



Audit Report



Report Number: OIG-SBLF-13-007

STATE SMALL BUSINESS CREDIT INITIATIVE:
Massachusetts' Use of Federal Funds for Capital Access and
Other Credit Support Programs

May 14, 2013

Office of
Inspector General

Department of the Treasury

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Abbreviations

The Act	The Small Business Jobs Act of 2010
Commonwealth	Commonwealth of Massachusetts
FAQs	<i>Frequently Asked Questions</i>
MBDC	Massachusetts Business Development Corporation
MCAP	Massachusetts Capital Access Program
MGCC	Massachusetts Growth Capital Corporation
National Standards	<i>SSBCI National Standards for Compliance and Oversight</i>
OCSP	Other Credit Support Programs
OMB	Office of Management and Budget
SBA	Small Business Administration
SSBCI	State Small Business Credit Initiative

*The Department of the Treasury
Office of Inspector General*

May 14, 2013

Don Graves, Jr.
Deputy Assistant Secretary for Small Business, Housing, and
Community Development

This report presents the results of our audit of the Commonwealth of Massachusetts' (Commonwealth) use of funds awarded under the State Small Business Credit Initiative (SSBCI), which was established by the Small Business Jobs Act of 2010 (the Act). Treasury awarded Massachusetts approximately \$22 million¹ in SSBCI funding, and as of June 30, 2012, the Commonwealth received its first allocation of approximately \$7.3 million.²

As of June 30, 2012, Massachusetts had obligated or spent approximately \$6.6 million of the funds disbursed, including \$4 million for the Massachusetts Growth Capital Corporation (MGCC) Loan Participation Program, \$2.1 million for the Massachusetts Business Development Corporation (MBDC) Loan Participation Program, and \$211,000 for the Massachusetts Capital Access Program (MCAP). The Commonwealth also incurred approximately \$321,000³ in administrative costs.

The Act requires the Treasury Office of Inspector General (OIG) to conduct audits of the use of funds made available under SSBCI and to identify any instances of reckless or intentional misuse. Treasury has defined reckless misuse as a use of allocated funds that the participating state or administering entity should have known was

¹ Rounded down from \$22,032,072.

² Rounded up from \$7,270,584.

³ Rounded up from \$320,886.

unauthorized or prohibited, and which is a highly unreasonable departure or willful disregard from the standards of ordinary care. Intentional misuse is defined as a use of allocated funds that the participating state or its administering entity knew was unauthorized or prohibited.

We contracted with TCBA Watson Rice LLP, an independent certified public accounting firm, to conduct the audit, which was performed from August 2012 to April 2013. The audit objective was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds.

To test participant compliance we randomly selected a sample of 35 of the expenditures made between the signing of the Allocation Agreement on September 13, 2011, and June 30, 2012. The accounting firm also reviewed the administrative expenses charged against the SSBCI funds to ensure they were allowable, reasonable, and allocable.

We conducted quality assurance procedures to ensure that the work performed by TCBA Watson Rice LLP was completed in accordance with *Government Auditing Standards*. We believe that the evidence obtained to address the audit objective provides a reasonable basis for the audit findings and conclusions. A more detailed description of our objective, scope, and methodology is in Appendix 1 of this report.

Results in Brief

Massachusetts appropriately used most of the SSBCI funds it had expended as of June 30, 2012, but spent \$237,000 to participate in an SBA-guaranteed loan under the MBDC Loan Participation Program, which Treasury officials said was prohibited. The loan participation, which the MBDC Executive Committee approved on August 15, 2011, credit enhanced a Federally-guaranteed loan, which is prohibited by Treasury's April 25, 2012 *Frequently Asked Questions* (FAQs).

However, Treasury's guidance on credit enhancing Federally-guaranteed loans is unclear. Treasury has not defined what

constitutes a “credit enhancement,” and the *SSBCI Policy Guidelines* prohibit the enrollment of only the unguaranteed portions of Federally-guaranteed loans, which may cause participating states to inadvertently violate Treasury guidance in the *FAQs*. The *FAQs* also state that “Treasury reserves the right to evaluate applications on a case-by-case basis,” which could be interpreted to mean that participation in Federally-guaranteed loans may be approved in some instances.

The audit also disclosed that Massachusetts did not obtain complete borrower and lender assurances by the time of loan closings for 31 (or 89 percent) of the 35 loans tested, as required by *SSBCI Policy Guidelines*. Despite the inadequate assurances, the Commonwealth certified in March 2012 and June 2012 that it was in compliance with all SSBCI requirements, which was materially inaccurate. However, at Treasury’s direction, Massachusetts made lenders and borrowers recertify to all assurances by September 2012.

