EVALUATION REPORT

# The OIG High Risk 7(a) Loan Review Program Recommends $1.8 Million in Recoveries

March 20, 2015

REPORT NUMBER 15-09

# EXECUTIVE SUMMARY

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### What OIG Reviewed

In fiscal year 2014, the Office of Inspector General (OIG) established the High Risk 7(a) Loan Review Program to minimize losses on Small Business Administration (SBA) guaranteed loans, help SBA improve the effectiveness and integrity of its 7(a) Program, and protect taxpayer dollars.

Our objectives were to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovery of guaranteed payments to lenders.

This report presents the results of our ongoing High Risk 7(a) Loan Review Program from July 2014 to February 2015. Using an internally-developed loan scoring system, we reviewed seven loans totaling $5.5 million to assess lender compliance with SBA's rules, regulations and procedures. These loans were approved by lenders under SBA's 7(a) Loan Guaranty Program. SBA honored its guaranty on these seven loans for a total purchase amount of approximately $4 million.

### What OIG Found

Our review of the seven early-defaulted loans identified material lender origination and closing deficiencies that justified denial of the guaranty for three loans totaling $1.8 million. To facilitate SBA's timely review and recovery of these payments, we issued three notices of finding and recommendation (NFR) that included detailed descriptions of the identified material deficiencies.

Two of the three loans with material deficiencies financed change of ownership transactions. We have previously identified change of ownership transactions as high risk. We identified material lender underwriting deficiencies (i.e. repayment ability) in all three loans. In a previous audit, we determined that SBA's limited reviews of lender underwriting resulted in improper payments. In addition, the National Guaranty Purchase Center quality control team reviewed one of the three loans during the purchase review process, but did not identify any material deficiencies with the loan. Further, this same loan was included in SBA's FY 2014 review of improper payments, and was not identified as an improper payment.

### OIG Recommendations

We recommended that SBA require the lenders to bring the three loans into compliance and, if not possible, seek recovery of approximately $1.8 million from the lenders.

### Agency Comments

SBA agreed with the findings and recommendations.

### Actions Taken

SBA contacted the lenders to obtain clarification and additional documentation. In the event that the lenders are unable to mitigate the deficiencies, SBA will seek recovery as appropriate.

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

**Final Report Transmittal**
Report Number: 15-09

**DATE**: March 20, 2015

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

**SUBJECT:** *The OIG High Risk 7(a) Loan Review Program Recommends $1.8 Million in Recoveries*

This report presents the results of our ongoing High Risk 7(a) Loan Review Program. The objectives of our review were to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovery of guaranteed payments to lenders.

The report contains three recommendations that SBA agreed to implement. Please provide us within 90 days your progress in implementing the recommendations.

We appreciate the courtesies and cooperation extended to us during this review.

/s/
Troy M. Meyer
Assistant Inspector General for Auditing

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# Introduction

The Small Business Administration (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 borrower defaults on an SBA-guaranteed loan, the lender can submit the loan to SBA for purchase. SBA reviews the loan to confirm the lender's compliance with the relevant SBA laws and procedures before purchasing the loan.[2] 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.

### The SBA OIG High Risk 7(a) Loan Review Program

In fiscal year (FY) 2014, we established the High Risk 7(a) Loan Review Program to minimize losses on SBA loans, help SBA improve the effectiveness and integrity of its 7(a) Program, and protect taxpayer dollars. We established this program because: (1) previous audits of improper payments and early-defaulted loans (loans that defaulted within 18 months of initial disbursement) noted a number of lenders failed to comply with SBA loan requirements, and (2) the impact from lender noncompliance with SBA's requirements may increase given that the Small Business Jobs Act of 2010 increased the maximum 7(a) loan amount from $2 million to $5 million, which increased the maximum SBA-guaranteed amount to $3.75 million.[3, 4]

The OIG High Risk 7(a) Loan Review Program evaluates lender compliance with SBA's requirements on 7(a) loans approved for $500,000 or more that defaulted within the first 18 months of initial disbursement. We use an internally-developed and evolving 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.

### Prior Work

Between FYs 2011 and 2013, we conducted a series of audits focused on high-dollar/early-defaulted (HD/ED) 7(a) loans funded under the American Recovery and Reinvestment Act (Recovery Act) that were purchased by SBA.[5] These audits identified material lender noncompliance with SBA loan origination and closing requirements, as well as suspicious activity on behalf of loan participants.[6] In addition, we found that loans were not reviewed during the SBA purchase review process with the scrutiny needed to identify material lender noncompliance, as required.[7] In summary, 23 of the 42 loans reviewed during these audits—or 55 percent—had either material deficiencies or indications of suspicious activity, which we referred for further investigation. In total, we recommended that SBA recover approximately $12 million from lenders

[1] Title 15 U.S. Code Section 636(a).
[2] Loans purchased from the secondary market receive a limited review prior to the purchase. SBA conducts a post-purchase review on these loans to assess lenders' compliance with SBA's requirements.
[3] The Improper Payments Elimination and Recovery Act of 2010 (IPERA) defines improper payments as expenditures that either should not have been made or were made in incorrect amounts under statutory, contractual, administrative, or other legally applicable requirements. Improper payments in the guaranty purchase process arise when an SBA purchase reviewer fails to identify material lender deficiencies in the handling of an SBA guaranteed loan.
[4] Public Law 111-240, Small Business Jobs Act of 2010 (September 27, 2010).
[5] Public Law 111-5, American Recovery and Reinvestment Act of 2009 (February 17, 2009).
[6] OIG Reports ROM 11-05, ROM 11-06, 12-11R, 13-16R, and 14-09 (See Appendix I for report details).
[7] OIG Reports 12-11R and 12-18 (See Appendix I for report details).

and implement improved procedures that would reduce future improper payments by at least $43 million.

In addition, we conducted two separate audits of SBA's improper payment review process for 7(a) loans purchased by SBA.[8] Both audits determined that SBA reported improper payment rates were significantly understated. In FY 2010, we identified improper payments in the 7(a) Loan Program as one of the most serious management and performance challenges facing SBA.[9]

## Objectives

Our objectives were to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovery of guaranteed payments to lenders. This report presents the results from our ongoing High Risk 7(a) Loan Review Program.

[8] OIG Audit Report 9-16, *The Small Business Administration's Fiscal Year 2008 Improper Payment Rate for the 7(a) Guaranty Loan Program* (July 10, 2009), and OIG Audit Report 13-07, *The Small Business Administration's Improper Payment Rate for 7(a) Guaranty Purchases Remains Significantly Underestimated* (November 15, 2012).
[9] Management Challenge 9, "The SBA needs to accurately report, significantly reduce, and strengthen efforts to recover improper payments in the 7(a) Loan Program" (established FY 2010).

## Results

### OIG Reviews of Defaulted 7 (a) Loans Continue to Identify Material Lender Noncompliance

Our review of seven early-defaulted loans, approved by lenders for approximately $5.5 million, identified material lender origination and closing deficiencies that justified denial of the guaranty for three of the loans. As shown in Table 1 below, all three loans had repayment ability deficiencies. Further, two of the loans also had eligibility deficiencies. SBA honored its guaranty on these seven loans, resulting in a total purchase amount of approximately $4 million. Six of the loans were purchased in FY 2014 for a total purchase amount of approximately $3.1 million. The remaining loan was purchased in FY 2012 for approximately $900,000.[10] Because of the lenders' noncompliance with SBA's origination and closing requirements, we recommended recovery of approximately $1.8 million on the three loans. (Details of the material lender deficiencies on the three loans are provided in Appendices II through IV.)

