

# EVALUATION REPORT

## CONSOLIDATED RESULTS OF THE OIG HIGH RISK 7(A) LOAN REVIEW PROGRAM





# EXECUTIVE SUMMARY

## CONSOLIDATED RESULTS OF THE OIG HIGH RISK 7(A) LOAN REVIEW PROGRAM

Report No.  
18-26

September  
27, 2018

### What OIG Reviewed

In fiscal year (FY) 2014, the Office of Inspector General (OIG) established the High Risk 7(a) Loan Review Program to minimize losses on Small Business Administration (SBA) guaranteed loans, improve the effectiveness and integrity of the 7(a) program, and protect program dollars.

Our objective was to consolidate the results of our ongoing High Risk 7(a) Loan Review Program. Specifically, we analyzed the results of the loans we reviewed from December 2017 through September 2018, and assessed them in the context of the collective results of our work to date. The objectives of the program 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. (See Appendix I for information on our scope and methodology.)

Using an internal loan scoring system, we selected and reviewed seven early-defaulted loans to assess lender compliance with SBA's rules, regulations, and procedures. In addition, we notified SBA of our findings in FY 2018 on another loan we reviewed during a previous project under our High Risk 7(a) Loan Review Program. The loans were approved by lenders under SBA's 7(a) Loan Guaranty Program. SBA honored its guaranty on these eight loans for a total purchase amount of approximately \$6.2 million.

### What OIG Found

Our review of the eight early-defaulted loans in FY 2018 identified material lender origination and closing deficiencies that justified denial of the guaranty for four loans in the amount of nearly \$2.7 million. We issued two advisory memorandums regarding these four loans to SBA for appropriate corrective action. We also identified suspicious activity on one purchased loan totaling \$665,126, resulting in a formal referral to our Investigations Division. We did not identify any material deficiencies with the remaining three loans reviewed.

### Summary of OIG Results to Date

Since FY 2014, under the OIG's High Risk 7(a) Loan Review Program, we have reviewed 27 loans with purchase amounts totaling almost \$23.2 million. We have recommended recoveries on 11 loans totaling more than \$8.5 million. Also, we have referred five loans totaling nearly \$4 million for further investigation.

Our reviews also have identified concerns with change of ownership transactions and SBA's review of improper payments. We recommended that SBA evaluate the time that National Guaranty Purchase Center loan specialists have to review complex early-defaulted loans involving change of ownership transactions. In FY 2018, we reported on four loans with deficiencies; however, we did not identify any new systemic issues based on the consolidated review of our results. Therefore, we are not making any recommendations in this report.

### Actions Taken by SBA

To date, SBA has contacted lenders to obtain additional information to mitigate the deficiencies, and has recovered more than \$4 million in guaranty payments to lenders on 5 of the 11 loans.

SBA made improvements to its review of loans, which included training, increasing loan review time, and updating its loan review checklist. SBA has also taken appropriate corrective actions when loan specialists identified material lender deficiencies. These corrective actions included denying or recovering the guaranty. In some cases, the lenders withdrew their requests for guaranty payment.

### Agency Response

SBA management expressed appreciation for the information provided in the report, reiterating the noted improvements in training and loan reviews. Management stated as a result of the improvements, SBA is identifying more instances of repayment ability issues and cases of potential fraud for referral to investigations.



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

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**Final Report Transmittal**  
Report Number: 18-26

**DATE:** September 27, 2018

**TO:** Linda E. McMahon  
Administrator

**FROM:** Hannibal "Mike" Ware  
Inspector General 

**SUBJECT:** Consolidated Results of the OIG High Risk 7(a) Loan Review Program

Attached for your review is the evaluation report consolidating the results of our ongoing High Risk 7(a) Loan Review Program. This is the third in a series of reports for the work we conducted in fiscal year 2018, and it includes an overall summary of our work to date. This report is considered "For Official Use Only" and should be handled with the appropriate safeguards.

We appreciate the courtesies and cooperation extended to us during this evaluation. Please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616 if you would like to discuss this report or any related issues.

cc: Pradeep Belur, Chief of Staff  
William 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

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## Introduction

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The Small Business Administration (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.<sup>1</sup> Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules and regulations. When a borrower defaults on an SBA-guaranteed loan, the lender can submit the loan to SBA for purchase. SBA reviews the defaulted loan to confirm the lender's compliance with the relevant SBA laws and procedures before purchasing the loan. SBA is released from liability on the guaranty, for example, if the lender fails to comply with any material SBA loan program requirement.

