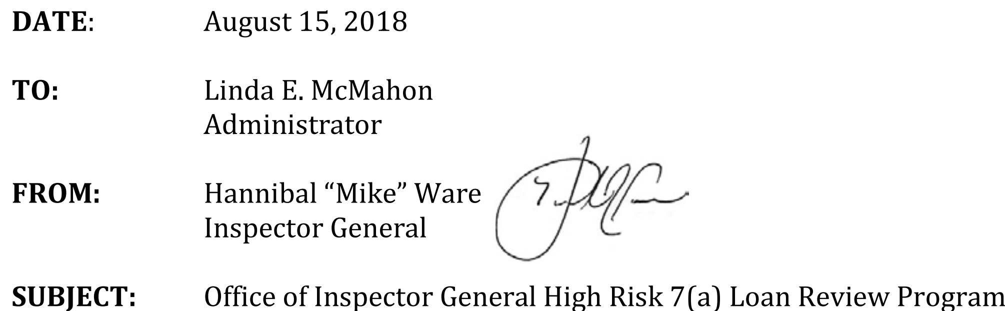
U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

Management Advisory
Report Number: 18-21



DATE: August 15, 2018

TO: Linda E. McMahon
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 two 7(a) loans as part of our ongoing High Risk 7(a) Loan Review Program. This is the first in a series of advisories for 7(a) loans we reviewed in fiscal year (FY) 2018, and this advisory includes one loan identified during a previous High Risk 7(a) loan review. The remaining loans will be presented in future reports. 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 exist that warrant recovery of guaranteed payments to lenders.

This advisory contains two recommendations that SBA agreed to implement. Please provide us your progress in implementing the recommendations 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. 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.

Because previous audits indicated that some lenders failed to comply with SBA loan requirements, 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 risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance or suspicious activity by loan participants.

[1] 15 U.S.C. 636(a).

Results

We reviewed these two high-dollar/early-defaulted 7(a) loans approved by lenders using their delegated authority. SBA honored its guaranty on each loan, resulting in a total purchase amount of $1,351,565. (See Appendix IV for a schedule of questioned costs.) We found that the lenders for both loans did not provide sufficient evidence to support that they originated and closed the loans in accordance with SBA's requirements. Specifically, the lenders did not provide adequate documentation to substantiate financial projections, terms for debt being refinanced, a borrower's inability to obtain credit elsewhere on reasonable terms, and that a franchise agreement was executed prior to the first disbursement. (See Appendixes II and III for details.)

SOP 50 10 5 states that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards. Consequently, the lenders' material noncompliance with SBA requirements while originating and closing the loans resulted in a combined potential loss to SBA of $1,351,565.[2]

Recommendations

We recommend that the Acting 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 $799,159 on the guaranty paid by SBA.

2. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $552,406 on the guaranty paid by SBA.

Analysis of Agency Response

SBA management agreed with the report findings and both recommendations, stating they conducted a preliminary review, and absent additional information from the lender, deficiencies appear to exist. If the lenders cannot provide information to bring the loans into compliance, the loans will be sent to headquarters for the denial review process. Management's planned corrective actions are sufficient to address the recommendations. (See Appendix V for SBA management's formal comments in their entirety.)

Summary of Actions Necessary to Close the Recommendations

This section provides the status of the recommendations and the actions necessary to close them.

1. **Resolved.** Management contacted the lender to obtain additional information to bring the loan into compliance and stated they will send the loan to headquarters for the denial review process if the lender cannot overcome the issues identified. This recommendation can be closed when SBA provides evidence that the lender provided information to bring the loan into compliance or that management recovered the appropriate amount from the lender.

[2] Proceeds from the liquidation process may further reduce this amount.

2. **Resolved.** Management contacted the lender to obtain additional information to bring the loan into compliance and stated they will send the loan to headquarters for the denial review process if the lender cannot overcome the issues identified. This recommendation can be closed when SBA provides evidence that the lender provided information to bring the loan into compliance or that management recovered the appropriate amount from the lender.

We appreciate the courtesies and cooperation extended to us during this evaluation. If you have any questions, please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616.

cc: Pradeep Belur, Chief of Staff
William M. Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Jihoon Kim, Acting Director, Office of Financial Program Operations
Christopher Pilkerton, General Counsel
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Timothy E. Gribben, Chief Financial Officer and Associate Administrator for Performance Management
LaNae Twite, Director, Office of Internal Controls

Appendix I: Objectives, Scope, and Methodology

This management advisory presents the results of our evaluation of two loans, as part of our ongoing High Risk 7(a) Loan Review Program. This is the first in a series of advisories for the seven 7(a) loans we selected for review in FY 2018 and one loan identified during a previous High Risk 7(a) loan review. The remaining six loans will be presented in future reports. 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 exist 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 97 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, 2015, and September 30, 2017. We eliminated loans for which SBA had not completed a purchase review. We then selected seven loans based on their assigned score and considered other factors, such as the outstanding balance and the period to default. The outcome of our review on one of these loans is included in this management advisory.