Finally, Massachusetts reported to Treasury \$200,000 in administrative expenses that was not adequately supported, and therefore, should be disallowed; and did not report \$51,248 in program income to Treasury, as required by its Allocation Agreement.

We recommend that Treasury define “credit enhancement” and revise program guidance to make the enrollment of Federally-guaranteed loans a clear prohibition, disallow \$200,000 in administrative expenses unless the Commonwealth can provide adequate support for such costs, and require the Commonwealth to demonstrate that it has a compliant system for allocating administrative costs. We also recommend that Treasury determine whether there has been a general event of default of the Allocation Agreement resulting from Massachusetts’ non-compliance with lender/borrower assurance requirements, materially inaccurate certifications, and failure to report program income. If such an event has occurred and not been cured, Treasury should consider the event’s impact on future funding to the Commonwealth.

Both the Commonwealth of Massachusetts and Treasury accepted all the report recommendations, and the Commonwealth agreed to work with Treasury to implement the corrective measures identified by the audit. Additionally, Massachusetts clarified that while it reported \$200,000 in administrative expenses, it did not charge the SSBCI fund for them and does not intend to seek reimbursement from SSBCI for these expenses. Formal written responses from Treasury and the Commonwealth of Massachusetts are included in their entirety in Appendix 2.

Background

SSBCI is a \$1.5 billion Treasury program that provides participating states, territories, and eligible municipalities with funds to strengthen Capital Access Programs and other credit support programs (OCSP) that provide financial assistance to small businesses and manufacturers. Capital Access Programs provide portfolio insurance for business loans based on a separate loan loss reserve fund for each participating financial institution. OCSPs include collateral support, loan participation, loan guarantee, and venture capital programs.

Each participating state is required to designate specific departments, agencies, or political subdivisions to implement the programs approved for funding. The designated state entity distributes the SSBCI funds to various public and private institutions, which may include a subdivision of another state, a for-profit entity supervised by the state, or a non-profit entity supervised by the state. These entities use funds to make loans or provide credit access to small businesses.

Primary oversight of the use of SSBCI funds is the responsibility of each participating state. To ensure that funds are properly controlled and expended, the Act requires that Treasury execute an Allocation Agreement with each state, setting forth internal controls and compliance and reporting requirements before allocating SSBCI funds. SSBCI disbursements to states are made in three allocations: the first when the Secretary approves the state for participation, and the second and third after the state certifies that it has obligated, transferred, or spent at least 80 percent of the previous allocation.

In addition, the participating state is required to annually certify that it has complied with program requirements.

Commonwealth of Massachusetts' Participation in SSBCI

On August 30, 2011, Treasury approved the Commonwealth of Massachusetts as a participant in SSBCI, awarding it approximately \$22 million. The Allocation Agreement between the Commonwealth and Treasury was signed on September 13, 2011, authorizing use of the SSBCI funds for three existing small business development programs: MCAP, the MBDC Loan Participation Program, and the MGCC Loan Participation Program. That same month, Treasury disbursed Massachusetts' first allocation of approximately \$7.3 million. As of June 30, 2012, Massachusetts had obligated or spent approximately \$6.6 million⁴ of the first allocation. Of the \$6.6 million, approximately \$321,000 was for administrative expenses incurred for its three programs.

Massachusetts Capital Access Program

MCAP has been in existence since 1993 and was designed to encourage banks to approve loans they might not normally approve by contributing to loan loss reserve funds of financial institutions. Under Massachusetts' SSBCI Allocation Agreement, SSBCI funds may be used to match borrower/lender contributions to loan loss reserve funds of financial institutions to cover losses from defaults on loans enrolled in the SSBCI program.

The Commonwealth of Massachusetts contracted with MBDC to administer MCAP. MBDC is a private, for-profit organization owned by New England banks and other investors and created in 1953 to provide capital to growing companies in the six New England states. Massachusetts allocated \$1.5 million of its total SSBCI award to MCAP. As of June 30, 2012, MBDC had obligated or spent \$211,000 of its first allotment of SSBCI funding on MCAP.

⁴ Rounded down from \$6,643,631.

MBDC and MGCC Loan Participation Programs

The MBDC Loan Participation Program, which has been in existence since the inception of MBDC in 1953, provides direct term loans to bridge the gap between financial needs and conventional bank financing. The program is an approved OCSP that is administered by MBDC and is primarily funded by private bank investments, which reduce the risk of exposure to loan losses. Massachusetts allocated \$6.6 million of its total SSBCI award to the MBDC program, of which \$2.1 million had been obligated or spent as of June 30, 2012.