### *The SBA OIG High Risk 7(a) Loan Review Program*

In fiscal year (FY) 2014, we established the High Risk 7(a) Loan Review Program to minimize losses on SBA loans, help SBA improve the effectiveness and integrity of its 7(a) program, and protect program dollars. We established this program because previous audits of improper payments and early-defaulted loans (loans that defaulted within 18 months of initial disbursement) showed that some lenders failed to comply with SBA loan requirements.

When a 7(a) loan goes into default and the lender requests guaranty payment, SBA reviews the loan documentation to determine whether the lender made, closed, serviced, and liquidated the loan in accordance with prudent lending standards and SBA requirements. Improper payments in the guaranty purchase process arise when an SBA purchase reviewer fails to identify material lender noncompliance with these requirements.

OIG's High Risk 7(a) Loan Review Program evaluates lender compliance with SBA's requirements on 7(a) loans approved for \$500,000 or more that defaulted within 18 months of 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 and suspicious activity by loan participants.

## Objectives

Our objective was to consolidate the results of our ongoing High Risk 7(a) Loan Review Program. Specifically, we analyzed the results of the loans we reviewed from December 2017 through September 2018, and assessed them in the context of the collective results of our work to date. The objectives of the program 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. (See Appendix I for information on our scope and methodology.)

## Results

### *Loans Reviewed in FY 2018*

From December 2017 through September 2018, our evaluation included eight early-defaulted loans approved by lenders. SBA honored its guaranty on each loan, resulting in a total purchase amount of approximately \$6.2 million. We identified material lender origination and closing deficiencies in four of the eight loans and notified SBA of the deficiencies for appropriate corrective actions. Specifically, the lenders did not provide adequate documentation to substantiate that the

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<sup>1</sup> Title 15 U.S.C. Section 636(a).

borrowers met requirements for credit elsewhere, repayment ability, size standards, the execution of a franchise agreement, equity injection, and debt refinance. In addition, we identified suspicious activity on one loan totaling \$665,126 and referred it to our Investigations Division for further review. (See the following table for details.)

#### Lender-Approved Loans Reviewed by OIG in FY 2018

Loan Number	Transaction Type	Issue Description	Purchase Amount	Recommended Recovery
1	Business Startup	(1) Credit elsewhere not fully supported, (2) Unsupported projections, (3) Unexecuted franchise agreement	\$552,406	\$552,406
2	Change of Ownership	No reportable deficiencies	\$576,110	N/A
3	Business Startup	(1) Affiliate not considered for repayment ability and size, (2) Inadequate support for equity injection	\$885,133	\$855,116
4	Debt Refinance	(1) Inadequate assurance of repayment ability	\$1,305,710	\$448,287
5	Change of Ownership	No reportable deficiencies	\$662,968	N/A
6	Change of Ownership	(1) Referred to Investigations	\$665,126	N/A
7	Change of Ownership	No reportable deficiencies	\$774,092	N/A
8	Debt Refinance	(1) Repayment ability, (2) Ineligible use of proceeds	\$799,159	\$799,159
<b>Totals</b>			<b>\$6,220,704</b>	<b>\$2,654,968</b>

Source: SBA loan files and results of OIG's reviews.

#### *Summary of OIG Results From FY 2014 Through FY 2018*

Since FY 2014, we have performed detailed reviews on 27 loans with purchase amounts totaling approximately \$23.2 million. Overall, we identified material lender origination and closing deficiencies in 11 of these 27 loans, resulting in questioned costs of more than \$8.5 million. Additionally, we identified suspicious activity in 5 of the 27 loans. These loans, purchased by SBA for approximately \$4 million, were referred to our Investigations Division for further review. The Investigations Division returned one of the five loans to the Audits Division, and we reported the findings to SBA in FY 2018 for corrective action on the identified material deficiencies. (See Appendix III for a summary of our results to date.)

In addition, in prior years, we reported concerns with change of ownership transactions and SBA's review of improper payments. For example, our reviews of the loans found material lender deficiencies or suspicious activity in change of ownership transactions. Our Investigations Division also has identified significant fraud in change of ownership transactions. As a result, we recommended that SBA evaluate the time that National Guaranty Purchase Center loan specialists have to review complex early-defaulted loans involving change of ownership transactions.<sup>2</sup> We also reported that four loans we reported on or referred to our Investigations Division were included in either SBA's FY 2014 or FY 2015 reviews for improper payments. Although those loans were reviewed for lender compliance by loan specialists, SBA did not identify or report the improper payments totaling \$4.5 million associated with these loans. In FY 2018, we reported on four loans with deficiencies; however, we did not identify any new systemic issues based on our consolidated review of our results. Therefore, we are not making any recommendations in this report.