In addition, we reviewed one of the loans included in this management advisory during a previous project under our High Risk 7(a) Loan Review Program. SBA honored its guaranty on this loan in FY 2015. Due to identified suspicious activity, we referred the loan for investigative consideration. However, after consideration, the loan was returned to the Office of Inspector General (OIG) Audits Division for appropriate action to address the lender's noncompliance with SBA requirements. Therefore, we included the results of our review in this management advisory.

We also reviewed origination and closing actions as documented in SBA loan files. When applicable, we contacted lenders to obtain additional documentation for review. 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 II: Evaluation of a $1.2 Million 7(a) Loan Used to Refinance Debt and Provide Working Capital

Background

We reviewed a $1.2 million early-defaulted loan approved by a lender under its delegated authority for refinancing existing debt and providing working capital. The borrower made seven loan payments before defaulting on the loan. SBA honored its guaranty and purchased the loan for $799,159. SBA charged off the loan with no further recoveries applied to the loan balance.

Results

We identified material lender noncompliance with SBA's loan origination and closing requirements. Specifically, the lender did not provide adequate assurance of the borrower's repayment ability. Further, the lender did not provide evidence that loan proceeds used for debt refinancing were eligible.

Inadequate Assurance of Repayment Ability

SOP 50 10 5(C) states that the cash flow of the small business applicant is the primary source of repayment, not the liquidation of collateral. Thus, if the lender's financial analysis demonstrates that the small business applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available. It also 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. Additionally, SBA required the lender to include the reasonableness for the supporting assumptions for the borrower's projections in its credit memorandum.

The borrower had net losses and negative debt service coverage in 2008, 2010, and the first 3 months of 2011. Subsequently, the lender relied on projections as the basis for the borrower's repayment ability. The projections, however, were unsupported and suggested that net income before taxes (NIBT) would increase from -$221,815 in 2010 to $594,897, or 368 percent, for the first year following loan disbursement. Given the significant change from the historical to projected financial statements, we annualized the 3-month interim financial statement and calculated an NIBT of -$918,400, while the first year projected NIBT was $594,897.

In addition, the lender conducted a comparison to the Risk Management Association (RMA) industry averages.[3] The RMA average for NIBT for this industry was 2.0 percent of sales. The projected NIBT was nearly 30 percent of sales. This was not a reasonable representation of the business' profitability based on the lender's comparison to industry averages.

Furthermore, the lender's justification for accepting the sales and expense figures from the borrower was that they had verbal and repeat commitments from the borrower's customers. The lender, however, did not provide evidence of the orders or any other contracts with the borrower's customers to verify this information. First-year sales following loan disbursement were projected

[3] 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.

to be $2,000,000. However, the lender did not verify approximately $1,900,000, or 95 percent, of the projected sales.

Based on our review, we concluded that the lender's financial analysis did not demonstrate a reasonable assurance of repayment.

Ineligible Use of Proceeds

SOP 50 10 5(C) states that supporting documentation for debt refinancing must be maintained in the lender's loan files. The lender refinanced two debts that were in the name of the borrower. The loan application stated that the debts being refinanced were lines of credit. However, the loan file did not contain supporting documentation to verify the terms for these debts. Because the lender did not provide supporting documentation to show that the debts were eligible for SBA financing, we determined that the lender did not adhere to SBA's requirements.

Conclusion

Our evaluation found that the lender did not provide sufficient evidence in the loan file to support that it had conducted an adequate financial analysis to ensure the borrower had repayment ability and verified the terms of debt being refinanced. As a result, the lender did not comply with material SBA requirements related to the origination and closing of the loan. Consequently, SBA should not have paid the guaranty in the amount of $799,159.

Appendix III: Evaluation of a $780,000 7(a) Loan Used to Finance Leasehold Improvements, Equipment, and Working Capital

Background

We reviewed a $780,000 early-defaulted loan approved by a lender under its delegated authority for financing leasehold improvements, purchasing equipment, providing working capital, and providing for a construction contingency and interim interest. The borrower made 16 payments before defaulting on the loan. SBA honored its guaranty and purchased the loan for $552,406.

Results

We determined that the lender did not originate and close the loan in accordance with SBA's requirements. Specifically, the lender did not provide adequate assurance of the borrower's repayment ability, adequate support that credit was not available elsewhere on reasonable terms, or evidence to support that the franchise agreement was executed prior to the first disbursement.

