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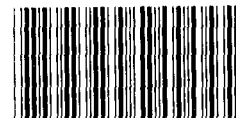
General Accounting Office

Additional Efforts Are Needed To Minimize Lease Guarantee Losses

In 1976, the Small Business Administration discontinued its program for guaranteeing rent payments on commercial and industrial space for small businesses. However, SBA remains contingently liable for outstanding guarantees and pays rent in the event of defaults on leases.

The majority of lease guarantee defaults are resolved and losses minimized through either rerentals or settlements with the lessors. However, SBA has made substantial monthly rent payments for some properties that have remained vacant or are occupied by tenants who do not pay rent. In some of these cases, SBA field offices have not reviewed lessor rerental activities and have no assurance that efforts are made to minimize SBA payments. GAO questions whether some lessors are making more than a minimum rerental effort to comply with the guarantee agreement. In two cases GAO reviewed, SBA field offices have not pursued rent collections that could offset SBA losses.

GAO makes recommendations to the Administrator, SBA, to improve the servicing of lease guarantee defaults.



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

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

B-206659

The Honorable James C. Sanders
Administrator, Small Business
Administration

Dear Mr. Sanders:

This report evaluates the Small Business Administration's (SBA's) efforts to minimize losses on lease guarantee defaults. Our report recommends actions to improve SBA's servicing of these guarantees, thereby helping to reduce costs. The review was made because of our concern with SBA's sizable contingent liability for outstanding guarantees. Our review was limited to default cases for which SBA made a guarantee payment during fiscal year 1981.

The report contains recommendations to you on page 15. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

In addition to the above committees, we are sending copies of this report to the Director, Office of Management and Budget, and the House and Senate Committees on Small Business.

Sincerely yours,

A handwritten signature in cursive script that reads "Henry Eschwege".

Henry Eschwege
Director

D I G E S T

In 1975, GAO projected substantial losses for the Small Business Administration's (SBA's) lease guarantee program; SBA subsequently decided to discontinue the program in September 1976. The program was intended to help small businesses obtain leases on commercial and industrial space, which, because of insufficient credit, they would otherwise be unable to obtain on reasonable terms. At the time it was discontinued, SBA had approved about 1,193 guarantees with a contingent liability of \$334 million.

As of September 30, 1981, the outstanding portfolio had decreased to 1,001 guarantees, representing a contingent liability of about \$165 million. Through September 30, 1981, SBA had paid about \$23.6 million in rents and settlements and expects that it will pay an additional \$17.5 million before the last guarantee matures in 1996.

GAO reviewed the 98 lease guarantee default cases SBA paid during fiscal year 1981 to determine whether SBA, lessors, and private insurers, who had participated in the program, had acted to minimize losses through rerentals and/or settlements. GAO found that in the majority of cases the defaults are resolved through either rerentals or settlements.

MORE EFFORT IS NEEDED
TO RESOLVE DIRECT LEASE
GUARANTEE DEFAULTS

GAO found that, in five cases, SBA has made monthly rent payments ranging from \$400 to \$2,200 for properties that have been vacant for over 1 year or are occupied by a tenant who does not pay rent. In these cases, SBA field offices have not complied with procedures that require a careful review of lessors' rerental efforts. The lessors provide SBA with little, if any, specific information on rerental efforts. Although the properties were usually difficult to rerent because they were single-purpose facilities or had a poor business location, SBA field offices have not assured that losses are minimized by following up on lessors' or

their agents' rereental activities. In some cases, it is questionable whether the lessors are making more than a minimum effort to comply with the lease guarantee agreement which requires that they make a diligent rereental effort.

SBA field offices in two cases have not pursued rent collections that could offset SBA losses. In one case, GAO estimates that SBA did not collect about \$74,000 in rent payments due the agency. After GAO pointed out this case to SBA officials, they collected \$11,000 and made arrangements with the tenant to collect the balance. In the other case, SBA paid \$75,000 on a property that was subsequently rereented for \$2,800 a month more than the guaranteed rent. Guarantee agreements usually entitle SBA to recover rents in excess of the guarantee to offset prior payments. In this case, SBA officials failed to follow up on whether SBA was entitled to the \$2,800 of excess monthly rent after the lessor questioned SBA's authority to collect the payments. An SBA district office attorney agreed to review the case to determine whether SBA could collect the rent. As of February 1982, GAO was unable to determine the disposition of this case.

SBA field office officials attribute their inattention to lease guarantee defaults to a lack of staff and higher priority work. GAO believes, however, that more attention to default cases could help to reduce losses and would only require a limited effort.