The MGCC Loan Participation Program, an approved OCSP, provides capital to borrowers in conjunction with bank financing. The program is administered by MGCC, which is a not-for-profit organization that Massachusetts created in 2010 from two previously existing organizations. Its mission is to create and preserve jobs at small, women-owned, and minority-owned businesses, and to promote economic development in low-income and moderate-income communities and 24 cities in Massachusetts. MGCC funds projects that cannot obtain financing from traditional capital markets or favorable credit terms. Massachusetts allocated approximately \$14 million⁵ of its total SSBCI award to the MGCC Loan Participation Program, which as of June 30, 2012, had expended or obligated \$4 million.

Massachusetts Generally Used SSBCI Funds Appropriately

We found that 34 of the 35 SSBCI transactions enrolled by Massachusetts that we tested were in compliance with program requirements. However, one transaction appeared to be prohibited by *SSBCI Policy Guidelines*. In addition, Massachusetts did not obtain complete borrower and lender assurances for 89 percent of the loans reviewed by the time of loan closing. Finally, Massachusetts charged \$200,000 in administrative costs to the SSBCI program that did not comply with program guidance, and Massachusetts did not include in quarterly reports to Treasury \$51,248 of program income.

⁵ Rounded up from \$13,932,072.

An MBDC Loan Participation Was Prohibited, but Treasury Guidance is Unclear

The Commonwealth used \$237,000 in SSBCI funds to participate in the guaranteed portion of an SBA-guaranteed loan enrolled in the MBDC Loan Participation Program, an SSBCI-approved OCSP, which is prohibited. According to SSBCI program officials, enrolling either the guaranteed or unguaranteed portion of a Federally-guaranteed loan in an OCSP would constitute a prohibited “credit enhancement,” which was communicated in *FAQs* clarifying the *SSBCI Policy Guidelines*. The *FAQs* specifically state that “SBA-guaranteed loans and other Federally-guaranteed loans may not be credit enhanced by OCSPs.”

Massachusetts officials told us they believed that the loan in question was compliant with program requirements because Treasury’s *SSBCI Policy Guidelines* prohibit the enrollment of only the unguaranteed portions of Federally-guaranteed loans. Therefore, they reasonably believed the prohibition on credit enhancement did not pertain to the guaranteed portion of Federally-guaranteed loans.

Massachusetts’ misinterpretation is understandable as Treasury’s guidance on credit enhancing Federally-guaranteed loans is unclear. As a result, participating states may have difficulty interpreting Treasury’s guidance. First, because Treasury has not defined “credit enhancement,” it is unclear whether the term means extending credit that reduces the lender’s risk in a loan or whether it should be interpreted as providing the borrower additional credit beyond the government loan guarantee. Second, the *SSBCI Policy Guidelines* prohibit only the enrollment of the unguaranteed portion of a Federally-guaranteed loan, giving the impression that enrollment of the guaranteed portion is allowed. Finally, while Treasury’s *FAQs* state that “SBA-guaranteed loans and other Federally-guaranteed loans may not be credit-enhanced by OCSPs,” it also states that, “Due to the variety of program structures that are possible, Treasury reserves the right to evaluate applications on a case-by-case basis.” This could be interpreted to mean that participation in Federally-guaranteed loans may be approved in some instances.

Since Treasury officials maintain that enrolling either the guaranteed or unguaranteed portion of a Federally-guaranteed loan in an OCSP would constitute a prohibited “credit enhancement,” Treasury will need to revise program guidance to make such enrollments a clear prohibition.

Massachusetts Did Not Obtain Complete Borrower and Lender Assurances at Loan Closing

Massachusetts did not obtain complete borrower and lender assurances for 31 (89 percent) of the 35 loans reviewed by the time of loan closing and before funds were transferred, as required by *SSBCI Policy Guidelines*. Of the 31 loans, 29 loans were enrolled in MCAP, and 2 were enrolled in the MBDC Loan Participation Program.

The *SSBCI Policy Guidelines* and the *National Standards for Compliance and Oversight* require that prior to the transfer of funds each state must obtain an assurance from the lender/investor affirming (1) the loan or investment is not for a prior loan or investment that is not covered under the approved state program or that was owed to the borrower or investee or an affiliate of the lender or investor, (2) the loan or investment is not a refinancing of a loan or investment previously made to the borrower or investee by the lender or investor or an affiliate of the lender or investor, and (3) no principal of the lender or investor has been convicted of a sex offense against a minor.⁶

SSBCI Policy Guidelines also require that lenders and investors obtain borrower or investee assurances that: (1) loan or investment proceeds will be used for approved business purposes; (2) loan or investment proceeds will not be used for specifically prohibited purposes; (3) the borrower or investee and the lender or investor are not related parties; (4) the borrower or investee is not engaged in specifically prohibited activities; and (5) the principals of the borrower or investee have not been convicted of a sex offense against a minor.

