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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT DIVISION

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MAY 10 1976

Mr. Louis F. Laun
Deputy Administrator
Small Business Administration

Dear Mr. Laun:

We have completed a survey of the Small Business Administration's (SBA) Consumer Protection Loan program--a regulatory disaster loan program. The survey objectives were to (1) evaluate the adequacy of SBA's policies and procedures for processing and approving consumer protection loan applications, and (2) test adherence by SBA district offices to prescribed policies and procedures for processing and approving loan applications. Subsequently, we expanded the survey to include policies and procedures for determining applicants' financial eligibility under the other SBA regulatory disaster loan programs--Air and Water Pollution Control, Occupational Safety and Health, and Coal Mine Health and Safety loans.

The survey primarily covered activities in SBA's Seattle Region. We interviewed (1) SBA officials at the Washington headquarters, the Seattle regional office, and at the Seattle, Portland, Spokane, and Boise district offices; (2) U.S. Department of Agriculture (USDA) officials of the Western Regional Office in San Francisco, California, and area offices in Salem, Oregon, and Olympia, Washington; and (3) officials at the Idaho State Department of Agriculture at Boise, Idaho. We also examined loan files and other documentation at these locations.

The Consumer Protection Loan Program and other regulatory disaster loan programs have not been administered to ensure that loan funds were used for purposes intended by legislation. Specifically,

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--although by statute, only small businesses which would suffer "substantial economic injury" without a regulatory disaster loan are eligible for assistance, SBA had not defined this term and consumer protection loan applicants had not submitted information on their injuries as required by SBA regulations;

--consumer protection loans were approved to finance expansion of buildings and land beyond the limits set in SBA procedures; and

--prescribed loan processing procedures were not always followed.

To correct these deficiencies we recommend that SBA,

--define "substantial economic injury" in terms helpful to loan specialists responsible for determining eligibility for regulatory disaster loans,

--require that consumer protection loan applicants submit evidence of economic injury as required by SBA regulations,

--insure that consumer protection loans are made to finance only such expansion of buildings and land as is allowed by SBA policy, and

--check the compliance of district offices not included in our review with consumer protection loan processing procedures and take appropriate corrective action.

Our findings and recommendations are discussed in more detail in the enclosure to this letter.

We were assured by officials in your Seattle Region that our findings and suggestions would be used to improve program administration at both the regional and district levels. In a January 20, 1976, directive to all district offices under its jurisdiction, the Seattle regional office discussed each GAO finding on district office operations and requested the districts to correct or strengthen loan processing practices not only for the consumer protection loan program, but also, where applicable, for the Air and Water Pollution Control, Occupational Safety and Health, and Coal Mine Health and Safety loan programs.

Thank you for the cooperation given our representatives. We hope that our survey results will be useful to you in strengthening the overall administration of the consumer protection loan program and other regulatory disaster loan programs. We would appreciate your comments on our findings and recommendations, including any actions you take or plan to take.

Sincerely yours,

John Landicho
Associate Director

Enclosure

SUMMARY--SURVEY OF SBA'S ADMINISTRATION OF CONSUMER PROTECTION AND OTHER REGULATORY DISASTER LOAN PROGRAMS

Most of our work during this survey covered the Consumer Protection Loan Program. We expanded our work to include certain aspects of other SBA regulatory loan programs--Air and Water Pollution Control, Occupational Safety and Health, and Coal Mine Health and Safety loans.

Our work generally disclosed that SBA had not established adequate guidelines for SBA district office personnel to follow in reviewing and approving loans and that guidelines which had been established were not always followed. Specifically:

--SBA had not defined "substantial economic injury" which the law requires for eligibility, and had not obtained from loan applicants information on the extent of their injuries as required by regulation;

--loans were used for buildings and land which were not within SBA's criteria; and

--district office personnel did not always follow prescribed internal operating policies and procedures for processing and approving consumer protection loan applications. Accordingly, there was inadequate assurance that loan funds were used for purposes approved by the legislation.

BACKGROUND

Section 25 of the Egg Products Inspection Act, approved December 29, 1970, amended the Small Business Act to authorize SBA to make loans to any small business that must make changes in its equipment, facilities, or operation to meet the requirements of the Wholesome Meat Act of 1967, Wholesome Poultry Products Act, and the Egg Products Inspection Act, if SBA determines that such a business is likely to suffer substantial economic injury without the loan. SBA refers to these loans to meat, poultry, and egg processors as "Consumer Protection Loans."

