

093032



UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

CIVIL DIVISION

FEB 18 1971

Dear Mr. Kleppe:

The General Accounting Office examined into the Small Business Administration's (SBA) evaluation and review of applicants' eligibility for business loans requested by firms whose owners have a large amount of personal resources and a high net worth. Our survey was conducted at the Washington, D.C., headquarters office of SBA, and the Boston and Denver Regional Offices.

Under section 7(a) of the Small Business Act (15 U.S.C. 636), SBA cannot extend financial assistance to a small business concern unless the assistance is not otherwise available on reasonable terms. SBA's National Directive 510-1A specifies that financial assistance will not be granted if the requested funds are obtainable, without undue hardship, through utilization of the personal credit or resources of the owners, partners, management or principal stockholders of the applicant. The directive further provides that to prevent the violation of the statutory restriction against making loans when personal resources or credit are otherwise available, the applicant must provide, for SBA's evaluation, adequate documentation of undue hardship.

NEED TO ESTABLISH ADEQUATE CRITERIA FOR EVALUATING THE ELIGIBILITY OF LOAN APPLICANTS WHOSE PRINCIPALS HAVE SUBSTANTIAL RESOURCES OR CREDIT

BEST DOCUMENT AVAILABLE

Our survey revealed that SBA is providing or guaranteeing part of the financing for amounts greater than necessary because loan specialists were not adequately considering the personal resources or credit of the owners, partners, management or principal stockholders of the applicants in their analyses of loan applications. We believe criteria should be established which would specify to loan specialists when a loan should be disapproved or SBA participation reduced because the personal resources or credit of the principals are substantial enough to be used without undue hardship of the principals.

We reviewed section 7(a) business loans made by the Boston and Denver Regional Offices to applicants whose principals had an outside net worth of \$50,000 or more. We made our selection from the 132 loans approved by the Boston Regional Office between July 1, 1969, and January 31, 1970, and from the 137 loans approved by the Denver Regional

714320

093032

Office between July 1, 1969, and December 31, 1969. Outside net worth of a principal does not include his equity in the business which applies to SBA for a loan.

We identified 68 loans that were made to applicants of which one or more principals had an outside net worth of \$50,000 or more. Our review of these loans revealed that loan specialists were not giving adequate consideration as to whether the principal's outside net worth was sufficient to allow the principal to obtain all the financing without SBA's financial assistance or to permit SBA to reduce its participation in the loan. Generally, the principals did not furnish documentation of undue hardship for SBA evaluation, and loan files did not contain documentation indicating that a determination had been made as to whether undue hardship would result if the principals were required to provide the funds from their own resources or were required to use such resources as collateral in arranging for a personal loan through commercial sources. Loan specialists in the Denver Regional Office gave greater consideration to the possibility that principals' personal resources might be used than did those in the Boston Regional Office.

We believe that, of the 68 loans reviewed, 6 loans totaling \$674,000 (one immediate participation loan and 5 guaranteed loans) should not have been approved by SBA and 13 loans totaling \$1,408,500 (two immediate participation loans and 11 guaranteed loans) should have been approved for lower amounts. Our conclusions on the 19 loans are based on one or more of the following:

- (1) Principal(s) had large amounts of liquid assets in relation to the loan.
- (2) Principal(s) had large equity in businesses other than in the business which applied for the loan.
- (3) Principal(s) had high-value, mortgage-free residence or summer home.

For example, the Denver Regional Office approved an immediate participation loan of \$66,000 whereby SBA was to finance 75 percent of the loan amount; a bank was to finance the remainder. One principal (40-percent stockholder) had investments in the business of \$2.2 million but also had an outside net worth of \$543,000, including \$77,302 in cash and \$362,283 in stocks and bonds. In addition, the business had outstanding two other SBA immediate participation loans totaling \$513,371 in which SBA's share was \$290,601.

Interviews with SBA loan specialists confirmed that little or no consideration was given to determining whether the principals' personal resources or credit could be utilized without undue hardship.

BEST DOCUMENT AVAILABLE

Loan specialists advised us that in businesses with more than one owner, it would be inequitable to require the principal with high outside net worth to make additional investments in the business when the other principals may not be financially able to do likewise. We were advised that there are no guidelines or directives concerning the action to be taken in this type of situation.