**Table 1: Lender Approved Loans Reviewed by OIG**

| Loan Number | Transaction Type | Deficiency Type^ | Deficiency Description | Purchase Date | Purchase Amount | Recommended Recovery |
|---|---|---|---|---|---|---|
| **4855765000** | Change of Ownership | - | - | 5/19/2014 | $265,465 | - |
| **3983365009** | Working Capital | - | - | 4/24/2014 | $878,289 | - |
| **3747925009** | Business Start-up | B | B) Unsupported projections and inadequate working capital | 3/10/2014 | $471,905 | $471,905 |
| **3368895002** | Business Start-up | - | - | 2/10/2014 | $265,011 | - |
| **3176445002** | Change of Ownership | A, B, C | A) Partial change of ownership, B) Unsupported financial statements, C) No business license and lease agreement | 1/16/2014 | $413,704 | $413,704 |
| **3200325002** | Change of Ownership | - | - | 11/26/2013 | $845,152 | - |
| **3597045009 *** | Change of Ownership | A, B | A) Lacked independent business valuation and fixed asset appraisal B) Questionable financial analysis and projections, Affiliates not considered | 11/17/2011 | $900,175 | $900,175 |
| **Totals** | | | | | **$4,039,701** | **$1,785,784** |

Source: SBA Loan Files and Results of OIG's Reviews
^Deficiency Type Legend: A) Eligibility Deficiency, B) Repayment Ability Deficiency, C) Closing Deficiency
*OIG sampled and reviewed this loan in a previous audit. SBA reviewed and purchased this loan in 2011.

[10] Material lender deficiencies on this loan were identified in a previous audit. Due to identified suspicious activity, the loan was referred for investigative consideration. The loan was returned to the OIG Auditing Division for appropriate action to address the lender's noncompliance with SBA requirements.

To facilitate SBA's timely review and recovery of these improper payments, we issued three notices of finding and recommendation (NFR) that included detailed descriptions of the identified material deficiencies. The NFRs issued to SBA are included in Appendices II through IV of this report. These NFRs included recommendations for recovery from the lenders as follows:

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

1. Require Monterey County Bank to bring the loan into compliance, and, if not possible, seek recovery of $413,704 (less any amounts received from liquidation) from Monterey County Bank on the guaranty paid by SBA for the loan to [Ex. 4] [redacted].

2. Require Ridgestone Bank to bring the loan into compliance, and, if not possible, seek recovery of $900,175 (less any amounts received from liquidation) from Ridgestone Bank on the guaranty paid by SBA for the loan to [Ex.4] [redacted].

3. Require USC Credit Union to bring the loan into compliance and, if not possible, seek recovery of $471,905 (less any amounts received from liquidation) from USC Credit Union on the guaranty paid by SBA for the loan to [Ex. 4] [redacted].

## Actions Taken by SBA

SBA substantially agreed with the findings presented in the three NFRs and contacted the lenders to obtain clarification, additional documentation, or seek recovery. For two of the loans, lenders were able to provide evidence mitigating some of the deficiencies we identified but could not overcome the recommendations for recovery. As of January 28, 2015, SBA was pursuing recovery for these two loans. SBA has requested additional documentation from the lender on the third loan.

## Results of the High Risk 7(a) Loan Review Program Confirm Known Risks

Our review confirms risks that our office has previously reported to the Agency. Two of the three loans we reported to SBA financed change of ownership transactions. As previously reported, we believe these transactions warrant a higher level of due diligence. We found lenders' material noncompliance with SBA's repayment ability requirements in all three of the reported loans. We believe further improvements are needed in SBA's evaluation of lender underwriting on early-defaulted loans. Finally, we remain concerned about the effectiveness of SBA's quality control program regarding HD/ED loans as well as SBA's efforts to prevent improper payments.

### *Change of Ownership Transactions*

Two of the three loans we identified, purchased for a total of $1.3 million, had material deficiencies that financed change of ownership transactions. Previous audits have identified that SBA loans financing change of ownership transactions included:

- Ineligible structures: partial change of ownership, seller retained control of the business;
- Inadequate support for equity injection: no evidence that the injection occurred, evidence provided supported an injection into a different business;
- Lack of repayment ability: unverified seller's financial statements, all liabilities not considered, impact of affiliates not considered, unsupported projected sales; and
- Inadequate business valuation: business valuations not obtained as required.

Our Investigations Division has also identified significant fraud in change of ownership transactions. For example, in 2013 an OIG investigation resulted in the conviction of a loan broker who was responsible for 124 fraudulent SBA loans having a value of $100 million. This is one of the largest fraud schemes in the history of SBA's loan programs. The defendant and associated brokerage firm specialized in securing loans for individuals interested in purchasing or refinancing small businesses.

In FY 2009, our Audit Division issued an information notice that recommended lenders and other program participants perform a higher level of due diligence in reviewing change of ownership transactions.[11] We also issued an internal memorandum to SBA in FY 2014 reporting our concern that change of ownership transactions pose a higher risk of loss to the Agency.

SBA has recently proposed guidance to strengthen its controls over change of ownership transactions. We commend the Agency on its efforts to address this risk, and look forward to the adoption and implementation of strengthened controls.

### *Repayment Ability*

We identified material repayment ability deficiencies in all three loans we reported to SBA. We previously determined that SBA did not follow Agency procedures when performing limited reviews of lender underwriting (i.e., repayment ability) during guaranty purchase reviews.[12] This resulted in improper payments. Specifically, SBA management did not expect loan specialists to evaluate whether the financial analyses of repayment ability performed by the lenders actually demonstrated reasonable assurance of repayment from the cash flow of the business, as required. Instead, management at the National Guaranty Purchase Center (NGPC) only required loan specialists to perform a superficial review of the lenders' credit memorandum, which did not allow them to determine whether early-defaulted loans approved under delegated authority had repayment ability.

SBA revised its purchase review process to strengthen reviews of the lender's repayment ability analysis. Further, loan specialists received training on commercial credit underwriting techniques. However, our work continues to identify material deficiencies with lenders' analysis of borrowers' repayment ability. As a result, SBA should continue to place greater emphasis on evaluating whether material deficiencies with the lender's underwriting contributed to an early default.

### *Quality Control and Improper Payments Within the Guaranty Purchase Review Process*

The guaranty purchase review is SBA's primary control for preventing the purchase of a 7(a) loan guaranty from lenders that failed to materially comply with SBA loan requirements. Improper payments in the guaranty purchase process arise when an SBA purchase reviewer fails to identify material lender deficiencies in the handling of an SBA guaranteed loan. To prevent improper payments in the guaranty purchase process, the NGPC, which is responsible for reviewing 7(a) guaranty purchase requests, has implemented a multi-level review process to ensure loans comply with SBA's requirements. Furthermore, recognizing the importance of ensuring the quality of its deliverables, in 2004 the NGPC developed a quality control program that performs additional independent reviews of the guaranty purchase process. Based on previous OIG recommendations,

[11] SBA Information Notice 9000-1793, *Detecting Fraud in Small Business Administration Lending Programs* (April 7, 2009).
[12] Audit Memorandum 12-18, *A Detailed Repayment Ability Analysis is Needed on High-Dollar Early-Defaulted Loans to Prevent Future Improper Payments* (August 16, 2012).

all early-defaulted loans with an outstanding balance of greater than $500,000 are reviewed for quality.

The need to establish an effective quality control program at the loan centers has been an SBA Management Challenge since FY 2007.[13] Since the issuance of this Management Challenge, the SBA has made significant progress in its development of an independent quality control program. However, our last evaluation of SBA's quality control program found that improvement was needed at the NGPC when performing reviews to assess quality in the majority of its loan purchase and liquidation oversight operations during FY 2013.[14] In FY 2014, SBA management reported that it had addressed many of the weaknesses that we previously identified. Nevertheless, two loans we reviewed that contained material deficiencies met the criteria for review by NGPC's quality control team.[15] The NGPC quality control team reviewed one of the loans and did not identify any material deficiencies. The other loan was not reviewed by the quality control team, as required. Therefore, we remain concerned about the effectiveness of SBA's quality control program at NGPC.