<sup>2</sup> SBA OIG Report 16-22, The OIG High Risk 7(a) Loan Review Program Recommends \$3.2 Million in Recoveries (September 30, 2016).

## **Actions Taken by SBA**

SBA has taken actions in response to the reports we issued as part of our High Risk 7(a) Loan Review Program. Specifically, these reports noted material deficiencies in 11 individual loans, and we recommended recoveries totaling more than \$8.5 million. To date, SBA has contacted lenders to obtain additional information on the identified deficiencies to mitigate the deficiencies, and SBA has recovered more than \$4 million in guaranty payments to lenders on 5 of the 11 loans.

Additionally, SBA implemented corrective actions to improve its review processes, which addressed several of our findings. Specifically, SBA offered additional training to the loan specialists at the National Guaranty Purchase Center and increased the time allotted to properly review complex early-defaulted loans. SBA also updated its loan review checklist and the purchase 10 tab system to require additional information from lenders.<sup>3</sup> We also found that when loan specialists identified material deficiencies, SBA took the appropriate corrective actions, such as denying or recovering the guaranty from the lenders. In some cases, the lenders withdrew their requests for guaranty payment.

## **Analysis of Agency Response**

SBA management expressed appreciation for the information provided in the report, reiterating the noted improvements in training and loan reviews. Management stated as a result of the improvements, SBA is identifying more instances of repayment ability issues and cases for potential fraud for referral to investigations. (See Appendix IV for SBA management's formal comments in its entirety.)

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<sup>3</sup> The purchase 10 tab system is used by lenders to organize documents submitted to SBA to support their requests for SBA to honor its guaranty.

## **Appendix I: Objective, Scope, and Methodology**

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This report presents the consolidated results of our ongoing High Risk 7(a) Loan Review Program from December 2017 through September 2018 and a contextual summary of our work for FYs 2014–2018. Our program 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 and 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 the use of loan proceeds. We obtained a universe of 97 high-dollar/early-defaulted 7(a) loans purchased by SBA between October 1, 2015, and September 30, 2017, 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. 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.

In addition, we reviewed one of the loans we reported on in FY 2018 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 preliminary review, the loan was returned to the OIG Audits Division for appropriate action to address the lender's noncompliance with SBA requirements, and we reported the results of our review in FY 2018.

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 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 Mainframe 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 was 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: Prior OIG Reports**

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SBA OIG issued the following OIG High Risk 7(a) Loan Review Program reports from FY 2015 to FY 2018.

<b>SBA OIG Report No.</b>	<b>Report Name</b>	<b>Date Issued</b>
<b>15-09</b>	The OIG High Risk 7(a) Loan Review Program Recommends \$1.8 Million in Recoveries	March 20, 2015
<b>15-17</b>	The OIG High Risk 7(a) Loan Review Program	September 30, 2015
<b>16-08</b>	Management Advisory Memo 16-08	January 7, 2016
<b>16-11</b>	Report 16-11: Management Advisory Memorandum	March 17, 2016
<b>16-19</b>	Management Advisory Memorandum 16-19	August 16, 2016
<b>16-22</b>	The OIG High Risk 7(a) Loan Review Program Recommends \$3.2 Million in Recoveries	September 30, 2016
<b>17-18</b>	The OIG High Risk 7(a) Loan Review Program	September 28, 2017
<b>18-21</b>	Office of Inspector General High Risk 7(a) Loan Review Program	August 15, 2018
<b>18-23</b>	Office of Inspector General High Risk 7(a) Loan Review Program	September 13, 2018