RECOMMENDATIONS

The Administrator, SBA, should require field offices to give more attention to servicing lease guarantee defaults and direct them to

- require lessors to submit specific information each month on their rereental efforts, such as the names of realtors and prospective tenants, the lease terms offered by the lessors, and documentation of advertisements;
- follow up on lessor rereental activities to determine whether additional efforts are needed; and
- collect all rents due SBA.

GAO discussed the report with the Director, Office of Portfolio Management, who is responsible for managing SBA's direct lease guarantees. The Director agreed to take action on the above recommendations and to follow up on the cases discussed in this report to assure that efforts are made to minimize SBA losses.



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ABBREVIATIONS

GAO	General Accounting Office
SBA	Small Business Administration

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CHAPTER 1

INTRODUCTION

The lease guarantee program was intended to help small businesses obtain leases on commercial and industrial space, which, because of insufficient credit, they would otherwise be unable to obtain on reasonable terms. The Small Business Administration (SBA) discontinued the program at the end of fiscal year 1976 after substantial losses were projected for the program. Although SBA remains contingently liable for outstanding lease guarantees, this liability has significantly decreased since the program was discontinued, and additional losses are projected to decline.

HISTORY OF THE LEASE GUARANTEE PROGRAM

The program was established in 1965 by Public Law 89-117 which added title IV to the Small Business Investment Act of 1958. Originally the program applied only to small businesses displaced by federally aided public projects and to those eligible for economic opportunity loans. In 1967, Public Law 90-104 amended title IV to include all small businesses.

The law required SBA to set fees (premiums) for guarantees using sound actuarial practices. SBA interpreted the law to require that the program be self-sustaining with premiums adequate to cover program defaults and administrative expenses. The portion charged to cover default payments was limited to 2.5 percent of the total rent guaranteed. According to SBA, the premium could be increased to cover administrative expenses. SBA established a premium schedule that ranged from 2.8 percent to 6.5 percent of the total rent guaranteed, depending on the number of years in the lease.

SBA was authorized to guarantee a lease directly or to participate in a guarantee with a private insurer (reinsurance). Participation agreements between SBA and private insurers usually provided that SBA would receive about 22 percent of the premium to cover its share of the risk. In the case of default, the insurer would pay the first 6 months' rent, after which it would pay 20 percent and SBA would pay the remaining 80 percent.

The conditions of the lease guarantee agreement between SBA and the lessors stated that the agreement could be canceled if the lessor approved a change in lessees without SBA approval or there was a material change in the property. The agreement also established the lessors' responsibilities to

- provide to SBA a notification of a default,
- make reasonable and diligent efforts to rerent after a default,

--obtain SBA approval of certain changes in the lease and/or lessee, and

--satisfy the terms of the lease.

The lease guarantee agreement provided SBA with certain rights, including the right to recover from the lessee amounts owed on the defaulted lease after SBA had paid a default claim. Most of these agreements also entitled SBA to recover losses when properties are rereanted after a default for amounts in excess of the guarantee.

Program discontinued

SBA discontinued the program at the end of fiscal year 1976. However, before the program was discontinued, we issued a report that projected substantial losses for the program entitled "Substantial Losses Projected for the Small Business Administration's Lease Guarantee Program" (Oct. 9, 1975, GGD-75-101). Our report noted that the program was not self-sustaining and projected significant net losses for guarantees issued through fiscal year 1974.

We noted that SBA made substantial default payments because of poor judgment in evaluating and approving applicants. Specifically, we stated that guarantees were issued even though the

--guaranteed rent was significantly higher than the fair market rent,

--applicant had no prior business-related experience,

--business location was poor,

--business had inadequate equity or working capital, and

--market for the service or product was not reasonably assured.

We also noted that SBA did not adequately consider the potential for rereanting a property after default. For example, SBA approved guarantees for many special-purpose facilities which ultimately accounted for significant losses when the original lessee went out of business because the facilities were difficult to rereant.

We recommended that SBA provide the Congress estimates of total losses, conduct new actuarial studies to determine self-sustaining premium rates, and take other actions to improve program administration. SBA generally agreed with our recommendations but stated that because of the cost and time associated with conducting new actuarial studies it wanted to discuss our recommendation with appropriate congressional committees. However, after consultation with concerned congressional committees, SBA decided not to seek additional program funding for fiscal year 1977 and has not approved additional guarantees since then.

