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REPORT TO THE CONGRESS

093785

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

The Small Business Administration Needs to Improve Its 7(a) Loan Program

Problems exist in the Small Business Administration's 7(a) loan program which need correction. Management, in line with GAO's recommendations, has initiated or plans to take appropriate actions to correct them.

The problems were that the agency

--has approved loans for questionable purposes, such as tranferring risk of loan repayment from banks and other creditors to the agency itself.

--did not, in certain cases, analyze the prospective borrowers' financial condition adequately or verify the adequacy of collateral pledged.

--has not acted effectively after loans were made to increase the chances of borrower success and loan repayment.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This is the fifth in a series of reports issued pursuant to Public Law 93-386, which requires us to conduct a full-scale audit of the Small Business Administration. This report discusses problems in the 7(a) loan program and agency actions taken, initiated, or planned to correct them.

We are sending copies of this report to the Director, Office of Management and Budget, and the Administrator, Small Business Administration.

Comptroller General
of the United States

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ABBREVIATIONS

ACE	Active Corps of Executives
GAO	General Accounting Office
MA	management assistance
PM	portfolio management
SBA	Small Business Administration
SBI	Small Business Institute
SCORE	Service Corps of Retired Executives

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

THE SMALL BUSINESS ADMINISTRATION NEEDS TO IMPROVE ITS 7(a) LOAN PROGRAM

D I G E S T

Under section 7(a) of the Small Business Act, the Small Business Administration guarantees and makes direct loans to small businesses. The 7(a) program is the agency's basic and largest business loan program.

As of June 1975, 80,582 loans valued at $3,930.4 million were outstanding and 6,880 loans valued at $344.1 million were delinquent 60 days or more or in liquidation.

GAO reviewed the 7(a) loan program at 24 of the agency's district offices, randomly selecting and examining 980 loans. (See app. III.)

Although the agency has aided, counseled, and assisted many small businesses throughout the Nation, GAO found problems that require management attention.

Loan proceeds were approved for questionable purposes.

--Numerous loans were approved which merely transferred the risk of loan payment from banks and other creditors to the agency itself. (See pp. 9 to 21.)

--Some loans were made to wealthy businesses not intended to receive assistance. (See pp. 21 to 24.)

The Small Business Administration did not always analyze the prospective borrowers' financial condition adequately or verify the adequacy of collateral pledged. As a result, loans were approved when it was questionable whether they were of such sound value or so secured as to reasonably assure repayment. (See ch. 4.)

The agency did not act effectively after loans were made to increase the chances of borrower success and loan repayment.

--Borrowers used loan proceeds for unauthorized purposes which went undetected. (See pp. 36 to 39.)

--The Small Business Administration did not have adequate procedures for detecting delinquent loans and the reasons for the delinquency, and therefore did not know of borrowers in need of help. (See pp. 39 to 44.)

--The agency did not routinely visit borrowers to check their progress. (See pp. 46 to 49.)

--Its management assistance program was not helping businesses overcome their problems. (See ch. 6.)

A problem which permeates the entire loan process is a shortage or improper alignment of personnel at the district office level.

To correct these problems, the Small Business Administration should take numerous actions, including:

--Insuring clarification of and compliance with established operating procedures.

--Determining its proper staffing level to effectively analyze and service the loans approved. To achieve this level, the agency should consider realigning its current personnel or requesting additional staff from the Congress. If these approaches fail, the only option would be to limit the number of loans approved. (See pp. 25, 34, 54, and 68.)

This is the fifth in a series of reports pursuant to Public Law 93-386, requiring GAO to conduct a full-scale audit of the Small Business Administration. The Congress can use this report in assessing the agency's management; administration; and fulfillment of its legislative mandate to aid, counsel, and assist small businesses.

The Small Business Administration generally agreed with GAO's recommendations. The agency

appreciated the overall positive tenor of GAO's report and acknowledged the managerial shortfalls uncovered.

It said that remedial measures are either underway or planned but these must be accomplished within budgetary constraints. (Specific agency comments are discussed on pp. 26, 34, 55, and 69.)

CHAPTER 1

INTRODUCTION

Because of concern over the management and operation of the Small Business Administration (SBA), in late 1973 and early 1974 the Congress, as part of the Small Business Amendments of 1974 (Public Law 93-386), directed us to make a full-scale audit of SBA. This report, part of our response to that mandate, deals with the administration of SBA loans made during fiscal years 1971-74 under section 7(a) of the Small Business Act, as amended (15 U.S.C. 636(a)) (the business loan program).

SBA 7(a) BUSINESS LOAN PROGRAM

SBA was established primarily to aid small businesses, which the Small Business Act defines as those not dominant in their field. A major SBA responsibility is administering the business loan program. Under this program, SBA makes loans to small businesses to finance plant construction, conversion, or expansion; to purchase equipment, facilities, machinery, supplies, and materials; and to supply working capital.

The act provides that

> "* * * No immediate participation [loan] may be purchased unless it is shown that a [guaranteed loan] is not available; and no [direct] loan may be made unless it is shown that a participation [loan] is not available."

A guaranteed loan is made by a lending institution under an agreement with SBA. This agreement obligates SBA to purchase the guaranteed portion of the loan (not more than 90 percent of the balance outstanding) from the lending institution upon default for more than 90 days in the repayment of principal or interest on the note.

An immediate participation loan is made by either SBA or the lending institution, and the lender purchases an agreed percentage of the loan immediately upon disbursement. The SBA share of an immediate participation loan generally cannot exceed 75 percent of the amount of the loan.

A direct loan is made by SBA with no participation by a lending institution.

The maturity of business loans shall be restricted to the minimum consistent with sound business practice. The maturity may not exceed 10 years, except for that portion

of a loan made to construct facilities, which may have a maturity of up to 15 years. (For additional details on the three types of 7(a) business loans, see app. II.)

The act limits the total amount of SBA-guaranteed or direct funds that can be outstanding to any one borrower to $350,000, except for a "pool" loan to a corporation formed and capitalized by a group of small businesses to obtain, for their own use, raw materials, equipment, etc. The amount outstanding for "pool" loans is limited to $250,000 times the number of small businesses which formed the corporation.

SUMMARY OF 7(a) LOANS MADE

In June 1975 the 7(a) loan program accounted for 80,582 (72 percent) of the business loans outstanding, 1/ exclusive of disaster loans. This program also accounted for about $3,930.4 million (80 percent) of the dollar value outstanding at that date. SBA provided funds for direct and immediate participation loans approved during fiscal years 1974 and 1975 totaling $67.5 million and $144.5 million, respectively. SBA's share of or liability for guaranteed loans approved in those years totaled $1,422.0 million and $1,102.7 million, respectively.

In fiscal years 1971-74, SBA approved a total of 80,166 7(a) loans totaling $5,942.7 million. The following table shows, by fiscal year and type, the number and value of 7(a) loans made during this period.

FY	Guaranteed		Immediate participation		Direct		Total	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
	(dollars in millions)							
1971	11,894	$ 817.0	1,602	$ 93.1	258	$ 13.8	13,754	$ 923.9
1972	17,619	1,275.5	888	53.2	1,374	37.0	19,881	1,365.7
1973	23,512	1,864.1	379	23.8	1,328	38.6	25,219	1,926.5
1974	19,472	1,652.8	274	19.2	1,566	54.6	21,312	1,726.6
Total	72,497	$5,609.4	3,143	$189.3	4,526	$144.0	80,166	$5,942.7

1/The remaining business loans outstanding were: 2,721 displaced business loans, 4,009 development company loans, and 24,927 economic opportunity loans valued at $244.0 million, $400.6 million, and $317.7 million, respectively.

We reviewed the operation and administration of the 7(a) loan program at 24 SBA district offices, which handled 35,618 (44 percent) of the loans approved and $2,802 million (47 percent) of the total dollar value of loans approved by all SBA offices. From this universe, we randomly selected 980 loans for detailed examination. (See app. III.)

ADMINISTERING THE PROGRAM

In April 1975, SBA operated 10 regional offices and 81 branch and district offices to aid the 8.8 million small businesses throughout the United States. (See app. IV.) Through these offices, SBA administers 17 programs, including the 7(a) loan program. SBA policies provide, as does the Small Business Act (15 U.S.C. 636), that all 7(a) loans shall be of such sound value or so secured as to reasonably assure repayment.

In administering the 7(a) loan program, the

--central office provides technical direction to regional offices, evaluates regional offices' operations, and supervises district offices;

--regional offices provide technical guidance to district offices, supervise district office operations, evaluate district office performance, make necessary corrections, and review declined loan applications or requests for reconsideration;

--district offices are operating offices under the jurisdiction of regional offices; and

--branch offices have limited operating responsibilities and are under the jurisdiction of district offices.

Each district office has three basic functions in the 7(a) loan process--loan approval, loan servicing, and management assistance. An organization chart for a typical district office is included as appendix V. The following sections show the requirements for each function as expressed in SBA's operating procedures.

Loan approval

A loan specialist in the financing division is responsible for reviewing the loan package and recommending approval or disapproval of loan applications. He is to issue a report (loan specialist's report) containing, at least:

--A statement of the applicant's eligibility as a small business.

--A determination that funds are not otherwise available on reasonable terms.

--A balance sheet for the applicant, with questionable items explained.

--An analysis of the adequacy of working capital.

--An analysis and comparison with industry averages of past and/or projected earnings.

--A brief description of the collateral, if any.

--A determination of the adequacy of invested capital or equity.

--Comments on management evaluations.

--Comments on the adequacy and conditions of leases if the applicant is renting.

--Comments on the adequacy and availability of hazard insurance.

--Support for any reduction in a bank's exposure explained in detail and thoroughly justified.

--A recommendation for approval or disapproval of the loan.

Two SBA officials must recommend each loan application for approval before a loan can be made. Approval is generally given by a combination of the following officials: loan specialist; supervisory loan specialist; chief, financing division; assistant director, finance and investment; or district director.

Loan servicing

Servicing, the responsibility of a loan specialist in the portfolio management (PM) division, begins at the time of loan closing (after the loan has been made).

The loan specialist looks primarily at loans with problem characteristics, rather than at the entire portfolio of loans assigned to him. He monitors his portfolio for warning signals, such as delinquent payments, requests for changes in terms and conditions of the loan, or adverse

changes or declining trends. If a borrower's problem is beyond the range of the loan specialist's technical knowledge, the case is to be referred to the management assistance (MA) division (business management specialist). If management assistance is needed, the MA division is to take the necessary action to provide it.

In short, servicing assistance is

--the early recognition that a problem or potential problem exists,

--the identification of the basic cause, and

--a determination as to the appropriate solution.

Management assistance

When management assistance is needed by a loan recipient, a business management specialist in the MA division is to provide the proper assistance through his own expertise or the professional expertise of the Service Corps of Retired Executives (SCORE), the Active Corps of Executives (ACE), the Small Business Institute (SBI), a consultant-contractor, and others.

The financing division can ask the MA division to evaluate the loan applicant's management needs. Also, SBA requires a monthly review of the problem or delinquent loans in the district office's loan portfolio from both servicing and MA personnel, to determine if the borrower needs management assistance.

PRIOR AUDITS OF THE PROGRAM

GAO and SBA's Internal Audit Division have issued several reports on various aspects of the 7(a) loan program. (See app. VI.)

CHAPTER 2

OBSERVATIONS ON OVERALL 7(a) LOAN PROGRAM

SBA has helped the small business community through its 7(a) loan program, and many businesses have been assisted and jobs probably have been maintained or created as a result. However, certain problems need management attention to improve the program.

From the beginning of the 7(a) loan program through June 30, 1974, SBA approved 183,835 loans valued at $9.9 billion and charged off 10,062 loans valued at $187 million. During fiscal years 1971-74, SBA approved 35,618 loans valued at $2,802.0 million at the 24 district offices reviewed. Of the 24 district offices' loans approved during that period, as of August 30, 1974, 1,540 loans were in liquidation and 733 loans were charged off, representing about $124 million and $31 million, respectively. Only about 6.4 percent of the loans went bad at these 24 offices. However, many problem loans were not included in this data. (See pp. 40 to 42.)

For all district offices, SBA's loss rate figures for fiscal years 1971-74 showed the following.

FY	Guaranteed loans	Immediate participation loans	Direct loans	Total
1971	3.07	2.98	6.86	4.14
1972	4.66	3.00	7.12	4.52
1973	6.13	3.07	7.23	4.99
1974	8.25	3.14	7.34	a/5.86

a/SBA's 1974 annual report showed an overall loss rate of 2.59 percent for the 7(a) loan program. No rates were presented for individual types of loans. The rate is lower than in previous years because of the elimination of anticipated losses in the calculation of a loss rate. The 1974 loss rates in the above chart were computed by SBA for administrative purposes on a basis consistent with prior years.

We noted, however, that SBA retained many loans in liquidation when there was little hope of recovering any money from the borrower. Thus, by not charging off a loan and instead keeping it in liquidation, SBA does not present a true picture of its losses. Also, retaining loans in this category increases the trouble rate.

SBA considers trouble loans to be those over 60 days delinquent or in liquidation. The trouble rate shown by SBA

statistics in June 1974 showed that 7.2 percent (6,255) of its loans, valued at $259.9 million, were in this category. By June 1975, the percentage had risen to 8.8 percent (6,880) of its loans, valued at $344.1 million. SBA does not have reliable information on which to compute a trouble rate. (See ch. 5.)

Although the indicated loss and trouble rates would seem intolerable for a commercial lending institution, they must be viewed in the light of SBA's mandate to approve loans only if they are not available commercially. This means SBA approves higher risk loans than commercial lending institutions. However, SBA should not approve a loan if the borrower does not demonstrate the earning potential to repay the loan.

STRENGTHS OF THE PROGRAM

SBA has helped many small businesses.

SBA reported that, as of August 30, 1974, for the 24 district offices about 94 percent of the 7(a) loans approved during fiscal years 1971-74 were current or had been paid in full. However, some loans are relatively new, others classified as current have delinquent payments, some were repaid from proceeds of other SBA loans, and others have had their payments deferred.

Generally, SBA's standard operating procedures provide a sound basis for evaluating the potential success of a loan applicant. However, problems have arisen because SBA failed to fully implement these procedures. This failure may be attributable to SBA's desire to provide as much financial assistance (loans approved) as possible and to the limited staff available to implement the procedures.

PROGRAM PROBLEMS

SBA approved loan proceeds for questionable purposes. (See ch. 3.)

SBA did not analyze the prospective borrowers' financial condition adequately or verify the adequacy of collateral pledged. (See ch. 4.)

SBA acted ineffectively after loans were made to increase the chances of borrower success and loan repayment. (See chs. 5 and 6.)

OVERALL AGENCY COMMENTS

SBA generally agreed with our recommendations. (See app. I.) The agency appreciated the overall positive tenor of our report and acknowledged the managerial shortfalls uncovered. SBA said that remedial measures are either underway or planned but that they are limited by budgetary constraints. (Specific agency comments are discussed on pp. 26, 34, 55, and 69.)

According to SBA, the staff responsible for the 7(a) loan program must also fulfill the requirements and needs of borrowers for all other financial assistance programs. The agency added that another burden on its staff resources is its continued efforts to bring minority businesses into the economic mainstream. This program requires, at the field level, devoting more job time per unit of production than is devoted to the routine majority applicant/borrower.

SBA further stated that it has pressed for additional staff but that budgetary constraints have kept its staffing level at just above 4,000 for the past few years. The agency was not surprised that our findings testify to its stretching of resources. SBA added that it is aware of its problems because its internal review functions have reported similar findings.

We agree that SBA has had additional burdens, which have stretched its resources beyond its current capabilities to fulfill its mandate of aiding, assisting, and counseling small businesses. This overextension is shown by the problems discussed in chapters 3, 4, and 5.

CHAPTER 3

PROCEEDS OF SOME LOANS APPROVED

FOR QUESTIONABLE PURPOSES

Loans were approved that (1) merely transferred the risk of obtaining repayment from banks and creditors to SBA, (2) refinanced questionable SBA loans, and (3) went to wealthy borrowers not intended to receive SBA assistance.

Loan proceeds were used as follows:

--202 of the 980 sampled loans were used to repay debts owed to participating banks, of which 87 reduced the banks' exposure by a total of $1.1 million. Twelve loans paid off debts, totaling $210,000, of participating banks which were in a position to sustain a loss. Included in these 202 loans were 126 loans where a portion of the loan proceeds were used also to pay other creditors, nonparticipating bank loans, or both.

--217 additional loans were used to pay debts owed to other creditors, nonparticipating banks, or both.

--104 loans were used to pay off prior SBA loans, of which 24 loans, or 23 percent, were questionable refinancings.

In addition, 17 of the 980 sampled loans had been approved at 6 SBA district offices where the borrower had substantial assets which, we believe, could have been used or at least pledged as collateral for securing a loan on the open market.

We believe that:

--Participating banks should be required to retain the same level of exposure that they had on any prior loans being paid with the SBA loan proceeds.

--SBA loan specialists should be required to more thoroughly evaluate loans where a large portion of loan proceeds are to be used for debt repayment and thoroughly justify in their reports the appropriateness of such use.

--Procedures should be established requiring additional documentation from the bank and the borrower when 50 percent or more of the loan proceeds are used to pay borrower debts.

SBA should (1) insure that loans are not made to individuals who have substantial financial resources and (2) require that these resources be used in lieu of part or all of the SBA loan.

DEBT REPAYMENT TO PARTICIPATING BANKS

SBA procedures provide that financial assistance not be provided to pay off a creditor in a position to sustain a loss and that any reduction in exposure be thoroughly justified in the loan specialist's report. SBA procedures, however, do not indicate what constitutes a thorough justification for reducing a bank's exposure other than the repayment of a bank loan made in anticipation of approval of an SBA loan. However, SBA has allowed participating bank debts to be paid off with the loan proceeds of SBA-guaranteed loans resulting in a reduction in the banks' exposure and, in some cases, bailing the participating bank out of a financial dilemma. Further, loan specialists did not obtain assurance or adequately justify that reductions in exposure were appropriate.

The following table shows our statistical projection of repaid participating bank loans, reductions in bank exposure, and bank bailouts for the 24 district offices. (See app. VII for further details.)

	Sample results	Projected total of the universe	Weighted percent of universe
Repaid participating bank loans	202	6,688	18.7
Bank exposure reduced	87	2,896	8.1
Bank bailouts	12	127	0.4

SBA procedures on repaying borrower debts

SBA procedures concerning reduction of bank exposure provide:

> "As a general rule, the bank's minimum participation in a loan * * * should be at least equal to the total bank loans being refinanced. Interim funds, which can be positively identified as having been advanced in anticipation of long-term financing with SBA participation, are an exception to this rule and may with explanation, be excluded from any calculations. Any reduction in a bank's exposure must not only be explained in detail but must be thoroughly justified in any recommendation for approval."

* * * *

"Financial assistance will not be extended by SBA * * * if the direct or indirect purpose or result of granting such assistance would be to * * * pay off creditors who are in a position to sustain a loss * * * resulting from * * * extension of credit which is inadequately secured. This would be a 'bailout.'"

* * * *

"* * * Financial assistance will not be extended by SBA to an applicant who may be insolvent or have such low net worth that the creditor, who has extended credit to the applicant on accounts or unsecured notes payable, may be in a position to sustain a loss."

SBA operating procedures state that debts should not be transferred from private to Government hands, but that a certain amount of refinancing is frequently necessary in any growing business. Loan specialists must exercise prudent judgment at all times so that loan proceeds do not bail out banks or other creditors. SBA procedures require that, if loan proceeds are used for debt refinancing, loan specialists carefully document in their loan evaluation reports the justification for debt payments and itemize in the loan authorization the debts to be paid.

SBA has told banks that it prefers not to get involved in debt refinancing and will do so only to further the orderly growth of a small business and not to merely substitute an SBA loan for private financing.

Reduction in bank exposure

Of the 980 sampled loans, 202 were used to repay participating bank loans. Of these, 87 resulted in a reduction in the banks' exposure, thereby transferring the risk of loan default from the banks to SBA. Participating banks should be required to maintain the same level of exposure that they had on any prior loans being paid with the SBA loan proceeds.

The total dollar reduction was $1,077,870, an average of $12,389 per loan (ranging from $154 to $105,360). We did not consider a loan to result in a reduction in exposure if it was used to repay a bank loan made in anticipation of an approval of an SBA loan, as stated in SBA procedures, unless there was information to the contrary or the loan files did not document that the bank loan was of that nature.

Some examples of the 87 loans that reduced the participating banks' exposure follow.

Example 1--On March 24, 1972, SBA approved a $105,500 loan with a 90-percent SBA guarantee. Proceeds were to be used as follows: $37,300 to repay a participating bank loan, $13,200 to purchase machinery and equipment, and $55,000 for working capital and inventory.

The bank's exposure was reduced by $26,750, as follows:

Exposure before loan	$37,300
Exposure after loan (10 percent of $105,500)	10,550
Reduction in exposure	$26,750

The loan specialist indicated that the bank loan of $37,300 had been adequately secured. However, neither the loan specialist's report nor the SBA files indicated that this financing was approved in anticipation of an SBA loan.

