulting early (within 18 months of disbursement). Our audit focused on loans that defaulted early, as these loans could identify areas of the underwriting process that may need improvement.

Our objectives were to determine the extent to which the Office of Disaster Assistance (ODA) complied with SBA and Federal guidelines over eligibility, creditworthiness, and repayment ability; and mitigated the risk of Hurricane Sandy loans defaulting early.

We statistically sampled and reviewed 21 early-defaulted Hurricane Sandy loans totaling $603,700.

What OIG Found

We determined that the overall early default rate on Hurricane Sandy loans was relatively low when compared to loans made for other disasters. However, we found that in 17 of the 21 loans we reviewed, ODA approved loans without verifying borrowers' eligibility, or approved loans to borrowers who generally lacked creditworthiness or repayment ability. Due to the significance of the errors in the areas of creditworthiness and repayment ability, we projected our results to the universe of early-defaulted loans. As a result, we estimated that at least 361 of the 501 early-defaulted loans, totaling $4.3 million were not approved in accordance with SBA and/or Federal requirements. Borrower creditworthiness was the most prevalent area of concern we noted on the early-defaulted loans. In the majority of loans we reviewed, SBA approved loans to borrowers with unsatisfactory credit histories. Additionally, we determined that while ODA routinely analyzed disaster loan portfolio risks, improvements could be made to reduce the rate of early defaults.

OIG Recommendations

We provide five recommendations to improve SBA's performance in mitigating the risk of disaster loans from defaulting early. These recommendations include clarifying guidance pertaining to borrower creditworthiness; providing training to employees related to our findings in the areas of creditworthiness, repayment ability, and eligibility; and improving existing portfolio risk analyses.

Agency Response

SBA management asserted that the release of SOP 50 30 8, in July 2015, addressed each of our findings and recommendations. Our audit took the revised SOP into careful consideration and acknowledged it as an improvement over previous guidance. However, the revised SOP does not resolve any of the findings or sufficiently address the recommendations made in this report. Therefore, the overall report is unresolved.

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

Final Report Transmittal
Report Number: 16-18

DATE: August 15, 2016

TO: Maria Contreras-Sweet
Administrator

James Rivera
Associate Administrator
Office of Disaster Assistance

FROM: Troy M. Meyer
Assistant Inspector General for Auditing

SUBJECT: *Early-Defaulted Hurricane Sandy Disaster Loans*

This report presents the results of our audit of the Small Business Administration's (SBA) Oversight of the Disaster Assistance Program. The objective of our audit was to determine the extent to which ODA complied with SBA and Federal guidelines over loan applicant eligibility, creditworthiness, and repayment ability; and mitigated the risk of Hurricane Sandy loans defaulting early. We previously furnished copies of the draft report and requested written comments on the recommendations. SBA management's comments are appended and were considered in finalizing the report. Based on SBA's response, the overall report is unresolved.

Please contact me if you would like to discuss this report or any related issues.

cc: Nick Maduros, Chief of Staff
Melvin F. Williams, Jr., General Counsel
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Tami Perriello, Associate Administrator for Performance Management and Chief Financial Officer
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Introduction

The Small Business Administration's (SBA) Office of Disaster Assistance (ODA) provides financial assistance in the form of low-interest Government loans to help homeowners, renters, and businesses throughout the United States affected by natural disasters. Hurricane Sandy, which struck the East Coast on October 29, 2012, caused approximately $67 billion in damage in the United States. It was the nation's most costly storm since Hurricane Katrina, which caused $128 billion in damage.[1]

As of November 2013, SBA had approved and funded 36,666 disaster home and business loans, totaling $2.6 billion, to applicants as a result of the storm.[2] Home loans are issued to disaster survivors to repair or replace damaged real estate or personal property. Disaster business loans and economic injury disaster loans (EIDL) are intended to repair or replace real and personal business property and pay operating expenses as a result of a disaster. Approximately 47 percent of the approved and funded home and business loans were ultimately cancelled-in-full prior to disbursement by request from the applicants. As a result of these cancellations and subsequent reductions of other loans, the total approval amount was reduced to 19,295 loans, totaling approximately $758 million, as shown in Table 1.

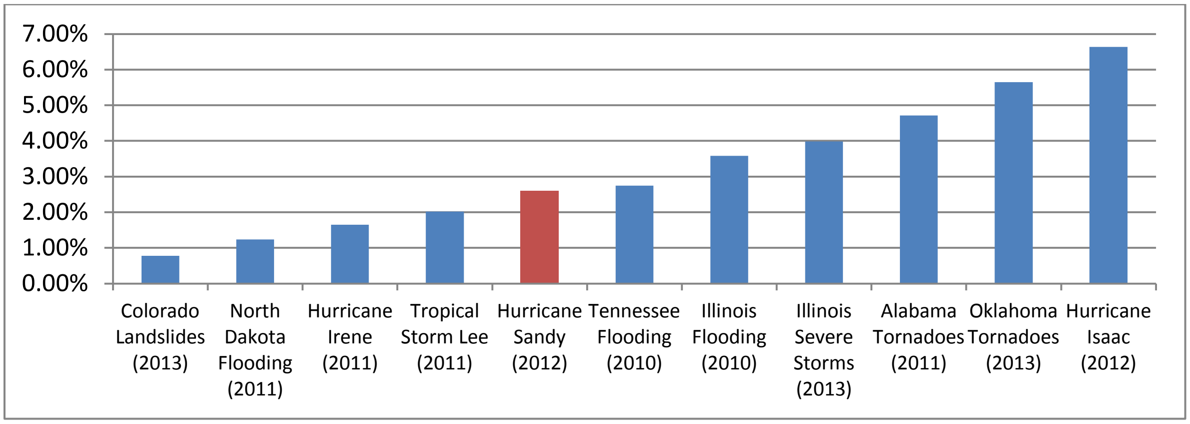
Table 1: Hurricane Sandy Approvals and Disbursements

	Home		Business/EIDL		Total	
Approvals	32,542	$2,111,369,190	4,124	$518,583,100	36,666	$2,629,952,290
Disbursements	17,092	$561,069,277	2,203	$196,841,692	19,295	$757,910,969

As of April 30, 2015, 501 Hurricane Sandy loans (2.6 percent), totaling $9.5 million, had defaulted early, within 18 months of the loan's initial disbursement and had been charged-off by SBA.[3] While Hurricane Sandy's 2.6 percent early default rate is relatively low compared to other recent disasters (See Figure 1), early-defaulted loans can represent poor loan approval decisions and may affect program performance and increase the risk for losses.

