AUDIT REPORT

SBA's Evaluation of Principal's Repayment Ability for Hurricane Sandy Business Loans

February 24, 2015

REPORT NUMBER 15-05

EXECUTIVE SUMMARY

Report 15-05
February 24, 2015

SBA's Evaluation of Principal's Repayment Ability for Hurricane Sandy Business Loans

What OIG Reviewed

Our objective was to determine whether SBA's evaluation of a principal's personal income resulted in reasonable assurance of the business' ability to repay its Hurricane Sandy business loan.

To achieve our audit objective, we obtained 2,532 approved Hurricane Sandy business loans as of July 29, 2014, which totaled approximately $234.4 million. From this, we reviewed a random, statistical sample of 70 loans and evaluated the borrower's cash flow information provided in the electronic loan file to determine whether the borrower had the ability to repay the disaster loan.

Our review focused upon the principal's contribution to the loan repayment ability. We used the fixed debt method to perform our own evaluation of the principal's contribution to the business borrower's repayment ability. Our methodology also included reviewing loan officer comments associated with each loan. Additionally, we interviewed Agency officials at SBA headquarters in Washington, D.C.

What OIG Found

We found that loan officers did not have guidance for performing the financial analysis to determine whether Hurricane Sandy business loan applicants had repayment ability. SBA Standard Operating Procedures (SOP) 50 30 7 states, "For business loans, we determine repayment ability by the results of the financial analysis performed on the business." However, the SOP provided no additional guidance regarding how to perform the financial analysis.

Because there was no guidance, loan officers used inconsistent methodologies when evaluating Hurricane Sandy business loans for repayment ability. We estimate that SBA approved at least 537 Hurricane Sandy disaster business loans, totaling at least $17.9 million, without sufficiently considering principals' living expenses when determining repayment ability. Therefore, we believe that for these loans, SBA did not have reasonable assurance that the borrowers had repayment ability, and these loans are at a higher risk of default.

According to a senior ODA management official, the SOP 50 30 7 criteria that applied specifically to evaluating the repayment ability of home owners was used in assessing the principal's contribution to the borrower's disaster business loan repayment ability. However, management at the Processing and Disbursement Center, where the loans were evaluated for repayment ability and approval, stated that loan officers used training materials as their guidance for evaluating and approving business loans.

OIG Recommendations

We recommend that SBA establish and implement clear, written policies and procedures for analyzing the repayment ability of disaster business loan applicants, including business loan principals and guarantors. Additionally, SBA should ensure that these procedures, whether included in the SOP or other written guidance, are reviewed and officially approved by the headquarters management responsible for administering the disaster loan program.

Agency Comments

SBA management generally agreed with our finding and recommendation. However, management did not agree with our projection that borrowers of at least $17.9 million in Hurricane Sandy disaster business loans did not have repayment ability.

Actions Taken

The Agency plans to establish and implement clear written policies and procedures for analyzing repayment ability of disaster business loan applications. These procedures will be incorporated into the next update of the SOP, which is officially approved by headquarters management responsible for administering the disaster loan program. The Agency also noted that the target implementation date is June 30, 2015.

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

Final Report Transmittal
Report Number: 15-05

DATE: February 24, 2015

TO: James Rivera, Associate Administrator for Disaster Assistance

SUBJECT: *SBA's Evaluation of Principal's Repayment Ability for Hurricane Sandy Business Loans*

This report presents the results of our audit to determine whether SBA's evaluation of a principal's personal income resulted in reasonable assurance of the business' ability to repay its Hurricane Sandy business loan.

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

We appreciate the courtesies and cooperation that SBA extended to our staff during this review.

/s/
Troy M. Meyer
Assistant Inspector General for Auditing

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Introduction

On October 29, 2012, Hurricane Sandy devastated portions of the Mid-Atlantic and northeastern United States. The Small Business Administration (SBA) provided recovery loans to homeowners, renters, businesses, and nonprofit organizations who were survivors of Hurricane Sandy. The loans provided disaster survivors with funds to repair or replace real estate and personal property that were physically damaged as the result of Hurricane Sandy, and provided working capital funds to help businesses to recover. As of July 29, 2014, SBA had disbursed—or made commitments to disburse—2,532 business loans, totaling approximately $234.4 million.