In addition, previous audits of SBA's improper payment review process determined that the improper payment rates reported for 7(a) guaranty purchases were significantly understated. We continue to identify improper payments within the 7(a) guaranty purchase process and question the accuracy of the reported estimated improper payments rates. For example, one loan we reviewed that contained material lender deficiencies was also included in SBA's FY 2014 improper payment sample.[16] SBA did not identify the material lender deficiencies and therefore did not identify the payment guaranty of $413,704 as an improper payment. Upon receiving our NFR, SBA substantially concurred with our findings on the loan and confirmed it as an improper payment. We believe that preventing improper payments in the 7(a) guaranty purchase review process continues to be a challenge for the Agency.

## Analysis of Agency Response

SBA management provided formal comments, which are included in their entirety in Appendix V. The following provides a summary of management's comments and the actions necessary to close the report.

The Agency agreed with our recommendations and is working with the lenders to either bring the loans into compliance or recover the improper payments. The Agency noted that it strives to ensure proper payments on guaranteed purchases and takes pride in its improvement and training efforts at the NGPC.

The Agency noted its exception that a loan purchased in 2011 was included in OIG's report. SBA stated that the inclusion of this loan did not provide an accurate representation of the current state of the NGPC's review process. SBA provided a series of notable enhancements intended to improve its processes for reducing and preventing improper payments. This includes emphasizing the evaluation of lender underwriting, performing quality control reviews on high-dollar early-defaulted loans, and improving guidance and training.

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[13] Management Challenge 4, "The SBA needs to implement a quality control program in its loan centers" (established FY 2007).

[14] Evaluation Report 14-08, *Improvement is Needed to Ensure Effective Quality Control at Loan Operation Centers* (January 17, 2014).

[15] NFR 14005-1, See Appendix II for details and NFR 14005-3, See Appendix IV for details.

[16] NFR 14005-1, See Appendix II for details.

We understand the Agency's concern with including a loan purchased in 2011 in our report. This loan was previously reviewed as part of our Audit of Purchased Recovery Act loans that was completed in December 2013. As noted above, due to identified suspicious activity, this loan was referred for investigative consideration, but was subsequently returned. This loan met the criteria for the OIG High Risk 7(a) Loan Review Program. As a result and in accordance with our mission, it was our responsibility to take appropriate action to address the lender's noncompliance with SBA requirements.

SBA also noted that the OIG investigation of significant loan broker fraud referenced in our report was initially identified through the diligent reviews and insight of NGPC employees. We note that NGPC employees have identified and referred several cases of suspected fraud to OIG over the years. The above fraud scheme was uncovered after the NGPC referred a suspected loan to OIG.

Further, SBA maintained that OIG is able to expend significantly more time to review loans than is available to the NGPC. SBA stated that it should be recognized that the application of additional resources and time to review a limited number of case files does, on occasion, serve to discover improper payments not as readily observed. However, we previously recommended that SBA: "Establish a specialized unit of well-trained, highly experienced loan specialists to perform purchase reviews with the level of scrutiny necessary to identify all material deficiencies on early-defaulted loans approved for $500,000 or more."[17] SBA agreed with this recommendation and now limits the review of these loans to loan specialists who are sufficiently experienced and receive intensive training.

Finally, SBA stated that it agreed with OIG that significant progress has been made in developing and implementing a quality control program, and that it is committed to further improving that program. SBA noted that the quality control program is tasked with reviewing various functions and OIG's identification of deficiencies in one area of its operation is not indicative of an ineffective program.

**Summary of Actions Necessary to Close the Report**

1. **Require Monterey County Bank to bring the loan into compliance, and, if not possible, seek recovery of $413,704 (less any amounts received from liquidation) from Monterey County Bank on the guaranty paid by SBA for the loan to [Ex. 4] [redacted].**

   OFPO stated that it will pursue recovery from the lender in the amount of $413,704, less any amounts received from liquidation. This recommendation can be closed upon OFPO's recovery from the lender.

2. **Require Ridgestone Bank to bring the loan into compliance, and, if not possible, seek recovery of $900,175 (less any amounts received from liquidation) from Ridgestone Bank on the guaranty paid by SBA for the loan to [Ex. 4] [redacted].**

   OFPO stated that it will continue to work with the lender to determine if the loan can be brought into compliance. If it is determined that the documentation provided cannot mitigate the concerns identified, OFPO will pursue recovery from the lender for the remaining balance of the loan. This recommendation can be closed upon OFPO providing

[17] Audit Memorandum 12-11R, *High-Dollar Early-Defaulted Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the National Guaranty Purchase Center* (March 23, 2012).

evidence supporting that the lender mitigated the deficiencies or it recovered the appropriate amount from the lender.

3. **Require USC Credit Union to bring the loan into compliance and, if not possible, seek recovery of $471,905 (less any amounts received from liquidation) from USC Credit Union on the guaranty paid by SBA for the loan to [Ex. 4] [redacted].**

   OFPO stated that it is reviewing additional information from the lender. If it is determined that the documents provided cannot mitigate the concerns identified, OFPO will pursue recovery from the lender for the remaining balance of the loan. This recommendation can be closed upon OFPO providing evidence supporting that the lender mitigated the deficiencies or it recovered the appropriate amount from the lender.

# Appendix I: Scope and Methodology

This report presents the results of our ongoing High Risk 7(a) Loan Review Program from July 2014 to February 2015. Our objectives were to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovery of guaranteed payments to lenders. Because this is a newly established OIG program, we will continue to revise our scope and methodology to ensure the most effective use of OIG resources and future analyses.

To accomplish our objectives, 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 obtained a universe of 31 high-dollar/early-defaulted 7(a) loans that were approved by lenders under the Preferred Lenders Program (PLP), which underwent very limited review by SBA prior to loan disbursement. NGPC purchased these loans between October 1, 2013, and May 31, 2014. We eliminated loans that had not received a completed purchase review by NGPC. We then selected six loans based on their assigned score and considered other factors, such as the outstanding balance of the loan and the period to default.

In addition, we selected one loan for which material lender deficiencies were identified in a previous audit, but was referred to Investigations due to identified suspicious activity. The loan was returned to the OIG Auditing Division for appropriate action to address the lender's noncompliance with SBA requirements. This loan met our definition of high-dollar/early-default and our scoring criteria. As a result, we reported the lender's deficiencies to SBA under our High Risk 7(a) Loan Review Program.

Furthermore, to answer the objectives, we reviewed origination and closing actions as documented in SBA loan files. We assessed these actions against all applicable SBA requirements. We also 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 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 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.

## Prior Coverage

*Small Business Administration-Office of Inspector General Reports*

Audit Report 9-16, *The Small Business Administration's Fiscal Year 2008 Improper Payment Rate for the 7(a) Guaranty Loan Program* (July 10, 2009).

Audit Report ROM 10-19, *Material Deficiencies Identified in Early-Defaulted and Early-Problem Recovery Act Loans* (September 24, 2010).

Audit Report ROM 11-05, *Material Deficiencies Identified in Four 7(a) Recovery Act Loans Resulted in $3.2 Million of Questioned Costs* (June 29, 2011).

Audit Report 11-06, *Material Deficiencies Identified in Five 7(a) Recovery Act Loans Resulted in $2.7 Million of Questioned Costs* (August 22, 2011).

Audit Memorandum 12-11R, *High-Dollar Early-Defaulted Loans Require an Increased Degree of Scrutiny and Improved Quality Control at the National Guaranty Purchase Center* (March 23, 2012).

Audit Memorandum 12-18, *A Detailed Repayment Ability Analysis is Needed on High-Dollar Early-Defaulted Loans to Prevent Future Improper Payments* (August 16, 2012).

Audit Report 13-07, *The Small Business Administration's Improper Payment Rate for 7(a) Guaranty Purchases Remains Significantly Underestimated* (November 15, 2012).

Advisory Memorandum 13-16R, *Purchase Reviews Allowed* $4.6 *Million in Improper Payments on 7(a) Recovery Act Loans* (June 14, 2013).

Evaluation Report 14-08, *Improvement is Needed to Ensure Effective Quality Control at Loan Operation Centers* (January 17, 2014).

Audit Report 14-09, *Purchase Reviews Allowed* $3.1 *Million in Improper Payments on 7(a) Recovery Act Loans* (January 29, 2014).