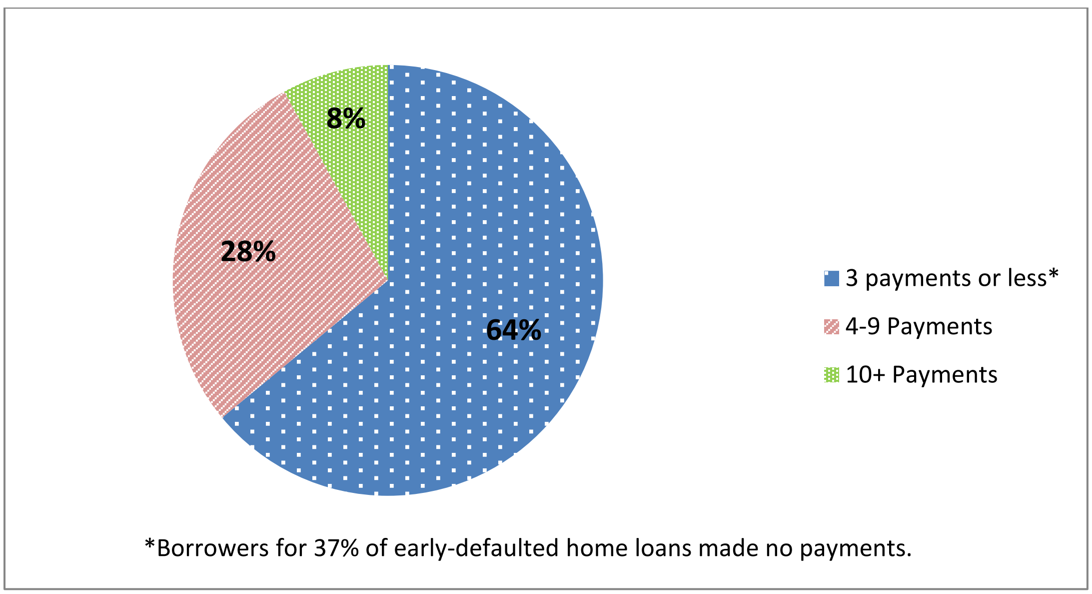
[1] This number is adjusted for inflation.
[2] At the beginning of this audit, the most current data available was through April 30, 2015. The scope of our audit is Hurricane Sandy loans that were approved and disbursed prior to November 1, 2013 to allow all loans in the universe 18 months to perform. OIG considers loans that default within 18 months of initial disbursement as defaulting early.
[3] A charge-off occurs when a borrower defaults and all reasonable efforts to achieve recovery have been exhausted and the account is deemed uncollectible. Subsequent collections may occur against defaulted disaster loans after charge-off either because the borrower repays the loan willingly or the Department of the Treasury collects through garnishing wages or tax returns.

Figure 1: Early Default Rates for Natural Disasters



Early-defaulted loans often indicate a higher risk that deficiencies occurred during underwriting, when applicants are evaluated for their eligibility, creditworthiness, and ability to repay the debt. Of the 501 early-defaulted Hurricane Sandy loans charged-off as of April 30, 2015, 446 were home loans and 55 were business loans. Borrowers for 64 percent of the 446 early-defaulted home loans made less than four payments on the loan prior to charge-off. The relatively small number of payments for these loans indicated that these borrowers may have lacked creditworthiness or repayment ability. Figure 2 depicts the percentage of payments made on the early-defaulted Hurricane Sandy home loans prior to charge-off:

Figure 2: Payments Made on Early-Defaulted Home Loans (%)



Source: Loan accounting system data provided by the Office of Disaster Assistance.

Subsequent Events

On July 1, 2015, ODA issued new standard operating procedures (SOP) for administering SBA's disaster assistance program.[4] This SOP defined what constitutes major instances of adverse credit and provided examples of acceptable explanations for them. On November 25, 2015, Congress passed the Recovery Improvements for Small Entities After Disaster Act of 2015.[5] This Act gave SBA the authority to reopen a 1-year period in which disaster survivors could apply for loans related to damage from Hurricane Sandy. On December 2, 2015, SBA reopened the application period for survivors affected by Hurricane Sandy to apply for low-interest disaster loans.

Objectives

Our objectives were to determine the extent to which ODA complied with SBA and Federal guidelines over loan applicant eligibility, creditworthiness, and repayment ability and mitigated the risk of Hurricane Sandy loans defaulting early. To achieve our objective, we selected and reviewed a random, statistically valid sample of 21 early-defaulted Hurricane Sandy loans. We reviewed the loans to determine whether the borrower was eligible, had satisfactory credit history, and had repayment ability. Due to the significance of the errors in the areas of creditworthiness and repayment ability, we projected our results to the universe of early-defaulted loans.

[4] SOP 50 30 8, *Disaster Assistance Program* (July 1, 2015).
[5] H.R.208, *RISE After Disaster Act of 2015*; Public Law No: 114-88 (November 25, 2015).

Finding 1: SBA Approved Loans to Borrowers with Unsatisfactory Credit History

We found that 13 of the 21 early-defaulted Hurricane Sandy loans we reviewed, totaling $142,100, were approved to borrowers with unsatisfactory credit history.[6] Based on our projected results, we estimate that SBA approved at least 309 loans, totaling $2,881,713, to borrowers with unsatisfactory credit.[7] To address weaknesses in the approval process and prevent similar issues in the future, ODA needs to 1) further clarify its guidance defining what constitutes unsatisfactory credit and acceptable explanations for poor credit so loan officers can consistently evaluate borrowers' credit and 2) improve its portfolio risk oversight in order to identify risks for appropriate action.

We recognize that borrowers in this program are disaster survivors in need of assistance and that SBA disaster loans are unexpected debts. However, the program is designed with the expectation that these loans are ultimately repaid. Borrowers with an unsatisfactory credit history are more likely to default and therefore, pose a greater risk to taxpayer dollars.

SBA Needs to Develop Additional Guidance Regarding Borrower Creditworthiness

The Office of Management and Budget's (OMB) Circular A-129 states that where creditworthiness is a criterion for loan approval, agencies and private lenders shall determine if applicants have the ability to repay the loan, taking into consideration the applicant's history of repaying debt.[8] Credit reports and supplementary data sources, such as financial statements and tax returns, should be used to verify or determine employment, income, assets held, and credit history.

SBA's SOP 50 30 7 similarly stated that the overall credit of an applicant, including affiliates, must be satisfactory prior to recommending a loan approval. It also stated that loan officers must give applicants with poor credit history every opportunity to provide explanations before reaching a conclusion about their overall creditworthiness. Generally, a history that consists of minor, isolated instances of poor credit or late payments is acceptable provided that the applicant: (1) explains the lapse and (2) has other accounts with current payment histories (i.e., paid as agreed). The loan officer cannot recommend approval if they determine that credit history is unsatisfactory.

Nevertheless, we found several instances where loan officers did not obtain explanations for instances of poor credit (i.e. derogatory items) listed on the borrowers' credit reports, and accepted unsatisfactory explanations for poor credit history. We believe this occurred, in part, because ODA did not have clear and specific guidance for assessing whether a borrower's credit history is satisfactory for the disaster program. For example, although SBA guidance stated that loan officers cannot recommend approval if they determine that credit history is unsatisfactory, it did not provide loan officers with clear guidance on credit issues that were not acceptable to SBA. Additionally, SBA's guidance neither defined what constituted "minor" and "isolated" instances of poor payment history, nor explained what constituted an acceptable explanation for the poor payment history.