This loan became delinquent in October 1972 and was placed in liquidation in May 1973. In May 1974, litigation was begun in an attempt to acquire and sell the borrower's real estate.

Example 2--A 90-percent-guaranteed loan for $30,000 was approved on October 5, 1972. The proceeds were used for working capital and to pay the participating bank $19,000 to refund an existing bank loan, thereby resulting in a reduction in exposure of $16,000, as follows:

Exposure before loan	$19,000
Exposure after loan (10 percent of $30,000)	3,000
Reduction in exposure	$16,000

The reduction in exposure was not justified in the loan specialist's report. The loan specialist's only comment was: "The bank's reduction in exposure seems justified." The chief, financing division, told us that, in his opinion, the reduction in exposure could possibly have been justified on the basis that the participating bank was not going to suffer a loss if the loan had not been refinanced. But he agreed that the loan specialist's analysis was inadequate and should have thoroughly explained the situation. According to the bank, the loan was current as of August 31, 1974.

Example 3--In April 1973 SBA approved a $30,000 loan with a 90-percent SBA guarantee. Proceeds were to be used in part to repay participating bank loans of $20,500.

The bank's exposure was reduced by $17,500, as follows:

Exposure before loan	$20,500
Exposure after loan (10 percent of $30,000)	3,000
Reduction in exposure	$17,500

The loan specialist justified this reduction in exposure on the basis that the participating bank loans to be repaid were interim loans. We contacted the bank officials to ascertain the specifics of these loans.

Information provided by the bank showed that a loan for $18,000 was approved on January 24, 1972, and another loan for $2,500 was approved on February 21, 1973. The bank did not say that these loans or specifically the latter loan was approved in anticipation of SBA approving the guaranteed loan. This would be the only situation, according to SBA procedures, which would justify refunding interim bank loans.

Appendix VIII gives more examples of approved loans that reduced the banks' exposure.

A February 5, 1973, SBA Internal Audit Division report stated that it had found significantly different interpretations and applications of the criteria relating to reducing a bank's exposure. The auditors noted that sometimes loan proceeds were used to reduce or virtually liquidate the participating bank's debts.

Bank bailouts

Of the 87 loans that resulted in a reduction in bank exposure, 12 refunded participating banks' loans when the bank was in a position to sustain a loss. These loans accounted for a total reduction in exposure of $209,822. We considered as bailouts only those loans for which we could prove on the basis of documentation available to the loan specialist or information he could have obtained at the time he approved the loan that the bank was in a position to sustain a loss. In other cases, it was not possible to determine whether the banks had been in a position to

sustain a loss; accordingly, we did not classify these loans as bank bailouts.

The following are examples of some of the 12 approved loans which resulted, in our opinion, in bailouts of participating banks.

Example 1--SBA had originally declined an application for a $10,000 90-percent-guaranteed loan because the firm had a deficit net worth and operating losses and because over 50 percent of the proceeds would be used to pay off the applicant's unsecured participating bank loan of $5,450. The application was resubmitted and approved in October 1970, without comment on the refunding of the bank loan, even though almost half the proceeds ($4,860) would still be used for that purpose.

This resulted in a reduction in exposure of $3,860, as follows:

Exposure before loan	$4,860
Exposure after loan (10 percent of $10,000)	1,000
Reduction in exposure	$3,860

The borrower went into bankruptcy in February 1972, and the bank incurred a loss of $731, while SBA lost $6,575--a total loss of $7,306.

Had SBA required the bank to retain its original exposure, the bank could have incurred a loss of $3,551 (48.6 percent of $7,306). This would have reduced SBA's loss by $2,820 ($6,575 minus $3,755--51.4 percent of $7,306).

Example 2--A $300,000, 90-percent SBA-guaranteed loan was approved on March 10, 1972, to repay borrower debts and provide working capital. Originally, SBA declined the loan due to the lack of the applicant's ability to repay.

The applicant's grain elevator business had suffered losses in 1968, 1969, and 1970 and had a net profit of $9,700 before depreciation or owner withdrawals for the first 10 months of 1971. The lack of earnings during this period resulted in the applicant's insolvency at the time of the SBA loan application. After SBA declined the loan, the president of the proposed participant bank wrote three Members of Congress to complain about the declined loan. The Members transmitted this letter to SBA. There is nothing in the record to indicate that the Members did any more than transmit the president's letter to SBA for its consideration. However, SBA reconsidered and approved the loan even though no additional evidence was furnished to indicate that the applicant was in a position to repay the loan.

The loan authorization did itemize debts being repaid, but the loan specialist did not document, though required, the justification for debt repayment. Of the debts to be repaid from SBA loan proceeds, only $10,000 was identified before loan approval as a debt owed to the participating bank.

The bank had charged off this loan. However, subsequent settlement sheets showed an additional $100,000 in notes and $25,360 in interest were paid to the participating bank using SBA loan proceeds. Therefore, the bank's exposure was reduced by $105,360, as follows:

Exposure before loan	$135,360
Exposure after loan (10 percent of $300,000)	30,000
Reduction in exposure	$105,360

SBA's loan specialist stated that he had no prior knowledge that the $100,000 was owed to the bank because the notes had been identified before the SBA loan approval as being owed to an individual. The loan was placed in liquidation on June 18, 1973, 1 year and 3 months after loan approval. In our opinion, the approval of this loan resulted in a bank bailout.

Appendix IX contains more examples.

Comments by various SBA district officials

SBA district officials commented as follows concerning refunding bank loans:

--They considered the repayment of bank debt as a valid use of loan proceeds, provided the bank debt was short-term financing (6 months or less).

--More emphasis would be placed on documenting the status of refunded debt.

--They did not analyze the bailout question thoroughly because of insufficient loan-processing time.

--They negotiated an increase in the percentage of the bank's participation when a 10-percent share would reduce the bank's dollar exposure.

However, as noted on the preceding pages, 87 SBA loans resulted in reducing the participating banks' exposure, when bank loans were other than loans made in anticipation of approval of an SBA loan. SBA district officials should

require banks to retain their prior exposure and loans should not be approved to bail out banks. If banks are required to retain their prior exposure, a bailout will not occur.

With regard to refunding bank loans, reducing a bank's exposure, or bailing out banks, the SBA Administrator stated in a February 5, 1975, letter to all field offices:

> "We have become increasingly concerned about the financial condition of small independent truckers, and others, who are caught in the current economic downturn and are unable to arrange conventional refinancing of debt on a long-term basis.
>
> "As a general rule, the bank's minimum participation in a loan * * * should be at least equal to the total bank loans being refinanced. Any reduction in a bank's exposure must not only be explained in detail but must be thoroughly justified in any recommendation for approval.
>
> "Thus, our present policy does permit refinancing, as well as reduction in bank exposure, when fully justified. I believe the present economic climate does fully justify refinancing and readjustment of existing debt, including reduction in bank exposure."

We agree that a reduction in exposure would be justified if loans made in anticipation of approval of an SBA guaranteed loan were being paid off or if the reduction was in the best interest of the small business. However, the Administrator's letter provides too general a basis for approving loans by which the bank's exposure is reduced. This blanket policy would result in many loans being approved which would merely transfer risk from banks to SBA.

SBA central office officials agreed that the Administrator's letter provides too general a basis for approving loans by which the bank's exposure is reduced. According to these officials, the letter will be either rescinded or replaced with a more specific directive.

DEBT REPAYMENT TO OTHER CREDITORS

We noted that 343 loans were used to pay off borrowers' debts owed to creditors, nonparticipating banks, or both. Portions of the proceeds for 126 of these loans were used also to repay borrower debts owed to participating banks. Loan specialists do not identify all the creditors to be paid with SBA loan proceeds; therefore, no determination

can be made as to the appropriateness of such payments. We believe SBA should thoroughly analyze and document these payments.

SBA procedures state that, if a major portion of the requested loan is to be used for payment of existing debt, the loan specialist's report must include:

- --A full explanation of the circumstances which resulted in the accumulation of such debt, if applicable.
- --Why the applicant could not or did not pay as agreed.
- --How the loan will improve the earnings and financial condition of the applicant.

The following examples show some of the creditor bailouts identified during our review and the inadequate documentation by the loan specialist.

Example 1--A 90-percent-guaranteed loan for $100,000 was approved on June 29, 1972. Half of the proceeds was used to pay creditors. The loan subsequently became delinquent, was purchased by SBA, and was placed in liquidation on July 23, 1973, with an outstanding balance of $97,862. Collateral pledged at the time of loan approval and valued at $78,700 was subsequently sold for $16,750.

Our analysis of the borrower's financial position at the time of loan approval indicated that the creditors were in a position to sustain a loss. We based our opinion on the borrower's financial statements, which showed long-term debts of $142,000, losses in the 4 previous operating years, and a deficit stockholders equity position of $126,000.

The loan specialist who approved this loan agreed with our determination of a creditor bailout but explained that SBA officials in this district office did not consider creditors in determining a bailout. Upon review of SBA regulations, however, he agreed that creditors should be considered in all bailout determinations.

Example 2--An immediate participation loan for $200,000 was approved on January 21, 1972. The loan file showed that $123,314 (62 percent) was used for debt payment and $66,686 for working capital. There was no documentation in the loan file on the additional $10,000.

Documentation in the loan file showed that in July 1969 the borrower was attending creditors' meetings and that in October 1971 the borrower requested a 2-month extension on making final payments to his creditors.

On July 19, 1972, SBA approved a second loan to the same borrower. The SBA Office of Portfolio Review commented on these loans in June 1973, saying "the second loan was approved in an attempt to salvage the first loan and look for a loss of $100,000 unless this business can be merged." In October 1973, the borrower was 8 months delinquent for a total of $27,200 and creditors were beginning to file suit to collect their accounts. The business ceased operations that month, when the union pulled its men off the job for nonpayment of union fringe benefits accrued as of June 1973.

In April 1974, a new borrower assumed responsibility for both SBA loans, and payments were current as of August 30, 1974.

The district chief for finance and investment agreed that the first loan was definitely a creditor bailout.

Example 3--A 90-percent-guaranteed loan for $300,000 was approved by SBA on December 21, 1970. The proceeds were used to retire interim bank financing of $81,564 and to pay creditor debts of $218,436.

The borrower later became delinquent in his payments and the loan was purchased by SBA. SBA placed the loan in liquidation on August 17, 1972, with an outstanding balance of $254,010. During the liquidation process the company filed for bankruptcy; SBA, having sold the collateral, charged off $110,131 on April 8, 1974.

Our analysis of the borrower's financial position and the loan specialist's report showed that the borrower's creditors were in a position to sustain a loss. The loan specialist's report indicated insolvency, stating that "Additional working capital is considered by the writer to be vital to the continued existence of this firm."

An SBA official said that an adequate review was not made and agreed that creditors should be considered in all bailout determinations.

Appendix X contains additional examples.

REFINANCING SBA LOANS

We estimate that of the 35,618 loans in our statistical universe, 3,865 refinanced prior SBA loans. Our analysis of sampled loans showed that 23 percent of the refinancings were questionable because the borrowers were delinquent in their loan payments or appeared to have little or no chance of recovery when the new loans were approved. Apparently, SBA

gambles in such cases, hoping that, with a little more money, the business and the prior SBA loan can be salvaged.

We recognize that refinancing delinquent SBA loans is a gray area, subject to many pressures and judgmental factors. Such refinancing loans should not be approved when the loan specialist's analysis shows that there is little hope for repayment. Approval of such loans to sustain a business in trouble is contrary to SBA procedures. Loan specialists should be required to prepare detailed justification, as stipulated in SBA's operating procedures, when loans are approved to refinance delinquent or problem SBA loans.

SBA procedures permit additional financing and refinancing of SBA loans but provide that this should not be done to protect an unsatisfactory existing SBA loan. Such loans are subject to the same credit standards as the original loans. The loan specialist is supposed to explain why the first loan did not accomplish its purpose and whether refunding can accomplish it and perform a thorough examination of the borrower's financial condition and repayment ability.

SBA procedures state:

> "* * * It is difficult to conceive of a set of circumstances in which an applicant showing insolvency resulting from operating losses could be considered to have a basis for loan approval, unless such losses were beyond the control of management."

While procedures do not prohibit SBA from refinancing its own loans, SBA has approved questionable loans to retain some chance of recovering funds from existing loans in trouble.

The following examples show the circumstances surrounding several questionable loans which were used to refinance SBA loans.

Example 1--An SBA-guaranteed loan for $73,000 was approved in July 1973 to refinance a delinquent SBA-guaranteed loan of $67,000 and provide an additional $6,000 for working capital. The borrower had been chronically delinquent on the prior loan, had received several deferments, and was making payments of only $75 per week, whereas the original terms called for payments of $821 per month.

The loan specialist's report recommended that the $73,000 loan be declined and identified a number of unfavorable factors in support of his recommendation:

--Lack of repayment ability.

--Disproportionately high debt to deficit net worth.

--Inadequate working capital before and after loan.

--Poor servicing experience with first loan.

--Delinquent withholding taxes now due.

Nevertheless, higher officials overrode his judgment and approved the loan. The only justification reported in support of the override was that the bank felt the borrower could "pull out" with the additional $6,000. One of these officials, the chief of the financing division, told us the approval was a calculated risk made on the basis that the additional money might save the business and the $67,000 already in jeopardy on the prior loan. He felt it was worth a try, particularly since the bank thought there was a chance. The SBA file had shown this second loan to be current, but the confirmation we received from the bank disclosed that it had been delinquent for 8 months as of August 30, 1974. The bank later disclosed that, as of February 1975, the loan was still delinquent.

Example 2--A borrower had two previous SBA loans. The initial loan, a direct loan of $5,000 at 5.5-percent interest, was approved on May 9, 1967. The second, a guaranteed loan of $10,000 at 10-percent interest, was approved on September 4, 1970, and was used in part to refinance the $1,829 outstanding on the first loan. SBA approved a third loan on May 23, 1973, for $13,000 at 9.25-percent interest, which was used in part to refinance $5,600 outstanding on the second SBA loan.

In the loan specialist's recommendation to decline the third loan, he stated the profit the borrower had projected would not be enough to provide himself an income and an ability to repay. However, the loan was approved by an acting supervisory loan specialist and the acting assistant chief of the financing division on the basis of the borrower's projected upswing in sales. Within 13 months, the loan was placed in liquidation and SBA charged off $10,245 as uncollectable on August 5, 1974.

Example 3--SBA approved a $65,000, 90-percent-guaranteed loan in October 1972. The SBA loan specialist's report indicated that $21,532 of the proceeds was to be used to

pay off an SBA-guaranteed loan, approved in September 1970, which the borrower had with the same bank. The loan specialist's report for the new loan stated that the existing loan had been in trouble from the start and unless the new loan was approved, liquidation was certain.

The loan became delinquent in March 1973 and was placed in liquidation in October 1973.

Appendix XI contains additional examples.

Officials in one district office agreed that delinquent SBA loans should not be refinanced if the analysis does not show a reasonable chance of repayment. They said that the loan specialist's report should discuss the negative factors and should state how these negative factors will be overcome in the decision to approve the loan. (However, as the examples above demonstrate, the loan specialists did not make such statements or, if they did recommend declining the loan, the decisions were overridden by their superiors.)

LOANS MADE TO BORROWERS WITH APPARENT ABILITY TO SECURE FINANCING WITHOUT SBA GUARANTEE

Before SBA approves a loan, assurance is required that it cannot be obtained from private sources and that the borrower does not have personal resources which can be used in lieu of, or to reduce the amount of, the loan. We identified 17 loans approved at 6 SBA district offices where the borrower had substantial assets which, we believe, could have been used, or pledged as collateral, for securing a loan on the open market. SBA should establish procedures to assure itself that loans are not made in these instances.

The Code of Federal Regulations (13 C.F.R. 120.2) provides that, before a loan application can be considered, it must be satisfactorily demonstrated that credit is not only unavailable from private lending institutions but is unavailable on reasonable terms through

--public offering or private placing of securities of the applicant;

--disposal at a fair price of assets not required by the applicant;

--use of the personal credit or resources of the owner, partner, management, or principal shareholders of the applicant; and

--other applicable Government financing.

SBA requires loan specialists to carefully review personal financial statements of prospective borrowers to ascertain whether there are any personal assets which could be used to raise funds in lieu of part or all of an SBA loan. A considerable loss from the forced sale of assets would be considered undue hardship.

Ordinarily, SBA does not insist on forced sale under such circumstances but requires the orderly liquidation and use of the proceeds for payment of the SBA loan. SBA does not consider that the desire to protect one's personal estate or the income taxes that accrue on the capital gains from the sale of assets constitutes a hardship.

Following are examples of instances in which the borrower or borrowers had substantial assets that, in our opinion, could have been used in part or in whole instead of an SBA loan.

Example 1--In one district office separate loans were made to two applicants with substantial net worth--both business and personal. The loan specialist's report did not indicate that he had critically evaluated the availability of funds from other sources. The financial backing of borrower A represented a net worth of about $1 million. Borrower B reported a net worth of $230,000. Borrower A received a guaranteed loan, approved on January 29, 1973, of $70,000. A $25,000 guaranteed loan to borrower B was approved on January 15, 1974.

Borrower A said he had received approval from his bank of account but was directed to SBA because he could get a lower interest rate.

Borrower B's loan file did not contain letters from the borrower's bank of account declining the loan, nor did the loan specialist justify why the borrower's personal assets could not have been used to raise the funds needed.

Example 2--One recipient of a $30,000 loan had a net worth of $151,300 in addition to his business, which included $67,300 in savings and stocks. The loan specialist did not request documentation to show that undue hardship would result if personal credit or resources were used.

Example 3--A 90-percent guaranteed loan of $120,000 was made to a small manufacturing partnership. SBA approved the loan on March 30, 1973. The loan was paid in full on May 29, 1974.

We analyzed the partners' personal financial statements, which were available to the loan specialist who approved the loan. One partner had a personal net worth of $551,414, an annual income of $91,000, and cash and marketable securities totaling $27,840. The other partner had a personal net worth of $318,899, an annual income of $80,250, and cash and marketable securities totaling $32,341. The loan specialist who approved this loan recognized that the partners had substantial net worth. However, the loan specialist did not justify why the borrowers' personal assets could not be used to raise the funds needed.

Example 4--A 90-percent-guaranteed loan for $60,000 was approved on February 22, 1974. The loan was current as of August 30, 1974. Our analysis of the personal financial statements of the firm's two partners showed net worths of $637,500 and $48,800. The first partner's assets included such items as cash and marketable securities valued at $47,100, recreational property valued at $23,400, a $20,000 interest in an oil and gas partnership, and $444,400 in unlisted securities.

The loan specialist's report recommending approval recognized this large net worth but stated that it would be unrealistic to ask the applicant to divest himself of the unlisted securities. The report also stated that the applicant argued that liquid assets should be retained in the event additional working capital was needed.

A supervisory loan specialist in the district office where the latter two loans were approved agreed that the analysis of funds available from other sources was inadequate. He stated that prior to August 1974, SBA had acquiesced to the judgment of the banks in these matters. Previously, efforts by loan specialists to determine if applicants had other sources of funds were met with criticism by the loan specialists' superiors. The chief of the financing division said that SBA's criteria do not require applicants to liquidate personal assets if undue hardship would result. He agreed, however, that undue hardship had not been determined before approving either of these two loans.

The district counsel said that, while SBA regulations do not require an applicant to sell his assets, they do require that assets be used to offset all or part of the loan. One method of using assets, in the event the applicant does not wish to sell, is to pledge them as collateral in acquiring a direct bank loan. The district counsel also explained that SBA attorneys, in the past, had not evaluated the financing division's conclusions that other sources of funds were not available for use by the applicants. In August 1974, the

district attorneys began to review loan specialists' analyses regarding applicants' use of personal assets in lieu of an SBA loan.

The chief of the financing division in one district office stated that loan specialists did not normally require documentation of undue hardship which would occur if the borrower had to dispose of his assets and that, if borrowers did have excessive liquid assets, then action would be taken to reduce the loan. However, a senior loan specialist in this district commented that he had never seen a letter documenting undue hardship and that he thought the requirement was being ignored.

This matter was the subject of our February 18, 1971, report to the SBA Administrator. We stated that loan specialists were not adequately considering the personal resources or credit of the owners, partners, management, or principal stockholders in analyzing loan applications. We concluded that criteria should be established to specify when loans should be disapproved or SBA participation reduced because the personal resources or credit of the principals were large enough to be used without undue hardship to the principals.

SBA's General Counsel reviewed the criteria and determined that they were adequate. The Administrator concluded that problems arose because of a lack of compliance with the criteria. Therefore, by letter dated March 16, 1971, the Administrator informed the regional and district directors to take whatever action was necessary to insure that a proper evaluation is made of the principal's ability to provide funds from personal resources and, when a determination is made of undue hardship in using personal resources, the file is adequately documented.

However, as our present review has shown, SBA district officials were not adequately considering the applicant's personal resources or documenting the undue hardship that may result from the use of personal resources.