## Appendix II: NFR 14005-1 Issued to SBA (Includes SBA's Response)

**NOTICE OF OIG FINDING AND RECOMMENDATION**
**NFR No. 14005-01**

**Date:** August 27, 2014

**BACKGROUND**

The purpose of this NFR 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 an OIG-developed scoring system to prioritize loans based on the risk of loss to the Agency. 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.

The lender, Monterey County Bank, was authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, the bank was permitted to process, close, service, and liquidate loans with limited documentation and review by SBA.

The lender approved a $585,000 7(a) loan on July 31, 2008, with a 75 percent SBA guaranty to [Ex. 4] [redacted] to purchase the business known as [Ex. 4] [redacted] and for working capital. The borrower was purchasing the San Jose, CA location while the seller retained ownership of the second location in Monterey, CA. Proceeds to effect the partial change of ownership transaction were disbursed on September 15, 2008. Additionally, four disbursements for working capital were made between October 9, 2008 and November 21, 2008. The borrower only made four loan payments prior to default of the loan on February 1, 2009. The NGPC purchased the loan on January 16, 2014, for $413,704.

**CONDITION**

We determined that the lender did not approve and disburse the loan in accordance with SBA's origination and closing requirements. Specifically, our review determined that loan proceeds were used to purchase a portion of the business, which did not constitute a total change of ownership, as required. [Ex. 4] [redacted] operated as a sole proprietorship in two locations in California—San Jose and Monterey. The borrower was purchasing only the San Jose location and the loan documents supported that the two business locations would continue to operate as [Ex. 4] [redacted] subsequent to the purchase transaction. Moreover, historically, the seller combined the two locations on one Schedule C, *Profit or Loss from Business*, of the Internal Revenue Service Form 1040.[18] In addition, there was only one contractor's license issued for [Ex. 4] [redacted], which was associated to the business since 2001. This further supported that the seller was operating one business with two locations.

We also determined that the lender did not perform adequate due diligence to address material discrepancies with financial information used to support repayment ability in this partial change of ownership transaction. The lender relied on financial statements for the San Jose location to

[18] U.S. Individual Income Tax Return

support its repayment analysis even though these statements were not signed by the seller, prepared by an independent public accountant, or verified with tax transcripts.[19]

Our analysis of the 2007 combined tax return and the financial statements for the San Jose location identified a disproportionate relationship between sales and cost of goods sold. Specifically, the financial statements for the San Jose location, purchased with SBA loan proceeds, accounted for 56 percent of the combined sales. However, the San Jose financial statements used by the lender, when compared to the consolidated tax return, showed that this location was responsible for only 23 percent of the combined cost of goods sold. The remaining 77 percent of the cost of goods sold, dedicated to the Monterey location, exceeded the sales for that location. Using the same financial information available to the lender, this would result in a gross profit margin (GPM) of 76 percent for the San Jose location and a GPM of 1.4 percent for the Monterey location. Further, when using the same allocation percentage of sales for the cost of goods sold, we determined that the San Jose location would not have demonstrated repayment ability. There was no indication in the loan file that the lender conducted a similar analysis of the combined tax returns to validate the San Jose financial statements.

Additionally, the lender did not confirm the existence of a partnership agreement, licenses to operate the business, and a lease for the place of business prior to loan closing, which were critical to the purchaser's ability to generate sufficient revenues to service debt. Loan documents indicated that [Ex. 4] [redacted] had an existing partnership with two Costco locations, which brought in approximately 35 percent of the sales leads. However, there was no indication in the loan file that the lender obtained the partnership agreement to confirm: (1) the terms of this agreement and (2) that it would continue under the new ownership. Additionally, the lender relied on projections, which considered the Costco partnership, to support its internal business valuation for this partial change of ownership transaction. Verification of this information was critical to ensure the viability of the business and that the sales price was appropriate. Further, loan documents also supported that prior to loan closing, the new borrower would obtain licenses to operate the business and a new lease agreement with the seller's landlord. We determined that the borrower did not obtain the required contractor's license until 2 months after it had defaulted on the loan. Additionally, we found no evidence in the file that a lease agreement was obtained.

The borrower defaulted after four full payments, had to liquidate collateral to service debt, and was unable to meet the significantly reduced payments offered by the lender. The lender was clearly negligent in its origination and closing of the loan. Specifically, the lender did not ensure a complete change of ownership, relied on unreasonable financial statements, and disbursed loan proceeds without satisfying all closing conditions. As a result, the lender's lack of due diligence placed SBA at risk of loss and contributed to the loan's default.

Finally, our review also determined that the lender did not obtain a SBA Form 159, "Compensation Agreement," for the services of a real estate broker as required. Specifically, documentation in the loan file showed that a real estate broker represented both the buyer and seller in this change of ownership transaction and submitted loan documents to the lender. As a result, the lender violated SBA loan requirements and this further demonstrates the lender's lack of due diligence.

[19] Given that the tax returns combined both locations, the lender could not verify the San Jose financial statements against the tax transcripts.

**CRITERIA**

13 Code of Federal Regulations (CFR) 120.202 states a borrower may not use 7(a) loan proceeds to purchase a portion of a business or a portion of another owner's interest. One or more current owners may use loan proceeds to purchase the entire interest of another current owner, or a borrower can purchase ownership of an entire business.

13 CFR 120.524 (a) (1-3) states that SBA is released from liability on a loan guaranty (in whole or in part), if the lender has failed to comply materially with any loan program requirement for 7(a) loans; the lender has failed to make, close, service, or liquidate a loan in a prudent manner; and the lender's improper action or inaction has placed SBA at risk.

13 CFR 120.150 states that the applicant must be creditworthy. Loans must be so sound as to reasonably assure repayment, considering past earnings, projected cash flow, future prospects, the ability to repay the loan with earnings from the business, and the effects of any affiliates.

Standard Operating Procedure (SOP) 50 10 4 states that SBA's business loan eligibility, credit policy, and procedures apply to PLP loans.

SOP 50 10 4 states 7(a) loans are eligible to accomplish a total change of ownership between two parties conducting an arm's length transaction providing there is a reasonable need for the change of ownership. It also states that under no circumstances can proceeds be used to finance a borrower's purchase of only a portion of the ownership interests of the present owners.

SOP 50 10 4 states that it is the PLP lender's responsibility to conduct a thorough and complete credit analysis of the applicant, and establishes that the loan is of such sound value as to reasonably assure repayment. Additionally, it states that the ability to repay a loan from the cash flow of the business is the most important consideration in SBA's loan-making process.

SOP 50 10 4 states that to determine the applicant's financial condition, SBA should require that the applicant (1) submit one or more income tax returns to confirm the veracity of statements submitted, or (2) obtain verification (from independent accountants or appraisers) of any questionable items prior to disbursement, or (3) submit statements by an independent public accountant before processing the package. It also states that all financial statements must be signed and dated by the proprietor, a partner, or an authorized officer of the applicant unless they are prepared by an outside accountant and properly certified. When the existing statements are questionable, SBA may require that their quality be upgraded. This upgrade can range from compiled, reviewed, or audited statements, depending upon the business and credit needs under review

Standard Operating Procedures (SOP) 50 10 4 states the applicant must furnish SBA the names of all representatives engaged in connection with obtaining financial assistance. Applicants must report all fees of these representatives on SBA Form 159, "Compensation Agreement."

13 CFR 120.10 states that the authorization is SBA's written agreement providing the terms and conditions under which SBA will make or guarantee business loans. It is not a contract to make a loan.

The loan authorization stated that it is lender's sole responsibility to (1) close the loan in accordance with the terms and conditions of this authorization, (2) obtain valid and enforceable loan documents, and (3) retain all loan closing documents. It also stated that the lender must submit these documents, along with other required documents, to SBA for review if the lender requests SBA to honor its guaranty on the loan, or at any time SBA requests the documents for review. Further, the loan authorization stated that the guaranty is contingent upon lender complying with the current SBA SOP and satisfying all of the conditions in the authorization. Finally, the loan authorization stated that $505,000 of proceeds will be used to purchase the business known as [redacted], according to the executed Purchase Agreement dated June 8, 2008.