[6] According to SOP 50 30 7, in effect when the loans were approved, the overall credit of an applicant must be satisfactory prior to recommending a loan for approval.
[7] See Appendix III for OIG identification of the total amount of associated questioned costs.
[8] OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables* (January 2013).

Further, our interviews with eight loan officers who processed Hurricane Sandy loans confirmed that SBA needs improved guidance to ensure that loan officers are consistently evaluating borrowers' credit. Specifically, we determined that loan officers used inconsistent criteria when determining whether applicant credit was satisfactory. For example, some of the loan officers we interviewed stated that they evaluated only the most recent 2 years of credit history, while others said they reviewed the borrower's entire credit history. Additionally, we found that definitions regarding what constituted minor or isolated instances of poor credit varied among the loan officers. When asked what they considered to be minor credit issues, one loan officer stated that minor instances of poor credit include late payments on medical bills. Another loan officer stated that a history of late payments and collections is considered minor. A third loan officer stated that any credit issue is acceptable as long as the borrower has an explanation for why it occurred. As previously noted, on July 1, 2015, ODA issued a new SOP that provided improved guidance for evaluating applicants with adverse credit issues. However, five of the eight loan officers we interviewed noted that ODA credit evaluation procedures were not specific enough.

In the absence of specific guidance, loan officers have discretion to determine whether the borrower is deemed creditworthy, which in some cases may lead to poor loan approval decisions and inconsistent application of credit standards. For example, for one loan we reviewed, the loan officer obtained a credit report showing that one of the borrowers (i.e., co-borrower) had a credit score of 521. This borrower had an account in collections, accounts closed by credit grantors, and other accounts that were past due and charged-off. The borrower's explanation for her credit issues was that she was unaware of the account in collections. The loan officer accepted this explanation without obtaining explanations for the other past due or charged-off accounts. It is not clear whether SBA considers these to be acceptable credit items or if this was an oversight by the loan officer. This loan was approved for $238,000, but ultimately, only $14,000 was disbursed to the borrowers. After receiving the $14,000 disbursement, these borrowers did not make a payment prior to charge-off.

In another example, a borrower's credit report showed a paid judgment and 14 other derogatory accounts that were either past due or charged-off with delinquent balances. At least one of these accounts was in default and charged-off within 1 year of applying for the SBA loan. The borrower's explanation for her poor credit history was that she was "a young, naïve person that spent too much and wasn't able to afford paying it back." Although SBA loan officers accepted this explanation as a valid circumstance for the derogatory credit, it is unclear whether SBA considered this explanation acceptable or if this was an oversight by the loan officers. This borrower only made seven payments against the $17,600 SBA loan before it was charged off.

We note that further improving SBA guidance will not only help with loan officer reviews but also will be beneficial to the required supervisory review. According to the SOP, loan recommendations generally require concurrence. Supervisory review functions as a control intended to ensure consistency and prevent the approval of loans to borrowers who are ineligible, not creditworthy, or who lack repayment ability. Because both reviews use the same guidance and criteria for their reviews, unclear guidance also can weaken this control.

Improvements to ODA's Portfolio Risk Management Oversight Could Reduce Early Defaults

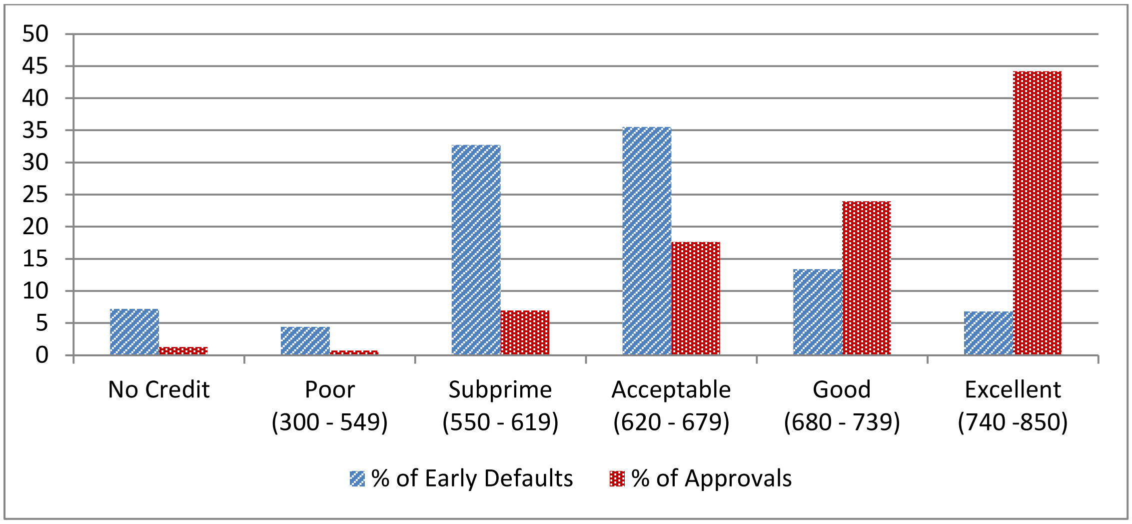
OMB Circular A-129 provides that agencies should develop oversight and control functions that are sufficiently independent of program management and have expertise and stature within the organization to identify emerging issues using real-time information about the outstanding portfolio, including credit and operational risks. Agencies must also have monitoring, diagnostic, and reporting mechanisms in place to provide senior-level policy officials and credit program managers a clear understanding of a program's performance. Such mechanisms should include regular collections, analysis, and reporting of key information and trends, and also be sufficiently flexible to deliver any analysis necessary to identify and respond appropriately to any developing issues in the portfolio. Agencies also should produce lists that highlight potential loans or types of loans that may warrant additional management oversight.

We interviewed ODA officials to determine how portfolio risks associated with the Hurricane Sandy loan portfolio and other disasters were analyzed and addressed. ODA management stated that they monitored the subsidy model performed by the Office of the Chief Financial Officer, and annually performed an informal credit analysis to determine risk tolerance for losses that had not been changed for several years.[9] However, these methods of program oversight are high-level. To identify and address emerging issues within the portfolio and highlight loans requiring additional attention, ODA management employed contractors to perform monthly portfolio performance and risk analyses. The types of risk analyses reported to ODA management include loan performance by credit score, collateral type, loan size, industry, location, loan terms, and disaster declaration type.

We performed independent data analyses of the universe of 19,295 approved and disbursed Hurricane Sandy loans. Borrowers with lower credit scores defaulted early at a much higher rate than borrowers with higher credit scores. Specifically, borrowers with credit scores of 619 or less accounted for less than 9 percent of disbursed Hurricane Sandy loans. However, these borrowers accounted for 44 percent of the 501 early defaults. Conversely, 72 percent of the 19,295 loans were approved to borrowers with credit scores of 680 or higher. These borrowers only accounted for 20 percent of the early defaults. (See Figure 3 for our analysis of approvals and early defaults by credit score category.) While the results were unsurprising, ODA should take further steps to limit the risk of early defaults.