ADMINISTRATION OF THE
LEASE GUARANTEE PORTFOLIO

Loan officers in SBA district offices responsible for administering outstanding lease guarantees primarily limit their efforts to servicing direct guarantee defaults. When notified of a default by a lessor, SBA's standard operating procedures state that the loan officer is to contact the lessee to determine why the default occurred. The procedures further state that, if necessary, the loan officer should visit the lessee to determine whether

- the lessee's default can be cured;
- a portion of the rental payment can be deferred for a period of time; or
- a settlement can be made with the lessor, relieving SBA of its obligation under the agreement.

If none of the above alternatives are viable and the lessee vacates the property, the loan officer is responsible for assuring that the lessor complies with the conditions of the lease guarantee agreement, including the lessor's responsibilities to make a diligent effort to re-rent and to maintain the property in a rentable condition.

According to SBA procedures, private insurers have the responsibility for servicing defaults on guarantees that they approved. SBA's involvement in these cases is limited primarily to reviewing claims filed by private insurers. SBA procedures do not require any servicing activity by the agency for these cases.

SBA's LIABILITY ON ITS
LEASE GUARANTEE PORTFOLIO
IS DECREASING

SBA's contingent liability for the lease guarantee portfolio has decreased by about 50 percent since the program was discontinued in 1976. The portfolio as of September 30, 1976, consisted of 1,193 outstanding guarantees, with a contingent liability of about \$334 million. By September 30, 1981, the portfolio had decreased to 1,001 guarantees, with a contingent liability of about \$165 million. The decrease resulted from the amortization over the past 5 years of a portion of each guarantee, maturities, terminations, and settlements.

The number of policies maturing each year will begin to accelerate after calendar year 1981. SBA reviewed the guarantees outstanding in August 1976 and found that, of the 1,175 lease guarantees outstanding at that time, only about 6.5 percent would mature from 1977 to 1981. However, by 1986 the percentage of matured guarantees would climb to about 38.7 percent and would increase to 86.4 percent by 1991. SBA estimated that the remaining policies (about 14 percent) would mature by 1996. (See app. I.)

The number of outstanding guarantees has actually decreased more rapidly than SBA originally anticipated because of settlements and terminations for reasons such as destruction of properties or violations of guarantee agreements. For example, while SBA estimated that 77 guarantees would mature by 1981, about 192 had actually been removed from the portfolio as of September 30, 1981.

A downward trend for lease
guarantee payments is projected

SBA has projected that its annual payments for lease guarantee defaults after fiscal year 1981 will decrease. As of September 30, 1981, SBA had paid a total of about \$23.6 million in rent payments and settlements. From fiscal year 1970 to fiscal year 1978 annual payments for lease guarantee defaults rose steadily from \$28,844 in 1970 to about \$3.46 million in 1978. (See app. II.) Since fiscal year 1979, annual payments have fluctuated.

In April 1981, SBA's Office of Planning and Budget analyzed leases that had defaulted throughout the program's history and estimated that about \$17.5 million would be needed to satisfy the agency's remaining contingent liability. The office projected that, after fiscal year 1980, payments on lease guarantee defaults would steadily decrease through the remaining term of the policies (assuming no shifts in the economy that might alter the projections in either direction). SBA rent and settlement payments, in fact, decreased from \$3.6 million in fiscal year 1980 to \$3.2 million in fiscal year 1981.

The Director, Office of Portfolio Management, attributes the decrease in lease guarantee payments to the fact that business failures were more likely in the early years of the guarantee and that the remaining guarantees cover successful businesses which are less likely to default on lease agreements.

STATUS OF THE LEASE
GUARANTEE REVOLVING FUND

The program's original authorization established a lease guarantee revolving fund from which all program expenses were paid and into which all program receipts, such as the one-time guarantee fee, were deposited. As of September 30, 1981, SBA reported that the fund had an unobligated balance of \$4,678,352. The Congress appropriated \$3 million to the fund in fiscal year 1977 and \$4 million in each subsequent fiscal year through 1981. SBA has requested \$3 million in fiscal year 1982 and an additional \$7 million in fiscal year 1983. SBA expects that these funds, together with the income from rerentals, will satisfy the program's remaining liability.

OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective in this review was to determine whether SBA is minimizing losses on lease guarantee defaults. We directed our attention primarily to determining what efforts are made by SBA to assure that lessors act to reread properties and to negotiate settlements. We did not conduct an indepth evaluation to determine the adequacy of lessor reread efforts because no criteria defining the lessors' responsibility to make a diligent reread effort are contained in the guarantee agreement. We did, however, discuss reread efforts with several lessors and their agents to determine what efforts were made and to verify information provided to SBA. The review was performed in accordance with GAO's current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

We reviewed SBA procedures to determine what servicing is required on lease guarantee defaults. We reviewed the 98 default cases on which SBA made a payment during fiscal year 1981 to determine their current status and efforts made to resolve the defaults. We discussed with SBA officials in selected district and branch offices (see app. III) their efforts to service guarantee defaults on those properties which were vacant or were reread for substantially less than the guarantee.

We also discussed with vice presidents and a claims manager from two private insurers their efforts to minimize losses on properties that were vacant or were reread for substantially less than the guarantee. These insurers accounted for over 90 percent of the reinsured default cases that SBA paid on during fiscal year 1981. We also visited the larger of these insurers and reviewed its default files to document its servicing activities.

CHAPTER 2

MORE ATTENTION TO PROBLEM CASES COULD

FURTHER MINIMIZE LEASE GUARANTEE LOSSES

After the lease guarantee program was discontinued, SBA's major responsibility in managing the portfolio was to minimize its losses on outstanding guarantees. Our review showed that, for the majority of lease guarantee defaults, losses are minimized through either rerelease of the properties or termination of the guarantee through settlements with the lessors. However, we noted instances where properties have either remained vacant for 1 or more years or were occupied by tenants who do not pay rent. Although SBA procedures require continual servicing of defaults and state that it is important for loan officers to review lessor and real estate agent activities to assure that a diligent rerelease effort is made, we found that SBA, in these cases,

- was obtaining little, if any, specific information from lessors on their actions to rerelease the properties and
- did not follow up to assure that the lessors were making the effort necessary to rerelease vacant properties or to rerelease properties occupied by nonpaying tenants.

SBA loan officers attribute their inattention to these cases to a lack of staff and higher priority work, such as servicing business loans.

We reviewed these cases and found several instances where it was questionable whether the lessors were making more than a minimum effort to rerelease properties. In other cases where SBA offices complied with procedure requirements and reviewed lessor efforts, the properties were rereleased.

SBA has also sustained losses on lease guarantee defaults because it has not always collected rents owed to it as a result of the property being rereleased. In one case, SBA did not collect about \$74,000 in rents that were due the agency.

SBA relies completely on private insurers to service reinsurance default cases. The private insurers we contacted were generally making an effort to service defaults and minimize losses.

LEASE GUARANTEE LOSSES ARE GENERALLY MINIMIZED

Generally, SBA, lessors, and private insurers are making an effort to minimize losses on lease guarantee defaults through rereleases or settlements. For example, SBA made guarantee payments on 98 default cases during fiscal year 1981. However, the majority of these properties were rereleased during part of the year or shortly thereafter.

The following table shows the status of these cases as of November 1981.

<u>Type of guarantee</u>	<u>Vacant</u>	<u>Settled, terminated, or matured</u>	<u>Rerented for an amount</u>			<u>Total rerented</u>	<u>Total</u>
			<u>Same as SBA's guarantee</u>	<u>More than SBA's guarantee</u>	<u>Less than SBA's guarantee</u>		
Direct	9	6	10	12	22	44	59
Reinsurance	<u>6</u>	<u>5</u>	<u>1</u>	<u>3</u>	<u>24</u>	<u>28</u>	<u>39</u>
Total	<u>15</u>	<u>11</u>	<u>11</u>	<u>15</u>	<u>46</u>	<u>72</u>	<u>98</u>

Our review of the default files showed that for the majority of direct cases that were rerented, the lessors advertised the property, listed it with a realtor, or had negotiated the rental directly with businesses. We also found that for some properties that are difficult to rent, the lessors had taken additional steps to minimize losses. For example, one lessor reported to SBA that he had

- distributed brochures to prospective businesses on the property's availability,
- discussed the property with the local chamber of commerce,
- listed the property with a realtor,
- worked with State officials to continue railroad service to the area which was considered important to renting the property, and
- hired a watchman for the property to minimize vandalism.

The two private insurers we contacted generally followed up on lessor rental efforts. Although the amount of effort each company expended varied on a case-by-case basis, company officials stated that active involvement by the insurer is very important to renting properties.

For example, one company required that for initial defaults, the lessor

- provide to the company an exterior picture of the property with a "for rent" sign evident,
- list the property with a commercial realtor,
- advertise the property at least weekly in a local newspaper, and

--provide the company with a monthly summary of rereental efforts.