SOP 50 51 2b states that a denial based upon a lender's underwriting may be appropriate if: (1) a lender failed to comply with an SBA lending requirement in making or closing the loan, which placed the Agency at financial risk; or (2) the lender was clearly negligent by failing to account for an obvious fact that could likely affect the borrower's ability to repay the loan.

**CAUSE**

The lender did not originate and close the loan in compliance with SBA's regulations and procedures.

**EFFECT**

The deficiencies on this loan resulted in a $413,704 guaranteed payment by SBA that should be recovered.

**RECOMMENDATION**

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

- Require Monterey County Bank to bring the loan into compliance, and, if not possible, seek recovery of $413,704 (less any amounts received from liquidation) from Monterey County Bank on the guaranty paid by SBA for the loan to [Ex. 4] [redacted].

**MANAGEMENT'S RESPONSE**

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

☒ Management substantially concurs with the Notification of Finding and Recommendation.

☐ Management does not concur with the Notification of Finding and Recommendation. Please give reasons for management's non-concurrence.

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

The lender will be notified within 30 days of the findings. After notification, the lender will have 45 days to respond. If issues are not overcome at that point the loan will be sent to HQ for the denial review process.

Management Official Signature: ______________________ Date: _9/30/2014____

## Appendix III: NFR 14005-2 Issued to SBA (Includes SBA's Response)

**NOTICE OF FINDING AND RECOMMENDATION**
**NFR No. 14005-02**

**Date:** October 10, 2014

**BACKGROUND**

The purpose of this notice of finding and recommendation (NFR) 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 developed by the Office of Inspector General (OIG) to prioritize loans based on the risk of loss to the Small Business Administration (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.

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

On August 26, 2009, the lender approved SBA loan number 3597045009 for $974,000, with a 90 percent SBA guaranty, to [Ex. 4] [redacted] (borrower). This loan was for the purchase of a restaurant known as [Ex. 4] [redacted], real estate, and working capital. Proceeds for this change of ownership transaction were disbursed on September 24, 2009. The borrower made only 10 full loan payments before the lender approved a 3-month deferment. The borrower defaulted on January 1, 2011, after making one other loan payment following the deferment period. The NGPC purchased the loan on November 17, 2011, for $900,175.

**CONDITION**

The lender did not approve the loan in accordance with SBA's origination and closing requirements. Specifically, the lender did not consider the impact that affiliated businesses—owned by the borrower's president—had on loan repayment ability. Additionally, the loan file did not provide the cash flow needs of the borrower's president; therefore, we were unable to determine its impact on repayment ability. Further, the lender used questionable financial information and unsupported projections in its repayment ability analysis. Based on these deficiencies, the lender did not demonstrate reasonable assurance of repayment for the SBA loan. Further, the lender did not obtain an independent business valuation or a fixed asset appraisal for this change of ownership transaction, as required. As a result, there was no assurance that the value of the business adequately supported the purchase price.

*Impact of Affiliated Businesses and Financial Information of Owner*

To demonstrate repayment ability for this loan, the lender only considered the seller's financial information for [Ex. 4] [redacted] and the personal financial information of the borrower's vice president (85 percent owner). The borrower's president (15 percent owner) owned two additional businesses,[Ex. 4] [redacted] and [Ex. 4] [redacted]. However, the lender did not consider the financial performance of the two affiliates in its repayment ability analysis and its loan file included limited financial information pertaining to the borrower's president.

We noted that the real estate owned by [Ex. 4] [redacted], which had an existing $826,000 mortgage, was taken as collateral for the subject loan. A February 5, 2011 appraisal of this real estate supported that, at the time of the lender's loan approval, the three-unit commercial building was not fully occupied by paying tenants. Specifically, one unit was occupied by a tenant that was approximately 2 years behind on rent. The appraisal further stated that [Ex. 4] [redacted] allowed this tenant to maintain occupancy due to a lack of interest from other prospective tenants and an occasional partial rental payment. Moreover, the borrower's president and [Ex. 4] [redacted] filed for bankruptcy on March 30, 2011. As a result, we question the financial position of the two affiliates and their impact on the repayment ability for the subject loan.

Moreover, the lender's analysis included a personal statement of cash inflows and outflows for the borrower's vice president, and considered her cash flow needs in the repayment ability analysis. However, while the lender's analysis provided the income of the president, it did not include her monthly debt obligations. As a result, the lender did not support how the cash needs of the borrower's president would affect repayment ability. Evidence in the loan file supported that the president's debt-to-equity ratio was 8.65, indicating that she may not have been generating enough cash flow to satisfy her debt obligations. Had the lender considered the affiliates' financial performance and the president's personal cash flow needs, this loan may not have been eligible for an SBA guaranty.

*Questionable Financial Analysis and Projections*

We question the reliability of the historical financial information and the reasonableness of projections used by the lender in its repayment ability analysis. The lender's cash flow analysis indicated that the [Ex. 4] [redacted], historically, had adequate debt service coverage after add-backs.[20] However, tip income was inappropriately treated as business revenue. Tip income should not have been treated as revenue because it is considered employee income. This same tip income was then used to reduce the cost of goods sold for the business. As a result, the tip income was effectively double counted, thus significantly overstating the seller's net income. We adjusted for the appropriate treatment of tip income, which resulted in inadequate debt service coverage for the business in 2006 and 2007 of ($80,009) and ($64,423), respectively. In addition, the loan file did not include a Profit and Loss Statement for 2008. As a result, we were unable to determine whether the 2008 debt service coverage was adequate.

We also found that the projections used by the lender for its repayment ability analysis were unsupported. According to both the lender's analysis and financial information in the loan file, [Ex. 4] [redacted] had declining sales and negative net income from 2006 to 2008. Based on the lender's analysis, the net profit margin from 2006 to 2008 would have been -2.2 percent, -1.2 percent and -2.3 percent, respectively. Despite 3 years of declining sales and negative net income, the lender projected a net profit margin of 29.2 percent—a 1,369 percent increase over 2008—for the [Ex. 4] [redacted] in its first year under new ownership. This large increase in net profit margin was based on a projected 69 percent decrease in business operating expenses, which was unsupported by the lender. Additionally, the lender's industry analysis provided that the average Risk Management Association (RMA) net profit margin for this type of

[20] Add-backs to the cash flow of the business were expenses in the historical financial information that did not affect the movements of cash (i.e., depreciation) or that would not be an expense for the new business (i.e., charitable contribution).

business was 2.9 percent.[21] Nonetheless, the lender used projections that were approximately 10 times higher than both the industry average and historic performance of the business.

Because of the declining historical financial performance of the business, an analysis of the interim financial statements was critical to determine if the business would continue to operate as a going concern. When annualized, the 2009 interim financial information indicated that sales would be 4.5 percent higher than 2008, while operating expenses would be 77 percent less than in 2008. The loan file did not include interim financial statements that would have provided line items to support these figures. Additionally, the only explanation given by the lender for the significant decrease in operating expenses was that the seller stopped expensing personal items through the business. However, our analysis of the business' financial information determined that the operating expense accounts appeared necessary for a restaurant.

*Inadequate Business and Collateral Valuations*

SBA requires an independent business valuation when a close relationship exists between the buyer and seller for loans that finance change of ownerships. The borrower's vice president had been either an employee or manager of the selling business since 2006. In its eligibility checklist, the lender indicated it had obtained the required independent business valuation, but instead conducted its own business valuation based on the business' historical earnings.

The selling price of the business, excluding real estate, was $460,000. However, the lender valued the business at only $228,000, based on historical earnings. We question the reliability of the lender's internal business valuation because it was derived from the seller's unreliable financial information. Further, the 2008 balance sheet showed fixed assets worth only $32,000. However, the lender stated that only $25,000 of the purchase price was for goodwill, indicating that the lender's value for fixed assets exceeded $32,000. We noted that the loan file did not include an independent appraisal of the fixed assets, as required. As a result, there is no assurance that the $228,000 internal valuation of the business was reliable.