Inadequate Assurance of Repayment Ability

SOP 50 10 5(F) states that the cash flow of the small business applicant is the primary source of repayment, not the liquidation of collateral. Thus, if the lender's financial analysis demonstrates that the small business applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined, regardless of the collateral available. For standard 7(a) loans greater than $350,000, the SOP also 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. Additionally, SBA required the lender to include the reasonableness for the supporting assumptions for the borrower's projections in its credit memorandum.

To assess the cash flow of the business, a new franchise, the lender used historical financial information from a second franchise owned by the guarantor. However, this second franchise location was only in operation for 13 months. Thus, the lender relied on 1 year of estimated financial statements to establish projections for the new franchise. The projections were unsupported and suggested first-year sales of $1.5 million for the new location, whereas the existing location's sales for the first 12 months of operation were $1.4 million. Using these projections, the lender calculated a debt coverage ratio of 1.98. However, we conducted an analysis using the $1.4 million in sales and determined that the debt coverage ratio was 1.03, which is below the required 1.15.[4] The lender also suggested an unsupported higher sales growth rate when determining the second-year sales totals.

In addition, the lender conducted a comparison to the RMA industry averages. The RMA average for operating expenses was 54 percent of sales. The projected operating expense was 51 percent. Also, the RMA average for gross profit margin was 61 percent of sales, although the projected gross profit margin was 69 percent. The lender indicated efficiencies and increased purchasing power as reasons for outperforming RMA averages; however, the lender did not provide any analysis to support those reasons. This was not a reasonable representation of the business profitability based on the lender's comparison to industry averages.

[4] SOP 50 10 5(F), Lender and Development Company Loan Programs (January 1, 2014).

Based on our review, we concluded that the lender's financial analysis did not demonstrate a reasonable assurance of repayment.

Inadequate Support for Credit Elsewhere

SOP 50 10 5(F) states that the lender must certify that credit is not available elsewhere on reasonable terms. In addition, the lender must substantiate the factors that prevent the financing from being accomplished without SBA support and retain the explanation in their loan file. However, the lender did not document a detailed explanation regarding credit not being available elsewhere and noted that it would not proceed without SBA involvement. Furthermore, the loan file did not include personal financial statements and other supporting documentation as evidence for why the lender would not proceed without SBA involvement. Therefore, we question whether the borrower could have obtained a regular commercial business loan without the SBA guarantee.

Unexecuted Franchise Agreement

SOP 50 10 5(F) states that the franchise agreement including any amendments and/or addendums must be executed by all parties prior to first disbursement. Also, in order to rely on the registry of approved franchise agreements, the lender must include an executed franchise agreement in the loan file. However, the loan file did not contain the franchise agreement; it included only a Certificate of Franchise, which was a lender certification that the franchise agreement was approved by SBA. Additional requests to the lender only yielded an incomplete and unsigned agreement that was for an affiliate of the borrower. Because the lender did not provide the franchise agreement, we could not determine whether the agreement was approved as required. Further, we could not determine the terms or the effect it had on the business operations, including startup costs and control over sales and expenses.

Conclusion

Our evaluation found that the lender did not provide sufficient evidence in the loan file to support that it had conducted an adequate financial analysis to ensure the borrower had repayment ability, the borrower could not obtain credit elsewhere on reasonable terms, and the franchise agreement was executed prior to the first disbursement. As a result, the lender did not comply with material SBA requirements related to the origination and closing of the loan. Consequently, SBA should not have paid the guaranty in the amount of $552,406.[5]

[5] Proceeds from the liquidation process may further reduce this amount.

Appendix IV: Questioned Costs

Table 1: Questioned Costs for OIG High Risk 7(a) Loan Review Sample

Sample	Approval Amount	OIG Questioned Costs
1	$1,200,000	$799,159
2	$780,000	$552,406
Totals	**$1,980,000**	**$1,351,565**

Source: Generated from evaluation results.

SBA

OFFICE OF FINANCIAL PROGRAM OPERATIONS

RESPONSE TO EVALUATION REPORT

TO: Hannibal M. Ware, Inspector General
Office of Inspector General (OIG)

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 - 18002

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 2018 draft report outlines the OIG's concerns regarding its review of High Risk 7(a) loans purchased in the NGPC and identified deficiencies in 2 loans with following recommendations:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $799,159 on the guaranty paid by SBA.
2. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $552,406 on the guaranty paid by SBA.

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

Management substantially concurs with the report and recommendations.

After conducting a preliminary review, and absent additional information from the lenders, deficiencies appear to exist. The lenders have been notified of the deficiencies and are currently conducting research. OFPO will work with lenders to obtain documentation to bring loans into compliance. If the issues are not overcome at that point the loans will be sent to HQ for the denial review process.