We discussed 5 of the company's 14 SBA reinsurance cases that were in default during 1981 with a company vice president and found that generally the company had followed up on efforts made by the lessors or their agents to rereent. According to this official, one rereental resulted, in part, because a company representative called a realtor and found out that the lessor had told the realtor not to rent the property for less than the guarantee. The representative instructed the realtor that the company would accept less rent. The property was subsequently rereented for about 55 percent of the guarantee, escalating after 3 years to the guaranteed rent.

We also reviewed 11 of the 22 defaults of the second company and found that company officials had followed up on rereental efforts in most cases. In two of these cases the insurer independently hired a realtor to find a tenant. According to a company official, in one case, the realtor was successful in rereenting the property.

According to officials of each company, there is little the companies can do to force efforts from lessors needed to rereent properties because the diligent effort requirement in the guarantee agreement is not defined. Consequently, they said it is important that the insurer follow up on the lessors' rereental efforts and/or make its own efforts to rereent.

Rerentals for less than the guarantee

Rerentals are often made at amounts that are, at least initially, less than the guarantee. In such cases, SBA and/or the private insurer pays the difference between the guarantee and the rereental amount. Of the 44 direct guarantee defaults that were rereented, 22 were rereented for less than the guarantee. Of the 28 reinsurance defaults that were rereented, 24 were rereented for less.

One private insurer attributed the lower rerentals to the status of the overall economy, the aging of the property, and changes in the purpose for which the property is rented. SBA district office loan officers responsible for approving rerentals stated that rerentals at amounts less than the guarantee are often the only way to minimize losses. For example, SBA approved a 1-year rerental of a property for \$200 a month although SBA's guarantee is \$2,075 per month. The loan officer responsible for the case told us that SBA and the lessor had tried to rereent the property for over a year but were unsuccessful. The property is a restaurant that has had four different tenants who have failed because of the poor business location. The loan officer stated that SBA could not minimize its loss through a settlement because the agency and the lessor could not agree on a settlement amount.

The loan officer concluded that no business was interested in the facility and agreed with the lessor that the property be rented to a church as the only way to minimize losses.

Settlement efforts

SBA tries in most cases to settle with lessors on those defaults where it expects that a property will remain vacant for a long time. As of December 30, 1981, about 70 guarantees have been settled by SBA and private insurers. During fiscal year 1981 SBA settled 6 of the 59 direct guarantees that were in default. SBA paid \$1.7 million in these settlements and reduced its contingent liability by about \$5.1 million.

Additionally, district office officials told us that they had contacted lessors about settlements in six of the nine direct guarantee defaults that were unresolved and which remained vacant at the end of fiscal year 1981. In one of these cases, SBA is negotiating a settlement; for the remaining five, the lessors were either not interested in settlements or proposed settlements that SBA was unwilling to accept. In the three cases where SBA had not pursued a settlement, the loan officers stated that either

- the guarantee would mature soon and it would not benefit SBA to settle;
- SBA expected the facility would be rerented; or
- periodic discussions with the lessor, most recently in 1979, had shown that the lessor was not interested in a settlement.

The Director of SBA's Portfolio Management Division stated, in October 1981, that SBA has settled most of the difficult defaults that were possible to settle. He expects few future settlements because lessors have little incentive to settle those cases that are difficult to rerent at amounts approximating the guarantee.

MORE ATTENTION TO SERVICING DIRECT DEFAULT CASES IS REQUIRED

While most losses are minimized through rerentals or settlements, other defaults are not resolved and result in substantial rental payments by SBA. In five cases we reviewed, SBA field offices are making little effort to service these defaults as required by SBA's procedures.

SBA's procedures require continual servicing of lease guarantee defaults and a careful review of lessor actions to assure that a diligent effort is made to rerent. SBA requires lessors to submit, usually on a monthly basis, default status reports on what actions were taken to rerent the property. We found that little specific information was contained in these reports for

five of the nine direct default cases which remained vacant throughout fiscal year 1981. The properties in each case have been vacant for 1 or more years. SBA either did not follow up on these cases or was unsuccessful in obtaining specific information on rereental efforts from the lessor or his or her agent. Generally, loan officers we talked to, who were responsible for reviewing these cases, were unaware of what efforts the lessors were making to rereent and had taken little action to resolve the case. Although these properties were often difficult to rereent because they were single-purpose facilities and/or had a poor business location, SBA did not follow up to assure that a reasonable effort was made to rereent the property.

SBA district office loan officers stated that they had not followed up on the cases because of a lack of staff and higher priority work.