CONCLUSIONS

SBA has approved a number of loans involving the refund of participating bank loans, payments to other creditors including nonparticipating banks, and refinancing of SBA loans. Many of these approvals were questionable because they reduced the participating bank's exposure, bailed out banks and creditors which were in a position to sustain a loss, or refinanced SBA loans which were delinquent. Numerous loans were approved for which 50 percent

and over of the proceeds were used merely to pay debts of the borrower. In these cases, we believe the loan specialist should be required to make a detailed analysis of the benefits to be derived by the SBA loan.

We believe that, except for bank loans made in anticipation of an SBA loan, participating banks should be required to maintain the same level of exposure they had on any prior loans being paid with the SBA loan proceeds. This would eliminate any possible bank bailouts.

Detecting a bailout involves determining if a bank or creditor is in a position to sustain a loss when an SBA loan is used to pay off debts. SBA loan specialists do not always insure or document the fact that SBA is not merely bailing out banks or creditors. Loan specialists should be required to thoroughly evaluate and document the status of any prior debts being paid with loan proceeds to insure that bailouts do not occur.

SBA should also insure that loans are not made to individuals that have financial resources which could be used in lieu of part or all of an SBA loan. We believe the borrowers in the 17 cases identified could probably have obtained financing on the open market by pledging their assets as collateral for a private loan.

RECOMMENDATIONS

To insure that SBA loans do not (1) merely transfer the risk of obtaining repayment from banks and creditors to SBA or (2) go to prosperous businesses, we recommend that the Administrator require:

--Loan specialists to follow established SBA procedures and fully analyze and document the appropriateness of (1) reducing a bank's exposure, (2) refunding bank loans, (3) paying off creditors, or (4) refinancing SBA loans so that, by paying off such debts, the borrower will have a better chance of becoming a viable business and that SBA will not merely be taking the place of existing creditors.

--Loan specialists to make indepth analyses of loans for which 50 percent or more of the proceeds are to be used for payment of borrower debts and to thoroughly justify the payment of such debts.

--Loan specialists to thoroughly analyze the financial resources available to a borrower so that SBA loans are made only to individuals otherwise unable to

acquire financing. SBA's Internal Audit Division should review the district offices' compliance with this procedure.

--Participating banks to retain the same level of exposure after the SBA loan that they had prior to the loan.

AGENCY COMMENTS AND PROPOSED ACTIONS

SBA fully agreed with our first three recommendations and said it would forward a written reminder to all loan officers to follow the procedures to the letter. (See app. I.) The agency also stated it will request their Internal Audit Division and Office of Portfolio Review to continually monitor field office compliance with these requirements.

In commenting on our final recommendation, SBA said it has attempted to severely limit any decrease in a bank's exposure, but to permit a decrease when the circumstances so warranted. SBA said it continues to feel that individual cases warrant consideration as possible exceptions. The agency stated, however, that it will further consider this recommendation and either implement it or further tighten the agency's present policy to make it clear that only in a very few cases, and under guidelines set by the central office, may exceptions be made.

We believe that, if SBA follows through with its stated actions, fewer loans will be made which merely transfer the risk of obtaining repayment from banks and creditors to SBA and fewer will be made to wealthy businesses.

CHAPTER 4

QUESTIONABLE LOANS APPROVED

BECAUSE OF INADEQUATE ANALYSIS

SBA has approved loans which carry a higher than anticipated risk because loan specialists have not properly analyzed the financial condition of the borrowers or adequately evaluated the collateral pledged to secure the loan. This has resulted in loans being approved when it was questionable whether the loans were of such sound value or so secured as to reasonably assure repayment.

SBA needs to improve its management so that loans are approved only when it can be demonstrated that the borrower has a reasonable chance of being successful and operating a viable business. This would provide the means for repayment of the loan and yet would not subject borrowers to financial hardships that possibly could have been avoided had loan specialists more thoroughly analyzed the borrowers' current and projected business prospects.

ANALYSIS OF APPLICANTS' FINANCIAL CONDITION NOT ADEQUATELY MADE OR DOCUMENTED

Loan specialists' evaluations of applicants' financial condition were not adequate or were not properly documented for 187 loans at 17 SBA district offices. Weaknesses noted were (1) a failure to resolve inconsistencies and questionable items in financial data provided by the borrowers, (2) a tendency to accept projections of sales and profits without complete analysis, (3) a failure to determine why businesses were operating at a loss, and (4) inadequate analyses of the borrowers' ability to repay the loans.

We believe that loan specialists are not fully utilizing data or techniques, such as cash flow analysis, which could help determine an applicant's potential repayment ability.

SBA procedures state that, although it is the agency's policy to accept higher risk and weaker credit than conventional lending sources accept, the loan specialist is responsible for making a complete professional review and an accurate analysis of the loan application and all supporting documents. Any unusual factors or important situations should be explained in sufficient detail to support the loan specialist's analysis and recommendations. The

procedures also provide that, while loan specialists may use some latitude in considering the soundness factors (character, management ability, financial condition, and collateral), there must be reasonable assurance that the applicant will be able to repay the loan.

SBA procedures further state that the ability to repay a loan from the cash flow of the business is the most important consideration in the loan-making process.

SBA procedures require that loan applicants provide such information as financial statements, general description and value of collateral offered, and proposed use of proceeds. On bank participation loans, a loan "package" is usually received from the bank with the information provided by both the bank and the loan applicant. Under the guaranteed loan program, participating banks are responsible for the initial screening of borrowers.

We did not assess the participating banks' processing of SBA loans. Rather, we concentrated on the adequacy of the SBA evaluation because SBA generally guaranteed 90 percent of the dollar amount of the loan and had a substantial interest in the borrower's ability to repay the loan.

Under no circumstances, according to SBA procedures, can blind acceptance of an applicant's optimistic representations be considered an adequate analysis. Loans approved by SBA are to be either of sound value or so secured as to reasonably assure repayment.

Financial statements, as well as other data provided by the borrower or participating bank, provide loan specialists with data for determining the financial condition of the applicant and his past and projected earnings. The result of this analysis is one of the major factors to be considered by the loan specialist in determining if a loan is sound and the prospective borrower has the ability to repay the loan from the cash flow of the business.

Our review of 980 7(a) loans showed that required financial statements were received for 854 loans, 84.5 percent of the loans approved during fiscal years 1971-74 by the 24 district offices. Statistically projecting this data to the universe of 35,618 loans indicates that applicants for 30,090 loans submitted the required financial statements with their loan applications.

We identified 187 loans for which the loan specialists had not made thorough or adequate evaluations of the borrowers' financial condition. Following are some examples of inappropriate evaluations by loan specialists.

Example 1--An existing business requested and received a guaranteed loan for $65,000 in July 1972 to improve its working capital which was at a deficit of $28,700. The loan specialist did not reconcile the borrower's net worth nor age the $52,000 accounts payable or the $12,300 accounts receivable. Neither did she reconcile the applicant's net worth from previous financial statements.

Appraised values of assets amounting to about $10,000 more than net book values were used by the loan specialist in her analysis. If the loan specialist had used net book values to reconcile net worth, her analysis would have shown that the business had operated at a loss and had a corresponding negative net worth. Thus, the loan specialist failed to recognize and question the reasons why the applicant got into a negative financial position.

The business failed within 7 months of receiving the loan, and as of February 1975 the loan was in liquidation.

The loan specialist was instructed by the chief of the financing division to write brief summaries and highlight the evaluation of the application. This was referred to as "streamlining" the loan specialist's report. The loan specialist agreed that, as a result, all relevant questions concerning the application had not been recognized or resolved.

Example 2--A guaranteed loan for $18,000, approved November 9, 1972, was to purchase a 22-month-old tavern business.

No projected income statements were submitted by the borrower, nor were they requested by the loan specialist. Instead, the loan specialist used a 9-month income statement of the previous owners to show that the profit from the business would be more than twice the amount needed to service the debt. The loan specialist showed that the borrower would inject $2,000 working capital but said zero working capital would not be adverse as sales were for cash and the major portion of debt was deferred. Also, from an analysis of the borrower's personal financial statements, he believed that outside income could be used to live on.

Our analysis showed the projected business profit made no allowance for Federal, State, and local taxes; depreciations; or withdrawals by the owner. In a discussion with the SBA loan specialist on this point, we were told that he took these items into consideration "mentally."

The borrower's personal financial statements showed his occupation as "electrician." The ability and qualification of the borrower to assume the responsibilities of the prior owners, such as duties of a bartender, were not addressed in the loan specialist's report. On the income statement of the the prior owners, the only labor expense shown was $3,187 for "casual labor." If any additional labor were necessary, the cost could have adversely affected the repayment ability of the borrower. The loan specialist said he had assumed that the borrower would be able to adequately perform any necessary functions of the business.

Also, the loan specialist stated that "repayment can be met with outside income to live on." Our analysis of the personal financial statements of the borrower showed that personal expenses and obligations exceeded income by about $122 a month.

This loan was charged off on April 16, 1974, by SBA in the amount of $15,645.

The loan specialist said it would be nice if the SBA loan specialists had time to do the types of analysis that we had done on this loan. However, he said they had no time to evaluate each case so thoroughly due to the pressure to get the loans processed.

COLLATERAL NOT APPRAISED FOR VALUE OR EXISTENCE

Section 7(a)(7) of the Small Business Act, as amended, requires that all loans be of such sound value or so secured as to reasonably assure repayment. Therefore, it is important that the collateral securing loans be carefully appraised and its existence verified. SBA procedures provide that documented evidence of collateral value be included in the loan files before approval and that the loan applicant provide a detailed list of the collateral.

For 384 of the sampled loans providing collateral as security, no one had appraised the collateral. SBA had appraised the collateral in 155 cases, the banks in 302 cases, and both in 22 other cases. Independent appraisers were only used in 66 cases to appraise the collateral.

When collateral is not properly appraised or its existence verified, losses can be higher than anticipated if the borrower defaults on his loan payments. SBA should properly evaluate the collateral offered as security for a loan, particularly when ability to repay is questionable.

SBA procedures provide that proposed collateral be such that, when considered with the integrity and ability of the management and the applicant's past and prospective earnings, repayment of the loan will reasonably be assured. SBA requires that the lending institution give a realistic opinion of the value of the collateral offered.

Collateral may consist of a mortgage on land, buildings, and equipment; assignment of warehouse receipts for marketable merchandise; assignment of certain types of contracts; a mortgage on chattels; or, in some instances, assignment of current receivables.

In one district office an SBA official contended that collateral was not a prime consideration in making loans. He stated that the reason for initially valuing collateral at cost or market was that loan specialists must be optimistic and portray a good picture for the applicant. The SBA procedures state that, under no circumstances, will a loan be declined only because collateral is inadequate. They caution against cluttering the loan authorization with meaningless collateral requirements to give the impression that sufficient assets are pledged.

Illustrations of the problems that can occur because collateral is not properly appraised follow.

Example 1--SBA approved an $18,500, 90-percent-guaranteed loan on January 5, 1972. The proceeds were used to purchase a carwash business with the carwash equipment as collateral for the loan. The loan specialist's report stated that the collateral was appraised for the bank by an independent appraiser as having a fair market value of $20,000 as assembled and $8,700 if disassembled. It was 4 months after disbursement of the loan before the loan specialist visited the business and found that the equipment was obsolete and inoperative when purchased by the borrower. The loan specialist servicing the loan stated this was a classic example of making a loan on an obsolete facility.

The borrower defaulted in loan payments, and attempts to sell the equipment were unsuccessful because it was considered out of date and in poor condition. Therefore, the collateral has been abandoned as worthless and SBA has charged off $17,244.

Example 2--SBA approved an $80,000, 90-percent-guaranteed loan in November 1970. Originally, the loan was declined by SBA because of a lack of reasonable assurance of ability to repay the loan and other obligations from earnings. However, when the loan was subsequently approved, SBA considered the loan fully covered by collateral which was appraised by the bank on April 30, 1970, at $165,979, subject to a $32,500 prior lien. SBA did not visit the borrower before loan approval.

The loan was placed in liquidation on August 27, 1971. On September 13, 1971, 17 months after the bank's appraisal of land and buildings at $80,000, SBA appraised the building at $39,500 and released its second mortgage on the property for $100 on the basis that SBA had no equity in the property after the prior lien of $32,119 and unpaid taxes of $9,457 were considered. The remaining collateral was sold for $9,000 in May 1972. Accordingly, only $9,100 was realized for collateral which had a net appraised value of $133,479 at time of loan approval. In November 1972, SBA charged off the principal and interest balance of $75,953.

Accounts receivable, which had a $32,620 collateral value when the loan was approved, had no value when the loan was liquidated. SBA's internal portfolio audit group was critical of the district loan specialist for not recognizing soft collateral (accounts receivable and furniture) and stated that this caused loan specialists to incorrectly conclude that loans were adequately covered.

<u>Comments by various SBA district officials</u>

District officials:

--Acknowledged that, on bank participation loans, SBA generally relied on the bank for appraisals of collateral and did not make an appraisal of its own.

--Doubted the validity of some appraisals, especially when the fee appraiser was paid by the borrower.

--Stated that collateral was not usually the determining factor when approving loans. SBA relied to a greater extent on ability to repay and projected earnings.

In October 1974 the Office of Portfolio Review criticized a district office for incorrectly concluding that collateral for 7(a) loans was adequate by relying on the stated book

value of machinery and equipment, inventory, and accounts receivable. According to the assistant district director for finance and investment, this district will now (1) value accounts receivable less than 90 days old at face value and older receivables for less, (2) value inventory at 50 percent of book value, and (3) value fixed assets at book value, relying on the bank for any adjustment.

During an August 1974 SBA regional directors meeting, it was recommended that an in-house appraisal capability should be established. The recommendation, which has been approved by the SBA Administrator, reads, in part:

> "* * * a modest in-house appraisal staff charged with providing appraisal services--especially in support of liquidation (special purpose collateral or estimated at more than $25,000). * * * It is expected that the identified need will not exceed two appraisers per region. * * *"

However, these positions are to be used primarily in support of the liquidation phase and not the loan approval phase.

CONCLUSIONS

Some borrowers were subjected to hardships that possibly could have been avoided had the SBA loan specialist thoroughly analyzed financial information submitted by the borrower and required supporting documentation.

SBA operating procedures do not provide definitive criteria for determining a 7(a) loan applicant's ability to repay a loan. Such criteria may be difficult to establish because each situation must be evaluated on its own merits. We therefore believe that each loan specialist must properly and fully analyze each prospective borrower's financial data and challenge and clarify all questionable items.

Loan specialists are not always using data or techniques, such as cash flow analyses, which could greatly help determine an applicant's potential repayment ability. If a loan specialist is required to make a more thorough analysis, he may take additional time before approving or disapproving a loan and the number of loans approved or processed may decrease without additional manpower.

SBA generally does not participate in appraisals of collateral offered to secure loans. Nor does it always require that participating banks make appraisals.

While the merits of a loan application cannot be judged solely on collateral, sounder appraisals would better protect the Government's interest. Perhaps certain loans would not be made or closer attention would be given to other factors, such as ability to repay the loan. Although the agency anticipates hiring two appraisers for each region, we believe more resources may be needed.

RECOMMENDATIONS

We recommend that the Administrator, SBA, emphasize the need for loan specialists to fully analyze the information provided by borrowers and document their justification for recommending loan approval. This would entail resolving any questionable items. We also recommend that the Administrator direct district officials to utilize fully other data and techniques, including analyzing cash flow, evaluating projected earnings, and making site visits before loan approval.

Additionally, we recommend that consideration be given to expanding the SBA appraisal function and that realistic appraisals of collateral be made where collateral is a critical factor in approving a loan.

AGENCY COMMENTS AND OUR EVALUATION

SBA agreed (see app. I) that new emphasis should be placed on the need for loan officers to fully analyze financial information and document their justification for approving loans. SBA said it will forward a written reminder to the field offices that this must be done.

Concerning the need to expand the SBA appraisal function, SBA stated that this had already been implemented. We noted on page 33 that appraisal positions had been authorized but pointed out that these positions were primarily to support the liquidation phase. SBA admitted that these appraisal services would be used almost totally for servicing/liquidation work, with little time spent on the loan-making activity.

SBA said that its limited staffing forced it to continue to rely on bank capability for appraising collateral prior to loan approval. However, as discussed on page 30, in 384 cases no one appraised the collateral. Therefore, if SBA is going to rely on banks to appraise collateral, every effort should be taken to insure that the banks do so.

CHAPTER 5

SBA ACTED INEFFECTIVELY AFTER LOANS WERE MADE TO INCREASE CHANCES OF BORROWER SUCCESS AND LOAN REPAYMENT

SBA has served neither the borrowers' nor its own interests by providing only limited loan servicing and management assistance. Although this failure is not precisely measurable in dollars, we believe SBA's losses and the rate of borrower failure are higher than they would be if more intensive servicing and management assistance were provided.

SBA's problems in safeguarding its loans can be grouped into the following categories.

--Failure to verify that loan proceeds were used for authorized purposes.

--Inadequate procedures for detecting delinquent loans and the reasons for delinquency.

--No knowledge of the problems and progress of borrowers.

--Inadequate management assistance to help borrowers overcome business problems.

These problems have resulted from:

--Understaffing in the PM divisions, which hindered the ability to service the SBA loans.

--An inappropriate reliance on participating banks to service guaranteed loans.

--Borrowers' reluctance to accept management assistance.

--A lack of coordination between the PM and MA divisions.

--A failure to obtain information before loan approval or during servicing about the borrower's needs for management assistance.

--A shortage of management assistance resources at some SBA district offices.

--The absence of an effective system for determining whether additional assistance was needed to implement management assistance recommendations.

The findings related to loan servicing are discussed in the following sections. Those related to management assistance are discussed in chapter 6.

FAILURE TO VERIFY USE OF PROCEEDS CAN RESULT IN MISUSE

SBA verified that loan proceeds were used for authorized purposes for only 5,294, or 14.9 percent, of the 35,618 loans in our statistical universe. Therefore, SBA had no assurance that the remaining 30,324 borrowers used loan proceeds as SBA intended when it approved their loans. Based on the information contained in SBA district office files for the sampled loans, we noted 11 instances of misuse of loan proceeds.

When SBA makes or guarantees a loan, it does so on the condition that proceeds will be used for certain specified purposes. These purposes are stated in the loan authorization, a document notifying the borrower or participating bank of SBA's approval of the loan application. The borrower agrees to use proceeds in accordance with the loan authorization by signing an SBA "loan agreement"; the participating bank agrees to disburse loans in accordance with the terms of the authorization by entering into a "loan guaranty agreement" with SBA.

The uses of loan proceeds specified in the authorization are intended to maximize the small business' chances of success. For example, by approving a loan to purchase equipment, SBA is making a judgment that the equipment will be productive in the borrower's business. Loan proceeds used instead to purchase additional inventory may not be as productive and may increase SBA's risk and reduce the small business' chances of survival and of repaying the loan.

SBA procedures provide two ways for it to insure that loan proceeds have been used only for authorized purposes: (1) banks submit settlement sheets showing how loan proceeds were disbursed and (2) the loan specialist checks use of loan proceeds during an initial field visit to the borrower. A bank which receives an SBA guarantee is required to submit, soon after disbursing loan proceeds, a settlement sheet showing what the proceeds were used for. The bank certifies that it has controlled the disbursement of proceeds (except proceeds approved for working capital) to insure their proper use as provided in the loan authorization.

Our review of 864 guaranteed loans showed that these two means had not always been used to determine the use of proceeds and disclosed instances where loan proceeds had been used for unauthorized purposes. Files for 602 loans contained settlement sheets. Thus, by statistical projection, we estimate that bank settlement sheets were received for 21,557 of the 35,618 loans in the universe.

SBA verified the use of loan proceeds by reviewing settlement sheets or making field visits in only 166 cases. Using statistical techniques, we estimated that SBA had adequately verified the use of loan proceeds in only 5,294 of the 35,618 loans.

SBA procedures require that the district counsel review the settlement sheets submitted by the bank and notify the PM division of any substantial variation between the use of proceeds as shown on the settlement sheet and loan authorization. The PM division should resolve differences with the bank. Unclear or nonspecific settlement sheets should be returned for clarification.

Some district offices had not attempted, for our sampled loans, to resolve differences between the authorized use of proceeds and the uses reported on the bank settlement sheets.

The problem of not receiving or reviewing bank settlement sheets is compounded by SBA's failure to make initial field visits to verify the proper use of proceeds. As stated on page 47, we estimated that SBA made only 12,082 initial field visits on the 35,618 loans in our universe.

Following are some examples of the 11 instances of misuse of loan proceeds noted during our review.

Example 1--On May 4, 1972, SBA approved a $125,000, 90-percent-guaranteed loan to a machinery sales and service business. Contrary to the loan authorization, which required that funds be used to purchase inventory, machinery, and equipment, the participating bank applied loan proceeds totaling $59,207 to notes owed by the borrower to the bank. This use was not reported to SBA on the bank's settlement sheet. The borrower said the funds were applied by the bank against the notes without his consent. The loan went into default and SBA purchased it on April 1, 1974.