Public Law 93-237, approved January 2, 1974, consolidated the consumer protection loan program together with SBA's other regulatory disaster loan programs under section

7(b)(5) of the Small Business Act. Public Law 93-237 also expanded SBA's loan authority to authorize small business loans to finance compliance with any Federal or conforming State regulatory standards (e.g., environmental, consumer, pollution, or safety standards) if SBA determines the firm would suffer "substantial economic injury" without the loan.

Consumer protection loan program administration

The consumer protection loan program was implemented by SBA in May 1971. SBA's Office of Financing in the central office is responsible for program administration. The district offices process and approve loan applications.

SBA directives contain the detailed policies, procedures, and requirements to be followed by SBA district office personnel who interview and counsel prospective applicants; determine the applicants' eligibility; and screen, accept, and process applications from eligible small businesses.

SBA policy limits the use of consumer protection loan proceeds to those additions to or alterations in equipment, facilities, and methods of operation which USDA or a state regulatory authority specifically considers necessary to meet the requirements of the egg, meat, and poultry acts.

As of October 9, 1975, SBA had made 296 consumer protection loans with a dollar value of $48.7 million. Of this total, SBA's Seattle Region, in which our survey was made, accounted for 35 loans with a total dollar value of $4.9 million.

GUIDELINES NEEDED FOR DETERMINING "SUBSTANTIAL ECONOMIC INJURY"

Consumer protection loan program

Before approving a consumer protection loan, SBA is required to determine that without SBA assistance, the applicant will suffer "substantial economic injury" because of regulatory requirements. Our survey disclosed that SBA had not provided its district offices with an operational definition of what constitutes substantial economic injury. Furthermore, SBA operating procedures did not require loan applicants to submit information on

the extent of their economic injury in the detail specified in SBA regulations.

The Egg Products Inspection Act authorized SBA to make consumer protection loans to small businesses if SBA determines that the applicant is likely to suffer substantial economic injury without such assistance. However, neither the act nor its legislative history defined the phrase "substantial economic injury." SBA directives similarly fail to define what constitutes substantial economic injury. SBA regulations (13 CFR 123) require that an applicant for a consumer protection loan submit certain information to establish substantial economic injury. But this requirement has not been included in SBA internal directives and the information is not being requested by SBA district office personnel.

Two directives guide SBA district offices in their administration of consumer protection loans--the National Policy directive for the consumer protection loan program issued on October 12, 1971, and the Standard Operating Procedures for Regulatory Disaster Loans issued on December 9, 1971. Neither directive defines what would constitute substantial economic injury a small business might suffer without the loan.

SBA regulations list the information applicants must submit to establish substantial economic injury when applying for a consumer protection loan. The regulations state that an applicant shall (1) furnish a statement of the extent to which the business has been injured by the need to correct the deficient conditions, (2) for purposes of comparison, furnish financial and operating conditions covering the current period and a 12-month period of normal operations before the application, (3) list any accounts and notes receivable which are delinquent due to the deficient conditions, (4) explain fully the reasons for an abnormally large and burdensome inventory, (5) list all payables which are delinquent due to the deficient conditions as well as current accounts payables, and (6) describe any adopted or planned economies designed to reduce costs of doing a smaller volume of business.

The SBA National Policy directive and Standard Operating Procedure for the program do not require loan officers to obtain and review the information specified in the SBA regulations. We found that loan officers were determining substantial economic injury on the basis of

limited financial data submitted by loan applicants rather than on the more comprehensive and detailed information specified in the regulations. As a result, consumer protection loans were made without adequate assurance that the applicants were eligible.

In 22 of the 26 consumer protection loans reviewed in the Seattle Region, we were unable to find evidence in the file showing how the SBA loan officers determined that the applicants would likely suffer substantial economic injury without the loans. We interviewed loan officers responsible for approving 14 of the 22 loans to learn how they determined the applicants would suffer substantial economic injury. In general, the loan officers stated that they assumed the applicants would have to close their businesses unless SBA made the loans. According to the loan officers, these judgments were based on the applicants' financial statements and letters from private financial institutions denying the applicants credit, both of which are required to be submitted with loan applications. In some cases, a letter denying credit was not in the loan file.

The financial statements and credit rejection letter do provide some information to the loan officer. However, the information specified in the regulations would provide a much more detailed and precise view of just how the requirements of the regulatory agency would adversely affect the applicant's financial position. This information would provide the loan officer with a clearer and more comprehensive understanding of how the business will be impacted by the changes required for compliance.

Recommendation to the Deputy Administrator

We recommend that SBA define "substantial economic injury" in operational terms and establish operating procedures and criteria for its loan officers to use in determining whether an applicant will suffer substantial economic injury without the loan. The policies and procedures should also require that the loan officer adequately document and include in the loan file the evidence supporting his determination. Such a determination is needed for proper administration of the consumer protection loan program in accordance with the act's requirements.

