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

Management Information Memorandum
Report 15-17

DATE: September 30, 2015

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FROM: Troy M. Meyer
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SUBJECT: *The OIG High-Risk 7(a) Loan Review Program*

The purpose of this memorandum is to provide an update on our oversight activities of the High Risk 7(a) Loan Review Program from April 2015 to September 2015. This memorandum contains no recommendations; therefore, no response by SBA is required.

Background

In fiscal year (FY) 2014, we established the High Risk 7(a) Loan Review Program to minimize losses on Small Business Administration (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;[1] 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.[2]

The Office of Inspector General's (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. In March 2015, we reported the results of our ongoing High Risk 7(a) Loan Review Program from July 2014 to February 2015.[3] This report identified material lender origination and closing deficiencies that justified denial of the guaranty for three loans. 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.

[1] 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.
[2] Public Law 111-240, Small Business Jobs Act of 2010 (September 27, 2010).
[3] SBA OIG, *The OIG High Risk 7(a) Loan Review Program Recommends $1.8 Million in Recoveries*, Report 15-09 (March 2015).

Objectives, Scope, and Methodology

Our objectives for this program are to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with SBA's rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovering guaranteed payments made to lenders. Our review considered loans that SBA purchased from October 1, 2013 to March 31, 2015. Lenders approved these loans under the Preferred Lenders Program (PLP), which undergoes very limited review by SBA prior to loan disbursement. To answer the objectives, we reviewed origination and closing actions as documented in SBA and lender loan files. We assessed these actions against all applicable SBA requirements. We also reviewed information in SBA's Loan Accounting System for all loans examined.

As listed in Table 1, we reviewed four 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 identified material lender deficiencies with one loan during a previous audit.[4] This loan was referred to our Investigations Division due to suspicious activity. During the current reporting period, we referred this loan to SBA management to address the material lender deficiencies, as appropriate.

Table 1: Lender-Approved Loans Reviewed by OIG

Reviewed Loans	Transaction Type	Purchase Date	Purchase Amount
1	Change of Ownership	11/19/2014	$903,297
2	Debt Refinance	10/29/2014	$921,853
3	Leasehold Improvements	06/23/2014	$2,046,465
4	Change of Ownership	09/09/2014	$1,419,275
5*	Change of Ownership	10/07/2010	$781,191
Totals			**$6,072,081**

Source: SBA's Loan Files and Loan Accounting System
*OIG sampled and reviewed this loan in a previous audit.

Results of Four Loans Reviewed

Our review of one loan identified potential material lender noncompliance with SBA's requirements. The lender approved this loan for over $1 million to finance a change of ownership transaction and the borrower defaulted after making only seven loan payments. SBA honored its guaranty on this loan for approximately $900,000. Because we identified suspicious activity, we referred this loan to our Investigations Division. We intend to present our findings on this loan to SBA management in a future report for appropriate action.

We also identified potential material lender noncompliance with SBA requirements on a second loan approved for $2.7 million and purchased by SBA for approximately $2 million. The borrower defaulted after making five interest-only payments. Further, the business never opened for operation. We intend to present our findings on this loan to SBA management in a future report for appropriate action.

[4] SBA OIG, *Purchase Reviews Allowed $4.6 Million in Improper Payments on 7(a) Recovery Act Loans*, Audit Report 13-16R (June 2013).

We reviewed two other early-defaulted loans approved for a total of $4.3 million and purchased by SBA for a total of $2.3 million. Based on our review of these loans, it appeared that the lender materially complied with SBA's origination and closing requirements and SBA's purchase decision was appropriate.

Result of Loan Reviewed in Prior Audit

During the reporting period, we referred to SBA a loan that contained potential material loan origination and closing deficiencies. The borrower made less than three full monthly payments before defaulting on this loan. SBA purchased this loan in October 2010 for $781,191. Our review of the loan documentation revealed that the lender's financial analysis did not support reasonable assurance of repayment in a timely manner from the cash flow of the business. Specifically, the projected revenue in the lender's analysis included unverified revenue streams that impacted the borrower's ability to repay the loan. Furthermore, the lender relied upon seller-prepared financial statements to support its underwriting and approval decision for a change of ownership transaction between close parties. Finally, we questioned eligibility and a restriction placed on the equity injection required from the borrower as well as the source of funds.

As previously noted, this loan was reviewed during a previous audit.[5] We did not make any formal recommendations in our referral because SBA purchased the loan in October 2010. However, we advised SBA to review the deficiencies to determine the appropriate corrective action(s). These actions may include recovery of the guaranty from the lender for approximately $551,000. SBA informed us that they are reviewing the loan.

Actions Taken by SBA on Previous Recommendations

As discussed above, we issued a previous report that presented our findings and recommendations for SBA to either bring the loans into compliance and, if not possible, seek recovery of $1.8 million from lenders for the guaranties paid on three loans. As of September 8, 2015, SBA was pursuing recovery of approximately $400,000 from the lender on one loan and still reviewing two other loans to determine whether recovery of another $1.4 million is appropriate.

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

[5] This loan met our definition of high-dollar/early-default and our scoring criteria.