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

Management Advisory
Report Number: 19-15

DATE: July 10, 2019

TO: Christopher M. Pilkerton
Acting Administrator and General Counsel

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) 2019. 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 existed 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. Further, when a lender requests guaranty payment on a defaulted secondary market loan, SBA must purchase the loan from the secondary market investor. After 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 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 covering the 7(a) loans we selected for review in FY 2019. 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 $5,531,290. 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 reasonable assurance that the borrowers met requirements for repayment ability, eligibility, collateral, equity injection, and debt refinance. (See appendixes II and III for details.)

SBA's standard operating procedure (SOP) 50 10 5(H) 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 $5,335,790.[2] (See appendix IV for a schedule of questioned costs.)

Recommendations

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 $3,000,297 plus interest on the guaranty paid by SBA.

2. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $2,335,493 plus interest on the guaranty paid by SBA.

Analysis of Agency Response

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

Summary of Actions Necessary to Close the Recommendations

The following provides the status of the recommendations and the necessary actions to close them.

1. **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

[2] Proceeds from the liquidation process after purchase reduced SBA's loss on these two loans. Additional proceeds from the liquidation process could further reduce this amount.

lender provided information to mitigate the finding or that SBA recovered the appropriate amount from the lender.

2. **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 that SBA 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: William M. Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Jihoon Kim, Director, Office of Financial Program Operations
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 covering a total of eight loans we selected for review in FY 2019. We are completing the review of the remaining six loans, and the results 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 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 190 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, 2018. We eliminated loans for which SBA had not completed a purchase review. We then selected eight 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 two 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 II: Evaluation of a $4,000,000 7(a) Loan Used to Purchase Commercial Property, Purchase a Business, and Provide Working Capital

Background

We reviewed a $4,000,000 early-defaulted loan approved by a lender under its delegated authority for purchasing commercial property, purchasing a business, and providing working capital. The borrower made 12 loan payments before defaulting on the loan. SBA honored its guaranty and purchased the loan from the secondary market for $3,024,679. However, SBA's share of the balance was reduced to $3,000,297 due to the reconciliation of expenses incurred from liquidation.

Results

We identified material lender noncompliance with SBA's loan origination and closing requirements. Specifically, the lender did not remedy an adverse change, value the business in accordance with SBA requirements, provide adequate assurance of the borrower's repayment ability, verify the source of the equity injection, and justify the value of the property being purchased in accordance with SBA requirements.

Inadequate Review of Franchise Agreements

SOP 50 10 5(H) states that the lender's credit memorandum and analysis must demonstrate the small business applicant's ability to repay the loan from the cash flow of the business by documenting other relevant information, such as a lender's review of the franchise agreement and all related documents, including the franchise disclosure document and any credit information.[3]

The borrower used loan proceeds to divide one hotel franchise, which consisted of two buildings, into two different franchise hotels that were located at the same address. We noted that these two franchise hotels were on the SBA franchise registry and that the lender obtained the franchise agreements for both hotels. However, the franchise agreements contained clauses that when executed together would prevent the operation of the hotels. Specifically, the franchise agreement for one of the hotels stated that officers or owners with 25 percent or more equity interest may not own, operate, or franchise any guest lodging facility other than the facility in the protected territory. The borrower owned 100 percent of both hotel franchises. As a result, the ownership of the two hotel franchises at the same address was a violation of the franchise agreement.

The other franchise agreement contained a clause that stated the franchisee and its owners shall not divert or attempt to divert any present or prospective customer to any competitor. The borrower owned another franchised hotel and intended to operate it simultaneously on the same property, which subsequently created an inherent conflict of interest that violated the agreement. Because the lender's analysis did not include the impact of the borrower immediately being in apparent violation of the signed franchise agreements, the lender did not meet SBA's credit underwriting requirements.

[3] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.2.

Lender Did Not Obtain Required Business Valuation

SOP 50 10 5(H) states that an accurate business appraisal is required for change of ownership transactions.[4] Further, the SOP states that if the amount being financed minus the appraised value of real estate and/or equipment being financed is $250,000 or less, the lender may perform its own valuation of the business being sold.[5] The loan authorization required a business valuation prior to disbursement showing a value of $1,170,043, which would not include the appraised value of real estate and equipment. The lender amended the loan authorization by removing the business valuation requirement, stating the transaction was completely reliant on real property and not business intangibles.