SBA Disaster Loans and Reasonable Assurance of Repayment Ability

SBA's Office of Disaster Assistance (ODA) administers SBA's disaster assistance program. Its mission is to help people recover from disasters and rebuild their lives by providing affordable, timely, and accessible financial assistance to homeowners, renters, and businesses. As noted in ODA's standard operating procedures (SOP), disaster loans are unplanned debts and create neither an increase in assets nor an improvement in lifestyle.[1] The SOP also notes that because disaster loans repair or replace existing property, applicants pay twice to maintain the same assets. For these reasons, there is a higher inherent risk of non-repayment for disaster loans than for purchase loans.

Loan officers assigned to ODA's Processing and Disbursement Center (PDC) evaluate disaster loan applications for approval and determine the maximum dollar amount that SBA can approve. In order for a loan officer to recommend approval for a disaster loan, the borrower must be eligible to receive the loan, have satisfactory credit, and SBA must have reasonable assurance that the borrower can repay the loan.

In order to evaluate a business applicant's ability to repay the disaster loan, the loan officer examines the combined annual cash flow for all principals, affiliates, and the business itself. If an eligible applicant and its affiliates have satisfactory credit and there is sufficient cash flow to repay the SBA loan, the loan officer recommends loan approval.

SBA uses the fixed debt method to evaluate repayment ability for disaster home loan applicants and sometimes uses this method to evaluate the principal's and guarantor's contribution to business loan repayment ability. According to SOP 50 30 7, the fixed debt method is a lending concept based on guidelines used by the mortgage banking industry. The fixed debt method assumes there is a maximum level of debt one can afford, known as the maximum acceptable fixed debt (MAFD). This is the percentage of gross income that can generally be allocated to pay fixed debts, such as housing payments, installment loans, and credit cards, or other revolving charge accounts, without incurring undue risk of non-repayment. If the maximum debt level is not exceeded, the remainder of an individual's gross income after fixed debts is available for personal living expenses, such as food, clothing, transportation, and utility bills. Once the maximum debt level is exceeded, default is more likely to occur.

[1] SOP 50 30 7, effective May 13, 2011.

The SOP states that "although replacing disaster damaged property is our mission, the nature and purpose of the debt does not affect the fact that there is a certain maximum level of debt that one can afford." Therefore, ODA is faced with a constant challenge to provide disaster loans to borrowers without exceeding the maximum level of debt those borrowers can afford. As stewards of taxpayer dollars, ODA must balance its mission to provide loans to disaster survivors with prudent lending standards that prevent borrowers lacking repayment ability from obtaining a loan. Strong criteria for evaluating borrower repayment ability helps mitigate the inherent risk of non-repayment associated with disaster loans.

Prior Audit Work

On September 29, 2014, the Office of Inspector General (OIG) issued audit report 14-22, *Controls Governing Economic Injury Disaster Loan Approval Need Improvement*. The scope of this audit included only economic injury disaster loans disbursed prior to April 2012; therefore, the audit did not include Hurricane Sandy loans. During the audit, the auditors observed that SBA sometimes allowed up to 100 percent MAFD for principals when evaluating economic injury disaster loans for repayment ability. This observation raised concerns that SBA may have overestimated the principal's ability to contribute to repaying some disaster loans. A further cause for concern was that SOP 50 30 7 did not contain criteria for determining repayment ability for disaster business loans. The SOP stated that "…SBA determines the repayment ability for business loans based upon the results of the financial analysis performed on the business." However, the SOP did not provide additional details regarding the criteria SBA used to perform the financial analysis. These issues precipitated the audit of the use of principals' personal income for repayment of Hurricane Sandy business loans.

Objective

The objective of the audit was to determine whether SBA's evaluation of the principal's personal income resulted in a reasonable assurance of the business' ability to repay the Hurricane Sandy business loan. To make this determination, we obtained a list of all 2,532 disbursed Hurricane Sandy business loans—totaling approximately $234.4 million—from the SBA Systems Operations Division. We reviewed a random, statistical sample of 70 loans and evaluated the maximum allowable fixed debt percentage SBA used for the principal—provided in the Disaster Credit Management System (DCMS) electronic loan file—to determine whether the borrower had the ability to repay the disaster loan.