Other regulatory
disaster loan programs

SBA guidelines for determining substantial economic injury are also needed for the other regulatory disaster loan programs. Public Law 93-237, approved January 2, 1974, authorized SBA to make loans to small businesses to finance compliance with any Federal (or conforming State) regulatory standards provided that SBA determines that the applicant will suffer substantial economic injury without the assistance. SBA had not yet established policies and procedures for determining substantial economic injury for these loan programs (i.e., Coal Mine Health and Safety, Water and Air Pollution, and Occupational Safety and Health). Our report to the Senate Committee on Labor and Public Welfare entitled, "Administration of Small Business Loan Program Under the Occupational Safety and Health Act," issued April 4, 1974, recommended that policies and procedures be established for determining substantial economic injury for these loans.

Status of SBA efforts

SBA has attempted to draft a definition of substantial economic injury for all the regulatory disaster loan programs, but according to an official responsible for managing the programs, agreement has not been reached within the agency on the terms of the definition. This official could not estimate when the definition would be issued to field personnel. Clear, workable criteria could greatly assist SBA district offices in dealing with questions of substantial economic injury for regulatory disaster loans.

PROCEDURES NEEDED TO INSURE
THAT UPGRADING IS NOT EXCESSIVE

SBA district offices made consumer protection loans for upgrading (increasing in size) buildings and/or land in excess of its criteria. Established procedures did not insure that loan officers would obtain information enabling them to identify the degree of upgrading and determine whether the upgrading was required for compliance.

Under SBA policy, construction funds may be loaned under the consumer protection loan program to construct a new building, to replace an old building where remodeling is not feasible, or to replace rented quarters

when needed rental arrangements cannot be arranged. The Egg Products Inspection Act does not specifically limit the amount of upgrading. But, SBA policy provides that except where required for compliance, new building space cannot be more than 33-1/3 percent larger than the applicant's present building space and that the amount of land cannot be more than 50 percent larger than the existing land area.

SBA's procedures require that applicants for consumer protection loans provide evidence of inspection from the appropriate inspection authority containing a list of requirements for compliance, and evidence that, upon satisfactory completion of the additions or alterations, the applicant should be in compliance with the provisions of the appropriate acts. But the applicant is not required to submit information which would enable SBA to determine whether the work proposed by the applicant involves upgrading of buildings and/or land or whether any upgrading is specifically required in order to meet the requirements of the inspection authority. Further, SBA's procedures do not require loan officers to document any comparison of the old and new facilities and land and, in cases of upgrading above SBA criteria, to resolve the difference with the appropriate inspection authority and document the results in the loan file.

Twenty-three of the 26 consumer protection loans we reviewed involved the use of loan proceeds for construction or remodeling of facilities and/or land acquisition. Seven of the 23 loans were authorized for upgrading of land and/or buildings in excess of SBA's criteria. The increase in building sizes in the seven cases ranged from 38 to 180 percent. In two of the cases, land increases were 67 and 218 percent.

In five of the seven cases, there was no evidence that the loan officer had compared the old and new facilities to determine if SBA's upgrading criteria would be exceeded. In three instances, information stating the square footage of the proposed new facility and the square footage of the old facility was submitted with the application and was available for comparison, but the comparison was evidently not made. In the other two cases, information on the size of the existing and proposed facilities was not secured by SBA.

In the remaining two cases, existing and proposed facilities were compared by SBA. In one case, there was no evidence that the loan officer recognized that the upgrading would exceed SBA's criteria. In the other, the loan officer recognized the excessive upgrading but concluded that it was not significant.

Recommendation to the Deputy Administrator

To prevent excessive upgrading, we recommend that SBA strengthen its review procedures. Specifically, applicants should be required to submit evidence on the size of existing and proposed facilities and land. Further, SBA should require loan officers to (1) document their comparison of the old and new facilities and land; (2) resolve, with the appropriate inspection authority, the need to exceed SBA upgrading criteria; and (3) where appropriate, document the need for the upgrading above SBA criteria in the loan file.

PRESCRIBED INTERNAL POLICIES AND PROCEDURES NOT ALWAYS FOLLOWED

SBA district offices included in our review did not always follow prescribed internal operating policies and procedures for processing and approving consumer protection loan applications. For example, SBA authorized loans without:

--obtaining inspection authorities' listings of improvements necessary for compliance;

--obtaining the required assurances, such as blueprint approvals, that after completion of planned work applicants would be in compliance; and

--obtaining evidence that private funding was not available.