**CRITERIA**

13 Code of Federal Regulations (CFR) 120.524 (a) (1-3) states that SBA is released from liability on a loan guaranty (in whole or in part) if the lender has failed to comply materially with any loan program requirement for 7(a) loans; the lender has failed to make, close, service, or liquidate a loan in a prudent manner; or the lender's improper action or inaction has placed SBA at risk.

13 CFR 120.150 states that the applicant must be creditworthy. Loans must be so sound as to reasonably assure repayment, considering past earnings, projected cash flow, future prospects, the ability to repay the loan with earnings from the business, and the effects of any affiliates.

Standard Operating Procedure (SOP) 50 10 5(A) states that SBA's business loan eligibility, credit policy, and procedures apply to PLP loans.

SOP 50 10 5(A) states that affiliation exists when one individual or entity controls or has the power to control another, or a third party or parties control or has the power to control both. SBA considers factors such as ownership, management, previous relationships with or ties to another

[21] RMA is a not-for-profit, member-driven professional association serving the financial services industry. RMA helps banking and nonbanking institutions identify and manage the impacts of credit risk, operational risk, and market risk on their businesses and customers.

entity, and contractual relationships when determining whether affiliation exists. The SOP also requires the lender to retain affiliate and subsidiary financial statements in its loan file.

SOP 50 10 5(A) states that the cash flow of the business is the primary source of repayment. Thus, if the lender's financial analysis demonstrates that the business lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined.

SOP 50 10 5(A) states that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards.

SOP 50 10 5(A) requires that the lender perform a financial analysis of repayment ability based on historical income statements and/or tax returns (if an existing business) and projections, including the reasonableness of the supporting assumptions.

SOP 50 10 5(A) states that when purchasing an existing business with loan proceeds, the 7(a) loan application must include (1) a copy of the seller's financial statements for the last 3 complete fiscal years or for the number of years in business if less than 3 years, and (2) interim statements no older than 90 days from date of submission to SBA.

SOP 50 10 5(A) states that all standard 7(a) loan applications must include a personal financial statement, dated within 90 days of submission to SBA, on all owners (20 percent or more), officers, and proposed guarantors—including spouses.

SOP 50 10 5(A) states that SBA considers a change of ownership to be a "new" business because it will result in new, unproven ownership/management and increased debt unrelated to business operations. It also states that determining the value of a business (not including real estate, which is separately valued through an appraisal) is the key component to the analysis of any loan application for a change of ownership. The lender's loan documentation must include a business valuation (not to include any real estate) by the lender or an independent third party hired by the lender with proven experience in business valuations. A business valuation assists the lender and the buyer in making the determination that the seller's asking price is supported by historic operations.

SOP 50 10 5(A) states that if there is a close relationship between the buyer and seller, the lender must obtain an independent business valuation from a qualified source. A qualified source is an individual who regularly receives compensation for business valuations and is either (1) accredited by a recognized organization, or (2) a licensed certified public accountant that performs the business valuation in accordance with the "Statement on Standards for Valuation Services" published by the American Institute of Certified Public Accountants.

SOP 50 10 5(A) states that if the valuation of fixed assets is greater than their depreciated value, an independent appraisal must be obtained to support the higher valuation.

SOP 50 51 2b states that a denial based upon a lender's underwriting may be appropriate if: (1) a lender failed to comply with an SBA lending requirement in making or closing the loan, which placed the Agency at financial risk, or (2) the lender was clearly negligent by failing to account for an obvious fact that could likely affect the borrower's ability to repay the loan.

**CAUSE**

The lender did not originate and close the loan in compliance with SBA's regulations and procedures.

**EFFECT**

The deficiencies on this loan resulted in a $900,175 guaranteed payment by SBA that should be recovered (reduced for any recoveries from liquidation).

**RECOMMENDATION**

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

1. Require Ridgestone Bank to bring the loan into compliance, and, if not possible, seek recovery of $900,175 (less any amounts received from liquidation) from Ridgestone Bank on the guaranty paid by SBA for the loan to [Ex. 4][redacted].

**MANAGEMENT'S RESPONSE**

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

☒ Management substantially concurs with the Notice of Finding and Recommendation.

☐ Management does not concur with the Notice of Finding and Recommendation. Please give reasons for management's non-concurrence.

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

After conducting an extensive review at the NGPC and multiple conversations with the lender, OFPO Management concurs that full recovery is warranted due to the lender's failure to secure an independent business valuation or otherwise value the equipment taken as collateral to support the purchase price. However we are not in concurrence with IG's position that two businesses of a 15% owner should have been analyzed as affiliates. Also we are not in concurrence with IG's position that business did not cash flow and was unable to service debt as seller's financial information appears reasonably accurate.

The lender was notified of the deficiencies on October 20, 2014. We are providing the lender an opportunity to overcome the business valuation issue. If the lender is not able to provide documentation to overcome the business valuation issue by December 8, 2014, the file will be processed as a denial of liability and recovery sought from the lender.

Management Official Signature: ________________________ Date: 11/10/2014

## Appendix IV: NFR 14005-3 Issued to SBA (Includes SBA's Response)

**NOTICE OF FINDING AND RECOMMENDATION**
**NFR No. 14005-03**

**Date:** December 19, 2014

**BACKGROUND**

The purpose of this notice of finding and recommendation (NFR) 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 developed by the Office of Inspector General (OIG) to prioritize loans based on the risk of loss to the Small Business Administration (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.

The lender, USC Credit Union, was authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, USC Credit Union was permitted to process, close, service, and liquidate loans with limited review by SBA.[22]

On November 13, 2009, the lender approved SBA loan number 3747925009 for $501,000, with a 90 percent guaranty,[23] to [Ex. 4] [redacted] (borrower). The purpose of this loan was to finance the purchase of equipment, leasehold improvements, inventory, and provide working capital for the start-up diner. The diner was being refurbished in conjunction with the development of an adjacent movie theater. The lender subsequently increased the loan amount on May 19, 2010, to $552,500 and disbursed proceeds between November 23, 2010, and July 15, 2011. During the disbursement period, the borrower made four monthly interest-only payments as required and only three full (principal and interest) loan payments. The borrower made its last payment on June 2, 2011. Upon final disbursement, the lender deferred loan payments for 8 months and the borrower defaulted on March 1, 2012. NGPC purchased the loan on March 10, 2014 for $471,905.

**CONDITION**

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 used unsupported projections and did not provide assumptions for how the business would achieve approximately $1.9 million in revenue during its first year and significantly increase revenues within subsequent years. Furthermore, the lender did not provide an analysis of the industry financial ratios in comparison to the borrower's projections or explain any significant differences. Additionally, the lender did not satisfy SBA requirements for the discussion of competition and need for the restaurant in the area. The above factors were further aggravated by the lender's lack of analysis to support the adequacy of the borrower's working capital. Based on these deficiencies, the lender did not demonstrate reasonable assurance of repayment for the SBA loan.

[22] USC Credit Union used a lender service provider (LSP) to assist with these areas. As the lender maintains the ultimate responsibility for any actions taken by the LSP, we refer to all areas of compliance as the lender's responsibility.
[23] This loan was funded by appropriations from The American Recovery and Reinvestment Act of 2009, which temporarily increased SBA 7(a) Loan Program guarantees to 90 percent.

***Inadequate Assurance of Repayment Ability***

*Questionable Financial Analysis and Projections*

We question the reasonableness of projections used by the lender in its repayment ability analysis. The lender relied on and provided unsupported projections to demonstrate repayment ability by the start-up business for the subject SBA loan. Per SBA procedures, the lender must conduct a financial analysis of repayment ability based on historical income statements or tax returns, and projections, including the reasonableness of the supporting assumptions. The loan documentation did not include an adequate assessment supporting how the business would achieve sales of $1.9 million within its first year of operations. Further, the projected second and third year business revenues were $2.4 million and $3.9 million, respectively. Additionally, the projected debt service coverage for the first 3 years of operation were 1.65, 9.12, and 18.36, respectively. The lender's credit memorandum also did not include any discussion of the diner's maximum occupancy and hours of operation. Finally, the lender's credit memorandum did not include any discussion on the need for the diner in the area and its competition as required.