Example 2--Two 90-percent-guaranteed loans were approved at a district office for a retail grocery. The loans were disbursed on September 23, 1971, in the amount of $125,000

and on March 1, 1972, in the amount of $7,500. 1/ On March 10, 1972, the borrower closed his business with outstanding loan balances totaling $128,042. SBA purchased the loans from the participating bank and in March 1972 placed the loans in liquidation. Sale of collateral brought $22,966. After its purchase of the loans, SBA was informed by an examiner of the Federal Deposit Insurance Corporation that the participating bank took $13,000 from the proceeds of the first loan to reduce, without SBA authorization, the borrower's personal loans. 2/ The settlement sheet submitted by the bank did not disclose this debt repayment. SBA did not visit the borrower or otherwise attempt to verify that proceeds were used for authorized purposes.

After being informed by the Federal Deposit Insurance Cooperation of the unauthorized use of loan proceeds, the district office referred the case to SBA's Security and Investigations Division, which forwarded it to the Federal Bureau of Investigation. The Bureau investigated the matter and presented the case to a U.S. Attorney, who declined to prosecute.

After we discussed this case with SBA, the district director wrote the participating bank to demand repayment of the amount SBA had paid the bank under its guaranteed agreements. SBA later settled its claim with the bank for $15,000.

Example 3--A jewelry business received an SBA-guaranteed loan of $300,000 approved March 23, 1973. The loan proceeds were to be used as follows:

--$144,700 to purchase machinery and equipment,

--$51,000 to purchase inventory,

--$24,500 to retire a note payable to the participating bank,

--$18,500 for leasehold improvements, and

1/The second loan was approved for $75,000 but only $7,500 had been disbursed at the time the borrower stopped operating.

2/The unauthorized use of proceeds involved the earlier, $125,000 loan. Only the second loan was included in our randomly selected sample.

--the balance for working capital.

The loan was disbursed in segments, with the final disbursement on October 31, 1973. SBA made an initial field visit on November 1, 1973, but the report of the visit did not indicate that the use of loan proceeds had been verified. The borrower became delinquent in January 1974 and SBA purchased the loan.

During a field visit to the borrower on April 26, 1974, the SBA loan specialist was unable to locate machinery and equipment worth "anything near $144,700 and only nominal inventory was present." One of the two owners claimed that much of the equipment belonged to employees "indicating that little or no new equipment was purchased with the loan proceeds." It was the loan specialist's opinion that "loan proceeds may have been misapplied". The loan is in liquidation.

The participating bank did not provide SBA with a settlement sheet at the time of loan disbursement. During discussions with us, an assistant treasurer of the bank stated that the bank did not verify that proceeds were used by an SBA borrower as authorized. He felt the bank did not have the personnel to get that involved.

The owners of the business admitted that loan proceeds were not used as authorized, and each blamed the other for their misuse.

Additional examples are included in appendix XII.

SBA PROCEDURES NOT ADEQUATE TO DETECT DELINQUENT LOANS AND REASONS FOR DELINQUENCY

Borrowers delinquent in loan payments have not received prompt attention from SBA--in part because participating banks do not give SBA timely notice of a borrower's default and in part because SBA has failed to respond even when notice is received. We estimate that 6,187 delinquency notices were received by SBA and that only 1,845, or about 30 percent, were received within the 30 days required by SBA. For the remaining 70 percent of the loans on which late notices were received, periods of delinquency averaged 113 days before SBA received notice.

SBA did not visit most delinquent borrowers in our sample between the time it received notice of delinquency and August 30, 1974, or the date SBA placed the loan in liquidation.

Banks not notifying SBA of loan delinquency within required time

SBA's ability to provide borrowers with timely assistance depends upon how soon it becomes aware of the borrowers' problems. Timely information is particularly vital when the borrower's problems have caused him to become delinquent on his loan. SBA has not received timely notice on the delinquency of guaranteed borrowers. In most cases participating banks have not complied with their loan guaranty agreements which require them to inform SBA promptly of a borrower's delinquency. SBA has received the late notices, on the average, about 4 months after borrowers became delinquent.

On guaranteed loans SBA must depend on the bank for information on the borrower's payment status. The standard loan guaranty agreement, which sets out the terms and conditions upon which the SBA guarantee is given, states:

> "Lender shall notify SBA in writing within 30 days of any uncured default by a borrower in making payments when due of any installment of principal or interest on any note. If such default continues uncured for 60 days (or less, if SBA agrees), and if the lender shall have duly notified SBA of default, lender may demand in writing that SBA purchase the guaranteed percentage of the loan." (Underscoring supplied.)

Despite this requirement, banks often do not notify SBA of borrower delinquency within 30 days. Our sample included 455 loans on which notices of delinquency were submitted by banks. Only 168 of them were provided within 30 days. For the remaining 287, we could determine the exact receipt date for only 278 bank notifications. The following chart shows the ranges into which the late notices fell.

Range in days	Number of loans
31 to 59	73
60 to 89	67
90 to 119	59
120 to 149	26
150 to 179	13
180 to 209	16
210 to 239	8
240 to 269	3
270 to 299	3
300 and over	10
Total	278

Projecting the above sample results on the total delinquency notices received and the number received within 30 days to the loan universe, we estimate that 6,187 delinquency notices were received by SBA and only 1,845, or about 30 percent, were received within 30 days. For the remaining 70 percent of the loans for which late notices were received, we estimate that delinquencies averaged 113 days before SBA received notice.

The lack of this timely information on delinquency understates the portfolio trouble rate and deprives SBA of information vital to its servicing responsibility.

Although participating banks are required to report a delinquency on each loan within 30 days after it occurs, our discussion with numerous bank officials across the country disclosed that some participating banks have adopted a policy of reporting delinquencies on some other basis. For example:

--An official of a bank participating in one SBA district told us the bank notified SBA of delinquent loans quarterly; an official of another bank in this district said the bank reported semiannually.

--In another district, officials of one bank said they notified SBA of delinquencies within 45 to 60 days, officials of another said they did so within 30 to 90 days, and officials of a third said they did so within 30 to 120 days.

Our sample in one district showed that, by the time SBA was notified of delinquency, the borrower had missed an average of three monthly payments. Loan specialists at this district office said that by this time the borrower usually had too many financial problems for SBA to be of any help.

Following are examples in which SBA was not informed by participating banks of borrowers' problems soon enough to provide assistance.

Example 1--A used-car dealer received an SBA-guaranteed loan in June 1972. The borrower was 6 months late on his payments and had gone out of business by the time the participating bank notified SBA of the delinquency in October 1974. Even before becoming delinquent, the borrower had been disposing of his cars at "junk" prices and using outside income in an effort to make payments on the guaranteed loan.

Example 2--Two guaranteed loans totaling $50,000 were approved in April and October 1972 for an auto repair shop and sales business. In June 1973, the bank notified SBA that the business had closed its doors and that the borrower was filing for bankruptcy. In August 1973, when the bank demanded that SBA purchase the loans, it disclosed that the first loan had been delinquent since November 1972 and that no payments had ever been received on the second loan which had been disbursed between November 1972 and February 1973.

Additional examples are included in appendix XIII.

In an October 3, 1974, memorandum to regional and district directors, SBA's Associate Administrator for Finance and Investment described the damage done to SBA's loan servicing efforts by late delinquency notification, as follows:

> "There is considerable evidence that the current [notification] procedures are too informal and have allowed the banks to become lax in fulfilling the requirement of notice of 30 day default. This has resulted in numerous instances where the servicing office knows little or nothing about the account until we are called upon to purchase. It follows that many purchased guarantees are beyond effective assistance and immediately become liquidation cases."

This memorandum also described a new SBA procedure to expedite the reporting of delinquencies by participating banks. The banks were to be supplied with standard forms on which to report borrower delinquency.

This new procedure may facilitate the reporting of borrower delinquency, but like the old system, its effectiveness depends on the cooperation of participating banks. If the banks continue to be lax in their reporting, the new procedure will still not provide SBA district offices with timely information on delinquent bank-serviced loans.

No aggressive followup on delinquent loans

The problem of delayed notice of delinquency is compounded by SBA's failure to take adequate corrective action once notice is received. Our sample contained 505 loans which were delinquent on August 30, 1974, or which had been delinquent at an earlier date. SBA had not visited the borrowers of 331 of these loans between the time SBA

was notified of their delinquency and August 30, 1974 (or the time they were placed in liquidation). Of the 174 delinquent borrowers visited by SBA, only 65 received more than one visit.

Following are examples of borrowers that did not receive intensive servicing despite SBA's awareness of the problems.

Example 1--A loan for $20,000 was approved in September 1972. At approval, payments were deferred until February 1973. In April 1973, SBA received the borrower's financial statements for the year ended December 31, 1972, which disclosed a $12,000 loss for the year. The loan became delinquent in May 1973 and remained delinquent until September 1973, when it was placed in liquidation. The loan specialist responsible for servicing this loan told us that he had not visited the borrower because of his heavy workload, he could not remember all loans in his portfolio and their problems, and he eventually would forget the problems until they recurred.

Example 2--On March 29, 1973, SBA approved a $15,000, 90-percent-guaranteed loan to a firm installing burglar alarm systems in homes, operating an answering service, and providing communication services to other businesses. The loan was considered marginal at the outset. Although the bank notified SBA in November 1974 that the loan was past due and it was having difficulty in contacting the borrower, the loan specialist who serviced the loan told us that SBA would take no action until the bank notified them as to the definite status of the loan.

Early warning signals which indicated the borrower was in trouble included:

--A tax lien against the borrower in December 1973.

--A law suit against the borrower in June 1974 by another creditor.

--Application to SBA for a direct loan in July 1974 for $40,000 with comments from the borrower's bank that the bank did not have confidence in borrower's management ability.

--Violation of loan conditions that the borrower not become indebted for money without permission of the lender. In his application for a direct

loan (which SBA declined), the borrower showed an increase of $31,400 in long-term liabilities since disbursement of the original loan on April 18, 1973.

When questioned on why no field visits had been made to this borrower or why management assistance had not been considered, the loan specialist who serviced the loan stated that it was the participating bank's responsibility to service guaranteed loans and that management assistance would not be considered until the bank requested it.

Additional examples are included in appendix XIV.

SBA's slow response to borrowers' problems seems to come from a reluctance by SBA personnel to become deeply involved in loans being serviced by participating banks and from loan specialists' heavy caseloads.

Comments by various SBA district officials

Loan specialists responsible for servicing loans at one district office said they attempted to determine the cause of delinquency through discussions with participating banks and then referred the case to the MA division.

At another district office, a loan specialist said he had attempted to follow up on delinquencies after 3 months but was having trouble keeping to this schedule. Another loan specialist in the same district told us that, because of his other servicing duties, delinquent loans were not getting any attention.

BORROWERS' PROBLEMS AND PROGRESS
NOT KNOWN TO SBA

SBA has not required participating banks to indicate their reasons for declining loans without an SBA guarantee, has not made initial field visits to borrowers, and has not obtained borrowers' financial statements after loan approval. As a result, SBA's loan servicing efforts have suffered.

We estimate that SBA obtained banks' reasons for refusing to make direct bank loans for only 3,081, or 8.7 percent, of the 35,618 loans in our loan universe; that SBA did not make the initial field visits required by its own operating procedures to 14,956 borrowers, or 41.9 percent of the statistical universe; and that SBA received the financial statements after loan approval for only 350 of the 1,869 direct loan borrowers and 5,334 of the 33,025 guaranteed loan borrowers.

Obtaining detailed reasons for credit refusal by banks

Our review showed that statements of terms and reasons for declining a direct loan were not obtained from the banks for 876 of the 980 sampled loans. Statistically projecting this to the total loans approved by the 24 SBA district offices reviewed, we estimated that appropriate bank declines would not have been obtained for about 32,537 loans. Accordingly, loan specialists have been deprived of the bank's reasons for declining to make a direct loan. If procedures had been followed, SBA would have had information at an early point in time, indicating problem areas with which the prospective borrower might need assistance.

Section 7(a)(1) of the Small Business Act states that "No financial assistance shall be extended pursuant to this subsection unless the financial assistance applied for is not otherwise available on reasonable terms." In this regard, SBA regulations require a bank's refusal of a direct bank loan as a condition for a borrower's obtaining an SBA direct, immediate participation, or guaranteed loan. The regulations state that "Proof of [a bank's] refusal must contain the date, amount and terms requested, and the reasons for not granting the desired credit."

District officials consider a bank's willingness to participate in the guaranteed loan program as a direct loan refusal. SBA officials told us that letters of decline were unnecessary for guaranteed loans and that a bank's application for an SBA guarantee was sufficient evidence that a bank would not make a direct loan.

The banks do sign the application for an SBA loan, which states that, without the participation of SBA to the extent applied for, the banks would not be willing to make the loan and, in their opinion, the financial assistance applied for is not otherwise available. However, the application form does not request proof of the refusal, including (1) the date, amount, and terms initially requested by the borrower and (2) the bank's reasons for declining to make the loan without an SBA guarantee.

We believe loan specialists would be in a better position to process and evaluate loan applications if they had the benefit of the bank's analysis, including the reason or reasons for declining. Further, the bank analysis could be useful in pointing out, at an early point in time, areas of weakness for which the borrower might need SBA management assistance.

Initial field visits to borrowers not made and borrowers' financial statements after loan approval not obtained

SBA procedures define "loan servicing" as a continuing effort to meet the problems of the small business borrower through full-service assistance. The borrower is to provide SBA with a complete and continuing picture of his operation which, with data developed by SBA, enables SBA to make sound suggestions and to take corrective action to strengthen the business and improve chances of loan repayment. In essence, loan servicing is:

--Early recognition of a problem or potential problem.

--Identification of the underlying cause of the problem.

--Determination of the appropriate solution.

SBA's steps implementing its full-service assistance include (1) an initial field visit to the borrower within a year of loan disbursement and (2) an analysis of financial statements submitted by borrowers after loan approval.

SBA had not fully utilized these methods of keeping itself informed of a borrower's progress and problems.

Initial field visits to borrowers not made

SBA procedures require that a loan specialist visit a borrower of a direct loan within 6 months of loan disbursement and a borrower of a guaranteed loan within 1 year of loan disbursement. The loan specialist is required to review various aspects of the borrower's operations, including:

--Compliance in the use of loan proceeds as stated in the loan authorization and settlement sheet.

--The maintenance of collateral.

--The adequacy and reliability of accounting records.

--The overall housekeeping of the place of business.

The loan specialist is also required to offer advice to forestall any financial difficulties and determine whether the borrower needs management assistance.

Our review of 980 loans included 757 for which the time for making initial field visits had expired. 1/ On 387 loans, field visits had been made within prescribed limits; on 87 loans, 2/ visits had been made but not within the prescribed limits (see app. XV); and on 280 loans, initial field visits had not been made.

By projecting these sample results to the loan universe (35,618), we made the following estimates.

	Percentage of loans (weighted)	Number of loans
Initial field visits made	33.9	12,082
Initial field visits made within prescribed time	27.5	9,788
Number of visits required as of August 30, 1974, but not made	35.5	12,662
Number of visits not yet required	21.6	7,684

Thus, borrowers of 14,956 loans 3/ would not have received initial field visits as required.

This failure can mean that SBA will not discover a borrower's need for management assistance. Following are examples of borrowers who were in apparent trouble but who did not receive a timely initial field visit.

1/Although, as we have indicated, SBA procedures require initial field visits to direct loan borrowers within 6 months of disbursement, to simplify the presentation of our data on field visits, we have considered all visits made within a year of disbursement to have been made within prescribed limits.

2/For three loans, we could not determine whether visits were made within the prescribed limits or not.

3/Loans not visited (12,662) plus the difference between total field visits made (12,082) and visits made within prescribed limits (9,788).

Example 1--An SBA direct loan for $35,000 was disbursed in June 1973. The borrower did not make the first loan payment, which was due July 5. It would seem that SBA should have scheduled a visit to the borrower when the loan became a problem in July 1973 even though this was a direct loan and an initial field visit was not due for 6 months. There was no visit, however, until February 1974, after SBA was notified by the borrower's landlord that he was evicting the borrower for nonpayment of rent. The loan specialist, during his visit about 8 months after disbursement, found the business closed with a notice of sheriff's sale on the door.

Example 2--A direct loan for $20,000 was disbursed in May 1971 to a furniture company. Payments were received late and subsequently were deferred for 4 months. Required financial statements were not submitted. Despite these problems, the first field visit was not made until 18 months after disbursement. The loan was placed in liquidation in January 1974.

Example 3--A direct loan for $20,600 disbursed in December 1972 was also a problem from the beginning. The payment record was erratic with payments deferred, received late, and on one occasion made with a bad check. There was no evidence in the file that a field visit was ever made, and the case was not referred to the MA division until a few weeks before the loan was placed in liquidation on August 1, 1974.

Example 4--A $26,000 guaranteed loan was approved in September 1971 and was disbursed in October 1971. The initial field visit, which should have been made by October 1972, was not made because SBA felt the business was doing all right. In May 1973, the bank informed SBA that the borrower had been delinquent for 8 months and SBA deferred the payments for that period. A field visit was not made after the deferment because, according to an SBA official, the bank was servicing the loan and there was no indication that the borrower was again delinquent. SBA assumed the business was doing all right. In February 1974, the bank informed SBA that the borrower had been delinquent since June 1973. In February, 28 months after disbursement, SBA made a field visit. In May 1974, the loan was referred to the MA division, and they made a visit in May 1974. The loan specialist made another visit in June 1974 and stressed to the borrower the importance of making his payments. As of August 30, 1974, the borrower had been delinquent for 16 months.

Reports of initial field visits do not always show that the important purposes were accomplished.

Examples drawn from four district offices are as follows:

--The initial field visit reports at one district office indicated that management assistance needs were identified and analyzed in only 3 of 24 visits and at another office in only 14 of 30 visits.

--Of the 27 initial field visit reports examined at one district office, only 1 discussed the use of proceeds; at another district office only 4 of 19 reports indicated that proceeds use had been verified.

--Only 10 of the 30 initial field visit reports examined at one district office indicated that collateral had been checked; none of the 27 reports reviewed at another office showed that collateral had been checked.

Comments by various district officials follow.

--Initial field visits were not being made because of personnel shortages, frequent disasters in the area (which often require the transfer of business loan personnel to the disaster loan program), and priority visits on trouble loans.

--The main indication of a problem is the 30-day delinquency notice. The loan specialist is supposed to make field visits and reschedule future visits on the basis of expected problems. However, this probably identifies very few trouble loans. Field visits to firms are often made only after the first delinquency notice.

Financial statements not received

Borrowers' financial statements make up another important element of SBA's servicing and early warning system. These statements may provide valuable information about a borrower's progress and compliance with loan terms. SBA received financial statements for only 149 of the 980 loans in our sample.

SBA procedures provide that financial statements shall be obtained from borrowers at the intervals stated in the note or loan agreement. Borrowers of direct loans are required to submit financial statements directly to SBA. Our sample of 7(a) loans included 86 direct loans. Financial statements had been received for only 14. By applying this result to the universe, we projected that financial statements would have been received for only 350 of the 1,869 direct loans.

Borrowers of guaranteed loans are required to submit financial statements to the participating bank but not generally to SBA. An SBA central office official told us that the district offices arranged for participating banks to forward the statements to the district office servicing the loan. However, SBA received financial statements for only 135 of the 864 guaranteed loans in our sample. By applying these figures statistically, we projected that financial statements would have been received for only 5,334 of the 33,025 guaranteed loans.

By failing to obtain the financial statements, SBA is missing valuable information about the borrower. A March 15, 1972, report by SBA's Internal Audit Division was critical of the inattention of district offices to the receipt and analysis of financial statements. The report stated that

> "The practical importance of financial statements for loan administration should be emphasized because the statements are the most effective and economical means that SBA has available to provide comprehensive loan administration."

SBA central office officials said that not receiving financial statements after loan approval is a definite violation of the agency's requirements and will be called to the attention of all field offices.

Our review disclosed several examples which point up the need to receive financial statements. A careful review of the financial statements mentioned in the examples would have given SBA valuable information about the borrower's need for assistance or about his use of loan proceeds.

Example 1--After reviewing a borrower's financial statement, we informed the loan specialist that the borrower appeared to be in trouble. The SBA official discovered that the borrower was having difficulties and took action to provide management assistance.

Example 2--An $85,000 guaranteed loan was disbursed in January 1974 for the following purposes: equipment, $43,700; leasehold improvements, $12,400; operating expenses, $28,900. Corporate financial statements as of April 30, 1974, in the SBA loan file disclosed that the proceeds were being re-lent to purchase fixed assets and provide working capital for a newly formed corporation owned by the same principal. When we brought this to the attention of district officials, they said that such re-lending of funds constituted an unauthorized

use of the proceeds and that the loan specialist servicing the loan should have pursued the matter when the financial statements were received. Subsequently, SBA made an inquiry to the bank about this case, and the bank replied on February 25, 1975, that the borrower had established the new corporation for tax benefit purposes but was moving to merge the two corporations, and transfer all assets to the original borrowers.

Additional examples are included in appendix XVI.

Why SBA failed to effectively service loans

SBA officials frequently explained that they were unable to fully comply with the procedures of the full servicing system because of heavy portfolios of cases and that they relied on participating banks for much of the necessary servicing on guaranteed loans.