It is questionable in some cases whether the lessors make more than a minimum effort to rereent in order to comply with the diligent effort requirement contained in the agreement. While the agreement requires that the lessor make a diligent effort to rereent, some lessors direct most of their efforts to selling rather than rereenting the properties. However, a sale does not reduce SBA's expenses because the guarantee remains effective provided the lessor notifies SBA of the sale. Once SBA approves the sale, the new lessor is entitled to the guarantee payments.

The following cases demonstrate the need for SBA to service default cases in order to assure that losses are minimized through rereentals.

Case 1

SBA paid about \$174,800 in rental payments through September 30, 1981, for a restaurant that has been periodically vacant since December 1969 and unoccupied since about October 1979. The monthly guaranteed rent is \$1,400. The lessor's status reports to SBA only state that the facility is listed with a realtor for lease or sale and provide no specific information, other than the realtor's name, on what efforts are being made to minimize SBA losses. District office officials, including the Chief, Portfolio Management, and a loan servicing assistant responsible for the case stated that in October 1981 they had requested specific information from the lessor, including copies of advertisements and names of prospective tenants, but had not received the requested information. The loan servicing assistant stated that, at that time, the lessor was informed that further guarantee payments would not be processed until SBA received the requested information.

We visited the property in November 1981 and found that the building had a "for sale" sign posted which did not indicate that the property was also available for lease. We also found that the building was in need of maintenance, including the replacement of a central front window and other smaller windows. The lessor's

real estate agent told us that the lessor wants either a sale or lease with sale option for the property. SBA officials stated that they would contact the lessor to require that the property be maintained and that "for lease" signs be posted at the facility. In February 1982 the loan servicing assistant told us that she had contacted the lessor and his agent and that an SBA loan officer had visited the property. She stated that a "for lease" sign had been posted and some minimal maintenance to the property had been performed. She also said that she had obtained a list of prospective tenants from the real estate agent.

SBA's contingent liability at the end of fiscal year 1981 was about \$41,000.

Case 2

SBA had paid about \$99,000 through September 30, 1981, in rent on a reception center that has been periodically vacant since 1974 and has not had a paying tenant since about July 1978. The guaranteed monthly rent is \$1,425. The lessor reported to SBA from February 1979 to about August 1980 that a caretaker occupied the center and that the property was advertised and listed with a realtor. From August 1980 to August 1981 the lessor reported only that the caretaker was the prospective tenant. During this time SBA continued to make monthly payments of the entire guarantee amount. The district office Chief of Portfolio Management told us that the caretaker does not pay rent but does pay the taxes and insurance on the property. He stated that the case has "dragged on" and that SBA has not put pressure on the lessor to reduce SBA's costs by obtaining a rent-paying tenant because of inadequate staff.

Subsequent to our discussions, the Chief of Portfolio Management visited the property and found that the tenant's business would not support a rental payment. He told us that the lessor was not making any efforts to rent the property to another tenant. The Chief told us in January 1982 that he would discuss the need to obtain a paying tenant with the lessor.

SBA's contingent liability was about \$202,000 as of the end of fiscal year 1981.

Case 3

SBA approved a rental in February 1981 for a monthly rent of \$1,000 on a default for which it has a monthly guarantee of \$2,200. The tenant paid a total of only \$300 to SBA in rent from June 1981 to January 1982. During that time, SBA continued to pay the \$2,200 guarantee payment.

The loan officer responsible for the case told us that he has called and sent letters to the tenant requesting payment but has not received a response. He also stated that the property is in a "run down" condition. We asked the loan officer, in February 1982, whether SBA had taken any action on this case to require

that the lessor obtain a paying tenant or maintain the property. He stated that SBA had not taken this action and agreed that he would discuss these points with the lessor.

As of the end of fiscal year 1981, SBA's contingent liability is about \$147,400.

Case 4

As of September 30, 1981, SBA had paid \$5,800 on a building that has been periodically vacant since about September 1974. The monthly guaranteed rent is \$400. The loan officer responsible for the case was unaware of any specific efforts by the lessor to rereant.

We visited the lessor in November 1981 and found that the property was not advertised nor listed with a realtor. The lessor told us that he has not advertised the property for the past 2 years because everyone in town knew he was leasing it. He stated that he is prominent in the community and that many people look at the property each month. He also stated that because he is a banker, he does not want to favor one realtor over another by listing the property. According to the lessor, the State's Department of Revenue recently expressed an interest in renting the building. The Acting Deputy District Director responsible for this case stated that the property should be advertised and that SBA would increase its efforts in reviewing the case.