⁶ The requirement that lender/investor assurances be obtained before the transfer of funds is set out in the *SSBCI National Standards for Compliance and Oversight*.

Many of these assurances were not obtained because MBDC developed its own assurance checklist, which did not include all affirmations required by the *SSBCI Policy Guidelines*. Treasury became aware of this issue before our audit field work began, and requested that MBDC discard its own assurance form and use the *Sample Small Business/Investee Certification for Use of Proceeds* provided in Appendix A of the *SSBCI National Standards for Compliance and Oversight (National Standards)*. Treasury also instructed MBDC to have lenders and borrowers recertify to all assurances. By September 2012, MBDC had obtained the recertifications from all borrowers and lenders.

Additionally, Massachusetts incorrectly certified to Treasury on March 31, 2012, and June 30, 2012, that its programs were being implemented in accordance with all program requirements. These certifications were materially inaccurate because complete borrower and lender assurances had not been obtained at loan closing or at the time of the certifications. The inaccurate certifications also demonstrate that the Commonwealth had not performed its due diligence in collecting the information needed to support its certifications to Treasury that it was administering its SSBCI funds in accordance with program requirements.

The Commonwealth's failure to collect all assurances prior to loan closing and its repeated inaccurate compliance certifications may have triggered a general event of default of its SSBCI Allocation Agreement. Under Section 6.1 of the agreement, Treasury, in its sole discretion, may find a participant to be in default if the participant materially fails to comply with, meet, or perform any term, covenant, agreement, or other provision contained in the agreement. Further, the participant may be in default of its agreement if it made any representation or certification to Treasury that is found to be inaccurate, false, incomplete, or misleading in any material respect.

Therefore, Treasury should determine whether a general event of default has occurred, and if such an event has occurred and not been adequately cured, whether future funding to Massachusetts should be suspended, reduced, or terminated.

Administrative Costs Reported Were Not Adequately Supported

We determined that \$200,000 of the \$321,000 in administrative costs reported to the SSBCI program as of June 30, 2012, did not comply with program guidance. All of that amount was related to the administration of the MGCC Loan Participation Program, of which approximately \$185,597 was for salary expense for loan processing, and \$14,403 was for executive travel and start-up costs. According to State officials, although these administrative costs were reported on the June 30, 2012 quarterly report to Treasury, they were never charged to the SSBCI program, and funds were not transferred to MGCC for reimbursement of these costs.

Section 4.2 of the Allocation Agreement says that the participating state shall use the allocated funds only for the purposes and activities specified in the agreement and for paying allowable costs of those purposes and activities in accordance with the cost principles set forth in OMB Circular A-87 (*Cost Principles for State, Local, and Indian Tribe Governments*) and codified in 2 C.F.R. part 235.

However, MGCC did not maintain employee time sheets or other payroll records to show how much time employees worked on SSBCI loans or prepare a cost allocation plan (in accordance with OMB A-87) that allocated the actual incurred costs to its programs and activities. Instead, MGCC estimated the number of hours required to process loans, including time for loan application due diligence, preparation of documents, and loan closing. MGCC then multiplied an average hourly salary rate (including salary and benefits) of \$67.49 by the estimated number of processing hours. Using this methodology, MGCC reported a total loan processing cost of \$185,597. In addition, MGCC claimed \$14,403 for "executive travel and startup costs," for which it had no supporting documentation.

Therefore, Treasury should disallow \$200,000 in administrative expenses that MGCC allocated to the SSBCI program unless the Commonwealth can provide documentation showing actual expenses and how they were allocated to the SSBCI program in accordance with OMB Circular A-87. Treasury should also require the

Commonwealth to demonstrate that MGCC has a process to document administrative costs or a cost allocation plan for SSBCI.

Massachusetts Did Not Report Program Income to Treasury

Massachusetts did not include in its March 31, 2012, and June 30, 2012, quarterly reports to Treasury \$51,248 of program income from the MBDC Loan Participation Program. The Allocation Agreement and *SSBCI Policy Guidelines* require states to deliver to Treasury quarterly reports that describe the use of allocated funds for each approved state program on both a quarterly and a cumulative basis. The reports must include the total amount of allocated funds used for direct and indirect administrative costs, the total amount of allocated funds used for loans and investments, and the amount of program income generated.