[9] The Federal Credit Reform Act of 1990 (FCRA) requires that the credit subsidy costs of direct loans and loan guaranties be expensed in the year loans are disbursed. For direct loans, the credit subsidy cost is the difference between the net present value of expected cash flows and the face value. SBA estimates future cash flows for direct loans using economic and financial credit subsidy models.

Figure 3: Approvals and Early Defaults by Credit Score Category (%)



We recommend that ODA utilize additional information it has available within the Disaster Credit Management System (DCMS) for its risk management. ODA has established controls within DCMS to mitigate the risk of approving loans to borrowers who are not creditworthy. DCMS performs a preliminary assessment of the applicant based on various business rules, such as the applicant's credit score. If an applicant does not satisfy these business rules, DCMS will then recommend the loan for decline. Supervisory loan officers can either accept the DCMS recommendation to decline the loan or overturn its recommendation.[10]

According to our analysis, approved Hurricane Sandy loans that were originally recommended for decline by DCMS due to unsatisfactory credit had an 8.1 percent early default rate—approximately seven times greater than loans DCMS did not recommend for decline due to unsatisfactory credit. The early default rate for Hurricane Sandy loans was 2.6 percent. As such, the early default rate for overturned system-declined loans was three times the rate for all Hurricane Sandy loans (See Table 2).

Table 2. Loan Performance of Approved Loans Recommended for Decline by DCMS

	Overturned System Declines Due To Borrower's Credit	Loans Not System-Declined Due To Borrower's Credit	Total Hurricane Sandy Loans*
Approvals	3,974	15,323	19,295
Early Defaults	322	179	501
Early Default Rate	8.1%	1.2%	2.6%

* Represents the number of Hurricane Sandy loans disbursed prior to November 2013

[10] Recommendations that are overturned are subject to the same credit and repayment ability analysis that other loan applications must undergo.

While DCMS decline recommendations indicated an increased risk of early default, we did not observe that loan officers reviewed these loans with increased scrutiny. Additionally, we noted that ODA did not have more stringent guidance for evaluating loans previously recommended for decline by DCMS. DCMS identified that borrowers had unsatisfactory credit in all 13 loans presented in this finding and recommended they be declined. Despite this recommendation, loan officers approved the loans. Going forward, it is important that ODA management and loan officers consider DCMS' findings for risk management purposes.

We determined that a high percentage of the Hurricane Sandy loans we reviewed, approximately 62 percent, were approved to borrowers with unsatisfactory credit histories. Under the RISE Act, SBA assistance for Hurricane Sandy has been extended through 2016. ODA has an opportunity to further mitigate risk to its programs and Federal taxpayers by improving its guidance and risk management practices.

Recommendations

We recommend that the Associate Administrator for the Office of Disaster Assistance:

1. Develop additional guidance that specifies what constitutes unsatisfactory credit, the period of credit history to be evaluated, and derogatory credit issues that are considered an unacceptable risk to SBA.

2. Develop additional approval criteria for loan officers to mitigate the risk of default associated with loan applicants that have been recommended for decline by DCMS due to unsatisfactory credit.

3. Improve existing portfolio risk analyses by monitoring DCMS decline codes that indicate a higher risk of early default.

Finding 2: SBA Approved Loans to Borrowers Who Lacked Repayment Ability

Borrowers for 9 of the 21 loans we reviewed lacked repayment ability. Specifically, ODA approved loans with unsupported income, improperly excluded debts, and increased maximum debt levels that borrowers could afford without proper justification. Many of these errors appeared to be the result of mistakes by loan officers when processing the loans. As a result, the nine loans, which totaled $281,900, defaulted within 18 months of disbursement. Projected to the universe of all early-defaulted Hurricane Sandy loans, we estimated that SBA approved at least 95 loans, totaling $1.46 million to borrowers who lacked repayment ability (See Appendix III).

SOP 50 30 7 stated that cash flow, not collateral, is the basis for establishing repayment ability. It also stated that loan officers must have reasonable assurance of an applicant's ability to repay any proposed loan. Loan officers are responsible for performing the repayment ability calculation, which is then reviewed by the supervisory loan officer. For home loans, ODA uses the fixed debt method for determining repayment ability, which assumes that there is a maximum debt level that a borrower can afford: the maximum acceptable fixed debt (MAFD).[11] For business loans, ODA performs a financial analysis of the business, its principals, and any affiliates, to determine the cash available to service additional debt.[12]

Throughout our testing, we found several instances where loan officers did not obtain reasonable assurance of the borrower's ability to repay the loan. In one example, the loan officer factored in the borrower's spouse's income when justifying an increase from the standard MAFD, even though the borrower's spouse was not included as a co-applicant for the loan. Further, the loan officer did not verify the spouse's income. Within 8 months of receiving the disaster loan, the borrower filed for a financial hardship waiver, stating that it was hard to pay the loan since her spouse was out of work. This borrower only made seven payments against the $17,600 SBA loan prior to defaulting and the loan being charged off.

For another loan, the loan officer did not obtain evidence of a significant portion (approximately 29 percent) of the borrower's reported income. According to the borrower, this income came from rental property. However, the borrower's tax returns did not provide support for this income, and SBA loan officers did not obtain other documentation to support it, as required. Without this income; the borrower lacked repayment ability. This borrower made only four payments against the $8,400 SBA loan prior to defaulting and the loan being charged off.

In another example, the loan officer improperly excluded some of the borrower's debts from the repayment ability calculation because he determined the debts were disaster-related, which is allowable under SBA guidance. However, we determined that the debts were not disaster-related. Additionally, this loan officer increased the borrower's MAFD to 100 percent to support repayment ability, which did not provide the borrower with any cash available for living expenses. Further, the loan officer did not justify the reason for increasing the MAFD in the electronic loan file, as required by ODA Policy Memorandum 13-03.[13] When including these debts, the borrower's cash available was negative. This borrower did not make a payment against the $12,000 SBA loan prior to defaulting and the loan being charged off.

[11] Per SOP 50 30 7, any increases beyond the standard MAFD ratios must be appropriately justified.
[12] This financial analysis includes an evaluation of the principal's MAFD.
[13] ODA Policy Memorandum 13-03, SOP Paragraph 89 (January 15, 2013).

In addition to the errors noted above, the majority of the loans that lacked repayment ability also had increased MAFD.[14] Specifically, loan officers raised the MAFD ratio without proper justification for seven of the nine loans that lacked repayment ability (See Table 3).