SBA's contingent liability was about \$28,000 at the end of fiscal year 1981.

Case 5

As of September 30, 1981, SBA had paid about \$26,000 in rent on a property that has been periodically vacant since 1975 and has not had a tenant since about December 1978. The guaranteed monthly rent is \$450. The lessor's status reports to SBA state that the property is listed with a realtor but provide no specific information on the realtor's efforts to rent the property. We discussed this case with the SBA loan officer responsible for servicing the guarantee and found that she was not aware of what the lessor was doing to rereant. She stated that SBA had not pressured the lessor to take action to rent the property nor had she followed up with the lessor's realtor to determine his rereant efforts. We discussed the property with the lessor's realtor who told us that about 95 percent of his effort is directed at selling the property rather than renting it.

SBA's contingent liability at the end of fiscal year 1981 was about \$8,100.

Because the loan officers responsible for these cases generally did not comply with procedures requiring servicing and followup, SBA had little assurance that the lessors were acting to minimize losses through rereantals as required by the guarantee

agreement. SBA loan officers stated that because of staff shortages and higher priority work, such as servicing the business loan portfolio, limited effort has been given to servicing these lease guarantee cases.

As pointed out by private insurers, it is very important to service defaults by following up on lessor rereental efforts. In several cases, we found that SBA had taken action to service the default and followed up on lessor rereental efforts. In these instances, the default was usually resolved. For example, in one case involving a default on a cattle feedlot for which SBA had guaranteed a monthly rent of over \$6,600, we found that SBA had

- required specific information regarding rereental efforts,
- visited the property twice to check on its maintenance,
- had frequent contacts with the lessor or his agents on rereental efforts, and
- checked with bankers and others familiar with the cattle industry on the value of the feedlot.

The property was rereented for more than the guarantee in November 1981 after SBA had made four guarantee payments. SBA is now pursuing collection of the overage to offset its losses.

ADDITIONAL COLLECTION EFFORTS
ARE NEEDED TO MINIMIZE LOSSES

SBA receives income resulting from properties rereented after a default. For some cases, it collects the rereental amount and continues to pay the guaranteed rent to the lessor. In other cases, the lessor collects the rereental and pays SBA amounts that exceed the guaranteed rent until actual SBA losses have been offset. We found that SBA is incurring additional costs because it has not actively pursued the collection of all rents owed it.

For example, in one case SBA had not collected a \$2,200 monthly rereental payment since about February 1980. Although the property has been rereented since 1975, the tenant has made only periodic rent payments to the district office since 1976. The tenant stopped all payments to the district office in February 1980. SBA, however, was unaware that the tenant had stopped making rent payments. Throughout 1980 and 1981 SBA district office officials approved monthly guarantee payments to the lessor of \$2,804 and stated in their approval that the property was rereented. We brought the tenant's nonpayment of rent to their attention. They subsequently contacted the tenant who acknowledged owing SBA rent and agreed to pay the arrearage.

The district office Chief of Portfolio Management attributes the failure to assure that rents were collected in this case to staff changes and shortages. We noted, however, that the district

office did not have a system to control rent receivables which would have made the staff aware of the tenant's obligation to SBA and his failure to pay rent. SBA district office officials agreed to establish such a system.

We estimate that, as of December 1981, the tenant owed rent of about \$74,000. An SBA district office loan officer told us in February 1982 that the tenant has paid SBA \$11,000 of the arrearage and agreed to double monthly rent payments to bring the rent current. The loan officer stated that the tenant has a substantial business and should be able to repay the remaining balance.

We noted that a district office did not recover losses on one case by collecting the rent resulting from a rerelease that was in excess of the guaranteed rent. SBA paid a monthly rent for the property of \$5,000 from November 1979 to January 1981, or a total of \$75,000 in guarantee payments. The lessor, however, rereleased the property on September 24, 1980, for a monthly rent of \$7,800, commencing January 1, 1981. Therefore, the property was rereleased for \$2,800 each month in excess of the guarantee. According to SBA's standard lease guarantee agreement, SBA is entitled to rental overages until its actual losses on a guarantee are offset.

SBA tried to collect the rent in February 1981 but was unable to because the lessor's attorney questioned SBA's authority under the guarantee agreement. An SBA district office attorney told us in November 1981 that no further action had been taken to determine whether SBA is entitled to the rent because of staff changes and a misunderstanding between staff in the district and branch offices concerning responsibility for the case. She stated that she would review the case and determine what, if any, action SBA can take to collect the rent.