Finding 1: SBA Approved Hurricane Sandy Disaster Business Loans Without Sufficiently Considering Principal's Living Expenses When Determining Repayment Ability

SBA applied inconsistent methodologies when performing its financial analysis to determine whether Hurricane Sandy business loan applicants had repayment ability. In some cases, SBA used the fixed debt method to evaluate the principal's contribution to repayment ability. In other instances, the fixed debt method was not used and the Agency did not account for personal living expenses. However, even when the fixed debt method was used, different debt thresholds were used without an explanation of why they were applied. This occurred because SBA did not provide guidance for how loan officers should perform the financial analysis to determine whether business disaster loan applicants had repayment ability.

According to the Code of Federal Regulations, 13 CFR Section 123.6, "there must be reasonable assurance that you can repay your loan out of your personal or business cash flow." Additionally, SBA's SOP 50 30 7, which established disaster operating policy, states, "For business loans, we determine repayment ability by the results of the financial analysis performed on the business."[2] However, the SOP provided no guidance regarding how to perform this financial analysis.

According to a senior ODA management official, the SOP 50 30 7 criteria that applied specifically to evaluating the repayment ability of *home owners*, the fixed debt method, was used in assessing the principal's contribution to the borrower's disaster *business loan* repayment ability.[3] Management at the PDC, where the loans were evaluated for repayment ability and approval, stated that loan officers instead used training materials as their guidance for evaluating and approving business loans.

Although PDC management stated that loan officers were following guidance in the training materials, we found that they inconsistently applied this guidance. Specifically, loan officers generally did not adhere to the training materials' instruction that living expenses and income taxes be considered in determining repayment ability for sole proprietors. Living expenses and income taxes are routine expenses that decrease the principal's cash flow available to service an SBA loan. When loan officers do not consider these expenses, they overestimate the cash flow available to service the loan. We found that 26 of the 27 sole proprietor sample loans we reviewed did not include living expenses for the principals. Additionally, approximately two-thirds (18 of 27) of the sole proprietor loans we reviewed did not account for income taxes when evaluating the principal's repayment ability.

We performed our own review of the principal's cash flow for 70 SBA-approved Hurricane Sandy disaster business loans. Our audit results indicated that SBA did not have reasonable assurance that borrowers for 21 of the 70 loans had the ability to repay their disaster business loans because loan officers did not sufficiently consider living expenses in their determinations. Projecting these results to the universe of disbursed Hurricane Sandy business loans, we estimated that SBA did not have reasonable assurance that borrowers for at least 537 Hurricane Sandy business loans, totaling

[2] SOP 50 30 7, effective May 13, 2011.

[3] ODA Policy Memorandum 12-43, effective November 9, 2012, allowed loan officers to routinely use higher MAFD percentages than specified in the SOP when evaluating repayment ability. The revised MAFD percentages provided in the Policy Memorandum were based upon specific gross annual income levels, but were generally capped at 50 percent. ODA Policy Memorandum 03-13, effective January 15, 2013, extended the higher MAFD percentages that were implemented by Policy Memorandum 12-43 and eliminated the need for loan officers to provide justification for using MAFD percentages of up to 50 percent.

approximately $17.9 million, had repayment ability. This represents approximately 21 percent of the disbursed Hurricane Sandy business loans and approximately 8 percent of the business loan dollars.[4]

Recommendation 1

Establish and implement clear, written policies and procedures for analyzing the repayment ability of disaster business loan applicants, including business loan principals and guarantors. Ensure that these procedures, whether included in the SOP or other written guidance, are reviewed and officially approved by headquarters management responsible for administering the disaster loan program.

Analysis of Agency Response

ODA management provided formal comments, which are included in their entirety in Appendix II. Management generally agreed with the finding and recommendation. A summary of management's comments and our response follows.