Table 3. Seven Loans with Increased MAFD

Sample Number	Loan Type	Standard MAFD	Actual MAFD	Net Loan Amount
1	Business	36%	100%	$12,000
9	Business	36%	100%	$2,700
14	Business	50%	80%	$17,800
15	Home	40%	49%	$17,600
16	Business	36%	100%	$43,300
19	Business	36%	100%	$126,000
21	Home	50%	75.5%	$51,300

In the event that one-third of the borrower's monthly cash flow does not amortize the loan within 30 years, ODA instructs its loan officers to set the disaster loan payment on home loans up to 100 percent of the borrower's cash available.[15] We identified similar practices that were performed on the business loans that we reviewed. We are concerned that utilizing all or a majority of the borrower's discretionary income for the disaster loan payment increases the risk of default for these loans.

The errors in assessing borrower repayment ability may have been attributable to the number of new employees responsible for making these assessments and the significant application volume for Hurricane Sandy. As we previously reported, ODA did not anticipate the volume of electronic loan applications and was not fully prepared for the surge in workload. The total number of applications received reached its peak in early December 2012, and in January 2013, there was a backlog of over 29,000 loan applications pending processing. To address this backlog, ODA hired a significant amount of additional personnel, 80 percent of which were pre-identified processing staff or new hires.[16]

Recommendation

We recommend that the Associate Administrator for the Office of Disaster Assistance:

4. Provide improved training and materials to current loan officers and new hires to address the issues identified in our findings, emphasize related criteria, and support appropriate repayment ability analyses.

[14] We noted our concerns regarding ODA's practice of approving loans after increasing the MAFD percentage to significant levels to management officials in SBA OIG Internal Memorandum, *Increase in Maximum Allowable Fixed Debt Percentages in Disaster Loans* (June 16, 2014).
[15] SOP 50 30 7, *Disaster Assistance Program* (May 13, 2011).
[16] SBA OIG Report 15-13, *Hurricane Sandy Expedited Loan Processes* (July 13, 2015).

Finding 3: SBA Approved Loans Without Verifying Eligibility

Federal guidelines require that Federal credit granting agencies and private lenders in guaranteed loan programs determine whether applicants comply with statutory, regulatory, and administrative eligibility requirements for loan assistance. We determined that 3 of the 21 loans we reviewed, totaling $46,400, were approved to borrowers who potentially did not meet these eligibility requirements.

SBA SOP 50 30 7 stated that a legal entity which is not in good standing in the state in which it is organized and in the state in which the disaster occurred is not eligible. For one loan we reviewed, we found that loan officers did not adhere to this guidance. Specifically, the loan officers did not obtain the business certificate or other evidence that the business was legally operating and in good standing within the State of New Jersey.

For a second loan, the loan officer determined that the borrower was delinquent on their Federal student debt. However, the loan officer did not obtain any evidence from the Federal agency that the debt was no longer delinquent. SBA requirements state that it will not approve loans to applicants who are delinquent on any Federal debt or have a judgment lien against their property, unless the Federal agency involved provides evidence that the debt is no longer delinquent and there is reasonable assurance that the applicant will comply with the terms of the loan agreement.

For a third loan, the borrower indicated on their loan application that he was not a United States citizen. While non-citizen nationals and qualified aliens are eligible to receive SBA disaster loan assistance, additional documentation to support their eligibility is required. However, we found no evidence that the loan officer requested or obtained such documentation.

Similar to Finding 2, these errors may have been attributable to the number of new employees responsible for making these assessments and the significant application volume for Hurricane Sandy. While we acknowledge that the eligibility of borrowers may not impact their ability to repay the SBA loan, each of these three loans also exhibited either a lack of repayment ability or creditworthiness (See Appendix II). Per OMB guidelines, any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements is an improper payment.[17] This includes payments made to ineligible recipients. Further, the guidance provides that payments based on insufficient documentation or a lack of documentation also must be considered improper payments. As a result, these three loans were improper payments.

Recommendation

We recommend that the Associate Administrator for the Office of Disaster Assistance:

5. Provide improved training to loan officers regarding SBA requirements regarding complex eligibility considerations.

[17] OMB Memorandum M-11-16, Appendix C to Circular No. A-123, *Requirements for Effective Estimation and Remediation of Improper Payments* (April 14, 2011).

Analysis of Agency Response

SBA management provided formal comments and partially agreed with all five of our recommendations. SBA's comments are included in their entirety in Appendix IV. SBA acknowledged their responsibility as a creditor to establish reasonable assurance that disaster loans will be repaid. SBA noted that its loan decisions are based on a balance between its role as a provider of disaster assistance and responsibility to protect the Government's interests and taxpayer dollars. SBA stated that disaster loans are a critical source of financial assistance to disaster survivors and are unplanned debts that create neither an increase in assets nor an improvement in lifestyle. SBA believes that this fundamental difference from non-disaster loan products requires the use of non-conventional approaches when determining credit worthiness and repayment ability.

SBA noted the large volume of applications received for Hurricane Sandy and objected to our assertion that a sample of 21 early-defaulted loans, approved under procedures in effect at the time of Hurricane Sandy, had broader implications to deficiencies in SBA's loan approval process. Additionally, SBA stated that it released updated standard operating procedures and provided subsequent training, and believes these actions addressed all report findings. Further, SBA stated that our findings and corresponding recommendations failed to recognize that these improvements are already addressing the concerns raised in the report. SBA stated that it is dedicated to the continual improvement of the Disaster Loan Program and intends to take our recommendations into careful consideration.

We acknowledged that Hurricane Sandy had a low early default rate. However, as presented in Figure 1 of our report, other recent disasters have had much higher rates of early default. Further, our results support that 17 of 21, or 81 percent, of the early default loans we reviewed had material errors. As a result, we believe that the report's findings do indicate broader implications in SBA's loan approval process. Due to the high rate of error observed on the sampled items, further sampling was not necessary. The appropriate sample size, coordinated with a qualified statistician, allowed OIG to project results to a 95 percent confidence interval that at least 361 of the 501 early defaulted Hurricane Sandy loans at the time of our audit had similar deficiencies related to borrower creditworthiness or a lack of repayment ability totaling $4.3 million. The report also acknowledged that SBA's SOP 50 30 8 was an improvement over previous guidance provided in SOP 50 30 7. We considered the revised guidance in preparing this report.

SBA also provided two technical comments for our consideration. SBA stated that the report should clarify the difference between auto declines and pre-LV recommended declines, which it refers to as DCMS recommendation(s) to decline. SBA also stated that the report should disclose that when a supervisory loan officer does not concur with a system-generated decline recommendation (pre-LV), the file is later assigned to a loan officer, reviewed by a supervisory loan officer, and subject to the same detailed credit and repayment analysis that other files must undergo.

Based on SBA's technical comments, we added a footnote to the report to further explain the process for loans that were recommended for decline by DCMS due to unsatisfactory credit. OIG did not feel it was necessary to clarify the difference between DCMS auto declines and pre-LV recommended declines as auto declines were not discussed in this report.