In addition, SBA apparently overpaid the lessor \$5,000 on this same case. According to the rerelease lease, rent payments from the new tenant were to commence on January 1, 1981. However, the lessor filed a claim on December 10, 1980, for SBA to pay the January rent. SBA paid this claim of \$5,000 on January 21, 1981. We pointed out to SBA the apparent overpayment, and SBA's district office attorney agreed to include it in her review. As of February 1982, we were unable to determine the disposition of this case.

CONCLUSIONS

For the majority of default cases, lease guarantee losses are minimized through rereleases or settlements. However, SBA's efforts to manage some lease guarantee defaults have not been adequate to assure that its losses are minimized.

SBA standard operating procedures require a review of lessor and real estate agent activities to assure that a diligent effort

is made to rerent. The private insurers we contacted also believed that such reviews were important to assure rerentals.

In some cases, however, SBA field offices have not complied with the procedures and have little assurance that efforts are made to rerent. In most of these cases, SBA received little, if any, specific information from the lessor on rerental efforts and did not follow up with either the lessor or the lessor's agent.

Additionally, in two cases that were rerented, SBA was not pursuing the collection of rents which could offset its losses substantially.

We recognize that SBA has limited staff whose attention is directed, on a priority basis, to servicing business loans. We believe, however, that increased attention to lease guarantee defaults could help to reduce SBA losses and would only require a limited effort.

RECOMMENDATIONS

We recommend that the Administrator, SBA, require field offices to give more attention to servicing lease guarantee defaults and direct them to

- require lessors to submit specific information each month on their rerental efforts, such as the names of realtors and prospective tenants, the lease terms offered by the lessor, and documentation of advertisements;
- follow up on lessor rerental activities to determine whether additional efforts are needed; and
- collect all rents due SBA.

We discussed our report with the Director, Office of Portfolio Management, who is responsible for managing SBA's direct lease guarantees. The Director agreed to take action on the above recommendations and to follow up on the cases discussed in this report to assure that efforts are made to minimize SBA losses.

SBA STATISTICS ON POLICY MATURITIES

<u>Year</u>	<u>Direct</u>	<u>Partici- pation</u>	<u>Total matured</u>	<u>Cumula- tive total</u>	<u>Percentage of policies matured</u>
1977	-	2	2	2	0.17
1978	1	8	9	11	0.94
1979	-	19	19	30	2.55
1980	1	23	24	54	4.60
1981	6	17	23	77	6.55
1982	12	26	38	115	9.79
1983	29	30	59	174	14.81
1984	34	37	71	245	20.85
1985	31	50	81	326	27.74
1986	48	81	129	455	38.72
1987	76	83	159	614	52.26
1988	87	68	155	769	65.45
1989	90	49	139	908	77.28
1990	54	21	75	983	83.66
1991	25	7	32	1,015	86.38
1992	29	17	46	1,061	90.30
1993	41	29	70	1,131	96.26
1994	18	12	30	1,161	98.81
1995	8	3	11	1,172	99.74
1996	<u>1</u>	<u>2</u>	<u>3</u>	1,175	100.00
Total	<u>591</u>	<u>584</u>	<u>1,175</u>		

Note: This table reflects policies outstanding as of August 1976.
A more complete and accurate update is not available.

SBA PAYMENTS ON DEFAULTED LEASES,FISCAL YEARS 1970-81

<u>Fiscal year</u>	<u>Dollars (note a)</u>
1981	\$ 3,227,505
1980	3,558,969
1979	2,728,799
1978	3,461,212
1977	3,325,368
1976 (transitional quarter)	627,372
1976	2,600,240
1975	1,517,146
1974	1,348,423
1973	620,349
1972	312,330
1971	209,301
1970	<u>28,844</u>
Total	<u>\$23,565,858</u>

a/SBA payments include settlements to relieve SBA of its contingent liability on outstanding guarantees.

SBA DISTRICT AND BRANCH OFFICES GAO CONTACTEDDistrict offices

Albuquerque, New Mexico
Boise, Idaho
Cleveland, Ohio
Dallas, Texas
Detroit, Michigan
Fargo, North Dakota
Indianapolis, Indiana
Little Rock, Arkansas
Los Angeles, California
Lubbock, Texas
Miami, Florida
Nashville, Tennessee
New Orleans, Louisiana
Omaha, Nebraska
Philadelphia, Pennsylvania
Providence, Rhode Island
Richmond, Virginia
Salt Lake City, Utah
San Antonio, Texas
Seattle, Washington
Wichita, Kansas

Branch offices

El Paso, Texas
Melville, New York

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