Based on the borrower's estimated price per meal and monthly projected meal revenue of $135,000 during the first year of operations, we determined that the diner would have to sell at least 450 meals per day. We found evidence supporting that the small diner, a refurbished historic train meal car, had only 26 available seats and an outdoor patio (see Exhibits 1and 2). Providing a reasonable maximum occupancy of 50 seats, including the patio, the diner would have had to turn over seats approximately nine times per day, every day, to achieve its first year monthly meal revenue projections.[24]

**Exhibit 1(Inside [Ex. 4][redacted])**

Source: SBA loan file

**Exhibit 2 (Outdoor Patio-[Ex. 4][redacted])**

Source: SBA loan file

The lender also did not submit an analysis of the projected financial ratios in comparison to industry averages, as required by SOP 50 10 5(B). The borrower's projected net profit margins were 13 percent for the first year, 32 percent for the second, and 39 percent for the third. However, according to the Risk Management Association (RMA), the net profit margin for a typical restaurant is 2.0 percent to 3.5 percent.[25] Additionally, RMA income statement studies support that average net profit margins for restaurants in 2007 were only 2.6 percent and only 1.9 percent in 2008. The

[24] The loan file also indicated that the diner had a take-out service. However, there was no discussion on how much of the monthly revenue the borrower expected to be generated from this service.

[25] RMA is a not-for-profit, member-driven professional association serving the financial services industry. RMA helps banking and nonbanking institutions identify and manage the impacts of credit risk, operational risk, and market risk on their businesses and customers.

lender did not provide evidence supporting that it used industry averages to analyze the reasonableness of the projections and did not discuss or support why the projected net profit margin for the subject business was significantly higher than these industry averages noted above. Within its submission package to SBA for purchase of the loan, the lender noted that the diner was only able to generate approximately 1/3 of the projected sales, which was insufficient to cover operating expenses.

*Insufficient Working Capital*

We also determined that the lender did not discuss the adequacy of the borrower's equity position during its start-up period. Per SBA procedures, the lender's application must include a pro forma balance sheet for the subject business. Additionally, the lender must conduct a financial analysis of the applicant's balance sheet before and after the loan to include any required adjustments—such as any equity injections—including a discussion of its adequacy. At the time of loan approval, the lender allocated $272,000 of loan proceeds to working capital. However, there was no evidence in the loan file that the lender conducted an analysis to determine whether this amount was sufficient to support the viability of the start-up diner. Furthermore, due to increased construction costs, the lender subsequently reduced the loan proceeds for working capital to approximately $90,000—a decrease of 67 percent. In the documentation submitted to SBA, the lender did not discuss how this reduction in working capital would affect the adequacy of cash available to assist the business operations during the start-up period. Adequate working capital was especially important given the borrower was a start-up and the diner car was being relocated to a new area that was still under development.

The borrower opened for business in April 2011 and continued only 8 months before ceasing its operations. As previously stated, the borrower only made a limited number of payments before the lender deferred payments for 8 months to assist the borrower during its early payment difficulties. Moreover, as discussed above, the lender did not submit sufficient evidence to SBA to support projections, and the diner was only able to generate approximately 1/3 of the projected sales, which was insufficient to cover operating expenses. The lender cited that the diner suffered primarily due to the construction of the adjacent movie theater, which opened for business approximately one week after the diner closed. However, the development of an arts district and ongoing construction within the immediate area that the business would operate was known to the lender at origination, further supporting the need for sufficient working capital.

**CRITERIA**

13 Code of Federal Regulations (CFR) 120.524 (a) (1-3) states that SBA is released from liability on a loan guaranty (in whole or in part) if the lender has failed to comply materially with any loan program requirement for 7(a) loans; the lender has failed to make, close, service, or liquidate a loan in a prudent manner; or the lender's improper action or inaction has placed SBA at risk.

13 CFR 120.150 states that the applicant must be creditworthy. Loans must be so sound as to reasonably assure repayment, considering experience and depth of management; strength of the business; past earnings, projected cash flow, future prospects; the ability to repay the loan with earnings from the business; and potential for long-term success.

Standard Operating Procedure (SOP) 50 10 5(B) states that SBA's business loan eligibility, credit policy, and procedures apply to PLP loans.

SOP 50 10 5(B) states that the cash flow of the business is the primary source of repayment. Thus, if the lender's financial analysis demonstrates that the business lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined.

SOP 50 10 5(B) states that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards.

SOP 50 10 5(B) states that the lender's analysis must include a financial analysis of repayment ability based on historical income statements and/or tax returns (if an existing business) and projections, including the reasonableness of the supporting assumptions. It must also include a description of and comments on the business plan, including financial condition of the business, need for the business in the area (if new), and competition.

SOP 50 10 5(B) states that the lender's analysis must include a ratio analysis of the financial statements, including comments on any trends and a comparison with industry averages. The lender's analysis must also include a financial analysis of the small business applicant's current balance sheet before and after the loan to include any required adjustments such as any equity injection, including a discussion of its adequacy, or stand-by debt.

SOP 50 10 5(B) states that for PLP lenders, all forms and exhibits required for the standard 7(a) application are required to be completed and retained in the lender's file.

SOP 50 10 5(B) states that all standard 7(a) loan applications, except for Small/Rural Lender Advantage Initiative loan applications of $350,000 or less, must include SBA Form 4-I, "Lender's Application for Guaranty." The Form 4-I must be completed in its entirety, including a pro forma balance sheet. The 7(a) loan application must also include justification for a new business, including a change of ownership. For new businesses and change of ownerships where historical repayment ability is not demonstrated, the lender must provide a narrative addressing the business plan and cite any areas of concern and justification to overcome them.

SOP 50 51 3 states that a full denial of liability is almost always justified if the lender's failure to make or close the loan in accordance with loan program requirements or prudent lending practices contributed to or allowed an early default. For example, denial is almost always justified on a PLP, Express or Pilot Loan Program loan based on deficient underwriting if the lender was clearly negligent in its cash flow analysis by failing to take into account an obvious fact that could easily affect the borrower's ability to repay the loan, such as, if:

a. The lender made the loan even though the borrower's projected expenses greatly exceeded projected revenues and the borrower had no other source of income; or
b. The lender failed to justify cash flow projections for the borrower by comparing the projected revenue of a start-up business against an industry standard or some other reliable measure including the lender's own experience making loans to similar businesses.

The loan authorization stated that it is the lender's sole responsibility to (1) close the loan in accordance with the terms and conditions of this authorization, (2) obtain valid and enforceable loan documents, and (3) retain all loan closing documents. It also stated that the lender must submit these documents, along with other required documents, to SBA for review if the lender requests SBA to honor its guarantee on the loan, or at any time SBA requests the documents for review. Further, the loan authorization stated that the guarantee is contingent upon lender complying with the current SBA SOP and satisfying all of the conditions in the authorization.

**CAUSE**

The lender did not provide sufficient documentation to justify SBA's purchase of the $471,905 guaranty.

**EFFECT**

SBA's $471,905 guaranteed payment to the lender is unsupported.

**RECOMMENDATION**

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

1. Require USC Credit Union to bring the loan into compliance and, if not possible, seek recovery of $471,905 (less any amounts received from liquidation) from USC Credit Union on the guaranty paid by the SBA for the loan to [Ex. 4] [redacted].

**MANAGEMENT'S RESPONSE**

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

☒ Management substantially concurs with the Notice of Finding and Recommendation.

☐ Management does not concur with the Notice of Finding and Recommendation. Please give reasons for management's non-concurrence.