The Allocation Agreement defines program income as “income from fees for services performed that were funded or supported with allocated funds and interest earned on loans made with allocated funds.” Additionally, Treasury’s *FAQs* define program income as “gross income received by the participating state, territory, or municipality, including any returns on capital that is directly generated by an SSBCI-supported activity or as a result of the SSBCI funds.”

MBDC indicated that program income was being tracked, but not reported, because it had misinterpreted guidance in Treasury’s *FAQs*, which conflicted with that contained in the Allocation Agreement. We agree that the definitions of program income can be easily misinterpreted because the *FAQs* also state that “interest, fees, refunds, or other types of gross income earned by financial institutions, private venture capital funds, or private investor networks on loans or investments made using SSBCI funds are *not* considered program income.” Massachusetts considered MBDC a financial institution and therefore believed the income earned from its loans was not considered program income. Although Treasury guidance is meant to prevent states from reporting income generated by private lenders and investors, it can be interpreted as instructing states to not consider interest, fees, or refunds generated by non-state entities that

administer SSBCI funds as income for reporting purposes. However, we noted that Massachusetts did not contact Treasury to seek clarification of the definition of program income, even though it believed Treasury's guidance was unclear.

The Commonwealth's omission from its quarterly reports of interest earned as program income may have triggered a general event of default under its SSBCI Allocation Agreement, and therefore, Treasury should determine whether the omission constitutes a general event of default of the agreement.

Recommendations

We recommend that the Deputy Assistant Secretary for Small Business, Housing, and Community Development:

- 1) Define "credit enhancement" and revise program guidance to make the enrollment of Federally-guaranteed loans a clear prohibition.
- 2) Disallow \$200,000 in administrative costs claimed, unless the Commonwealth provides documentation in accordance with OMB Circular A-87, showing actual expenses incurred and how they were allocated to the SSBCI program.
- 3) Require the Commonwealth to demonstrate that it has a system for allocating administrative costs that is compliant with program requirements.
- 4) Determine whether there has been a general event of default under Massachusetts' Allocation Agreement resulting from the Commonwealth's non-compliance with the lender/borrower assurance requirements, its filing of inaccurate certifications that it complied with all program requirements, and its failure to report program income. If such an event has occurred and has not been adequately cured, determine whether it warrants a reduction, suspension, or termination of future funding to the Commonwealth.

Management Comments and OIG Response

We provided a draft of this report to Treasury on April 18, 2013, and received formal written comments on May 9, 2013, in which Treasury and Massachusetts accepted all of the report recommendations. Additionally, Massachusetts clarified that while it reported \$200,000 in administrative expenses, it did not charge the SSBCI fund for them and does not intend to seek reimbursement from SSBCI for these expenses.

In response to recommendation 1, management stated that it is in the process of revising program guidance on the enrollment of Federally-guaranteed loans. Regarding recommendations 2 and 3, management reported that it will verify that the \$200,000 in administrative expenses was not charged to the SSBCI program and will verify that Massachusetts' system for tracking administrative expenses complies with OMB Circular A-87. Finally, management stated it will determine whether Massachusetts has adequately cured its non-compliance with program requirements and determine whether additional action is warranted, as proposed in recommendation 4.

We believe Treasury's planned actions to be fully responsive to the recommendations.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the evaluation. If you wish to discuss the report, you may contact me at (202) 622-1090, or Lisa DeAngelis, Audit Director, at (202) 927-5621.

/s/

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight

Appendix 1: Objective, Scope, and Methodology

We contracted with TCBA Watson Rice LLP, an independent certified public accounting firm, to conduct the audit, which was performed from August 2012 to April 2013. The audit objective was to test participant compliance with State Small Business Credit Initiative (SSBCI) requirements and prohibitions to identify any reckless or intentional misuse of funds.

To determine participant compliance, the accounting firm tested a sample of 35 expenditures that were made between the signing of the Allocation Agreement on September 13, 2011, and June 30, 2012. These included 3 of the 10 loans in the Massachusetts Business Development Corporation (MBDC) Loan Participation Program, and 32 of the 60 loans in the Massachusetts Capital Access Program. The firm reviewed loan documentation for the loans sampled to determine whether Massachusetts complied with program requirements for use of proceeds, capital at risk, and other restrictions noted in the Small Business Jobs Act of 2010 and *SSBCI Policy Guidelines*.