ODA agreed to establish and implement clear written policies and procedures for analyzing the repayment ability of disaster business loan applicants—specifically business loan principals and guarantors. This recommendation can be closed when ODA provides us with its approved procedures for analyzing the repayment ability of disaster business loan applications.

While ODA agreed with our recommendation, it disagreed with our projection that approximately $17.9 million in loans lack repayment ability. Specifically, management stated that it determined in its review of the sampled business files that although the justifications for loan approval could have been clearer, repayment ability did exist. For example, they identified non-applicant spousal income that was not applied toward the repayment calculation and not explained in the file, as more than sufficient to cover personal living expenses. Management also stated that none of the sampled loans have defaulted, and that two-thirds of the loans have repayment terms shorter than the 30-year maximum; therefore, if the borrowers experienced financial hardship, SBA could extend the loan term in order to reduce the monthly payments. In addition, management noted that the draft report incorrectly stated that "if an applicant has ***good*** credit…the loan officer recommends loan approval." As stated in SOP 50-30-7, Chapter 8, Paragraph 82, the overall credit of an applicant, including affiliates, must be **satisfactory** in order for the loan officer to recommend loan approval. OIG revised the introduction section of the report to reflect this change.

Regarding the projections, as discussed in our report, loan officers did not adequately consider living expenses when determining repayment ability for 21 of 70 loans (30 percent) included in our sample. To obtain our projections, we used two different Government statistical sampling software applications that yielded the same results. Therefore, we believe that our sample size was sufficient to statistically determine that based on the information contained in the loan file, the dollar amount of loans for which SBA did not have reasonable assurance of the borrower' repayment ability was at least $17.9 million.

[4] This represents the increased risk resulting from using a higher MAFD than permitted in the ODA policy memoranda. The auditors did not verify the accuracy of the income or debt of the principals or the income, debt, or expenses of the businesses. Additional risk of default may exist due to reasons other than repayment ability.

We acknowledge it is difficult to determine at this time how well these loans will perform long-term, given that none of the loans had an opportunity to mature beyond 2 years. As a result, we have revised the finding title to reflect our conclusion that SBA approved at least $17.9 million in Hurricane Sandy business loans without sufficiently considering principal's personal living expenses when determining repayment ability. Management's statement that repayment ability did exist for the loans we reviewed is based on information that they acknowledged was not clearly explained in the file as a consideration in the repayment calculation. In our review of these files, there was no indication that the applicants had other income available to cover personal living expenses or that the loan officers were aware of outside income or the principal's actual living expenses at the time these loans were approved. Also, based on management's statements regarding none of the loans being delinquent, we maintain that many of these loans are relatively new and have not aged enough to determine that they will not default. Furthermore, management stated that SBA could adjust the loan term if the borrower encountered financial hardship—which recognizes the increased risk associated with these loans. We recognize that there is risk associated with disaster business loans; however, as recommended, loan officers need adequate guidance regarding their evaluation of repayment ability to give SBA and taxpayers a reasonable assurance that these dollars will be repaid. Management has agreed to establish and implement appropriate policies and procedures to address this issue.

Appendix I: Scope and Methodology

We conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objective of the audit was to determine whether SBA's evaluation of the principal's personal income resulted in a reasonable assurance of the business' ability to repay the Hurricane Sandy business loan. To make this determination, we obtained a complete record of the 2,532 approved, non-cancelled Hurricane Sandy business loans as of July 29, 2014, from the SBA Systems Operations Division. The loans totaled approximately $234.4 million. We reviewed a random, statistical sample of 70 loans and evaluated the borrower's cash flow information, including the principal's cash flow provided in the electronic loan file, to determine whether the borrower had the ability to repay the disaster loan. Our methodology also included reviewing loan officer comments associated with each loan. Additionally, we interviewed Agency officials at SBA headquarters in Washington, D.C.