We also found that SBA had authorized applicants to use loan proceeds for working capital purposes in violation of SBA policy.

These findings are discussed in the following sections.

No evidence of inspection and compliance requirements

SBA procedures require that, to establish their eligibility, small poultry, meat, or egg processors applying for consumer protection loans must supply evidence of inspection by the appropriate inspection authority containing a list of requirements for compliance. This list of required changes and additions (known as a letter of survey) is the basis upon which the SBA determines the loan amount needed by the applicant and the purposes to which use of loan funds will be limited.

Of the 26 loans we reviewed, 4 loans were authorized without the required letter of survey. There was no evidence in these four cases that SBA had asked for the letter of survey from the inspection authority. Loan officers who approved these loans were unable to explain the basis used for establishing the applicants' eligibility. In these cases, SBA had no assurance that the applicants were eligible.

No blueprint approval

SBA standard operating procedures also require that before an application for a loan can be approved, SBA must have a copy of an acceptable form (ordinarily a blueprint approval letter) from the appropriate inspection authority indicating that the applicant should be in compliance with the provisions of the appropriate act upon satisfactory completion of additions to or alterations in plant, facilities, or methods of operation.

We found that SBA authorized 13 of 26 loans without the required blueprint approval or its equivalent. In four of the cases, no blueprint approval letter was ever received and SBA could give no reason for not obtaining the required letter. For three loans, SBA received a copy of the blueprint approval letter after the loan was authorized. In the remaining six cases, SBA officials stated that a blueprint approval letter was not required because either construction had been substantially completed by the time the loan was authorized or no construction was to be done.

SBA loan officers stated that their practice of authorizing loans without blueprint approval was permitted by SBA if the loan authorization included the condition that

a copy of such approval must be received by SBA before any disbursements on the loan were made. We found, however, that this practice has provided SBA with little control over loan disbursements. Six loans contained clauses making blueprint approval prerequisite to disbursements, but disbursements were made on four of the loans before receipt of the blueprint approvals. In three of these instances, SBA never obtained the blueprint approval. For only two of the six loans did SBA receive the blueprint approval letter before loan funds were disbursed.

In the absence of blueprint approval letters, SBA had inadequate assurance that the applicants would be in compliance with the requirements of the appropriate act when the loan proceeds were disbursed.

No letter denying credit

SBA loan policy states that SBA financial assistance should not be provided to applicants if funds are available at reasonable rates and terms from private credit sources. SBA's "Application for Loan," SBA Form 4, requires the applicant to submit evidence that efforts have been made to obtain financial assistance from private financial institutions within 60 days of the application to SBA, and that letters declining to extend credit as well as declining to participate with SBA must be obtained from the financial institution.

Of the 26 loans reviewed, we found that SBA authorized six loans without the required letters denying credit. In three of the cases, the responsible loan officers stated the applicants' banks were contacted by telephone. For one of these, there was a memorandum of the telephone conversation but, for the other two cases, there was no record of the calls. In the other three cases, SBA did not have any evidence that financing was unavailable to the applicant from private credit sources. Consequently, there was no assurance that SBA's financial assistance was necessary.

Funds improperly authorized for working capital

SBA policy restricts the use of consumer protection loan funds for working capital to (1) replace working capital used for compliance, (2) meet fixed costs when

operations are curtailed, (3) help finance startup costs, and (4) finance changes in methods of operation required by inspection authorities.

In 11 of the 26 loans reviewed, SBA authorized the use of loan proceeds for working capital purposes other than those approved by policy. In 5 of the 11 cases, working capital funds were actually disbursed. In one case, working capital funds totaling $17,410.75 were authorized for new furniture and a new product line, neither of which were required by the examining authorities. In the four other cases, funds totaling $15,544.16 were disbursed as a matter of convenience to SBA in order to bring the loan amounts disbursed up to the loan amounts authorized. SBA had no assurances in these cases that the loan funds disbursed were used for the purpose of coming into compliance with the requirements of the appropriate inspection authority.

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As discussed above, at district offices we visited prescribed policies and procedures were not always followed in processing and approving consumer protection loan applications. These policies and procedures are for the purpose of insuring that financial assistance is limited to eligible applicants and that the loan funds are used only for purposes approved by the act.

As a result of our review, officials of the SBA Seattle Regional Office have directed district offices within the region to strengthen their loan processing practices.

Recommendation to the Deputy Administrator

To assure the proper use of consumer protection loan funds, we recommend that SBA assess the compliance of other district offices with prescribed policies and procedures and take corrective action if necessary.