Summary of Actions Necessary to Close the Report

The following provides the status of each recommendation and the necessary action to resolve the recommendation.

1. **Develop additional guidance that specifies what constitutes unsatisfactory credit, the period of credit history to be evaluated, and derogatory credit issues that are considered an unacceptable risk to SBA.**

   Unresolved. SBA partially concurred with this recommendation and stated that the additional credit guidance in SOP 50 30 8, released on July 1, 2015 and additional training following the release of this SOP more than addressed the recommendation. SBA stated it will continue to look for ways to improve credit guidance for loan officers.

   We acknowledge that SBA issued SOP 50 30 8, which addresses some of our concerns related to evaluating borrower creditworthiness. However, we do not believe that the new guidance would have prevented many of the loans we identified as having unsatisfactory credit from being approved. Specifically, we analyzed SOP 50 30 8 during our audit and prior to issuing the draft audit report, taking into consideration its improvements related to guidance over assessing borrower creditworthiness. We determined that while the new SOP defines types of major adverse credit, it does not define minor instances of poor credit, the period that loan officers should consider when examining the borrower's credit history, how loan officers should examine the credit history of co-borrowers (on applications with multiple borrowers), and derogatory credit issues that are considered an unacceptable risk to SBA. Furthermore, we conducted interviews with eight SBA loan officers in February 2016, 6 months after the new SOP was issued. The majority of loan officers we interviewed noted that SBA's credit evaluation procedures were not specific enough.

   As a result, we recommend that SBA issue guidance that would improve the ability of loan officers to make sound approval decisions and provide further assurance that disaster loans will be repaid. This recommendation can be resolved when SBA agrees to issue additional guidance that clarifies the period of a borrower's credit history that should be examined, how co-applicants with low credit scores should be assessed, and major adverse credit issues and adverse credit scenarios that should not be approved.

2. **Develop additional criteria for loan officers to mitigate the risk of default associated with loan applicants that have been recommended for decline by DCMS due to unsatisfactory credit.**

   Unresolved. SBA partially concurred with this recommendation and stated that the additional credit guidance in SOP 50 30 8 and additional training following its release more than addressed the recommendation. SBA stated it will look into developing additional criteria for loan officers to mitigate the risk of default associated with loans recommended for decline by DCMS for unsatisfactory credit.

   As previously noted, we evaluated SOP 50 30 8 during our audit, and did not find guidance in the SOP that required loan officers to further scrutinize applicants that had been recommended for decline by DCMS for unsatisfactory credit. We reiterate the analysis presented in this report supporting that the early default rate for Hurricane Sandy loans that were originally recommended for decline by DCMS due to unsatisfactory credit was approximately seven times greater than loans DCMS did not recommend for decline due to unsatisfactory credit. As a result, this recommendation can be resolved when SBA agrees to develop and issue supplemental guidance that provides criteria for loan officers to follow that will help mitigate the risk of default associated with loans that were recommended for decline by DCMS due to unsatisfactory credit.

3. **Improve existing portfolio risk analyses by monitoring DCMS decline codes that indicate a higher risk of early default.**

   Unresolved. SBA partially concurred with this recommendation and stated that SBA will continue to monitor the disaster loan portfolio, with particular emphasis on early-defaulted loans associated with DCMS decline recommendations.

   During our audit we evaluated SBA's quarterly loan portfolio analyses and noted that it did not include an analysis of the risks associated with DCMS decline recommendations. As a result, this recommendation can be resolved when SBA agrees to incorporate the evaluation of DCMS decline recommendation data into its quarterly loan portfolio risk analyses.

4. **Provide improved training and materials to current loan officers and new hires to address the issues identified in our findings, emphasize related criteria, and to support appropriate repayment ability analyses.**

   Unresolved. SBA partially concurred with this recommendation and stated that additional training had been developed and provided to loan officers following the release of SOP 50 30 8. SBA stated that it will continue to provide updated training to staff on the target areas provided in this report. This recommendation can be resolved when SBA agrees to update training materials to include case study examples regarding repayment ability based on the findings in our report and highlighting the associated criteria that were not adhered to.

5. **Provide improved training to loan officers regarding SBA requirements regarding complex eligibility considerations.**

   Unresolved. SBA partially concurred with this recommendation and stated additional training had been developed and provided following the release of SOP 50 30 8. SBA stated that it will continue to provide training on complex eligibility considerations to staff. We noted that SOP 50 30 8 was issued prior to this report and did not emphasize the issues identified in this audit report related to borrower eligibility. This recommendation can be resolved when SBA agrees to update training documents to include case study examples regarding complex eligibility considerations based on the findings in our report and highlighting the associated criteria that were not adhered to.

Appendix I: Scope and Methodology

This report presents the results of our audit of early-defaulted Hurricane Sandy loans. Our objectives were to determine the extent to which ODA complied with SBA and Federal guidelines over eligibility, creditworthiness, and repayment ability; and mitigated the risk of Hurricane Sandy loans defaulting early.

To answer our objectives, we reviewed OMB Circular A-129 and various versions of SBA's Standard Operating Procedures (SOPs) including 50 30 7, 50 30 8, and internal memoranda.[18] We also reviewed Government Accountability Office standards and OMB guidance. Further, we met with ODA officials to discuss the interpretation of OMB Circular A-129. We also obtained and analyzed SBA's approved training slides and SBA's loan accounting system data. Additionally, we interviewed SBA officials responsible for the Disaster Assistance Program oversight and enforcement within the Agency and loan officers responsible for reviewing and approving loans.

We selected and reviewed a random, statistical sample of 21 early-defaulted Hurricane Sandy loans. These loans were selected from a universe of 501 early-defaulted loans disbursed prior to November 2013. We reviewed the loans to determine whether the borrower was eligible, had satisfactory credit history, and had repayment ability. We engaged a third-party statistician to assist in projecting our results of early-defaulted Hurricane Sandy loans. Based on our projected results, we estimate with 95 percent confidence that at least 361 of the 501 early-defaulted loans, totaling $4.3 million, were not approved in accordance with SBA and/or Federal requirements.[19]

We also performed data analyses using the loan accounting system data and other loan data received from ODA. We performed analyses to determine if any trends existed among the approved and disbursed loans in the universe of Hurricane Sandy loans that suggested a higher risk of default.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Use of Computer-Processed Data

We relied on information from SBA's Mainframe Loan Accounting System (LAS), documenting approved Hurricane Sandy loans, to select our random sample of early-defaulted Hurricane Sandy loans. Previous OIG engagements have verified that the information maintained in LAS is reasonably reliable. In addition, we relied on reports generated by ODA from DCMS. We conducted reliability tests of this data. For example, we verified that the data was within the scope of our requests and did not include data errors. Further, data elements associated with the reviewed loans were verified against the sampled loan source documents. As a result, we believe the information was reliable for the purposes of this audit.

[18] OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables* (January 2013).
[19] The overall projection amount includes loans that had multiple deficiencies.