Neither SOP 50 30 7, effective May 13, 2011, nor other official Agency directives specified how loan officers should perform a financial analysis of the business to determine an applicant's repayment ability for business loans. However, DCMS contained a business financial analysis tool, which loan officers used to facilitate this analysis. This tool included a blank field for MAFD, which loan officers were required to populate as part of the business financial analysis, in order to evaluate the cash flow available from business principals. In the absence of other guidance for evaluating the principal's contribution to repayment ability for business loans, we used the MAFD criteria contained in the ODA policy memoranda for home loan applicants.[5] We believe the policy memoranda specified reasonable thresholds for fixed debt. Furthermore, a senior Agency official informed us that this was the criteria loan officers were using in their evaluations of business principals and guarantors contribution to disaster loan repayment ability.

In order to evaluate the principal's cash flow and determine whether SBA had reasonable assurance of the borrower's repayment ability, we reviewed DCMS electronic loan file data for each of the 70 loans in our audit sample. From the DCMS loan file information, we determined the MAFD the loan officer used when approving each Hurricane Sandy business loan. We then compared the MAFD the loan officer used for each of the principals when approving the loan to the MAFD specified in the ODA policy memorandum in effect at the time the loan was approved.[6] If the loan officer used the MAFD specified in the applicable ODA policy memorandum, we assumed that the calculation was performed correctly and that SBA had reasonable assurance of the borrower's repayment ability. However, if the loan officer used an MAFD that was higher than permitted by the criteria in the ODA policy memorandum, we recomputed the cash flow and repayment evaluation using the MAFD

[5] SBA modified the MAFD criteria the SOP provided for home loan applicants in ODA Policy Memorandum 12-43, effective November 9, 2012; and, ODA policy memoranda 03-13, effective January 15, 2013.

[6] For the loans in our sample, we applied the applicable ODA policy memorandum relevant on the date the loan was approved. These ODA policy memoranda modified the MAFD percentages listed in the SOP. ODA Policy Memorandum 12-43, effective November 9, 2012, allowed loan officers to routinely use higher MAFD percentages than specified in the SOP when evaluating repayment ability. The revised MAFD percentages provided in the policy memorandum were based upon specific gross annual income levels, but were capped at 50 percent. ODA Policy Memorandum 03-13, effective January 15, 2013, extended the higher MAFD percentages that were implemented by Policy Memorandum 12-43 and eliminated the need for loan officers to provide justification for using the higher MAFD percentages.

specified in the applicable ODA policy memorandum. We did not verify the source or amount of income or debt for the principals or borrowers.

In order to project our audit results to the universe of disbursed Hurricane Sandy business loans, we multiplied the average amount of dollars questioned in our sample by the number of items in the universe. We projected our sampling results at the 90 percent confidence interval. Using the lower bound of this confidence interval we estimate that at least 537 loans valued at $17.9 million may not have repayment ability.

Review of Internal Controls

OMB Circular A-123 provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls.[7] During the audit, we reviewed SBA's evaluation of the principal's personal income available for repayment of Hurricane Sandy business loans. Therefore, we limited our assessment of internal controls to an evaluation of the controls governing disaster business borrower repayment ability. The primary internal control governing disaster business loan approval is SBA's Standard Operating Procedure 50 30 7, dated May 13, 2011. We reviewed the SOP and determined that it did not address how to perform a financial analysis to evaluate a disaster business loan application for repayment ability. We concluded that SBA needs to develop, officially approve, and implement formal written procedures for analyzing the repayment ability of disaster business loan applicants.

Use of Computer-Processed Data

We relied on data provided by the SBA Systems Operations Division that was generated from DCMS. The SBA Systems Operations Division identified the Hurricane Sandy business disaster loans approved and disbursed as of July 29, 2014. Based upon data reliability integrity testing, we believe the information is reliable for the purposes of this audit.

Nature of Limited or Omitted Information

No information was omitted due to confidentiality or sensitivity, nor were there limitations to information for this audit.

Prior Coverage

U.S. Government Accountability Office Audit Reports

> Report GAO-12-253T, Small Business Administration, *Progress Continues in Addressing Reforms to the Disaster Loan Program*(November 30, 2011).

Small Business Administration-Office of Inspector General Reports

> Audit Memorandum, Project 14801, *Increase in Maximum Allowable Fixed Debt Percentages in Disaster Loans* (June 16, 2014).

[7] OMB Circular A-123, *Management's Responsibility for Internal Control* (December 21, 2004).