SBA officials' contention that the PM divisions at the district offices are understaffed appears to have merit. Most of the loan specialists we interviewed at district offices said their heavy caseloads precluded adequate servicing.

The following chart shows the portfolio, excluding disaster loans, for selected district offices we visited.

District office	Average portfolio per loan officer
Indianapolis	644
Columbus	598
Kansas City	467
Hartford	333
Clarksburg	292
Salt Lake City	283
New York	260

Comments by various district officials follow.

--That because of their workload, they have little time to devote to current loans. Instead they struggle to keep up with problem loans. (The comments of this official are substantiated by data on field visits maintained at this district office, which showed that during the period September through December 1974, 1,385 of the 1,454 field visits made by loan specialists were made to delinquent borrowers.)

--That loan specialists are spending basically all their time liquidating loans and servicing loans that are over 60 days past due even though most of them are eventually put into liquidation and that the servicing functions envisioned in the SBA standard operating procedures are not being performed.

--That although SBA loan specialists should periodically visit participating banks to review bank servicing of outstanding loans, such visits have been made infrequently because of a lack of staff.

--That in March 1974 initial field visits were suspended except for Economic Opportunity Loans and 7(a) minority enterprise loans because of the staff shortage. In a report sent to the regional director in June 1974, the assistant regional director for finance and investment said:

> "Portfolio Management staffing in all Districts is most serious. Other problems continue to crop up when we are doing the routine servicing. We are putting way too much time into putting out the fires and we are not doing the servicing that we should and not giving the borrowers the help that they should have."

--That a heavy workload prevented the adequate accomplishment of the following servicing functions:

> --Analysis of financial statements.
> --Visits to borrowers.
> --Monthly contacts with banks.
> --Monthly portfolio reviews.

During our discussions with SBA officials on the limited extent of SBA servicing, we were frequently told that SBA relied on participating banks to service guaranteed loans. Some officials regarded this reliance as proper; others thought it was the only feasible way of operating in view of SBA's limited servicing staff.

We did not attempt to evaluate the quality of servicing performed by banks on SBA-guaranteed loans. However, even assuming that the banks service SBA-guaranteed loans with the same degree of effort as their unguaranteed loans, we believe it is not reasonable for SBA to substitute bank servicing for its own. First, the risk of loan default rests heavily on SBA. The SBA guarantee generally limits

a bank's exposure on a loan to 10 percent of principal and interest; SBA usually bears 90 percent of the risk of nonpayment. Secondly, the Small Business Act (15 U.S.C. 631) states that the agency was established to "* * * aid, counsel, assist, and protect, insofar as it is possible, the interests of small business concerns * * *." In our opinion, SBA is not fulfilling this role unless it provides servicing to a borrower of a guaranteed loan.

CONCLUSIONS

SBA procedures established a system to provide full-service assistance to a borrower of a direct or guaranteed 7(a) loan. The elements of this system include a careful monitoring of a borrower's operation through an initial field visit after loan disbursement, verification of the use of proceeds, an analysis of the borrower's financial statements, prompt notice of delinquency, and intensive followup on delinquent borrowers. Implementing this system would benefit both the Government, by increasing the chances of loan repayment, and the borrower, by improving his chances of success.

Our review showed that the loan servicing system prescribed by SBA procedures had not been fully implemented at the 24 district offices. Specifically:

--Use of loan proceeds was frequently not verified through a review of settlement sheets or initial field visits. In a number of cases, proceeds were misused by banks or borrowers.

--SBA did not obtain the reasons why banks were not willing to make loans without an SBA guarantee.

--In most cases, participating banks did not promptly notify SBA of borrowers' delinquency. As a result, SBA did not have the information it needed to effectively service problem loans.

--Aggressive followup was not taken on delinquent loans. SBA did not provide intensive servicing on delinquent loans. No field visits were made to many delinquent borrowers; others received only limited help.

--Initial field visits were often not made. Reports of visits that were made did not always indicate that a full review (including checks of collateral, use of loan proceeds, or the borrower's need for

management assistance) was made of the borrower's operations.

--Financial statements were not received from most borrowers.

SBA's failure to implement fully its loan servicing system appears to be the result of heavy caseloads in the district offices' PM divisions.

We believe that reliance on bank servicing as a substitute for a close SBA-borrower relationship (1) is not reasonable in view of the fact that SBA normally assumes 90 percent of the loss from a borrower's default and (2) appears to be inconsistent with SBA's objective of assisting the small businessman.

RECOMMENDATIONS

To insure that the benefits of SBA's prescribed loan servicing system are realized by the Government and the small business borrower, we recommend that the Administrator:

--Enforce SBA's requirements for participating banks to submit, promptly after loan disbursement, settlement sheets showing in detail how loan proceeds were disbursed and for loan servicing personnel to resolve any major discrepancies.

--Determine the staffing level which would permit effective servicing, including initial field visits of the required scope to all borrowers and intensive followup on delinquent loans. Once this staffing need is determined, the Administrator should attempt to meet it through personnel realignments, changes in methods of operations to free personnel for servicing duties, or a proposal to the Congress for additional staff. If all other approaches fail, the only remaining alternative would be to limit the number of loans approved.

--Enforce SBA's requirement that participating banks submit written notice of borrower delinquency within 30 days.

--Require borrowers to submit to SBA financial statements. SBA should consider the feasibility of a computerized analysis of these financial statements to enable a more extensive analysis of a borrower's progress.

--Require loan applicants to obtain the reasons why banks have refused to make loans to them.

AGENCY COMMENTS AND OUR EVALUATION

SBA generally agreed with our conclusions and recommendations. (See app. I.)

SBA stated that its intention is to have settlement sheets provided by the banks upon loan disbursement and to promptly review them. It expressed dismay at the extent of the lapse reported in the review of settlement sheets and said that steps will be taken to assure prompt receipt and review in the future. It plans to highlight and expand these instructions in an SBA circular as soon as possible to emphasize the need for prompt action on any identified discrepancies. SBA noted and fully concurred that a major reason for the inability to provide a fully effective servicing effort is the existing staffing level within the servicing division.

SBA added that it has a staffing standard for servicing but that budgetary constraints have not allowed slots to man the function at the standard level. The agency said this places it at a disadvantage in providing ordinary lender's controls over outstanding loans. However, SBA has felt that the risks being taken were worth the benefits otherwise being provided to small business.

SBA stated that it now recognizes that this balance may have tipped too far and that the potential for unacceptable loss levels is too high and the level of control and care of existing borrowers too low. The agency said, therefore, it was taking steps to resolve this situation, such as streamlining agency functions, studying its servicing efforts, and determining proper use of personnel. Other improvements planned are better servicing by participating banks and improved loan packages.

SBA intends to strengthen its effort with regard to notification of delinquencies by banks. The agency said a system of penalties (loss of interest) has been devised and published and a new guaranty agreement has been proposed which should help clarify the mutual responsibilities of SBA and the bank in this area. SBA has also instituted a computerized system to allow uniform, timely notice to SBA of default on bank-serviced loans.

SBA has concurred in our recommendation to require the submission to SBA of finanical statements by borrowers of both guaranteed and direct loans. SBA has also agreed

with our recommendation as to the need to analyze the financial statements. SBA stated that it has had difficulties in that such an analysis has not been possible under the staffing restrictions. The agency noted that a procedure was recently developed whereby an automatic computer notice of financial statement due is provided directly to the borrower. SBA stated that computerized analysis of financial statements has been under consideration since March 1975 and is a formal objective of SBA's developmental staff in its Office of Advocacy, Planning and Reseach.

The agency stated that its operating procedures and regulations do require loan applicants to obtain the reasons why banks have refused to make loans to them for direct SBA loans. It added that both are somewhat vague as to guaranteed loans and that they will be revised and clarified.

We believe that, if SBA implements the actions promised, its service to borrowers after loans are made will improve and thereby the chances of borrower success and loan repayment will be enhanced.

CHAPTER 6

MANAGEMENT ASSISTANCE PROGRAM:

IMPROVEMENTS NEEDED

SBA has provided only limited management assistance to borrowers of 7(a) loans. We estimate that the borrowers of only 6,257, or 18 percent, of the 35,618 loans in our universe received management assistance. When provided, such assistance often reached the borrower only after serious problems had arisen and often was not intensive enough.

Causes of this failure to provide timely and indepth management assistance included borrowers' resentment of "interference" in the operation of their businesses, failure by SBA to identify borrowers' need for management assistance, failure to focus management assistance on borrowers, the absence of an effective system for determining whether additional assistance was needed to implement management assistance recommendations, a scarcity of management assistance resources, and the use of inappropriate program goals.

SBA MANAGEMENT ASSISTANCE PROGRAM

This program is designed to foster the establishment, growth, and success of small business. The importance of timely management assistance is described in an SBA publication explaining the program:

> "The need for [management] assistance is pointed up by failures that occur in the small business community every year. It is estimated that managerial deficiencies cause 9 out of 10 business failures. This represents a tremendous loss to the nation's economy. Many of these business failures could have been avoided had the owners received management assistance in time. A major objective of the SBA is to remedy this situation. Through the facilities of the Office of Management Assistance, SBA works to improve and strengthen the management capabilities of small business men and women."

The SBA management assistance program is carried out in the district offices by MA divisions with assistance from a number of volunteer groups and paid consultants. A description of their duties follows:

--SBA staff. An assistant district director for MA supervises the use of MA resources at each district. SBA employees known as business management specialists advise small businesses and may call upon the assistance of volunteers and paid consultants.

--Service Corps of Retired Executives (SCORE). This is an organization of retired business executives who volunteer their services to help small business owners solve their problems.

--Active Corps of Executives (ACE). This is an organization of volunteers drawn from the ranks of active executives in industry, trade associations, educational institutions, and the professions.

--Small Business Institute (SBI). This is a program which provides faculty-supervised management counseling to small businesses by university graduate and undergraduate students.

--The Call Contract program. This program employs consultants to provide management and technical assistance to small business owners who are eligible under the Economic Opportunity Act of 1964.

--The professional associations program. Under this program members of professional associations, such as the National Association of Accountants, provide management and technical assistance to small businesses on a voluntary basis.

Management assistance can be provided through counseling by SBA personnel, volunteer groups, or consultants or through management training in prebusiness workshops, courses, conferences, and clinics.

FEW BORROWERS RECEIVED MANAGEMENT ASSISTANCE

Although SBA recognizes the need for management assistance to small businessmen and although our sample contained 500 loans which were in liquidation or had been charged off, the borrowers of only 235 of the 980 loans in our sample received management assistance. 1/ We estimate that only 6,257, or 18 percent, of the 35,618 loans in our universe received management assistance.

1/Management assistance was provided on only 148 of the 500 loans in liquidation or charged off.

Such assistance that was provided often came late or was not intensive. At many of the 24 district offices we visited, loans on which assistance was provided were often already delinquent. The following chart indicates the late provision of assistance at district offices where it was common.

	Borrowers	
District office	Number who received management assistance	Number whose loans were delinquent when assistance provided
Baltimore	12	5
Birmingham	11	7
Columbus	11	7
Hartford	15	7
Seattle	9	6
Boston	6	5

We agree that management assistance should be provided to delinquent borrowers; however, we believe it would be most effective to provide such assistance before problems have led to delinquency. An assistant district director for MA at one district office told us that many delinquent borrowers may be beyond help.

In addition to being late, SBA management assistance often consisted of a single contact with the borrower. The chart on the following page shows the extent of assistance provided to borrowers in our sample.

Type of assistance (note a)	Number of borrowers
SCORE:	
1 contact	67
2 contacts	18
3 contacts	5
More than 3 contacts	6
SBA business management specialist:	
1 contact	65
2 contacts	10
3 contacts	3
More than 3 contacts	6
ACE:	
1 contact	8
3 contacts	1
Call Contractors	b/49
SBI	b/35
More than one type of assistance	c/40

a/As used in this chart, a "contact" includes telephone discussions, visits by a borrower to the SBA office, or visits by an SBA management assistance representative to the borrower.

b/SBA officials told us that assistance under the Call Contractor program normally involved about 22 hours of contact with the small businessman; SBI assistance usually involved about 20 hours of contact.

c/Included in figures above.

As the chart indicates, most borrowers who received SCORE, ACE, or SBA business management specialist assistance had only one contact with the counselor.

WHY SBA FAILED TO PROVIDE EFFECTIVE MANAGEMENT ASSISTANCE

The reasons most commonly cited by SBA district office officials for the limited management assistance to borrowers and the reasons we identified follow. These reasons may not apply uniformly to each district office we visited; however, cumulatively they explain, in large part, why so few borrowers received management assistance.

Borrowers reluctant to accept management assistance

The assistant district director for management assistance at one district office told us that the average small businessman feels you can't tell him anything about his business. A staff member told us he believed that the main reason small businessmen failed to avail themselves of management assistance was that they were more interested in day-to-day operations.

Officials at another district office said that the effectiveness of any counseling was highly dependent on the receptivity of the business being counseled. Many borrowers do not want counseling, and often the borrower with the greatest need resists help.

At another district office, officials said that small businessmen were generally reluctant to seek assistance from SBA. Among the reasons cited were the independent nature of the small businessmen, unwillingness to allow outsiders to get involved in their businesses, and the creditor position of SBA.

An assistant district director for management assistance at another district office estimated that about half of all borrowers turn down available management assistance for such reasons as a lack of understanding of SBA services and a desire to control their businesses themselves.

Lack of coordination between PM and MA divisions

At one district office, loan specialists had referred four of our sampled loans to SCORE for assistance. SCORE records disclosed that two of the four referrals had not been received by the SCORE coordinator, one was received but no counselor was assigned, and the other was assigned a counselor but he was unable to contact the borrower. There was no evidence in the file that the loan specialists followed up to determine whether management assistance was provided.

At another district, management assistance was provided on four of our sampled loans but was not indicated in the loan servicing file. According to an official, the PM division gets little feedback from the MA division. To correct this, the district director now requires all field visit reports by MA personnel, Call Contractor reports, and counseling reports to be routed to the appropriate loan specialist and file.

The MA division at one district had received only 33 referrals from the PM division from the time the MA division became operational in April 1974 through October 1974. The chief of the PM division told us that his division had been reluctant to make referrals because the MA division had been recently established and PM division personnel did not know how to refer cases to them. According to a management assistance official, at this district the lack of communication between the PM and MA divisions, and between SBA and borrowers, prevented borrowers from receiving adequate management assistance.

SBA procedures require a monthly review of all delinquent loans by both servicing and MA personnel to determine whether management assistance would be beneficial. Officials at an office where this required review was not being made told us that loan specialists rarely referred businesses for management assistance.

An official at another district stated that no effective way to refer cases for management assistance had been established and that some loan specialists failed to notify the MA division of borrowers who needed assistance. A loan specialist at this district said he never referred cases for management assistance and had so advised the district director. According to this loan specialist, the district director was not disturbed and told him to handle his own cases.

An official of SBA's Office of Management Assistance told us that many borrowers were not receiving assistance because the PM divisions at the district offices were not referring cases to the MA divisions.

<u>MA divisions receive late notification of a borrower's delinquency</u>

We discussed in chapter 5 the delays by participating banks in reporting delinquencies to SBA. These delays may preclude SBA's providing management assistance to a borrower before he is several months delinquent.

In the opinion of various SBA officials, management assistance can be most effective when provided to a borrower whose business problems have not yet led to delinquency. We agree. The effectiveness can be reduced if assistance is not provided promptly after the borrower becomes delinquent.

At one district office, 13 of 16 SBA personnel said they were not aware of problems on guaranteed loans soon enough to provide the borrower with timely management assistance. Officials at another district office where 7 of

the 11 sampled loans received management assistance only after delinquency told us that late notice of delinquency by participating banks reduced the value of management assistance and the possibility of saving the loan. At still another district office, an assistant district director for management assistance told us that earlier identification of borrowers requiring management assistance was needed.

SBA has not closely monitored the borrowers' progress

As discussed in chapter 5, SBA did not make initial field visits to many borrowers and in most cases did not receive financial statements from borrowers after loan approval. In the opinion of many SBA officials, SBA could not become deeply involved in servicing guaranteed loans. As a result, SBA may not know of a borrower's need for management assistance.

A business management specialist in one district office told us that the lack of communication between SBA and borrowers hindered the efforts of the MA division. Often, according to this official, a borrower will not hear from SBA until his loan becomes delinquent, at which point he may refuse assistance because he feels it is just a collection effort.

We asked a loan specialist at a district office why he had not referred a delinquent borrower to the MA division. He said that it was the participating bank's responsibility to service guaranteed loans and that management assistance would not be considered until the bank requested it.

MA needs of borrowers not identified at time of loan approval

Management assistance could have its greatest impact on a borrower's operations and the chances of his repaying the loan, if his management assistance needs were identified at the time of loan approval and the assistance were provided soon after. The identification of management assistance needs at this time is particularly important in view of SBA's limited contact with many borrowers after loan approval. SBA procedures state that:

> "The capability of management is a critically important factor in the loan-making function. It would be difficult to assess without the benefit of a visit to the applicant's business. * * *

While the opinion of the bank * * * is taken into consideration, it must be remembered that management analysis is a basic part of the loan-making decision, and must be carefully commented upon by the loan specialists. If there are management deficiencies, they should be cited and a determination made as to whether such deficiencies could be cured by loan conditions requiring training, SCORE, or other assistance. * * *" (Underscoring supplied.)

Despite the importance that SBA procedures give to field visits to evaluate a borrower's management ability and need for management assistance, field visits were made before loan approval to only 302 of the borrowers in our sample of 980 loans. We estimate that only 7,242, or 20.3 percent, of the 35,618 borrowers in our statistical universe received a preapproval field visit.

District officials commented that:

--The volume of applications being received precluded preapproval field visits.

--Loan specialists relied on statements furnished by banks and applicants because funds and personnel were not always sufficient to make field visits.

SBA central office officials told us that the importance of making a field visit before loan approval to a borrower to evaluate his management ability and need for management assistance will be brought to the attention of the loan-making personnel as a reminder of its importance in the loan analysis process.

Borrowers did not receive priority in the provision of management assistance

During most of the years in which our sampled loans were made, SBA did not require that borrowers get priority over nonborrowers in providing management assistance despite SBA's stake in their success. Management assistance efforts had not been focused on borrowers. Statistics which distinguish between assistance provided to borrowers and nonborrowers indicate that, for fiscal year 1973, borrowers received 8,847 management assistance counseling sessions while nonborrowers received 36,730. In fiscal year 1974, SBA counselors took 18,147 management assistance "actions" with regard to borrowers but 54,346 such actions with regard to nonborrowers.

Lack of effective followup system on management assistance recommendations

SBA had not established an effective system for determining whether additional assistance was needed to implement recommendations made by management assistance counselors. Procedures did not specify intervals for followup visits to recipients of management assistance to help them implement recommendations. The statistics we developed for our sampled loans, which showed that borrowers often received only one management assistance contact, indicate that followup assistance was not provided to many borrowers. The need was apparent, because many of our sampled borrowers' loans went into liquidation.

An assistant district director for management assistance told us that, unless a borrower's problem was critical, management assistance recommendations were followed up only during annual field visits. However, he said these visits were difficult to make.

At another district office, management assistance officials stated that there was no prescribed time within which a followup visit should be made and that limited manpower prevented them from making a commitment to follow up on all recommendations.

Management assistance resources at some SBA district offices are small in relation to need

At one district office, responsibility for initial field visits was transferred from the PM division to the MA division to relieve the loan specialists' workload. However, the MA division's workload then became unmanageable, and in September 1974, the assistant district director for management assistance requested that initial field visit referrals from the PM division be suspended because he lacked sufficient manpower to continue them.

At another district office, the assistant district director for management assistance said that the efforts of the MA division at his district had been primarily directed toward delinquent borrowers. This was done because of the large size of the district's portfolio and the limited number of personnel.

At another district office, responsibility for initial field visits and followup on trouble loans was assigned to the MA division. However, this division had, as of December 19, 1974, made only 22 of 71 initial field visits assigned

since August 1974. As of December 19, the division had made visits on only three of eight loans which had been delinquent on September 30, 1974, and assigned before the end of October 1974. The assistant district director for finance and investment at this office told us that it was a waste of a loan specialist's time for him to refer a borrower for management assistance because business management specialists do not make the necessary visits.

Program goals need revision

SBA goals have not directed management assistance efforts toward improving the operations of 7(a) loan recipients. Goals encourage the performance of a certain number of activities, such as counseling and training courses, but there have been no goals for improvements in businesses and no goals for providing management assistance to 7(a) borrowers.

RESULTS OF MANAGEMENT ASSISTANCE PROGRAM NOT EVALUATED

SBA has not made an overall evaluation of the impact of its management assistance program on small business since 1969. The 1969 study showed that management assistance increased the profits of small businesses. Since that time numerous changes have occurred in the program.

Until February 1974, SBA procedures required the district offices to periodically evaluate the usefulness of management assistance, but this requirement was not complied with and was eliminated because the evaluations were too time consuming.

We believe that SBA should evaluate its current management assistance program. The evaluation would have two uses. First, it would help SBA determine where improvements are needed; second, if it demonstrates the value of management assistance, it might overcome the reluctance of borrowers to accept assistance from SBA.