The accounting firm also reviewed the Commonwealth's accounting procedures and quarterly reports for completeness, and interviewed Massachusetts officials who administer, account for, and report on SSBCI funding. The firm visited the Massachusetts Executive Office of Housing and Economic Development in Boston, MA, to interview its SSBCI compliance officer and its Chief Financial Officer, who are responsible for preparing and submitting quarterly reports to Treasury. It also visited MBDC offices in Wakefield, MA, and Massachusetts Growth Capital Corporation (MGCC) offices in Charlestown, MA, where it interviewed MBDC and MGCC personnel who administer, account for, and report on the SSBCI program. Finally, the accounting firm reviewed the administrative expenses charged against the SSBCI funds to ensure they were allowable, reasonable, allocable, and adequately supported in accordance with Office of Management and Budget (OMB)⁷ and Treasury guidelines.

We conducted quality assurance procedures to ensure that the work performed by TCBA Watson Rice LLP was completed in accordance with *Government Auditing Standards*. Those standards require that the audit be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable

⁷ OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Government*.

basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained to address the audit objective provides a reasonable basis for the audit findings and conclusions.

Appendix 2: Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 9, 2013

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Ritt:

Thank you for the opportunity to review the Office of the Inspector General's (OIG) draft report entitled *State Small Business Credit Initiative: Massachusetts' Use of Federal Funds for Capital Access and Other Credit Support Programs* (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

We appreciate the Report's finding that Massachusetts generally used State Small Business Credit Initiative (SSBCI) funds appropriately and that all but one of the sampled loans complied with SSBCI program requirements. With your consent, Treasury transmitted a copy of the Report to Massachusetts program officials on April 23, 2013. Treasury asked Massachusetts to provide a narrative response describing measures it has taken or plans to take to address the deficiencies noted in the Report.

In its reply, enclosed, Massachusetts addressed the loan questioned by OIG and recommendations 2, 3, and 4. Massachusetts agreed that it will work with Treasury to implement any corrective measures necessary to address the loan questioned by OIG. In response to recommendation 2, Massachusetts clarified that it reported \$200,000 in administrative expenses, but did not charge the SSBCI fund for the reported administrative expenses and does not intend to seek reimbursement from the SSBCI fund for these expenses. In response to recommendations 3 and 4, Massachusetts described its system for allocating administrative expenses, as well as its procedures for verifying compliance with program requirements and the filing of accurate program certifications, including program income reporting and the complete and timely collection of borrower and lender assurances. Massachusetts provided explanations for the deficiencies identified in the Report with respect to the reporting of program income and the collection of borrower and lender assurances.

Treasury accepts each of the Report's recommendations. With respect to the first recommendation, SSBCI is in the process of revising program guidance on this issue. Regarding recommendations 2 and 3, Treasury will work with Massachusetts to verify that the \$200,000 in administrative expenses was not charged to the SSBCI fund. Treasury will also verify that Massachusetts's system for tracking administrative expenses complies with OMB Circular A-87. Finally, with respect to recommendation 4, Treasury will determine whether Massachusetts has

adequately cured its non-compliance with requirements for assurances, certification filings, and program income reporting. Treasury will also determine whether additional action is warranted.

Thank you once again for the opportunity to review the Report. Treasury appreciates our work together throughout the course of the SSBCI program.

Sincerely,



Don Graves
Deputy Assistant Secretary
Small Business, Community Development, and
Housing Policy

Enclosure



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May 6, 2013.

VIA ELECTRONIC MAIL

Mr. Don Graves, Jr.
Deputy Assistant Secretary
Small Business, Community Development, and Housing Policy
Department of Treasury
Washington, D.C. 20220

Dear Mr. Graves:

Thank you for allowing the Commonwealth of Massachusetts, Executive Office of Housing and Economic Development (EOHED) an opportunity to review and comment on the draft audit report issued by the Office of Inspector General (OIG) titled "State Small Business Credit Initiative: Massachusetts' Use of Federal Funds for Capital Access and Other Credit Support Programs." This letter serves as EOHED's response to your letter dated April 23, 2013.

The U.S. Department of Treasury, State Small Business Credit Initiative (SSBCI) staff have been extremely helpful in assisting the EOHED to successfully implement its' programs while providing invaluable guidance on ways to rectify past deficiencies and to ensure the Commonwealth is compliant with SSBCI guidelines going forward. Below you will find a narrative describing the measures and actions EOHED has developed to address the four recommendations contained in the OIG draft report. Of note, the checklist and quarterly site visit matrix referenced in the responses to recommendations three and four were provided to Treasury staff under separate cover.

