OFFICE OF INSPECTOR GENERAL HIGH RISK 7(A) LOAN REVIEW PROGRAM

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Office of Inspector General

U.S. Small Business Administration

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Management Advisory
Report Number: 20-18

DATE: August 25, 2020

TO: Jovita Carranza
Administrator

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: Office of Inspector General High Risk 7(a) Loan Review Program

This management advisory presents the evaluation results of a 7(a) loan as part of our High Risk 7(a) Loan Review Program. The objectives of our evaluation were to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with the Small Business Administration's (SBA's) rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

This advisory contains one recommendation that SBA agreed to implement. Please provide us your progress in implementing the recommendation within 90 days.

Background

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 7(a) loan goes into default and the lender requests guaranty payment, SBA reviews loan documentation to determine whether the lender made, closed, serviced, and liquidated the loan in accordance with prudent lending standards and SBA requirements. Further, when a loan sold on the secondary market defaults and is placed in a liquidation status, either the lender or SBA must purchase the guaranteed portion of the loan from the secondary market investor. After SBA's purchase of the secondary market loan, SBA reviews loan documentation to evaluate the lender's compliance with program rules and regulations. SBA is released from liability on the guaranty, in whole or in part, at the Agency's discretion, if the lender fails to comply with any material SBA loan program requirements.

Previous audits indicated that some lenders failed to comply with SBA loan requirements; therefore, we established the High Risk 7(a) Loan Review Program in FY 2014. This program evaluates lender compliance with SBA requirements for high-dollar/early-defaulted 7(a) loans (loans approved for $500,000 or more that defaulted within the first 18 months of the initial disbursement). We use an internal scoring system to prioritize loans for review based on known

[1] 15 U.S.C. § 636(a).

risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance or suspicious activity by loan participants.

Results

This memorandum includes the results of our review of a 7(a) loan as part of our High Risk 7(a) Loan Review Program. We reviewed this high-dollar/early-defaulted 7(a) loan approved by a lender using its delegated authority. SBA honored its guaranty on the loan, resulting in a purchase amount of $2,077,766. We found that the lender did not provide sufficient evidence to support that it closed the loan in accordance with SBA's requirements. Specifically, the lender did not provide adequate documentation to substantiate reasonable assurance that it met requirements for equity injection. (See appendix I for details.)

SBA's standard operating procedure (SOP) 50 10 5 states that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. Consequently, the lender's material noncompliance with SBA requirements while closing the loan resulted in a loss to SBA of $2,094,574.[2] (See appendix IV for a schedule of questioned costs.)

Recommendation

We recommend that the Administrator require the Director for the Office of Financial Program Operations:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $2,094,574 on the guaranty paid by SBA.

Analysis of Agency Response

SBA management agreed with the recommendation stating they conducted a preliminary review, and unless the lender provides additional information, deficiencies appear to exist. If the lender cannot provide information that would bring the loan into compliance, SBA will seek recovery from the lender. Management's planned corrective actions are sufficient to address the recommendation. (See Appendix V for SBA management's formal comments which are included in their entirety.)

Summary of Actions Necessary to Close the Recommendation

The following provides the status of the recommendation and the necessary actions to close it.

Resolved. Management will contact the lender to obtain additional information to bring the loan into compliance. They stated if the issues are not overcome, SBA will seek recovery from the lender. This recommendation can be closed when SBA provides evidence that the lender provided information to mitigate the finding or recovered the appropriate amount from the lender if necessary.

We appreciate the courtesies and cooperation extended to us during this evaluation. If you have any questions, please contact me or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6586.

[2] Reconciliation of expenses incurred from the liquidation process increased SBA's loss on the loan.

cc: William M. Manger, Chief of Staff and Associate Administrator, Office of Capital Access
Brittany Biles, General Counsel
John Miller, Deputy Associate Administrator, Office of Capital Access
William Briggs, Deputy Associate Administrator, Office of Capital Access
Jihoon Kim, Director, Office of Financial Program Operations
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Tami Perriello, Chief Financial Officer
Tonia Butler, Director, Office of Internal Controls

Appendix I: Evaluation of a $2,939,000 7(a) Loan Used to Purchase a Business and Provide Working Capital

Background

We reviewed a $2,939,000 early-defaulted loan approved by a lender under its delegated authority for purchasing a business and providing working capital and closing costs. The borrower made four loan payments before defaulting on the loan. SBA honored its guaranty and purchased the loan for $2,077,766. SBA charged off the loan with no further recoveries applied to the loan balance. However, SBA's share of the balance was increased to $2,094,574 due to the reconciliation of expenses incurred from liquidation.

Results

We identified material lender noncompliance with SBA's loan closing requirements. Specifically, the lender did not adequately verify the cash injection in accordance with SBA requirements.

Inadequate Support for Cash Injection

SOP 50 10 5(I) states adequate equity is important to ensure the long-term survival of a business. Lenders must verify cash injection prior to disbursing loan proceeds and must maintain evidence of such verification in their loan files. Verifying cash injection requires the following documentation:

- Copy of a check or wire transfer along with evidence that the check or wire was processed showing the funds were moved into the borrower's account or escrow,
- Copy of the statements of account for the account from which the funds are being withdrawn for each of the two most recent months prior to disbursement showing that the funds were available, and
- Subsequent statement of the borrower's account showing that the funds were deposited or a copy of an escrow settlement statement showing the use of the cash.[3]

Lenders are expected to use reasonable and prudent efforts to verify that equity is injected and used as intended, and failure to do so may warrant a repair or partial/full denial.