Review of Internal Controls

SBA's internal control systems SOP provides guidance on implementing and maintaining effective internal control systems, as required by OMB Circular A-123.[20] OMB Circular A-123 provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls.[21]

To assess internal controls during the audit, we assessed the control environment in which SBA underwrote and approved Hurricane Sandy disaster loans. To perform our assessment, we interviewed ODA management and loan officers responsible for approving Hurricane Sandy disaster loans. We also assessed internal controls by reviewing SBA training slides, policies, and procedures, and through reviewing loans. Overall, we found that internal controls were operating effectively. However, we identified deficiencies in loans that we reviewed and weaknesses in SBA procedures and oversight, as noted in this report.

Prior Coverage

Small Business Administration Office of Inspector General Reports

Evaluation 14801, *Increase in Maximum Acceptable Fixed Debt Percentages in Disaster Loan* (June 2014). This memorandum noted that increasing the MAFD may pose additional risks to the Hurricane Sandy loan portfolio.

Evaluation 14801, *Potential Fraud and Improper Payments Found in Hurricane Sandy Loans* (July 2014). This memorandum noted that for four early-defaulted Hurricane Sandy loans, the borrowers were ineligible or the loans had questionable or inadequate supporting documentation.[22] Consequently, the loans, which totaled $88,400, constituted improper payments.

Audit Report 14-20, *Controls Governing Economic Injury Disaster Loan Approval Need Improvement* (September 2014). This report noted that SBA approved nearly $1 million more than it should have for 11 EIDLs consisting of an ineligible borrower and 10 other loans for an unsupported or incorrect dollar amount.

Audit Report 15-13, *Hurricane Sandy Expedited Loan Processes* (July 2015). This report noted that expedited procedures did not provide sufficient guidance for addressing and determining repayment ability on complex disaster loan applications, and EIDL approvals contained errors and inaccurate calculations, resulting in incorrect loan amounts to recipients.

Audit Report 15-05, *SBA's Evaluation of Principal's Repayment Ability for Hurricane Sandy Business Loans* (February 2015). This report noted that for 21 of 70 Hurricane Sandy disaster business loans that were reviewed, SBA approvals did not sufficiently consider the principal's living expenses when determining repayment ability.

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[20] SOP 00 02, *Internal Control Systems* (January 1986).
[21] OMB Circular A-123, Management's Responsibility for Internal Control (December 21, 2004).

Appendix II: Summary of Loans Reviewed and Exceptions

Table 5. Loans Reviewed and Exceptions

Sample Number	Net Gross Amount	Deficiency Type	# of Payments Made
1	$12,000	A, B, C	0
2	$8,400	B, C	8
3	$14,000	B	0
4	$5,200	B	5
5	$14,000	B	8
6	$13,400	A, B	0
7	$2,800	B, C	10
8	$14,000	B	6
9	$2,700	B, C	5
10	$9,500	B	14
11	$10,700	B	1
12	$14,000	-	0
13	$21,000	A	9
14	$17,800	B, C	0
15	$17,600	B, C	12
16	$43,300	C	0
17	$28,700	-	10
18	$40,000	-	4
19	$126,000	C	7
20	$137,300	-	0
21	$51,300	C	15

Deficiency Type:

- A- Eligibility
- B- Credit History
- C- Repayment Ability
- \- No material deficiencies identified

Appendix III: Questioned Costs

Table 6. OIG Schedule of Questioned Costs[23]

Description	Explanation	Amount
Unsatisfactory credit history	Approved at least $2,881,713 to 309 borrowers that did not have satisfactory credit history.	**$2,881,713**
Lacking repayment ability	Approved at least $1,465,852 to 95 borrowers that did not have repayment ability. Because some of these loans also had unsatisfactory credit history, we have reduced this number to $1,337,724.	**$1,337,724**
Total Questioned Costs		**$4,219,437**

[23] Questioned costs are expenditures that are not supported by adequate documentation at the time of the audit or otherwise do not comply with legal, regulatory, or contractual requirements.

SBA

OFFICE OF DISASTER ASSISTANCE

RESPONSE TO AUDIT REPORT

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

Date: June 23, 2016

To: Troy M. Meyer
Assistant Inspector General for Auditing

From: James E. Rivera
Associate Administrator
Office of Disaster Assistance

Subject: OIG Draft Report – Early-Defaulted Hurricane Sandy Disaster Loans
(Project No. 15803)

We have reviewed the OIG Draft Report. The objectives of this audit were to determine the extent to which SBA's Office of Disaster Assistance (ODA) complied with SBA and Federal guidelines over credit worthiness, repayment ability, and eligibility; and mitigated the risk of early defaults for SBA disaster loans for Hurricane Sandy. Thank you for the opportunity to respond to the Report.

The mission of the SBA Disaster Loan Program is to help disaster survivors recover from disasters and rebuild their lives by providing affordable and timely financial assistance to businesses, homeowners and renters. Consistent with the mission to provide affordable and expedient disaster assistance, SBA remains committed to providing assistance quickly and effectively, in recognition of the significant stress and other challenges the disaster communities and survivors are experiencing at the time. Because SBA utilizes taxpayer funds to lend to disaster survivors, it is also our responsibility as a creditor establish a reasonable assurance that disaster loans will be repaid. Accordingly, our loan decisions are based on a balance between our role as a provider of disaster assistance and our responsibility to protect the government's interests and taxpayer dollars. SBA is confident that disaster lending policies are on the right track, which is evident by the Report's finding that Hurricane Sandy represented one of the lowest early default rates (2.5 percent) in recent years. It is important to also note that Sandy was the third largest disaster in SBA's history, behind only the 2005 Gulf Coast Hurricanes (Katrina, Rita and Wilma) and the 1994 Northridge Earthquake.

Based on a limited sample size of just 21 SBA disaster loans for Hurricane Sandy, the Report concluded the following findings: (1) *SBA Approved Loans to Borrowers with Unsatisfactory Credit History*; (2) *SBA Approved Loans to Borrowers Who Lacked Repayment Ability*; and (3) *SBA Approved Loans without Verifying Eligibility*. Keeping in mind that SBA received more than 85,500 disaster loan applications for Hurricane Sandy, we object to the Report's assertion that such a small fraction of disaster survivors who defaulted on their disaster loan has broader implications of deficiencies or weaknesses in SBA's loan approval process. Furthermore, as we discuss in more detail in later sections, the scope of the audit focused on a small sample of defaulted Sandy loans which were processed prior to SBA's release of its updated standard operating procedures (SOP) for the Disaster Assistance Program, SOP 50 30 8 and subsequent training, which addresses all Report findings.