1. Federally Guaranteed Loans Clarification:

The Executive Office of Housing and Economic Development will work with SSBCI staff to implement any corrective measures needed up to and including reimbursing the SSBCI loan participation account for the original amount of the enrolled questioned loan.

2. Disallowance of \$200K in MGCC Administrative Costs:

Page 9 of the audit report states “We determined that \$200,000 of the \$321,000 in administrative costs charged to the SSBCI program as of June 30, 2012, did not comply with program guidance.” While the Commonwealth does not contend that cost documentation was non-compliant with OMB A-87, the Commonwealth would like to clarify that the MGCC never charged the \$200K of expenses to the SSBCI fund.

The costs were reported to the Commonwealth as expenses on the quarterly reports by MGCC, but they were never charged to the fund, nor were expenses transferred out of the SSBCI fund managed by MGCC to reimburse itself for the reported \$200K. The Commonwealth has worked with MGCC to develop a system for charging direct expenses to the SSBCI program. The MGCC is not seeking reimbursement for any of the initially reported \$200K. Through the close of reporting period 12/31/2012 MGCC has only charged \$12,439 to the SSBCI program for administrative costs. The aforementioned \$12.4K represents costs incurred during the quarter ending 12/31/12.

Currently the MGCC is requiring employees to keep weekly timesheets of the loans on which they are working. When a loan is compliant with SSBCI guidelines and enrolled in the SSBCI portfolio, the timesheets are being utilized as the basis for actual costs charged to the SSBCI program. MGCC is using excel to calculate the total allowable costs, and is exploring the ability to develop a database to ease reporting. The MGCC is using the same level of documentation for travel reimbursements. Employees must document the loan they were working on for travel reimbursement requests. Once a loan is enrolled in the SSBCI portfolio, all travel previously charged can be tracked back directly to the loan in the SSBCI portfolio.

3. System for Allocating Administrative Costs:

The Executive Office of Housing and Economic Development has allowed all administrative expenses for the SSBCI program to be utilized by the MGCC and the MBDC (the two administering agencies). In order to ensure compliance with SSBCI program requirements, the EOHED has implemented monitoring procedures of the administrative expenses reported by the administering agencies. Within 60 days of the close of a reporting quarter, EOHED staff perform on-site quality assurance visits to both MGCC and MBDC. A significant portion of the costs reported for the prior quarter are reviewed to determine compliance with OMB A-87 standards and are allowable, allocable and reasonable. Neither administering entity has a federally negotiated and approved indirect cost plan, and the SSBCI staff do not have resources to approve a cost allocation plan. Therefore, all costs must be directly related and traceable to a loan in the SSBCI portfolio. If the EOHED finds non- allowable costs charged to the program it will

require the administering entity to reimburse the SSBCI fund and will notify SSBCI staff to determine appropriate next steps.

4. Procedures to Assure Compliance Going Forward:

On page 11 the OIG report states that “Massachusetts did not include in its March 31, 2012 and June 30, 2012, quarterly reports to the Treasury \$51,248 of program income from the MBDC Loan Participation Program.” This statement is accurate to the extent that \$51,248 of interest income and fees, collected by MBDC under the SSBCI Loan Participation Program, was not reported as “Program Income” in the SSBCI quarterly on-line reporting application. Please note that all collections of fees and interest income on all SSBCI loan participations were properly documented and segregated in accordance with SSBCI guidelines. This documentation was provided to OIG during the audit process.

This amount was not classified by MBDC as “Program Income” based upon the guidance that we had at that time. MBDC is a private lender authorized to participate as an SSBCI lender by the state of Massachusetts and by the Treasury Department. During 2012, at the time of the reporting period referenced, the Treasury department website for SSBCI offered the following guidance on reporting “Program Income:” “interest, fees, refunds, or other types of gross income earned by financial institutions, private venture capital funds, or private investor networks on loans or investments made using SSBCI funds are not considered program income.” In accordance with this guidance, MBDC, as a private financial institution participant in the SSBCI program, did not classify interest collected as program income. In a phone conversation with SSBCI staff, the Commonwealth was informed that administering agencies, even if private entities, are responsible for reporting on program income directly generated. The Commonwealth informed MBDC that its already tracked interest income should be classified as “Program Income,” and asked for it to report all program income generated in previous quarters through current reporting periods. MBDC did report all interest and fee income as “Program Income” as requested and continues to do so.

At the conclusion of this audit, the Commonwealth will work with SSBCI staff to update previously filed quarterly reports to reflect actual program income earned.