However, our analysis identified that the transaction also included transferring business intangibles. Therefore, the transaction qualified as a change of ownership. Specifically, the purchase agreement included $154,101 in goodwill intellectual property, software licenses, and other intangible personal property. The lender did not obtain a business valuation to support the intangibles acquired in the business purchase, as required for change of ownership transactions.

Inadequate Assurance of Repayment Ability

SOP 50 10 5(H) states that the cash flow of the small business applicant is the primary source of repayment, not the liquidation of collateral.[6] 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 or outside sources of cash.[7] Further, the lender's credit memorandum must include an analysis of assumptions supporting the projected cash flow.[8] For 7(a) loans greater than $350,000, the applicant's debt service coverage ratio must be equal to or greater than 1.15 on a projected cash flow basis.[9]

The historical financial information showed the borrower did not have adequate debt service coverage. Specifically, the historical debt service coverage ratios for the previous 3 years were 0.59, 0.72, and 0.68, which were less than the required 1.15. The lender relied on projections to determine the borrower's repayment ability. However, we determined that the lender did not adequately support the projections. Specifically, the operating expenses from 2014 compared to year 1 projections decreased from approximately $2,185,000 to $1,415,000, or by approximately 35 percent. This resulted in an increase in net income from $31,000 to $716,000, or 2,222 percent. The lender stated that the decrease in projected operating expenses was because the borrower would have hands-on operators. We determined that this explanation was not sufficient to justify the large decrease in operating expenses, especially given that the company hired a management company to run the hotel. Without additional justification and analysis to support the significant change in expenses, the lender did not adequately show reasonable assurance of the borrower's repayment ability.

[4] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section II.C.5.
[5] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section II.C.5.a.i.
[6] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.
[7] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.
[8] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.2.e.
[9] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.A.2.d.

Inadequate Support for Equity Injection

SOP 50 10 5(H) states that adequate equity is important to ensure the long-term survival of a business. The lender must determine if the equity injection and the pro forma debt-to-worth are acceptable based on the factors related to that type of business, experience of the management, and the level of competition in the market area. Further, typically the equity injection cannot be borrowed funds. It also states that lenders must verify the equity injection prior to disbursing loan proceeds and maintain evidence of such verification in the loan files.[10] Verifying a cash injection requires a copy of a check or wire transfer, evidence showing the funds were moved into the borrower's account, and a copy of the statements for the account from which the funds were withdrawn for the two months prior to disbursement showing that the funds were available.[11]

The loan authorization required a cash injection of at least $760,000. The lender did not fully document the source of the cash injection. In its credit memorandum, the lender only addressed the source for $200,000 of the $760,000. The lender also noted in the file that the source of the equity injection was not fully documented. As the lender did not document the source of the full cash injection, it did not comply with SBA requirements.

Inadequate Appraisal for Commercial Property

SOP 50 10 5(H) states that for loans involving commercial real estate greater than $250,000 the lender must obtain an appraisal by a state licensed or certified appraiser.[12] Additionally, if the loan is used to acquire an existing building that does not require construction, the appraiser should estimate market value on an as-is basis.[13]

The loan authorization required an appraisal for the commercial property showing a fair market value of at least $5,300,000. The subject property contained two existing buildings, operating as one hotel franchise. However, per the lender's credit memorandum, the borrower intended to operate the two buildings under separate hotel franchises. One building had 96 rooms and the other had 50 rooms. The lender provided an "as-is" appraisal for the 96-room building, which showed a value of $2,800,000.

The lender did not obtain an adequate appraisal to support the value of the 50-room building. Specifically, only minor renovations were required prior to opening the hotel. Therefore, the lender was required to obtain an appraisal with an estimated market value on an as-is basis. Instead, the lender provided an appraisal of the building that was based on assumptions of other performing similar franchised hotels. Further, the appraiser noted that certain events needed to occur before the property was ready for business, which included cosmetic improvement such as painting, signage, and décor. The appraisal report stated the building had an as-is value of $2,000,000. We do not believe the appraisal appropriately represented an as-is value because the appraisal was based on assumptions of other similarly performing franchises, and improvements were needed before the building could operate as the franchise hotel.

The lender provided two separate appraisals, which included a total as-is value of $4,800,000 for both buildings. This amount did not fully support the required total fair market value of $5,300,000. As a result, the lender did not comply with SBA's commercial property appraisal and loan authorization requirements.

[10] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.E.
[11] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.E.3.a.
[12] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section II.C.
[13] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section II.C.