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

After conducting an extensive review of the file at the National Guaranty Purchase Center, OFPO concurs that the lender failed to properly address all necessary aspects of the loan during underwriting, which warrants a full recovery of this loan. OFPO found that the lender insufficiently explained how the carry out aspect of the business would contribute to the overall revenue. The lender also did not justify how the profit margin projections were acceptable, given the fact that they were significantly higher than industry standards. OFPO also agrees that the lender did not properly address the working capital needs of the business. OFPO has already reached out to the lender and is allowing them time to overcome the issues before pursuing the recovery efforts on this loan. Should the lender provide information which satisfies the issues noted above, OFPO may change the recommended final course of action. If the lender does not respond by February 23rd, the file will be sent to OFPO HQ to be processed as a denial/litigation case and funds will be sought from the lender.

Management Official Signature: ____________________ Date: 1/26/15

## Appendix V: Agency Comments

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

MEMORANDUM
March 17, 2015

TO: Troy M. Meyer
Assistant Inspector General for Auditing

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

SUBJECT: Response to Draft Report on The OIG High Risk 7(a) Loan Review Program Recommends $1.8 Million in Recoveries

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 Small Business Administration (SBA) strives to ensure proper payments on guaranty purchases consistent with SBA's regulations and policies. The Office of Financial Program Operations (OFPO) takes great pride in its continuous improvement efforts at the National Guaranty Purchase Center (NGPC) and is always looking for ways to enhance the effectiveness of the review of guaranty purchase requests. SBA also recognizes the importance training plays in ensuring its employees possess the knowledge and skills required to perform guaranty purchase reviews and works diligently to ensure it provides quality training for their continued improvement.

In FY 2014, the OIG established the High Risk 7(a) Loan Review Program. As part of this effort, the OIG initiated ongoing reviews of high-dollar/early-defaulted 7(a) loans purchased by the NGPC between October 1, 2013 and May 31, 2014. In a July 21, 2014 Audit Entrance Conference, the OIG stated that it planned to review and report individual loan findings to management on an ongoing basis, and indicated that in doing so, the NGPC could address deficiencies on recent guaranty purchases providing for a more efficient and effective resolution.

The draft report outlines the OIG's concerns regarding its review of high-dollar/early defaulted loans purchased in the NGPC and concludes that three of the seven loans reviewed should be brought into "…compliance and, if not possible, seek recovery of approximately $1.8 million from the lenders." High-dollar/early defaulted loans are defined as loans approved for $500,000 or more that defaulted within the first 18 months of initial disbursement. Of the three loans with identified deficiencies, two were purchased in 2014 and total approximately $886,000; the remaining loan was purchased in 2011 totaling approximately $900,000 – representing over half of the improper payments headlined in this draft report.

The OIG chose to include one loan purchased in 2011 that met their definition of high-dollar/early default and their scoring criteria, despite the transaction occurring several years ago. As it is currently written, the draft report implies that the existing process at the NGPC is responsible for $1.8 million in improper payments. Though OFPO agrees with OIG's recommendation regarding that loan, OFPO takes exception with its inclusion in this report, and contends that its conclusion is misleading, and does not provide for an accurate representation of the current state of the NGPC's review process, as the purchase in 2011 preceded a number of changes which OFPO initiated subsequent to that time in order to reduce the incidence of improper payments.

Since 2011, OFPO has made significant and purposeful strides in improving its process to reduce and prevent material deficiencies and improper payments.

- We enhanced the 7(a) guaranty purchase review process placing a greater emphasis on evaluating the lender's analysis of a borrower's repayment ability as well as change of ownership transactions, sourcing of equity injection, and business valuations.

- We implemented internal controls requiring that early defaulted loans with an outstanding balance over $500,000 undergo a rigorous quality control review prior to purchase.

- We issued a new Standard Operating Procedures (SOP) manual, effective March 1, 2013, which increased repayment ability and creditworthiness standards.

- We provided intensive training on commercial credit underwriting techniques to our employees through internal training sessions and formal training by an external training company.

Regarding the loan purchased in 2011, the OIG's review determined that the lender did not approve it in accordance with SBA's origination and closing requirements, specifically stating that the lender did not demonstrate a reasonable assurance of repayment for the SBA loan, and did not provide assurance that the business valuation supported the purchase price. While the lender of this loan remains steadfast in its position in that there was neither a violation of the SBA's SOP nor weak underwriting at the time of origination, OFPO will continue its efforts to resolve the loan with the lender.

The draft audit also makes reference to an OIG investigation, which led to the "…conviction of a loan broker who was responsible for 124 fraudulent SBA loans having a value of $100 million." It is important to note that this fraud scheme was initially identified through the diligent reviews and insight of NGPC employees, who alerted the OIG of the potential fraud scheme. In fact, the NGPC has referred several cases of suspected fraud to the OIG, and this is just one such example.

Furthermore, the OIG cites material deficiencies with one loan included in the SBA's FY 2014 improper payment audit, which was not detected by the Center during its review. While OFPO agrees with OIG's recommendation regarding this loan, it should be noted that the OIG is able to expend significantly more time in the conduct of its reviews than is available to the NGPC. It is unfortunate that any improper payment should occur, but it ought to be recognized that the subsequent application of additional resources and additional time to the subsequent review of fewer case files, does, on occasion, serve to ferret out improper payments not as readily observed under less optimal circumstances. It should be noted that the inclusion of this loan in the FY 2014 improper payment rate calculation has a minimal impact, approximately 0.42 percent, on the overall 7(a) guaranty purchase improper payment rate.

The draft reports states that it remains concerned with the effectiveness of the SBA's quality control (QC) program in the NGPC. This assertion appears to arise from two loans included in this audit. Yet, in 2014, the OIG conducted an evaluation of OFPO's QC program and concluded that OFPO, "made significant progress in implementing a QC program for its loan centers."[26] OFPO agrees that significant progress has been made in developing an independent QC program, and OFPO is committed to further improving that program. Moreover, while OFPO recognizes the OIG's concerns, QC is tasked with reviewing various critical functions in the Center, and OIG's identification of deficiencies in one area of its operation is not indicative of an ineffective program and should not serve to impugn the QC program as a whole.

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

***1. Require Monterey County Bank to bring the loan into compliance, and, if not possible, seek recovery of $413,704 (less any amounts received from liquidation) from Monterey County Bank on the guaranty paid by SBA for the loan to[Ex. 4]*** [redacted].

OFPO agrees with this recommendation and will pursue recovery from the lender in the amount of $413,704, less any amounts received from liquidation.

***2. Require Ridgestone Bank to bring the loan into compliance, and if not possible, seek recovery of $900,175 (less any amounts received from liquidation) from Ridgestone Bank on the guaranty paid by SBA for the loan to [Ex. 4]*** [redacted].

OFPO agrees with this recommendation and will continue to work with the lender to determine if it can be brought into compliance. If it is determined that the documentation provided cannot mitigate the concerns identified, OFPO will pursue recovery from the lender for the remaining balance of the loan. It should be noted that the loan has received recoveries and the SBA's share of the outstanding balance is $674,060.40 plus interest.

OFPO would like to further emphasize, as noted above, that since the purchase of this loan

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[26] OIG Report 14-08, Improvement is Needed to Ensure Effective Quality Control at Loan Operations Centers

in 2011, the NGPC has made extensive enhancements to its 7(a) purchase process placing a greater emphasis on the lender's evaluation of a borrower's repayment ability. Additionally, items addressing change of ownership transactions, sourcing of equity injection, and business valuations have been added to the 7(a) guaranty purchase action. These enhancements, in conjunction with the SOP revisions and the intensive training provided to NGPC employees, have substantially improved the 7(a) guaranty purchase process, OFPO contends that the deficiency and associated improper payment would likely have been prevented if reviewed under the current process.

***3. Require USC Credit Union to bring the loan into compliance and, if not possible, seek recovery of $471,905 (less any amounts received from liquidation) from the USA Credit Union on the guaranty paid by SBA for the loan to [Ex. 4] [redacted].***

OFPO agrees with this recommendation and is reviewing additional information from the lender. If it is determined that the documents provided cannot mitigate the concerns identified, OFPO will pursue recovery from the lender in the amount of $471,905, less any amounts received from liquidation.