On page 3 and on page 8, the OIG audit report states, “Massachusetts did not obtain complete borrower and lender assurances by the time of loan closings for 31 of the 35 loans tested.” This statement requires clarification.

The 35 loans referenced include three loan participation loans and 32 CAP loans. The bulk of these loans were made in the early stage of the SSBCI program, before suggested reporting forms were promulgated by Treasury. MBDC followed the guidance provided in *SSBCI National Standards for Oversight and Compliance* dated May 15, 2012 which states “administering entities may design their own certification forms”. Prior to September, 2012, MBDC utilized its own certification forms, designed similarly to the forms used to provide certifications to the federal government under the United States Small Business Administration loan program.

In August of 2012, the Commonwealth was applying for a second tranche of funding. Upon review of selected loans, SSBCI staff notified the Commonwealth that the certifications being utilized were not fully compliant with program guidelines. The Commonwealth, in conjunction with the administering entities decided it would inventory all of the loans enrolled in the SSBCI program, and go back and require all borrower and lender certifications to be compliant with the recommended format in the *SSBCI National Standards for Oversight and Compliance*. This action step was conveyed to SSBCI staff during a conference call on 9/21/2012, and in a subsequent email on 10/15/2012. This process took place from September 14, 2012 to October 31, 2012. The Commonwealth and its administering agencies determined that any loans lacking proper documentation would be removed from the SSBCI portfolio and the SSBCI fund would be reimbursed for all costs associated with the loan. The decision was made to recertify all loans utilizing the forms suggested by Treasury to ensure consistency with all other state participants in SSBCI. All loans have been properly certified since that date.

Under the SSBCI Loan Participation Program, MBDC is the participating lender and all certifications were made properly at the time of the funding of the loans and were then recertified as recommended by SSBCI staff.

Of the 32 CAP loans examined by OIG, all but one were recertified using the format recommended by the *SSBCI National Standards for Oversight and Compliance*. The SSBCI fund was reimbursed for the cost of the one guarantee that could not be recertified.

The Commonwealth devised and implemented an enrollment form/checklist that administering entities must send to the Commonwealth SSBCI program manager for review and signature prior to MGCC or MBDC enrolling any loan/guarantee in an SSBCI program portfolio. The checklist requires MBDC and MGCC to certify the loans are compliant with programmatic requirements and to certify all lender and borrower certifications are complete and compliant with the recommended format in the SSBCI National Standards for Oversight and Compliance. Once the EOHED SSBCI program manager signs and approves the form, the loan can be enrolled in one of the SSBCI funds.

In addition, the Commonwealth has developed monitoring procedures to ensure all loans reported on quarterly certifications from administering programs have been signed off by the Commonwealth SSBCI program manager, and the Commonwealth is conducting quarterly sub-recipient monitoring visits to MGCC and MBDC to do random selection and testing of a substantial portion of loans and administrative costs for compliance with program guidelines and administrative cost allowance. Beginning with the second quarter of 2013, the Commonwealth is requiring the checklist developed by New Jersey to accompany all loans enrolled in Loan Participation programs by administering agencies.

In summary, the Commonwealth has addressed all issues brought to its attention as a result of the tranche request and the OIG audit prior to the draft audit results (with the exception of the SBA guaranteed loan as we are awaiting a ruling from SSBCI). EOHED thanks you for all your help

and looks forward to continuing our collaboration with the U.S. Department of the Treasury in providing capital to businesses in Massachusetts through the SSBCI program.

Sincerely,

A handwritten signature in black ink, appearing to read 'Gregory Bialecki', with a stylized flourish at the end.

Gregory Bialecki
Secretary, Executive Office of Housing and Economic Development

Appendix 3: Major Contributors

Debra Ritt, Special Deputy Inspector General

Clayton Boyce, Audit Director

Lisa DeAngelis, Audit Director

John Rizek, Audit Manager

Andrew Morgan, Auditor-In-Charge

Safal Bhattarai, Auditor

Kimberly McKeithen, Referencer

Appendix 4: Distribution List

Department of the Treasury

Deputy Secretary
Office of Strategic Planning and Performance Management
Risk and Control Group

Office of Management and Budget

OIG Budget Examiner

United States Senate

Chairman and Ranking Member
Committee on Small Business and Entrepreneurship

Chairman and Ranking Member
Committee on Finance

Chairman and Ranking Member
Committee on Banking, Housing and Urban Affairs

United States House of Representatives

Chairman and Ranking Member
Committee on Small Business

Chairman and Ranking Member
Committee on Financial Services

Government Accountability Office

Comptroller General of the United States