Conclusion

Our evaluation found that the lender did not provide sufficient evidence in the loan file to support that it conducted an adequate analysis to ensure the borrower met SBA requirements for eligibility, repayment ability, equity injection, and collateral. As a result, the lender did not comply with material SBA requirements related to the origination and 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 $3,000,297 plus interest on the guaranty paid by SBA.[14]

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

Appendix III: Evaluation of a $3,315,000 7(a) Loan Used to Finance Leasehold Improvements, Purchases, and Working Capital

Background

We reviewed a $3,315,000 early-defaulted loan approved by a lender under its delegated authority for financing the purchase of land and improvements, refinancing a debt, and providing working capital. The borrower made 10 loan payments before defaulting on the loan. SBA honored its guaranty and purchased the loan from the secondary market for $2,506,611. However, SBA's share of the balance was reduced to $2,335,493 due to recoveries during liquidation.

Results

We identified material lender noncompliance with SBA's loan origination and closing requirements. Specifically, the lender did not adequately verify the source of the equity injection and meet the requirements for debt refinancing.

Inadequate Support for Equity Injection

SOP 50 10 5(H) states that adequate equity is important to ensure the long-term survival of a business. The lender must determine if the equity injection and the pro forma debt-to-worth are acceptable based on the factors related to that type of business, experience of the management, and the level of competition in the market area.[15] It also states that the source of the injected equity must not be cash that is borrowed. Additionally, lenders must verify the equity injection prior to disbursing loan proceeds and must maintain evidence of such verification in the loan files.[16] Lenders are expected to use reasonable and prudent efforts to verify that equity is injected and used as intended.[17]

The lender stated the equity injection was based on the borrower's improvements to the building that were completed 2 years prior to loan disbursement. The lender's file included invoices stamped paid from a construction company for the 2 years prior to disbursement, but the cancelled checks and documentation to support the source of the payments were not included. The lender's credit memorandum noted that the funds used to pay for the improvements were stated to be gifted from family members. We did not find evidence that the lender properly supported that the improvements were made and that the funds used to pay for the improvements were gifted and not borrowed. Based on our review, the lender did not adequately verify the equity injection.

Inadequate Support for Debt Refinance

SOP 50 10 5 (H) requires that when refinancing debt, the new installment amount must be at least 10 percent less than the existing installment amount.[18] The SOP also states that guaranteed loan proceeds may not be used to refinance debt originally used to finance a loan purpose that was ineligible for SBA financing at the time it was originally made unless the condition that would have made the loan ineligible no longer exists.[19]

[15] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.E.1.
[16] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.E.
[17] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section I.E.3.a.
[18] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section IV.E.3.
[19] SOP 50 10 5(H), Lender and Development Company Loan Programs, May 1, 2015, Chapter 4, Section IV.E.1.

According to the lender, $298,500 of the loan proceeds would be used to refinance a working capital loan with an interest rate of 24 percent. However, the loan file did not contain the note or other sufficient documentation to verify the terms for this debt or its original purpose. We determined that the lender did not comply with SBA's requirements because it did not provide supporting documentation to show that the debt was eligible for SBA financing.

Conclusion

Our evaluation found that the lender did not provide sufficient evidence in the loan file to support that it conducted adequate analysis to ensure the borrower met SBA requirements for equity injection and debt refinancing. As a result, the lender did not comply with material SBA requirements related to the origination and 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 $2,335,493 plus interest on the guaranty paid by SBA.[20]

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

Appendix IV: Questioned Costs

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

Sample	Approval Amount	Purchased Amount	OIG Questioned Costs
1	$4,000,000	$3,024,679	$3,000,297
2	$3,315,000	$2,506,611	$2,335,493
Totals	$7,315,000	$5,531,290	$5,335,790

Source: Generated from evaluation results.

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 26, 2019

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 2019 draft report lists the OIG's evaluation results of two 7(a) loans 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 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 reasonable assurance that the borrowers met requirements for repayment ability, eligibility, collateral, equity injections, and debt refinance.

OIG made the following recommendations:

1. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $3,000,297 plus interest on the guaranty paid by SBA; and,
2. Require the lender to bring the loan into compliance or, if not possible, seek recovery of $2,335,493 plus interest 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 lenders and work with the lenders to obtain documentation to bring the loans into compliance. If the issues are not overcome, SBA will seek recovery from the lenders.