SOP 50 30 8 Disaster Assistance Program SBA

It is important to note that all of the loans reviewed for this audit were processed under the previous standard operating procedures, SOP 50 30 7. On July 1, 2015, SBA released SOP 50 30 8, an update to its standard operating procedures, which included comprehensive changes to remove redundancy, streamline processes, increase underwriting flexibility and add mitigating measures. SBA also supported the release of SOP 50 30 8 with training to its staff, including disaster loan processing and disbursement staff. The Report acknowledges that SBA's updated SOP 50 30 8 provides "improved guidance over evaluating applicants with adverse credit issues," which the Report also concluded was an area of concern for the 21 loans reviewed. However, SBA feels strongly that the Report findings and corresponding recommendations fail to recognize that the July 2015 release of SOP 50 30 8, and the subsequent training to staff that followed, is already addressing the concerns raised in the Report. During the course of the audit, SBA brought to the auditor's attention that SOP 50 30 8, which was released 60-days after the April 30, 2015 cut-off date for the sample of loans used, included policy changes for areas covered by the scope of the audit. However, the audit continued to focus its attention on SOP 50 30 7 and base its recommendations for changes on standard operating procedures that were already out-of-date.

SBA Approved Loans to Borrowers with Unsatisfactory Credit History and Lacked Repayment Ability, and Approved Loans without Verifying Eligibility

SBA provides financial assistance to businesses of all sizes, private nonprofit organizations, homeowners and renters recovering from disasters. Following a declared disaster, disaster survivors turn to SBA to help restore businesses and repair homes when insurance and other forms of disaster assistance, such as FEMA grants, are not sufficient to cover their losses. At a time when a disaster survivor's life has been turned upside down, SBA disaster loans are a lifeline for recovery, especially for disaster survivors without sufficient personal savings or the financial means to secure credit through private-sector lending needed to rebuild.

When making disaster loans, SBA evaluates disaster survivors based on three general categories: eligibility, credit history and repayment ability. The Report concluded that 13 of the 21 Sandy loans reviewed had what the OIG considered to be unsatisfactory credit. Accordingly, the Report recommends that SBA clarify its guidance regarding creditworthiness; however, the release of SOP 50 30 8 included additional guidance and further clarification regarding satisfactory and unsatisfactory credit. For example, loan officers and supervisory loan officers are instructed to "consider the totality of circumstances affecting the overall credit of the applicant when evaluating credit," and that "satisfactory credit history is defined as a history that generally shows payments of creditors as agreed unless otherwise justified." SBA attempts to give disaster survivors with adverse credit history every opportunity to provide explanations before making a determination about their overall creditworthiness. Generally, a history of minor, isolated instances of adverse credit or late payments is acceptable for an SBA disaster loan. Major instances of adverse credit such as unpaid judgments, repossessions, previous foreclosures, charge-offs, and unpaid collections can be overcome if the disaster survivor can explain the lapse and other accounts with “as agreed” payment records. SBA evaluates adverse credit within the totality of circumstances, for example, financial difficulties caused by one-time situations such as divorce, job loss, serious medical illness or other unexpected hardships.

With regards to repayment history, the Report concluded that for 12 of the 21 Sandy loans reviewed, repayment ability was sufficiently established in the approval process. For the remaining 9 loans the auditors concluded that the disaster survivors’ repayment ability was not sufficiently documented. The Report findings do not suggest there is a larger issue with SBA’s policies for establishing repayment ability but rather the result of human error associated with inexperienced, newly hired staff brought on to assist with the heavy workload of Hurricane Sandy. It is important to note that disaster loans are a critical source of financial assistance to disaster survivors and are unplanned debts that create neither an increase in assets nor an improvement lifestyle. By taking a disaster loan to help repair or replace damaged property, disaster survivors are paying twice to maintain those disaster damaged assets. This fundamental difference from non-disaster loan products requires that SBA use non-conventional approaches when determining credit worthiness and repayment ability but it is absolutely necessary in order to have a net positive impact in communities recovering from disasters.

With regards to the Report’s findings on eligibility, SBA does not agree that two of the three loans identified were ineligible to receive disaster loan assistance. In a follow up review, SBA determined that two loans did have eligibility, and the third was lacking sufficient documentation to address the question of citizenship status. SBA updated its standard operating procedures with the release of SOP 50 30 8 and provided training to loan processing and disbursement staff to support policy changes to address that issues related to complex eligibility, credit and repayment analysis. SBA feels strongly that the Report’s findings have been sufficiently addressed by the release of SOP 50 30 8 and the subsequent training to staff that followed. However, because SBA is dedicated to the continual improvement of the Disaster Loan Program, we intend to take the OIG recommendations into careful consideration when developing new-hire and refresher training modules.

We have the following technical comments on statements in the Report:

Report – Comments

Page 7, Paragraph 1
“Supervisory loan officers can either accept the DCMS recommendation to decline the loan or overturn its recommendation.”

Agency Response: The Report should clarify the difference between auto declines and Pre-LV recommended declines, which it refers to as DCMS recommendation(s) to decline. The Report should disclose that when a supervisory loan officer does not concur with a system-generated decline recommendation (Pre-LV), the file is later assigned to a loan officer, reviewed by a supervisory loan officer, and subject to the same detailed credit and repayment analysis that other files must undergo.

OIG Recommendations and Agency Response

1) *Develop additional guidance that specifies what constitutes unsatisfactory credit, the period of credit history to be evaluated, and derogatory credit issues that are considered an unacceptable risk to SBA.*

ODA Response: ODA partially agrees with the recommendation.
Additional credit guidance developed and released July 1, 2015 with SOP 50 30 8 and Home and Business loan training developed following the release of SOP, more than addresses this recommendation. SBA will continue to look for ways to improve credit guidance for loan officers.

2) *Develop additional criteria for loan officers to mitigate the risk of default associated with loan applicants that have been recommended for decline by the DCMS system due to unsatisfactory credit.*

ODA Response: ODA partially agrees with the recommendation.
Additional credit guidance developed and released July 1, 2015 with SOP 50 30 8 and Home and Business loan training developed following the release of the SOP, more than addresses this recommendation. SBA will look into developing additional criteria for loan officers to mitigate the risk of defaults associated with Pre-LV decline recommendations for unsatisfactory credit.

3) *Improve existing portfolio risk analyses by monitoring DCMS decline codes that indicate a higher risk of early default.*

ODA Response: ODA partially agrees with the recommendation.
SBA will continue to monitor the disaster portfolio, with particular emphasis on early default loans associated with Pre-LV decline recommendations.

4) *Provide improved training and materials to current loan officers and new hires to address the issues identified in our findings, emphasize related criteria, and to support appropriate repayment ability analyses.*

ODA Response: ODA partially agrees with the recommendation.
Additional training developed and provided following the July 1, 2015 release of SOP 50 30 8 more than addresses this recommendation. ODA will continue to provide updated training to staff on the target areas provided in this report.

5) *Provide improved training to loan officers regarding SBA requirements regarding complex eligibility considerations.*

ODA Response: ODA partially agrees with the recommendation.
Additional training developed and provided following the July 1, 2015 release of SOP 50 30 8 more than addresses this recommendation. SBA will continue to provide training on complex eligibility considerations to staff.