Also, the loan applications in question were those referred to SBA by banks which requested SBA participation (generally a loan guarantee). We found that the SBA loan specialists approved SBA participation in the loans with little consideration of the principals' personal resources or credit because (1) the request by the bank implied that the applied for funds were not otherwise available on reasonable terms, and (2) SBA is heavily dependent on the banking industry for the success of its lending programs and it appears that loan specialists may be overly concerned that reducing or disapproving the loan would alienate the banks.

We recognize SBA's dependence on the banking industry for the success of its lending programs and appreciate the concern expressed by the loan specialists. Such concern, however, should not lead SBA to extend financial assistance to businesses when such assistance is otherwise available on reasonable terms. We believe that loan applications referred to SBA by banks should be carefully evaluated and the financial statements of the principals involved should be reviewed in sufficient depth to ascertain whether personal resources could be used, without undue hardship, in lieu of all or part of an SBA loan or guarantee.

For certain loan applications, we questioned SBA officials why those principals of the applicants who held high-valued securities could not have obtained additional funds for the business on the basis of their personal resources. The SBA officials indicated that the principals might have experienced undue hardship if they would have had to sell their securities at the time when prices in the stock market were falling. ND510-1A provides that forced sale of assets resulting in a considerable loss is considered undue hardship. However, documentation was not provided to show that a considerable loss would result if securities were sold. In lieu of selling the securities, they might have been utilized as collateral in arranging for a personal loan through commercial sources.

With regard to the use of non-liquid personal assets, the Chief, Financial Assistance Division, Boston Regional Office, stated that he would not suggest that an individual sell real estate in order to obtain funds for his business. We agree that SBA should not go so far as to

BEST DOCUMENT AVAILABLE

disapprove an application because a principal will not sell such assets. We believe, however, that if a principal has a large equity in another business, residence, summer home or other fixed assets, SBA should not approve the loan unless the principal can demonstrate that he is unable to obtain the requested funds through a mortgage or loan secured by such assets.

CONCLUSIONS AND RECOMMENDATIONS

Loan specialists are not adequately considering the personal resources of the owners, partners, management or principal stockholders of the applicant in their analyses of loan applications. The lack of criteria to assist loan specialists in determining what conditions or factors constitute undue hardship has created a situation which provides the processing loan specialists with a large judgmental area as to when lending assistance should be disapproved or reduced because the personal resources or credit of the principals are substantial enough to be used without undue hardship to the principals.

We recommend that SBA establish criteria to assist a loan specialist in deciding whether an application for SBA assistance should be disapproved or modified, on the basis that the personal resources or credit of the applicant's principals are substantial enough and that additional financial assistance can be obtained elsewhere without undue hardship to the principals. We further recommend that when a loan specialist has determined that undue hardship would result if a principal's personal resources or credit were utilized, the basis for such a determination be adequately documented in accordance with existing SBA policy.

INCOMPLETE DOCUMENTATION OF CHARACTER INVESTIGATIONS

To preclude SBA from making loans to members of organized crime and other persons not of good character, SBA national directives require that Statements of Personal History (SBA Form 912) be submitted by the applicant for certain principals and officials of the concern. Loan officers are required to forward these forms to the Office of Security and Investigation for its review. Twenty-one of the 68 loan files reviewed did not contain the required Statements of Personal History.

Our review of the 68 loans showed that, based on available information, none of the loans were made to businesses whose principals or officials were known to be members of organized crime. We believe, however, that the Statements of Personal History should be included in all loan files as required.

BEST DOCUMENT AVAILABLE

We recommend that appropriate follow-up be made to ensure that the statements are submitted and reviewed before loan applications are approved.

- - - -

We appreciate the cooperation extended to our representatives during the survey, and we will be pleased to discuss our report with you or your representatives if you so desire. We plan no further reporting on the matters discussed in the report at this time; however, we would appreciate your comments on the action taken or contemplated on our recommendations.

Sincerely yours,

Henry Eschwege

Henry Eschwege
Associate Director

The Honorable Thomas S. Kleppe
Administrator, Small Business
Administration

BEST DOCUMENT AVAILABLE