According to the loan authorization, the lender required the borrower to inject $384,895 to fund $349,870 of the business acquisition and to fund $35,025 of closing costs. Based on our analysis, the lender only provided SBA sufficient evidence to support $8,500 of the $384,895 required injection. Specifically, the loan file indicated the remaining $376,395 was wired to a closing attorney to fund part of the business acquisition and closing costs. However, the lender did not adequately verify the source of the $376,395.

Our evaluation found $250,000 of the $376,395 was supported by a bank statement with a balance of $191,823, however, the loan file did not contain adequate support for the remaining $58,177. In addition, the loan file included a wire transfer agreement that indicated $250,000 was being transferred from the bank account to the closing attorney that managed the change of ownership disbursements. However, we did not find the supporting bank statement to show that $250,000 was withdrawn from the account. Instead, the loan file included a printout that allegedly was for an account held by the closing attorney showing a deposit of $250,000. We noted that the printout did

[3] SOP 50 10 5(I), Lender and Development Company Loan Programs, January 1, 2017, Subpart B, Chapter 4, Section I.E.3.

not include an account number, name of account owner or any other information that would substantiate the printout was an account statement. (See Appendix II for a copy of the printout.) Therefore, we concluded that the loan file did not contain sufficient evidence to fully support $250,000 of the $376,395.

Further, the loan file indicated $126,395 of the $376,395 cash injection was sourced from the sale of a rental property and wired directly from the title company for that sale to the closing attorney. We identified the settlement statement for the sale of the rental property. However, the file did not contain sufficient evidence to substantiate that the wired $126,395 was deposited in the closing attorney's account. Specifically, the evidence used to support this wire was the printout of the account allegedly held by the closing attorney, which showed the wire was pending. Again, it is important to note that the printout did not include an account number, name of account owner or any other information that would substantiate the printout represented an account statement. Additionally, the alleged pending wire transfer was dated the same date as the closing of the business acquisition.

In accordance with SBA's requirements, the lender was required to verify the injection prior to disbursing the loan proceeds. Without adequate documentation such as a processed wire transfer and bank statements showing the funds were withdrawn from the account, there was no assurance the cash injection was sourced as required.

Conclusion

Our evaluation found that the lender did not adequately verify the cash injection. As a result, the lender did not comply with material SBA requirements related to the closing of the loan. Due to lender noncompliance with SBA requirements, SBA should require the lender to bring the loan into compliance or, if not possible, seek recovery of $2,094,574 on the guaranty paid by SBA.

Appendix II: Equity Injection Support for Sampled Loan

Amount included in Available Balance

Processing Transaction layer	WIRE TRANSFER CREDIT ON 05/19	activity type credit	27,000.00 [redacted]
Processing Transaction layer	WIRE TRANSFER CREDIT ON 05/19	activity type credit	211,478.78 [redacted]
05/18/2017	Show additional information for activity type credit 250,000.00WIRE TYPE:WIRE IN DATE: 170518 TIME:1100 ET TRN:2017051800240104...	activity type credit	250,000.00

injection to

Ex. 6

print out from
his account

Note: The redaction marks after the dollar values were present in the original document.

Appendix III: Objectives, Scope, and Methodology

This management advisory presents the results of our evaluation of a loan, as part of our High Risk 7(a) Loan Review Program. Our objectives were to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders.

To accomplish our objectives, we used an internal loan 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 or 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 use of loan proceeds. We obtained a universe of 287 high-dollar/early-defaulted 7(a) loans that were approved by lenders under the Preferred Lenders Program. Under this program, lenders are delegated the authority to process, close, service, and liquidate most SBA-guaranteed loans without prior SBA review. SBA honored its guaranty on these loans between October 1, 2016, and September 30, 2019. We eliminated loans for which SBA had not completed a purchase review. We then selected six loans based on their assigned score and considered other factors, such as the outstanding balance and the period to default. The outcome of our evaluation on one of these loans is included in this management advisory.

We also reviewed origination and closing actions as documented in SBA loan files. We assessed these actions against all applicable SBA requirements and 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 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.

Appendix IV: Questioned Costs

Questioned Costs for OIG High Risk 7(a) Loan Review Sample

Sample	Approval Amount	Purchased Amount	OIG Questioned Costs
1	$2,939,000	$2,077,766	$2,094,574

Source: Generated from evaluation results

Appendix V: Agency Comments

SBA OFFICE OF FINANCIAL PROGRAM OPERATIONS RESPONSE TO EVALUATION REPORT

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

TO:	Hannibal M. Ware, Inspector General Office of Inspector General (OIG)
FROM:	Jihoon Kim Director, Office of Financial Program Operations
SUBJECT:	Response to Draft Report on General High Risk 7(a) Loan Review Program
DATE:	June 24, 2020

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 2020 draft report lists the OIG's evaluation results of one 7(a) loan as part of the OIG's ongoing High Risk 7(a) Loan Review Program. The OIG's purpose was to determine whether (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with the Small Business Administration's (SBA's) rules, regulations, policies, and procedures and (2) material deficiencies existed that warrant recovery of guaranteed payments to lenders. The OIG determined that the lender did not provide sufficient evidence to support that they originated and closed the loans in accordance with SBA's requirements. Specifically, the lender did not provide adequate documentation to substantiate reasonable assurance that the borrowers met requirements for equity injection.

IG made the following recommendation:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $2,094,574 on the guaranty paid by SBA.

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

Management acknowledges the recommendations listed in the report. After conducting a preliminary review, and absent additional information from the lender, deficiencies appear to exist. OFPO will notify the lender and work with the lender to obtain documentation to bring the loan into compliance. If the issues are not overcome, SBA will seek recovery from the lender.