RECENT CHANGES IN THE MANAGEMENT ASSISTANCE PROGRAM

Our sample of 7(a) loans was drawn from a group approved during fiscal years 1971-74. Because of a number of recent policy changes, our findings may not be indicative of the extent and type of assistance borrowers will receive in the future.

The SCORE, ACE, and Call Contractor programs were established before fiscal year 1971, but the SBI program was not established until 1972. Assistance was first provided by volunteer professional associations in 1971. Therefore, not all the presently operating management assistance programs were available to borrowers during the entire period of our sample.

In addition, the MA divisions in the district offices were not created until July 1973 and did not become operational at some of the district offices we visited until later. Previously, management assistance at the district offices had been the responsibility of divisions which also handled procurement assistance and loan administration. According to an SBA headquarters official, the new organizational structure was intended to give greater emphasis to management assistance.

In February 1974, SBA revised its procedures to establish an order of priorities for providing management assistance. Under this new system, SBA borrowers and contractors who participate under section 8(a) of the Small Business Act of 1953 had first claim to assistance. The new procedures required that all direct loan applicants starting new businesses attend a "prebusiness workshop" and provided that initial field visits to borrowers should generally be made by management assistance personnel.

In January 1975, all management assistance goals for the remainder of fiscal year 1975 were discontinued. This action was part of a special short-term effort, called the Client Assistance Project, to concentrate management assistance resources on delinquent borrowers.

Finally, SBA has developed new management assistance goals, which are scheduled for use in fiscal year 1976. They concentrate on helping borrowers and other participants in SBA programs.

These new procedures, if properly implemented, should correct some of the deficiencies discussed in this chapter and result in an increase in the number of 7(a) borrowers who receive timely management assistance.

CONCLUSIONS

During the period in which our sampled loans were approved, management assistance was provided to relatively few 7(a) borrowers--about 6,257, or 18 percent, of the 35,618 loans in our statistical universe. The assistance that was

given was often not intensive and reached the borrower only after he was delinquent. The causes of the limited assistance provided to borrowers included

- --the reluctance of borrowers to accept help,
- --lack of coordination between the MA and PM divisions at the district offices,
- --delays by participating banks in notifying SBA of borrowers' delinquency,
- --SBA's failure to closely monitor the progress of borrowers,
- --SBA's failure to identify management assistance needs at time of loan approval,
- --SBA's failure to focus management assistance on borrowers,
- --the absence of an effective system for determining whether additional assistance was needed to implement management assistance recommendations,
- --a shortage of management assistance resources at some district offices, and
- --program goals which did not channel efforts toward providing indepth assistance to borrowers.

SBA should identify areas of the management assistance program which need improvement and should demonstrate the value of the program to borrowers by evaluating the impact of the program.

SBA has recently revised its policies and procedures to provide for more timely and extensive management assistance to borrowers. Proper implementation of these changes should result in improvements in providing management assistance.

RECOMMENDATIONS

To increase the usefulness of management assistance to the small business borrower, we recommend that the Administrator, SBA:

- --Improve coordination between the PM and MA divisions at the district offices.

--Evaluate the impact of management assistance to identify areas needing improvement and demonstrate to borrowers the value of the assistance.

--Establish a system for determining whether additional assistance is needed to carry out recommendations.

--Intensify efforts to determine a borrower's need for management assistance at the time of loan approval.

In addition, adoption by SBA of the recommendations we made in chapter 5 relating to loan servicing would improve the delivery of management assistance to borrowers by making possible more timely identification of borrowers' needs.

AGENCY COMMENTS AND PROPOSED ACTIONS

SBA stated that the MA division was not a separate unit within the SBA field and central office organization during the time in which the loans we reviewed were made. We agree, as noted on page 67, that some MA divisions were not established during the entire 4-year period. However, other district offices established MA divisions as early as July 1973. In these offices, we noted a problem of coordination between the PM and MA divisions. If the policies cited by SBA in its comments (see app. I) are effectively implemented by the district PM and MA divisions, coordination between the two divisions should increase to the benefit of borrowers.

SBA stated that the following improvements in the management assistance area have been implemented recently or are planned for future implementation.

--The Office of Program Evaluation and Field Coordination was established within the Office of Management Assistance to specifically evaluate all management assistance programs. In addition, special studies are being undertaken by SBA personnel and outside consultants in the area of small business management development and other areas, to recommend new and improved programs to meet the changing needs of the small business community.

--A concept of an integrated management delivery system incorporating basic operating data is being developed to show the value of management assistance to borrowers and other clients. This program will also develop a means to insure followup assistance to implement initial management assistance recommendations. Coupled with this program, new management assistance targets

have been designed to encourage indepth, long-range management assistance.

--New self-study methods, a greater number of smaller training programs addressed to specific areas of need, more management development plans, and increased availability of prebusiness workshops are being encouraged to identify borrower management deficiencies as soon as possible.

--A limited trial program is being tried in some district offices to inform the MA division of a new borrower before loan closing so that a program of management assistance can be developed as needed.

We believe that, if SBA implements these actions, the usefulness of management assistance to small business borrowers will be greatly improved. In this way SBA will be enhancing the borrower's chances of successfully operating a viable business while, at the same time, improving his ability to repay the loan.

CHAPTER 7

SCOPE OF REVIEW

We reviewed the administration of the 7(a) loan program at 24 SBA district offices. (See app. III.) We randomly selected 980 loans from the total 35,618 loans approved by these offices during fiscal years 1971-74. SBA officials provided a list of approved loans for these 4 years and their status as of August 30, 1974. Our sample was divided into three different groups as follows.

Group I--Included current 7(a) loans, loans approved but not disbursed, loans canceled after approval, and loans paid in full. We sampled a total of 480 loans from the universe of 33,345 in this group.

Group II--Included loans in liquidation. We sampled a total of 250 loans from the universe of 1,540 in this group.

Group III--Included loans charged off. We sampled a total of 250 loans from the universe of 733 in this group.

We then reviewed the 980 loan files in detail. We analyzed several standardized attributes and selected variables for these loans. We then combined the results of these three groups, which were weighted by district office and group, to project the results of our findings to the universe of 35,618 loans at the 24 district offices reviewed. (See app. VII.) Group I had the greatest impact on these results because of its size.

We developed information on how loans are made and serviced and how objectives are set and met, reviewed district office correspondence, and interviewed professional employees in each district office. We also interviewed 119 officials of banks participating in the loans sampled and 110 borrowers of the sampled loans.

In addition to the sampled loans, we reviewed other loans that (1) were delinquent, (2) were brought to our attention by SBA employees, (3) had attracted congressional interest, or (4) were made to borrowers of sampled loans.

We reviewed data for fiscal years 1971-74 at all 24 district offices and the 10 regional offices concerning goal

development for loan processing, loan servicing, and management assistance. Loans were examined for conflict of interest, and those identified were referred to the appropriate authorities.

We reviewed records and spoke with SBA officials concerned with the 7(a) program in the Washington, D.C., headquarters and in the field. We carried out our fieldwork between October 1974 and June 1975 in all 10 SBA regional offices and at 24 SBA district offices.

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

OFFICE OF THE ADMINISTRATOR

November 25, 1975

Mr. Victor L. Lowe
Director, General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

This is in response to your request for our comments on your draft report entitled, "SBA 7(a) Loan Program: Action Needed to Improve Services to Small Businesses."

Enclosure I is our specific comment to each of the recommendations made in the report.

[See GAO note 2, p. 89.]

In addition to these comments, we would want to make the following comments which we believe should be considered in your final report.

Generally, the audit finds fault with the Agency's not following its own procedures and that our current volume cannot be handled by our present staffing level. This leaves us two options: either obtain a larger staff or decrease our production volume. The ever increasing demand for our services by the small business community renders the latter option untenable. We are proud of our response to the demonstrated needs of the nation's small businesses. We have consistently pursued the first option, pressing for additional staff, but budgetary constraints have kept our staffing at just above the 4,000 level for the past several years. Thus, we were not surprised that the reported findings testify to SBA's stretching of resources. Perhaps, this stretching has restrained us from fully documenting actions that were actually justified, and would have been so recognized

had we consumed the time necessary to record the supportive documentary materials. In this regard, we believe we can more adequately document our loan files while increasing the quality of our loan analysis and presentation by maximum use of automated equipment and streamlined procedures.

Further, since the Agency is mandated to provide financial assistance for those who cannot obtain regular commercial aid, it follows that our cases frequently require expanded staff time to complete. Taking this additional time for the small business man also results in edging out further into the grey area of loan marginality, in both the minority and majority sectors, which has the natural by-product of increasing the economic risk. This economic risk taken to its natural conclusion, finally equates with a possible larger percentage of losses. Yet, the report does not cite these mitigating factors when reporting on various loss situations. Nor does the report take into account the fact that the same number of limited staff mentioned above have had added to their financial assistance functions a total of seven new programs in the past five years. In some of these programs, the processing and servicing of new types of loans require even more documentation and analysis than 7(a) loans; but the people doing this job are the same people who are continuing to handle the 7(a) workload.

Another most important factor that must be kept in mind is our program to bring minority businesses into the economic mainstream. This program requires, at the field level, devoting expanded job time per unit of production, beyond what the routine majority applicant/borrower either needs or consumes. Our managers insist that all personnel go beyond normal standards in minority loan and client situations; therefore, minority actions require a greater expenditure of staff time. The report, however, seemed to ignore this facet of our operations. We believe that this commitment merits specific recognition in weighing our overall performance.

Finally, we have been and continue to be alerted to our problems through our own internal review functions which have reported to us many similar findings as your report brings out. Therefore, some of the management actions already initiated to overcome these problems are:

a. An expanded Office of Portfolio Review.

b. Creation of a regional overview capability including the position of the Assistant Regional Directors for Finance and Investment, and a supporting staff.

c. Requiring periodic District Office reviews by the ARD/F&I and his staff of the financing program including both quantity and quality.

d. Task Force studies of loan processing, disbursing and servicing leading to streamlining of procedures and District Office uniformity.

e. Increasing both the number and activity of the Office of Audits and Investigations.

f. Piloting an early warning system with SCORE volunteers actually helping clients to compose basic operating statements and balance sheets.

Other managerial concepts that are being considered are listed below:

a. Expanding the composition of district portfolio review sessions to provide mandatory attendance by management assistance, financing division and legal, as well as the portfolio management unit.

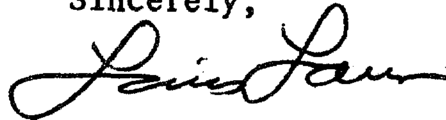
b. Expanding both the number of SCORE volunteers and the scope of their involvement.

c. An increased use of disaster temporaries in disaster loan making managerial positions, thereby freeing middle managers to attend to their normal functions. This, of course, affords us greater management continuity in both sectors.

d. The results produced by our Task Force on processing are so visible that additional task forces are being planned and certain findings translated into immediate procedural changes. Thus, in short order, our servicing procedures should also benefit from a streamlining study. We view the Task Force activity as yet another method in our continuing managerial improvement process.

In conclusion, we appreciate the overall positive tenor of the GAO report. At the same time, we do recognize the reality of the managerial short falls that the audit uncovered. As outlined above and in the enclosures, remedial measures are either already underway or in the planning stage. Of course, they must be accomplished within budgetary constraints that are also part of our real situation. But again, our reaction is most positive as we continue to respond to the multi-faceted demands of the small business community.

Sincerely,



Louis F. Laun
Acting Administrator

Enclosure

ENCLOSURE I

SMALL BUSINESS ADMINISTRATION COMMENTS

ON

GENERAL ACCOUNTING OFFICE DRAFT REPORT

ENTITLED

"SBA 7(a) LOAN PROGRAM: ACTION NEEDED TO IMPROVE SERVICES TO SMALL BUSINESSES"

(Submitted to SBA, October 22, 1975)

"RECOMMENDATIONS TO THE ADMINISTRATOR (Pages 36 & 37)

To ensure that SBA loans do not (1) merely transfer the risk of obtaining repayment from banks and creditors to SBA, or (2) go to wealthy businesses, we recommend that SBA:

--require loan specialists to more closely follow the established SBA procedures and fully analyze and document the appropriateness of reducing a bank's exposure, refunding bank loans, paying off creditors, or refinancing SBA loans, to ensure that as a result of paying off such debts the borrower will have a better chance of becoming a viable business and that SBA will not merely be taking the place of existing creditors.

--require loan specialists to perform a more in-depth analysis of those loans where 50 percent or more of the loan proceeds are to be used for payment of borrower debts and thoroughly justify the payment of such debts.

--require the participating banks to retain the same level of exposure after the SBA loan as they had prior to the SBA loan.

--require its loan specialists to thoroughly analyze the financial resources available to a borrower so that SBA loans are made only to those individuals unable to acquire financing. To assure this is accomplished, SBA's Internal Audit Division should review the district offices' compliance with this procedure."

The first, second, and fourth recommendations relate to requiring loan specialists to more closely follow established procedures regarding reduction of banks' exposure, refunding bank loans, other refinancing, in-depth analysis where 50 percent

or more of the loan proceeds are for debt payment, and the inability of applicants to receive financing elsewhere. We are in full agreement with these recommendations and will forward a written reminder to all loan officers to follow our procedures to the letter, as well as requesting the Internal Audit Division and our Office of Portfolio Review to continually monitor field office compliance with these requirements.

The third recommendation is for a major change in policy, that is, to require that banks must retain the same level of exposure after an SBA loan as previously held by the bank. We have attempted, in present policy, to severely limit any decrease in a bank's exposure, but to permit a decrease where the circumstances of an individual case so warranted. We continue to feel that individual cases warrant consideration of exception to the general policy; however, we will give this recommendation further consideration and either make the recommended change or further tighten our present policy to make it clear that only in a very few cases, and under guidelines set by the Central Office, may exceptions be made.

"RECOMMENDATIONS TO THE ADMINISTRATOR (Page 49)

We recommend that the Administrator emphasize the need for loan specialists to fully analyze the information provided by borrowers and document their justification for recommending approval of the loan. This would entail resolving any questionable items. We also recommend that consideration be given to the feasibility of developing a definitive criteria for use by district loan specialists in establishing a prospective borrower's ability to repay. This may entail establishing certain financial ranges of acceptability. In the meantime, district officials should be directed to fully utilize other data and techniques available to them including cash flow analyses, evaluating projected earnings, and making site visits before loan approval.

Additionally, we recommend that consideration be given to expanding the SBA appraisal function and that realistic appraisals of collateral be made where collateral is a critical factor in approving a loan."

The first recommendation again relates to the need for loan officers to fully analyze financial information and document their justification for approving loans. We agree that new emphasis should be placed on this, and will forward to our field offices a written reminder that this must be done.

[See GAO note 2, p. 89.]

The second recommendation, that consideration be given to expanding the appraisal function in the loan-making process, has already been implemented, at least to a considerable degree. On June 3, 1974, Administrator Kleppe approved a recommendation to permit regional directors to fill two positions in each region for full-time appraisal work.

These two positions were to be augmented by the hiring of WAE appraisers where needed, by requesting the use of appraisers in other Government agencies, and by using fee appraisers in appropriate cases. While all of this appraiser capability was to be used primarily for liquidation cases, it could also be used for the loan-making process as deemed necessary or desirable by the regional director. Admittedly these appraisal services will be used almost altogether for servicing/liquidation work, with little time spent on the loan-making activity. However, with our limited staffing, we can see no alternative than to continue to rely on bank capability for appraising collateral prior to loan approval and to hiring fee appraisers where necessary. Our SOP does permit the cost of an appraisal to be paid from the proceeds of the loan, when this is deemed to be appropriate.

RECOMMENDATIONS TO THE ADMINISTRATOR (Page 78)

Recommendation

"Enforce its requirement that participating banks submit promptly after loan disbursement, settlement sheets showing in detail how loan proceeds were disbursed and that loan servicing personnel resolve any major discrepancies."

It is our intention that this material be provided by the bank upon disbursement and reviewed promptly upon receipt by SBA.

We are dismayed at the extent of the lapse reported in the review of settlement sheets. We will instruct counsel to take steps to assure prompt receipt and review in the future. We have included general instructions on this point in our recently issued SOP 50 50-2 "Loan Servicing" dated October 10, 1975. We will highlight and expand on these instructions in the "SBA Circular" (desk to desk distribution) as soon as possible with a view toward emphasizing the need for prompt action on any identified discrepancies.

Recommendation

"Determine the staffing level which would permit effective servicing including initial field visits of the required scope to all borrowers and intensive follow-up on delinquent loans. Once this staffing need is determined, the Administrator should attempt to meet it through personnel realignments within SBA, changes in methods of operations to free personnel for servicing duties or through a proposal to the Congress for additional staff. If SBA finds that an increase in servicing personnel is not possible, SBA should consider limiting the number of loans it approves to those which it can effectively service with available staff."

GAO has found and we fully concur that a major reason for the inability to provide a fully effective servicing effort is the existing staffing level within the servicing division.

We do have a staffing standard for servicing but budgetary constraints have not allowed sufficient slots to man the function at the "standard" level during this period of substantial portfolio increase. We recognize that this places us at a disadvantage in providing ordinary lender's controls over outstanding loans. However, we have felt that the risks being taken were worth the benefits otherwise being provided to small business in the overall.

We now recognize that this balance may have tipped too far and that the potential for unacceptable loss levels is too high and the level of control and care of existing borrowers is too low. We are therefore taking steps to resolve this situation such as:

1) Streamlining various agency functions to improve and speed up work flows.

2) Study the full range of ongoing SBA efforts to identify which are most effective, which are least effective, which are most desirable, which are least desirable and to prioritize them.

3) With the priorities thus clearly identified, we would then determine utlization of people as against these priorities throughout the Agency - including our servicing efforts.

Concurrent with the foregoing, we plan to initiate improvements in a variety of people intensive areas and to emphasize the use of non-agency resources to the fullest extent possible. Some such efforts will involve:

1) getting better servicing by participants

2) reducing interview time by upgrading receptionists, using banks, using SCORE volunteers, etc.

3) improve loan packages by providing training for bankers regarding SBA requirements, etc.

4) better standardization in a variety of areas (forms, control systems, computer support, etc.)

[See GAO note 2, p. 89.]

Recommendation

"Enforce its requirement that participating banks submit written notice of borrower delinquency within 30 days to the SBA district office servicing the loan."

It is our intention to strengthen this effort and in this regard a system of penalties (i.e., loss of interest, etc.) has been devised and published. We are also collecting trouble rate data for bank serviced loans and should by June 30, 1976, be able to identify trends, lapses, etc., on a regional or district basis so that appropriate emphasis can be applied as necessary and where necessary. In addition, a new guaranty agreement has been proposed which should help in clarifying our mutual (bank/SBA) responsibilities in this area.

Further, a procedure has been established to allow uniform and timely notice to SBA of default on a bank serviced loan. (SBA Form 1071) This procedure has been fully computerized and is fast becoming a formal, enforceable system for control in this area.

[See GAO note 2, p. 89.]

Recommendation

"Require the submission to SBA of financial statements by borrowers of both guaranteed and direct loans. In this connection, SBA should consider the feasibility of a computerized analysis of these financial statements to make feasible a more extensive analysis of a borrower's progress for its own and the borrower's use."

We concur with this recommendation. Financial statements are, have been and probably always will be the major barometer of progress, or lack of it, available to the credit man. In this business, we can only make determinations on the basis of the financial statements. The Agency's requirements for obtaining financial statements is, basically, that one should be obtained on each loan (direct and guaranty) at least yearly until a loan is seasoned or the requirement has been specifically (on a loan by loan basis) waived. This is a continuing requirement in the new (just published) servicing directive.

As stated by GAO, receipt of the statement must go hand-in-hand with its analysis and here again we have had difficulties in that such an analysis has not been possible under the staffing restrictions.

In an effort to resolve this problem, we have developed a procedure whereby an automatic computer notice of financial statement due is provided directly to the borrower. This relieves field offices of the substantial tickler requirements in this regard and leaves only the follow up duties for obtaining statements on accounts which did not respond to the first "automatic" computer notice. This system flows through to the use of MA and SCORE resources if secondary follow up activity by PM does not bring results.

With regard to the second part of this recommendation concerning computerized analysis of financial statments, this method has been under consideration since March of this year and is a formal "objective" of the Agency's developmental staff in our Office of Advocacy, Planning and Research.

Recommendation

"Require loan applicants to obtain the reasons why banks have refused to make loans to them."

The last recommendation is that we require loan applicants to obtain the reasons why banks have refused to make loans to them. Both our SOP and our regulations do have such a requirement in the case of direct loans; both are somewhat vague as to guaranteed loans. These instructions will be revised and clarified. In the case of guaranteed loans, we have felt that the statement on the application form, signed by the bank and certifying that without the SBA guaranty the bank would not make the loan was sufficient. As a practical matter, banks are in many cases unwilling to state a specific reason. In most cases, the loan sought is a marginal one, considered by the bank not to be up to its standards of loan-making without SBA guaranty, and thus exactly the type of loan case that SBA's loan authority covers.