## Appendix III: Summary of OIG High Risk 7(a) Loan Review Program Results FYs 2014–2018

Loan Number	Transaction Type	Issue Description	Purchase Amount	Recommended Recovery	Recovery Status
1	Debt Refinance	(1) Ineligible use of proceeds, (2) Affiliates not considered	\$1,205,359	\$850,791	SBA recovered \$855,000
2	Change of Ownership	No reportable deficiencies	\$573,204	N/A	N/A
3	Change of Ownership	(1) Unreliable business valuation, (2) No fixed asset appraisal	\$903,297	\$299,318	SBA recovered \$860,000 <sup>4</sup>
4	Debt Refinance	No reportable deficiencies	\$921,853	N/A	N/A
5	Change of Ownership	(1) Referred to Investigations	\$599,910	N/A	N/A
6	Debt Refinance	(1) Unsupported projections, (2) Ineligible use of proceeds	\$799,159	\$799,159	Under review by SBA <sup>5</sup>
7	Change of Ownership	No reportable deficiencies	\$1,419,275	N/A	N/A
8	Leasehold Improvements	(1) Final construction plans not obtained, (2) Interim and final site inspections not performed	\$2,046,465	\$2,046,465	SBA recovered \$1,891,803
9	Change of Ownership	No reportable deficiencies	\$265,465	N/A	N/A
10	Working Capital	No reportable deficiencies	\$878,289	N/A	N/A
11	Business Startup	(1) Unsupported projections, (2) Inadequate working capital	\$471,905	\$471,905	SBA recovered \$236,000
12	Business Startup	No reportable deficiencies	\$265,011	N/A	N/A
13	Change of Ownership	(1) Partial change of ownership, (2) Unsupported financial statements, (3) No business license	\$413,704	\$413,704	SBA recovered \$207,000
14	Change of Ownership	No reportable deficiencies	\$845,152	N/A	N/A
15	Change of Ownership	(1) Lacked independent business valuation and fixed asset appraisal, (2) Questionable financial analysis and projections, (3) Affiliates not considered	\$900,175	\$900,175	No recovery from lender
16	Debt Refinance	No reportable deficiencies	\$1,501,675	N/A	N/A
17	Business Startup	(1) Referred to Investigations	\$1,028,484	N/A	N/A
18	Change of Ownership	(1) Referred to Investigations	\$901,138	N/A	N/A
19	Change of Ownership	(1) Unsupported equity injection, (2) Inadequate credit elsewhere determination, (3) Insufficient collateral	\$949,870	\$917,107	No recovery from lender
20	Debt Refinance	No reportable deficiencies	\$863,444	N/A	N/A

<sup>4</sup> SBA determined during its review of the loan that a full denial was warranted and sought recovery from the lender.

<sup>5</sup> We initially referred the loan for investigative consideration during a previous project, but it was returned to the OIG Audits Division for appropriate action to address the lender's noncompliance with SBA requirements. The deficiencies on this loan were reported to SBA in FY 2018.

Loan Number	Transaction Type	Issue Description	Purchase Amount	Recommended Recovery	Recovery Status
21	Business Startup	(1) Credit elsewhere not fully supported, (2) Unsupported projections, (3) Unexecuted franchise agreement	\$552,406	\$552,406	Under review by SBA
22	Change of Ownership	No reportable deficiencies	\$576,110	N/A	N/A
23	Business Startup	(1) Affiliate not considered, (2) Inadequate support for equity injection	\$885,133	\$855,116	Under review by SBA
24	Debt Refinance	(1) Inadequate assurance of repayment ability	\$1,305,710	\$448,287	Under review by SBA
25	Change of Ownership	No reportable deficiencies	\$662,968	N/A	N/A
26	Change of Ownership	(1) Referred to Investigations	\$665,126	N/A	N/A
27	Change of Ownership	No reportable deficiencies	\$774,092	N/A	N/A
<b>Totals</b>			\$23,174,379	\$8,554,433	\$4,049,803 <sup>6</sup>

Source: Lender loan files, SBA loan files, and results of OIG's reviews.

<sup>6</sup> Amount recovered by SBA as of August 2018.

SBA

OFFICE OF FINANCIAL PROGRAM OPERATIONS

RESPONSE TO EVALUATION REPORT

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



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

FROM: Jihoon Kim  
Acting Director, Office of Financial Program Operations

SUBJECT: Response to Consolidated Results of the Office of Inspector General High Risk 7(A) Loan Review

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 Small Business Administration (SBA) strives to ensure proper payments on guaranty purchases consistent with SBA's regulations and policies. The Office of Financial Program Operations (OFPO) takes great pride in its continuous improvement efforts at the National Guaranty Purchase Center (NGPC) and is always looking for ways to enhance the effectiveness of the review of guaranty purchase requests. SBA also recognizes the importance training plays in ensuring its employees possess the knowledge and skills required to perform guaranty purchase reviews and works diligently to ensure it provides quality training for their continued improvement.

In FY 2014, OIG established the High Risk 7(a) Loan Review Program. The OIG has since continued to review and report individual loan findings to management on an ongoing basis, and in doing so, the NGPC can address deficiencies on recent guaranty purchases providing for a more efficient and effective resolution.

SBA has made substantial progress in reviewing complex high dollar early default loans by evaluating the time allowed to review and process these risky purchases. As a result of these assessments the SBA has increased the time required to complete a thorough review of complex early default loans. The improvements to the processing of these risky purchases has resulted in the National Guaranty Purchase Center identifying more instances of repayment ability issues as well as referred cases to investigations for potential fraud. The continuing review of process improvements has contributed to the enormous strides The National Guaranty Purchase Center has made in studying complex early default purchases.