Audit Report 14-20, *Controls Governing Economic Injury Disaster Loan Approval Need Improvement*(September 29, 2014).

Appendix II: Agency Comments

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

Date: December 31, 2014

To: Robert A. Westbrooks
Deputy Inspector General

From: James E. Rivera
Associate Administrator
Office of Disaster Assistance

Subject: OIG Draft Report – SBA's Use of Principal's Personal Income for Disaster Business Loans (Project No. 14806)

We have reviewed the OIG Draft Report regarding SBA's Use of Principal's Personal Income. The objective of this audit was to determine whether the SBA's evaluation of the principal's personal income resulted in reasonable assurance of the business' ability to repay its Hurricane Sandy business loan. Thank you for the opportunity to respond to the Draft Report.

The report concludes that SBA did not provide its loan officers with clear guidance for performing the financial analysis to determine whether Hurricane Sandy business loan applicants had repayment ability, which resulted in approved loans for businesses that do not have repayment ability. The OIG recommends that SBA establish and implement clear, written policies and procedures for analyzing the repayment ability of disaster business applicants, including business loan principals and guarantors.

Finding: ***The SBA Approved at Least $17.9 Million in Hurricane Sandy Disaster Business Loans to Borrowers that Did Not Have Repayment Ability***

We disagree with the OIG's estimate that so many approved Hurricane Sandy business loan applicants lack repayment ability and the method used to arrive at this finding. The OIG arrived at this finding using a "projection" which was based on their review of 21 business loans and in turn "estimated" that approximately $17.9 million in loans lacked repayment ability.

The OIG's audit results indicated that, based on their calculation, 21 out of 70 Hurricane Sandy business files sampled did not have the ability to repay a disaster business loan. However, when we reviewed the 21 Hurricane Sandy business files in question, we determined that although the loan officers' justifications for loan approval could have been clearer, repayment ability did exist. For example, we found that some of the business applicants had outside income (e.g. non-applicant spouse's income) which was more than sufficient to cover personal living expenses, but was not applied towards the repayment calculation and not fully explained in the file.

Furthermore, a recent review of the repayment status on the 21 loans in question showed that all 21 are current and none are delinquent. Nearly one-third of the business loans have monthly payments of $100 or less and nearly two-thirds of the loans have repayment terms shorter than the 30-year maximum, ranging from 4 years to 20 years. As such, we have the flexibility to extend the loan term in order to reduce the monthly payment should the borrower ever encounter a financial hardship.

While SBA disagrees with the OIG's attempt to extrapolate the total amount of loan funds provided to Hurricane Sandy businesses without repayment ability from such a small sample of files, SBA does agree that written policies and procedures for calculating business loan repayment ability, specifically for business loan principals and guarantors, should be made clearer. The audit process has revealed a definite area for improvement in SBA's loan processing and procedures which we intend to address in our next update of our Standard Operating Procedures, SOP 50-30-8, due to be released in Spring 2015.

We have reviewed the OIG Draft Report and have the following technical comment:

<u>Draft Report – Comments</u>

Page 5, Paragraph 4
*"If an eligible applicant has **good** credit and there is sufficient cash flow to repay the SBA loan, the loan officer recommends loan approval."*

The report incorrectly states that "if an applicant has ***good*** credit…the loan officer recommends loan approval." As stated in SOP 50-30-7, Chapter 8, Paragraph 82, the overall credit of an applicant, including affiliates, must be **satisfactory** in order for the loan officer to recommend loan approval.

<u>OIG Recommendations and Agency Response</u>

1) *Establish and implement clear, written policies and procedures for analyzing the repayment ability of disaster business loan applicants, including business loan principals and guarantors. Ensure that these procedures, whether included in the SOP or other written guidance, are reviewed and officially approved by Headquarters management responsible for administering the disaster loan program.*

ODA Response: ODA agrees with the recommendation.
ODA agrees to establish and implement clearer written policies and procedures for analyzing the repayment ability of disaster business loan applications, specifically business loan principals and guarantors. ODA plans to incorporate these procedures into the next update of the SOP which is officially approved by headquarters management responsible for administering the disaster loan program.