We will continue to require that banks document their reason(s) in the case of direct loans, but we believe that present policy (which will be clarified) regarding guaranteed loans is a sound one.

RECOMMENDATIONS TO THE ADMINISTRATOR (Page 96)

Recommendation

". . .improve the coordination between the Portfolio Management and Management Assistance Divisions at the district offices."

During the time in which the loans reviewed were made, Management Assistance (MA) was not a separate office within the SBA field and Central Office organization. This realignment was subsequently instituted for the purpose of improving coordination between Portfolio Management (PM), Financing, other programs, and Management Assistance. Appropriate program Standard Operating Procedure manuals set forth the method by which these offices are to interface with Management Assistance to facilitate the early provision of MA to borrowers in need of management counseling and training. Statistics are being accumulated to measure the extent of this interface.

Appropriate SOP's state that district office ADDMA's are to be included in monthly portfolio reviews conducted by the district ADDFI. Borrower client lists have been developed to assist the ADDMA in informing PM personnel of what management assistance has been provided portfolio clients. It is a requirement that each portfolio client in need of in-depth, long term management counseling be assigned to a particular Management Assistance Officer who is to develop a file of all MA provided that client. Copies of all MA reports concerning that client are placed in that file and made available to the PM servicing loan officer. Individual copies of call contractor and SBI reports on a client are provided to the PM servicing loan officer for his review and filing in the loan docket file.

In addition, a current Agency goal targets an appropriate Regional percentage of borrowers to receive Management Assistance. Other Agency targets and guidelines have been adopted to encourage greater activity by MA on priority clients, including loan applicants, loan holders, 8(a) firms, surety bond holders and lease guarantee recipients. It must be recognized that any small business requesting management assistance cannot be turned away.

Recommendation

"Evaluate the impact of management assistance to identify areas needing improvement and demonstrate to borrowers the value of the assistance."

Since the report was completed, the Office of Program Evaluation and Field Coordination has been established within the Office of Management Assistance to specifically evaluate all management assistance programs. In addition, special studies are being undertaken by Agency personnel and outside consultants in the area of small business management development, entrepreneurship training and other areas to recommend new and improved programs to meet the changing needs of the small business community. A concept of an integrated management delivery system incorporating basic operating data is being developed to show the value of management assistance to borrowers and other clients.

Recommendation

"Establish a system for determining whether additional assistance is needed to implement management assistance recommendations."

The integrated management delivery system is being designed to develop a program to insure follow-up assistance to implement initial management assistance recommendations. The assignment of an MAO to a particular client needing in-depth long term management assistance and the maintence of a client history file should improve the monitoring of management assistance provided. Since SCORE is the largest resource available to provide management assistance, new brochures have been developed and distributed to field and volunteer personnel to explain how to use this resource in conjunction with other MA resources (i.e., call contractors, SBI.)

Additionally, new management assistance targets have been designed to encourage in-depth, long range management assistance.

Recommendation

"Intensify efforts to determine a borrower's need for management assistance at the time of loan approval."

Current MA and FD Standard Operating Procedures require that all direct loan and EOL recipients attend a prebusiness workshop or receive comparable counseling. Through this method,

it is hoped that those borrowers needing management assistance will be identified in a timely manner so that a counseling and training program can be developed early to meet the borrowers' needs. In addition, new self-study methods, a greater number of smaller training programs addressed to specific areas of need, more management development plans, and increased availability of prebusiness workshops are being encouraged to identify borrower management deficiencies as soon as possible.

A limited trial program is being attempted in some district offices to inform management assistance of a new borrower prior to loan closing in order that a program of management assistance can be developed as needed.

GAO notes: 1. Page references in this appendix may not correspond to pages in the final report.

2. Deleted comments referred to material contained in the draft report which has been revised or not included in the final report.

DESCRIPTION OF 7(a) LOANS

Guaranteed loans

These loans are made by financial institutions to small businesses under agreement with SBA. This agreement provides that, if the borrower defaults on the loan, SBA will purchase its guaranteed percentage (up to 90 percent) of the loan balance. Payment would include interest from the date of last payment. Interest rates must fall within those established by SBA. The established SBA interest rate has varied over the years but has not exceeded 11.5 percent.

SBA charges the financial institutions a one-time guaranty charge--1 percent of the amount of the authorized portion of the loan. The charge is payable at first disbursement by the participating lender. Such guaranty charges are not to be charged by the financial institution to its borrower. The Comptroller General ruled on March 13, 1975, that it was appropriate for SBA to accept late guaranty payments provided the loan was not in default and that neither SBA nor the lender was aware of, or had any information indicating, an imminent default.

Immediate participation loans

These loans are made in part by the financial institution and in part by SBA. The SBA share is normally limited to 75 percent of the total loan amount. The interest rate on the financial institution's share of the loan is set by the institution within the rates established by SBA.

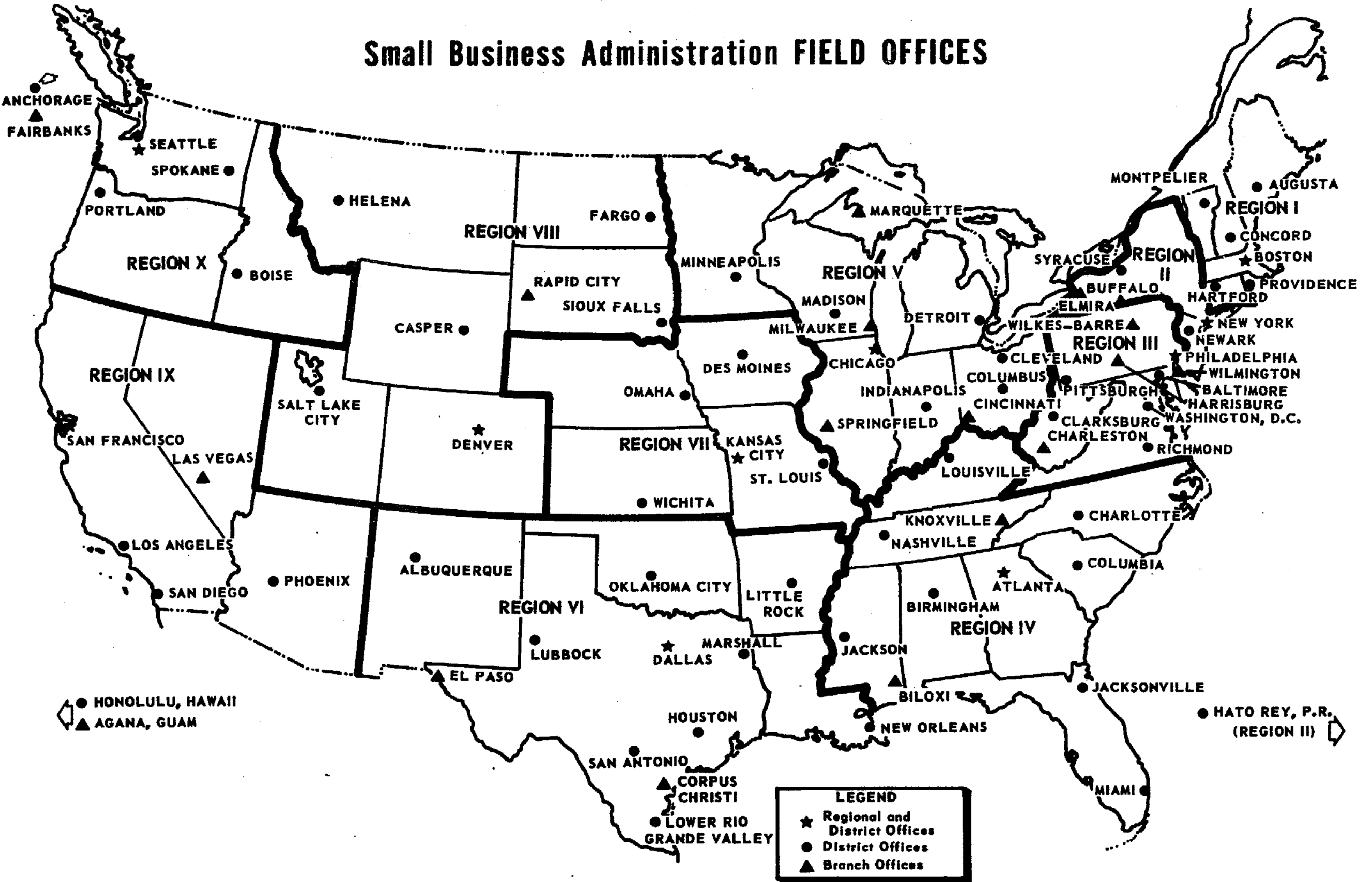
The interest rate on the SBA share of the loan amount has been set by SBA at 5.5 percent in recent years. However, on August 23, 1974, this rate was increased to 6.75 percent. SBA is prohibited by law from entering into a participation loan unless a guaranteed loan is unavailable. SBA has established an administrative limit of $150,000 on the SBA share of an immediate participation loan. However, regional directors may, subject to availability of funds, waive the administrative ceiling.

Direct loans

A direct loan is made by SBA using only Federal funds. Interest rates on direct loans are the same as for participation loans (6.75 percent). SBA is prohibited by law from making a direct loan unless an immediate participation loan is not available. SBA has established an administrative limit of $100,000 for direct loans. However, regional directors may, subject to availability of funds, waive the administrative ceiling.

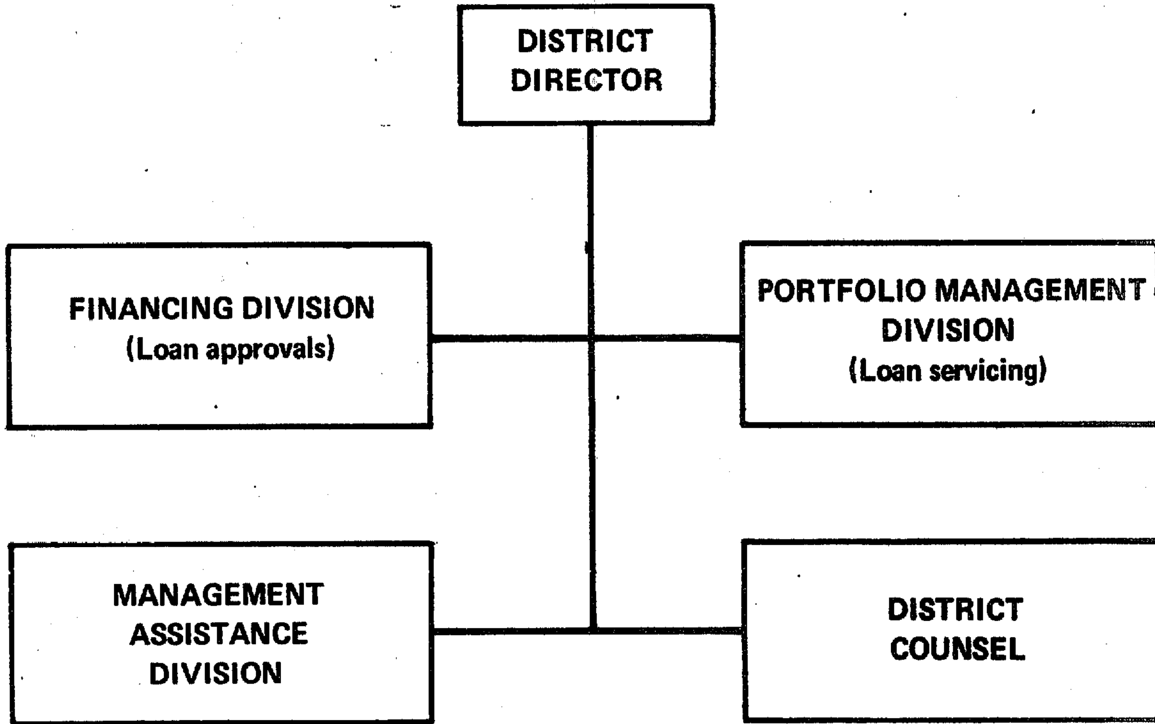
SBA DISTRICT OFFICES REVIEWED, LOANS APPROVED, AND LOANS SAMPLED, FISCAL YEARS 1971-74

SBA district office	7(a) loans approved		Loans randomly sampled	
	Number	Amount	Number	Amount
		(000 omitted)		(000 omitted)
Boston	1,977	$ 138,097	43	$ 1,976
Hartford	1,127	67,984	43	2,174
New York	2,090	238,136	40	3,634
Newark	1,110	111,710	40	4,055
Baltimore	605	46,665	46	3,536
Clarksburg	813	74,300	48	3,474
Birmingham	978	63,167	45	2,336
Charlotte	839	45,325	42	2,273
Detroit	1,398	121,862	42	3,454
Cleveland	948	81,796	43	2,963
Chicago	1,852	171,194	42	2,754
Indianapolis	2,400	180,170	40	2,986
Columbus	952	91,298	42	3,958
Houston	1,765	132,407	43	2,766
Kansas City	2,252	138,332	43	2,405
St. Louis	1,811	100,814	42	2,246
Denver	1,838	124,014	44	2,477
Salt Lake City	1,251	104,775	34	3,411
San Francisco	3,059	181,183	42	2,649
Los Angeles	2,795	299,073	39	4,316
Honolulu	605	45,796	26	1,738
Seattle	1,700	129,186	42	2,235
Philadelphia	1,219	102,330	42	3,902
Las Vegas	234	12,390	27	957
Total	35,618	$2,802,004	980	$68,675



APPENDIX IV

ORGANIZATION OF AN SBA DISTRICT OFFICE



REPORTS ISSUED ON THE 7(a) LOAN PROGRAM BY GAO AND SBA'S INTERNAL AUDIT DIVISION

PRIOR GAO REPORTS

In a January 1960 report to the Congress on financial assistance activities of SBA, 1/ we stated that SBA had made some loans to applicants whose past earnings records were poor and that SBA needed to emphasize the ability of applicants to repay the loans from future earnings. At the time, SBA Washington officials said that the determination of a borrower's ability to repay a loan was a matter of judgment but that our findings would be brought to the attention of the regional offices.

In a January 1964 report to the Congress on a review of business loan activities of SBA, 2/ we cited nine loans for which we believed the applicants' ability to repay had not been adequately considered. For some loans, SBA's conclusions that applicants could repay were based on what we considered to be applicants' unrealistic projections of future earnings. In other cases, the applicants had not submitted any projections. Five of the nine loans either were problem cases or were in liquidation, and of the other four, two had had at least three monthly payments deferred to the maturity dates of the loans. The SBA Administrator said that an applicant's ability to repay a loan could not be measured to the degree indicated by us but that these determinations were decisions of judgment.

In the January 1964 report, we also stated that, for four loans on which SBA estimated it would lose almost $100,000, the applicant either submitted inaccurate and misleading financial information or did not furnish pertinent financial information, a fact that might have been disclosed by an independent audit before the loan was made. The circumstances were such that, had SBA known the actual financial condition of the borrowers, it might not have made the loans. We concluded that it was essential for SBA to obtain reliable and complete financial data in order to make a sound credit

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1/"Review of Financial Assistance Activities of the Small Business Administration, December 1958" (B-114835, Jan. 20, 1960).

2/"Need for Better Supervision and Administration of Business Loan Activities of the Small Business Administration" (B-114835, Jan. 31, 1964).

analysis of the borrower's financial condition. We recommended that SBA require applicants for large loans to submit independently audited financial statements.

In commenting on this matter, the Administrator advised us that he did not believe the discretionary provisions for audited statements should be changed to an absolute requirement based on an arbitrary dollar minimum.

Another report on the 7(a) loan program was issued in November 1969. 1/ This report cited 85 selected direct and immediate participation 7(a) business loans and concluded that the SBA loan specialists' analyses of the borrowers' business operations and financial conditions were not sufficiently comprehensive to adequately determine whether repayment was reasonably assured from earnings of the borrowers' business. Such assurance is required by SBA's basic policies, based on provisions of the Small Business Act. In commenting on this matter, the Administrator said actions had been taken to improve supervision over loan processing.

SBA INTERNAL AUDIT REPORTS

The SBA Internal Audit Division has issued reports during the past several years dealing with many of the weaknesses we noted. A March 15, 1972, report, titled "A Review of the Use of Financial Statement Analysis for Identifying Needs for Management Assistance and Determining Economic Soundness of Loans and Loan Repayment Ability," stated that:

--Although a sufficient quantity of basic financial data was usually obtained for use in loan application processing, its reliability, in certain cases, was doubtful.

--Although field office representatives were generally aware that the participating banks servicing SBA loans had various incentives and capabilities for loan servicing, including the effective use of financial statements, responsibility was frequently not assumed for followup on the analysis of financial statements that may have been accomplished by these banks.

--Whether referring to the financial statement analysis accomplished on the bank-serviced or the SBA-serviced loans, the analysis was not usually accomplished in a

1/"Analyses of Applications for Business Loans Need Improvements" (B-114835, Nov. 6, 1969).

satisfactory manner. The analysis that was accomplished had no apparent relation to need for analysis, but instead was accomplished at the discretion of various individuals or on an "as time permits" basis.

--Various actions taken by the field offices, such as field visits and deferments, could have been much more effective with timely and adequate financial analysis.

A second report issued on February 5, 1973, titled "Applicable to the Small Business Administration's Guaranty Loan Program," found

--that some participating banks were not servicing loans as they agreed to during loan processing,

--inadequate field visits on bank-serviced loans, and

--the need for uniform bank settlement sheets and verification of the use of loan proceeds.

A third report issued on February 6, 1973, stated that SBA should stress the importance of settlement sheets because they were not always being submitted and/or information submitted was inadequate for the district counsel to make an adequate evaluation of whether loan proceeds were used in accordance with the terms and conditions set forth in the loan authorization.

PROJECTIONS OF SAMPLE RESULTS

Sampling attribute	Sample result	Estimated percent of loans (note a)	Sampling error 95% confidence (+-)	Estimated number of loans	Sampling error 95% confidence (+-)
Number of guaranteed loans	864	92.7	2.2	33,025	789
Number of immediate participation loans	30	2.0	1.0	724	354
Number of direct loans	86	5.2	2.0	1,869	713
Reasons obtained for bank decline	104	8.7	2.4	3,081	853
Field visits made before loan approval	302	20.3	3.0	7,242	1,059
Initial field visits made	477	33.9	3.9	12,082	1,404
Initial field visits made within time limit	387	27.5	3.6	9,788	1,279
Number of loans not visited as of 8/30/74 and should have been	280	35.5	4.1	12,662	1,473
Number of field visits not required	181	21.6	3.8	7,684	1,369
Refund of participating bank loan	202	18.7	4.7	6,688	1,683
Participating bank exposure reduced	87	8.1	2.2	2,896	796
Bank bailouts	12	.4	.3	127	123
Refinanced SBA loans	104	10.8	2.6	3,865	944
Bank settlement sheets in loan files	602	60.5	3.8	21,557	1,371
Proceeds verified as to proper use by SBA	166	14.9	3.0	5,294	1,052
Financial statements received before approval	854	84.5	3.3	30,090	1,161
Financial statements for guaranteed loans received after approval	135	15.0	3.1	5,334	1,108

a/This percentage was weighted by district office and loan group. (See p. 71.)

Sampling attribute	Sample result	Estimated percent of loans (note a)	Sampling error 95% confidence (+-)	Estimated number of loans	Sampling error 95% confidence (+-)
Financial statements for direct loans received after approval	14	1.0	.7	350	252
Bank notification of borrower default within 30 days	168	5.2	1.4	1,845	504
Total bank notifications of borrower default	455	17.4	2.8	6,187	1,008
MA referrals to SBA business management specialist	290	22.6	3.6	8,039	1,276
Number of loans which received MA contacts	235	17.6	3.3	6,257	1,172
Number of loans which had payments deferred	219	13.9	3.0	4,957	1,070

a/This percentage was weighted by district office and loan group. (See p. 71.)

Variable	Sample average	Sampling error 95% confidence (+-)
Number of months before initial field visit made	7.89	1.03
Number of months no field visit made and should have been	24.88	1.54
Number of days borrower delinquent before SBA notified by bank (over 30 days)	113.38	20.35
Number of months of deferred payments	5.50	.80

REDUCTION IN PARTICIPATING BANK EXPOSURE: EXAMPLES

Example 1 - A 75-percent-guaranteed loan was approved on December 8, 1972, for $200,000. The loan authorized the use of:

1. $55,000 to pay off a real estate mortgage.
2. $67,000 to pay off notes to the participating bank.
3. $33,000 to purchase leased equipment.
4. $45,000 for working capital.

Although the loan authorization only showed $67,000 to be paid to the bank, the loan specialist's report showed a reduction in exposure of $17,000 (from $67,000 to $50,000; 25 percent of $200,000). The settlement sheet, however, showed that the $55,000 for the real estate mortgage went to the participating bank, an actual reduction in exposure of $72,000. The reduction in exposure based on the loan authorization and the settlement sheet is summarized below.

	Loan authorization	Settlement sheet
Bank's exposure before loan	$67,000	$122,000
Bank's exposure after loan (25 percent of $200,000)	50,000	50,000
Reduction in exposure	$17,000	$ 72,000

A thorough search of the loan file did not reveal that SBA had any prior knowledge that the $55,000 was to be paid to the participating bank. However, a bank official said that

the bank notified SBA that it held the mortgage in question.

The SBA loan specialist was not aware of this decrease in exposure until we mentioned it to him. He said that, since the report listed $67,000 as the amount to be paid to the bank and not the $122,000, he obviously was not aware that the real estate note was owed to the participating bank. He added that even had he known about the note, SBA probably would have made the loan, as it was very well secured.

Example 2 - A borrower received a $70,000 guaranteed loan in which the bank participated 20 percent, or $14,000. According to the loan specialist's report, $18,403 of the proceeds were to pay off a previous loan to the borrower from the participating bank. The loan specialist's report did not justify this bank loan as being made in anticipation of an SBA loan.

The bank's exposure was reduced by $4,403, as follows:

Bank's exposure before loan	$18,403
Bank's exposure after loan (20 percent of $70,000)	14,000
Reduction in exposure	$ 4,403

An SBA internal auditor noted that about $11,000 in unsecured notes were being paid off, including about $3,000 to the participating bank. The loan specialist justified the bank's reduction in exposure because the bank was diluting its collateral position. That is, the bank agreed to share its collateral on the first loan with SBA.

Example 3 - SBA approved an $85,000, 90-percent-guaranteed loan on March 17, 1972. The loan was used in part to pay debts totaling $12,604 owed to the participating bank. The payments to the bank were for its share of a prior SBA-guaranteed loan, which had a balance of $19,038 (10 percent of $19,038 = $1,904 bank's share) and $10,700 in outstanding bank loans to the borrower.

The bank's exposure was reduced by $4,104, as follows:

Bank exposure before loan ($10,700 bank loans and $1,904--10 percent of prior SBA loan of $19,038)	$12,604
Bank exposure after loan (10 percent of $85,000)	8,500
Reduction in exposure	$ 4,104

The loan specialist's report failed to provide any justification for the reduction in exposure although it was noted that the previous SBA loan was current in its payments. This new loan was current as of November 1974.

BANK BAILOUTS: EXAMPLES

Example 1 - SBA approved a 50-percent-guaranteed loan for $314,500 on January 24, 1973. The loan was secured by collateral consisting primarily of land, buildings, furniture, and fixtures valued at $93,300 by an outside appraiser. Prior liens of $18,850, however, left a net collateral value of $74,450.

The borrower's interim balance sheet at December 31, 1972, showed the business had assets of only $284,000 and liabilities of $329,300. In addition, information in the loan file showed that the firm had sustained operating losses, ranging from $14,236 to $65,118, in each of the 3 preceding fiscal years.

The loan was disbursed by the bank on April 3, 1973:

--$282,470 for debt repayment.

--$32,030 for working capital.

The debt repayment included $16,735 for a mortgage, $102,073 for three SBA loans, and $163,662 for five direct bank loans.

The narrative section of the loan specialist's report did make reference to bank loans. It stated that the participating bank had extended credit of approximately $170,000 to the borrower based on a verbal commitment from SBA and that, although SBA had no legal obligation to honor the commitment, its duty was obvious.

The direct bank loans were, for the most part, demand notes secured by the borrower's assets which were not sufficient to satisfy its liabilities. At the time SBA approved the loan, the borrower was seriously delinquent on one direct bank loan and two of the three SBA loans. This loan resulted in a reduction in the bank's exposure of $14,860, as follows.

Exposure before loan (5 bank loans totaling $163,662, plus bank's 10-percent share of the guaranteed loan which had a balance of $84,479)	$172,110
Exposure after loan (50 percent of $314,500)	157,250
Reduction in exposure	$ 14,860

We classified the reduction in exposure as a bank bailout because we believe the bank was in a position to sustain a loss. As stated above, the borrower was in financial trouble at the time of loan approval.

The borrower became delinquent on interest payments in January 1974 and on principal payments in June 1974. As of May 1975, the borrower had not yet reduced the principal and was more than 6 months delinquent in interest.

The SBA loan specialist stated that the bank expected the loan to be made current in July or August 1975, based on the successful completion of contracts at that time.

Example 2 - SBA approved a $35,000 guaranteed loan on July 27, 1972. The SBA guarantee on this loan was 56 percent. Loan proceeds were to be used as follows: $19,100 to refund an unsecured bank loan to the participating bank, $8,500 for purchase of machinery and equipment, and $7,400 for working capital.

The bank's exposure was reduced by $3,700, as follows:

Bank's exposure before loan	$19,100
Bank's exposure after loan (44 percent of $35,000)	15,400
Reduction in exposure	$ 3,700

We classified the $3,700 reduction in exposure as a bailout. The loan became delinquent on September 18, 1973.

The loan specialist acknowledged the reduction in the exposure in his report, and the supervisory loan specialist considered it insignificant. SBA officials stated that the participating bank had indicated its faith in the loan by assuming a 44-percent exposure. The loan specialist also stated that, although there were obvious weaknesses in the credit line, SBA should make the loan if only to bring the bank back into SBA's guarantee participation program. As of October 23, 1974, the loan had been delinquent 12 months.

CREDITOR BAILOUTS: EXAMPLES

Example 1 - SBA approved a $40,000 guaranteed loan on April 21, 1971. The loan was made with a 90-percent SBA guarantee. The borrower was in the business of rehabilitating rundown houses. Loan proceeds were to be used as follows: $14,000 to refund bank loans to the participating bank, $6,000 to pay off accounts payable, and $20,000 for working capital. Collateral for the loan consisted of accounts receivable which were valued by the bank at $4,500.

The bank loans refunded were used to pay off (1) a $10,000 unsecured loan (which was used to pay off accounts payable), (2) a $2,000 unsecured short-term bank note, and (3) an unidentified $2,000 payment to the bank. We classified the $6,000 used for trade accounts payable and the $10,000 unsecured loan as a bailout of creditors.

SBA officials told us that the loan was processed under the Operation Business Mainstream and that credit requirements were relaxed because it was a minority loan. SBA also stated that paying outside creditors seemed consistent with the philosophy of aiding minorities and that repayment ability was deemed reasonable. Although collateral was not considered adequate by either SBA or the bank, it was not considered primary to loan approval.

The borrower became delinquent on the loan in June 1972. The loan was placed in liquidation in September and was charged off in November 1972.

Example 2 - SBA approved a $50,000 loan on July 14, 1971. The loan was made with SBA assuming a 70-percent guarantee. The loan proceeds were to be used as follows: $15,000 to refund a participating bank loan (no reduction in exposure), $25,000 to pay off trade accounts, and $10,000 for working capital.

We believe the $25,000 used to pay off trade accounts was a creditor bailout because the creditors were in a position to sustain a loss. Our position is based on the unsecured nature of the debt and the insolvent financial position of the borrower at the time of loan approval.

Payments on the loan were deferred from May 1972 to April 1973. The loan was delinquent from May 1973 until April 1974 when it was refinanced with another SBA-guaranteed loan. The refinanced loan was current as of October 1974.

REFINANCED SBA LOANS: EXAMPLES

Example 1 - In August 1970 a loan of $50,000 was approved for a manufacturer whose immediate 6-month sales were only $6,500. An initial SBA loan of $150,000, approved in October 1969, had failed to assist the business to begin producing profitably. The injection of the additional $50,000 from the second SBA loan also failed to assist the business in establishing a profitable production line. Both loans were immediate participation loans with SBA's share being $100,000 and $37,500, respectively. Within 6 months of disbursement of the second loan, the manufacturer was insolvent and closed.

SBA sold the business to another company for $190,500 in August 1972, and financed the new company with a $250,000, 90-percent-guaranteed loan. Sale proceeds were used to pay in full the first SBA loan of $150,000, back taxes, accumulated interest, and a portion of the second loan. SBA was forced to charge off $42,798 of the second loan.

The loan specialist, who approved the loan to the new company along with the loan servicing officer, commented that, by not approving the follow-on loan, SBA would realize a large loss--about $125,000 to $140,000.

During its first 2 years of operation, the new company failed to make any principal payments, although intermittent interest payments were made. In addition, the borrower received a $75,000 SBA disaster loan in 1973. SBA assumed servicing of the guaranteed loan in August 1974, as interest payments were missed. As of February 1975, the outstanding debt to SBA amounted to about $353,000 including interest. The company was attempting to sell out but had been unable to locate a buyer. Thus, as noted above, SBA realized a loss of $42,798 while still having about $353,000 invested in a business of unappraised value. No financial statements had ever been submitted. We later learned that financial statements were received on March 20, 1975.

Example 2 - On May 5, 1971, a borrower received a 90-percent SBA-guaranteed loan for $65,000. Of this amount, $52,200 was used to repay an SBA loan approved in September 1970. At the time the second SBA loan was approved, the first loan was delinquent. The loan specialist reported that the borrower was in a deficit financial condition and that loan payments were about 5 months in arrears. However, he stated that a business upturn was evident and repayment ability was indicated.

By August 1971, the second loan was also delinquent. The loan was subsequently placed in liquidation and in November 1973 approximately $62,000 was charged off.

MISUSE OF LOAN PROCEEDS: EXAMPLES

Example 1 - Settlement sheets submitted by a bank participating in a guaranteed loan approved in October 1970 for a small manufacturer had not accounted for about $19,000 in loan proceeds. At our request, the district counsel and the PM division at the district office followed up with the bank. This followup disclosed that a reporting error was responsible for the $19,000 understatement in the disbursement of proceeds. During the course of the followup, however, it was disclosed that the bank may have disbursed $22,000 authorized for working capital to pay debts the borrower owed to another bank. SBA is performing additional followup on this loan. We discussed these factors with bank officials, but they could not substantiate or deny the facts as presented because there were no individuals still employed by the bank who had originally been involved with this loan.

Example 2 - A borrower was granted an SBA guarantee on a $30,000 loan to be used as follows:

--$17,000 for machinery and equipment.

--$11,000 for working capital.

--$2,000 for plant repair.

The loan was disbursed on May 21, 1971. The participating bank did not submit a settlement sheet to SBA, but 7 months later, on December 15, 1971, the bank notified SBA that the loan proceeds were not used as originally agreed. According to the bank:

--$6,100 was used for machinery.

--$5,000 for plant repair.

--$2,900 for operating expenses.

--$16,000 to pay a debt to the borrower's landlord.

SBA had not made an initial field visit to the borrower's place of business to verify that proceeds were used properly.

On January 14, 1972, the bank requested that SBA purchase the loan, certifying that the loan had been disbursed and serviced in compliance with the guaranty agreement. On March 8, 1972, SBA purchased the loan from the participating bank.

The SBA loan specialist who approved the purchase stated that failure of a bank to supervise the use of loan proceeds was not a serious enough violation to warrant denying SBA's liability to purchase the loan. He felt that the misuse of proceeds left SBA with less collateral than if the machinery was purchased; nevertheless, this was not enough to deny liability.

SBA charged off the loan in November 1973. The borrower could not be reached for comment.

Example 3 - The loan proceeds of an $80,000 SBA-guaranteed loan approved on September 19, 1973, were to be used as follows:

--$34,600 to repay a note owed to a nonparticipating bank.

--$25,000 to purchase machinery and equipment.

--$12,400 for working capital.

--$8,000 to repay a note owed to the bank participating in this loan.

The loan was disbursed on April 16, 1974. The bank settlement sheet showed that approximately $6,000 of the loan proceeds were used to retire a debt owed to the participating bank by an affiliate of the borrower. (This was in addition to the loan proceeds authorized for repayment of the borrower's debt.) This loan had been outstanding since October 1971. The loan was not revealed to SBA prior to loan disbursement by either the borrower or the participating bank.

After reviewing the loan settlement sheet, it was the district office counsel's opinion that the "borrower was shortchanged." The district office took no followup action.

The assistant director for finance and investment stated that this was an oversight. Payments on the loan are presently current.

The president of the company told us he was required to pay off the prior debt owed by him or affiliated companies to the participating bank. Only by so doing would the bank have made the loan. He stated that, given his own choice, he would have preferred not to retire the debt but to use the loan proceeds for inventory purchases.

An attorney for the participating bank and a member of its board attempted to justify the bank's action by telling us that SBA had given implicit if not explicit approval for the loan closing and that SBA raised no objections to the retirement of the debt when the loan settlement sheet was submitted. According to the attorney, the bank believes that loan authorizations are instructions which require only substantial compliance.

Example 4 - In November 1971, SBA approved a $10,000 guaranteed loan. Loan proceeds of $5,200 were to be used for equipment and inventory. The participating bank did not submit a settlement sheet which described how loan proceeds were used, and SBA did not visit the borrower's place of business until May 30, 1973, one week after the borrower declared bankruptcy. During bankruptcy proceedings, the borrower admitted that he had not purchased equipment as required by the loan authorization but had, instead, used a portion of the loan proceeds to live on.

LATE NOTIFICATION OF BORROWER

DELINQUENCY BY BANKS: EXAMPLES

Example 1 - A $15,000 loan to a laundromat business became delinquent January 12, 1973. The bank did not advise SBA of this until November 1, 1973--293 days later. The loan specialist servicing the loan had previously informed the banker that it was absolutely necessary that SBA be advised of any adverse conditions in the loan. The banker explained that they had been trying to plan a solution with the borrower. The loan was charged off in October 1974 with $7,475 outstanding.

Example 2 - After making two payments on a $50,000 guaranteed loan approved in August 1970, the borrower requested a 3-month deferment which was approved by the bank and SBA. Following the deferment, only one full payment and two partial payments were made by the borrower and yet the bank did not notify SBA of the delinquency until about 11 months after the last full payment. The bank notified SBA of delinquency in January 1972, and demanded that SBA purchase the guaranteed portion of the loan in June 1972. On July 17, 1972, SBA honored the guaranty and paid the bank $47,868, including accrued interest through June 2, 1972.

LACK OF FOLLOWUP ON DELINQUENT LOANS: EXAMPLES

Example 1 - A 90-percent-guaranteed loan of $17,500 was approved on February 15, 1973. The loan had been declined a month earlier because (1) reasonable assurance of the borrower's ability to repay the loan from earnings was lacking, (2) applicant's equity was modest in relation to the amount requested, and (3) projected income did not seem reasonable.

The loan specialist recommending approval of the loan did not comment on the earlier decline, and there was no evidence of any new information being submitted. The chief of the financing division gave his final approval to the loan request with the comment "marginal request resolved in favor of applicant."

An initial field visit was made to the borrower's business on May 1, 1973. The loan specialist's only comments on his field visit were: "The store is neat, orderly, and well-arranged. Problem is too much spent on advertising." The extent to which the advertising problem was discussed with the borrower or whether management assistance was offered is not known.

In July 1974 SBA approved the borrower's request for a 4-month deferment of principal payments. No information updating the financial condition of the business was obtained. The first two payments following the deferment were 10 to 15 days late. It was apparent by the deferments and late payments that the business was in some financial strain. In view of these circumstances and the fact that the loan was classified "marginal" at the outset, another field visit would have seemed warranted, but one had not been made, and the SBA loan specialist servicing the loan said none would be made until the loan became 30 to 60 days delinquent.

Example 2 - A loan of $148,900, 90-percent guaranteed by SBA, was disbursed by the participating bank on April 5, 1972. Loan repayment was to commence on May 5, 1972; however, the bank notified SBA on May 25, 1972, that the loan was in default. SBA agreed to defer the first four payments from May through August 1972 because the borrower was not ready to begin operations.

In January 1973, 9 months after disbursement, an SBA loan specialist visited the participating bank and while there called the borrower who had moved his business to another State. The contact resulted in a promise by the borrower to bring his account up to date.

We reviewed the field visit report and noted that the loan specialist stated that the loan was poorly handled by the bank. Although an early indication of a problem was apparent (default in loan payment and poor servicing by bank), no field visit was made.

In May 1973, the bank requested SBA's permission to sell some equipment and apply the proceeds to the loan. At this point, the borrower was again delinquent on two payments.

Between May 1973 and January 1974, the bank informed SBA on numerous occasions of late or delinquent payments. On January 16, 1974, the loan specialist met with the borrower and bank officials. The bank requested that SBA purchase its guaranty. In February 1974, SBA purchased its share of the loan for $112,200.

Upon purchase, SBA assumed servicing of the loan. The borrower requested that he be allowed to remain in business and promised to remit more than the original monthly installment of $3,678. However, after remitting eight weekly checks for $1,000 each, the borrower requested that payments be reduced to $3,200 per month.

On April 25, 1974, the borrower was nine payments, or $33,102, in arrears. SBA approved a deferment of the principal due from August 1973 through April 1974, to note maturity. At this time, 2 years after loan disbursement, management assistance was requested to assist the borrower in accounting and bookkeeping.

In May 1974, all eight $1,000 checks were returned by the bank to SBA. The bank noted on the checks that the borrower's account was closed.

The loan specialist responsible for servicing the loan indicated that on May 28, 1974, a field visit to the borrower was made. At this time the borrower stated that he would be filing bankruptcy in the near future. As a result, SBA accelerated the note and classified the loan in liquidation effective June 14, 1974.

Example 3 - In July 1971, SBA approved a $7,000 guaranteed loan to a borrower who already had a guaranteed loan with a balance of $33,229. An initial field visit was made to the borrower in September 1971. In February 1972, SBA approved a deferment of payments on both loans from December 1971 through February 1972, after being informed by the participating bank that the borrower had been delinquent for that period. The borrower again became delinquent in June 1972, although SBA was not informed of this until August 1972. The loan was placed in liquidation in September 1972 when the balances of the first and second loans were $31,946 and $6,807, respectively. SBA did not make a second visit to the borrower until November 1972, 2 months after his loan was placed in liquidation.

INITIAL FIELD VISITS MADE
MORE THAN 1 YEAR
AFTER LOAN DISBURSEMENT

Months after disbursement	Number of loans
13 to 15	29
16 to 18	23
19 to 21	11
22 to 24	10
25 and over	14
Total	87

NEED TO OBTAIN AND ANALYZE

FINANCIAL STATEMENTS: EXAMPLES

Example 1 - The loan conditions for a $300,000, 75-percent-guaranteed loan approved on June 28, 1971, required audited yearend financial statements and unaudited quarterly statements.

On May 11, 1972, the owner of the business died. The bank received $73,454 of insurance proceeds, but rather than applying the funds to the SBA loan, the bank requested that the funds be released for working capital since the business was to continue. SBA agreed to the bank's request on July 18, 1972, without requiring updated financial statements which were then due for the period ending June 30, 1972. When financial statements were received, they showed an operating loss of $417,320 and a deficit net worth of $262,239. The loan was placed in liquidation and SBA's loss, including the insurance proceeds of $73,454, amounted to $102,115.

Example 2 - In March 1971, SBA approved a $77,750 guaranteed loan. In October 1973, the participating bank notified SBA that the borrower was over a year delinquent in his payments. SBA purchased the loan in December 1973 and in May 1974 placed it in liquidation. The loan authorization required the borrower to submit quarterly financial statements to the bank but not to SBA. Further, there were no financial statements in the SBA loan file. If SBA had received and reviewed the borrower's statements as required, we believe evidence of financial problems might have been identified from adverse trends despite the untimely notice from the bank.

PRINCIPAL SBA OFFICIALS RESPONSIBLE FOR THE ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
ADMINISTRATOR:		
Louis F. Laun (acting)	Oct. 1975	Present
Thomas S. Kleppe	Jan. 1971	Oct. 1975
Hilary Sandoval, Jr.	Mar. 1969	Jan. 1971
DEPUTY ADMINISTRATOR:		
Louis F. Laun	Sept. 1973	Present
Anthony Chase	Feb. 1971	Sept. 1973
Einar Johnson	June 1970	Feb. 1971
ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT (note a):		
John T. Wettach	Sept. 1975	Present
Ronald G. Colemen (acting)	Feb. 1975	Sept. 1975
Einar Johnson (acting)	Jan. 1975	Feb. 1975
David A. Wollard	Feb. 1973	Jan. 1975
Anthony S. Stasio (acting)	Jan. 1973	Feb. 1973
Jack Eachon, Jr.	Dec. 1969	Jan. 1973
DEPUTY ASSOCIATE ADMINISTRATOR FOR FINANCE (note b):		
Anthony S. Stasio	July 1970	Oct. 1974
ASSOCIATE ADMINISTRATOR FOR OPERATIONS (note c):		
Daniel T. Kingsley	Mar. 1975	Present
William M. Lendman	Oct. 1973	Mar. 1975
Louis F. Laun	Feb. 1973	Sept. 1973
Stephen H. Bedwell, Jr. (acting)	Oct. 1972	Feb. 1973
Claude L. Alexander	Feb. 1972	Oct. 1972
Arthur Singer	June 1971	Feb. 1972

a/Before February 1973 this position was Associate Administrator for Financial Assistance.

b/This position was abolished in October 1974.

c/From June 1971 through February 1972, this position was the Associate Administrator for Operations and Investments. From February 1972 through April 1972, it was the Assistant Administrator for Administration and Operations. It reverted to Associate Administrator for Operations and Investments in April 1972 and became the Associate Administrator for Operations in February 1973.

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