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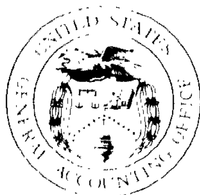
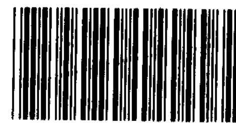
Report to the Chairman, Committee on Small Business, U.S. Senate

December 1991

SMALL BUSINESS

Improving SBA Loan Collateral Liquidations Would Increase Recoveries





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Resources, Community, and
Economic Development Division

B-244259

December 19, 1991

The Honorable Dale L. Bumpers
Chairman, Committee on Small Business
United States Senate

Dear Mr. Chairman:

Your letter requesting this review expressed concern about whether the Small Business Administration (SBA) is properly managing loan collateral, especially for those loans in liquidation. You requested that we assess SBA procedures for liquidating loan collateral and determine whether they adequately protect the government's, and ultimately the taxpayer's, financial interests. This report summarizes our findings on these issues.

The report asks the Congress to consider whether more stringent collateral requirements are needed for SBA loans. It also makes several recommendations to the Administrator, SBA, to improve SBA's procedures for managing acquired collateral and for monitoring the liquidation activities of private lenders whose defaulted loans SBA has guaranteed.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Administrator, SBA; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others on request.

Our work was conducted under the direction of John M. Ols, Jr., Director, Housing and Community Development Issues, who can be reached at (202) 275-5525. Other major contributors are listed in appendix III.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

Section 7(a) of the Small Business Act authorizes the Small Business Administration's (SBA) general business loan program, which provides assistance to new or ongoing small businesses in the form of direct (government-funded) loans or guaranteed loans made by private lenders. With almost $11.5 billion in outstanding loans as of June 30, 1991, the general business loan program is SBA's largest financial assistance program. However, over $1.2 billion of these loans are in liquidation.

The Chairman of the Senate Committee on Small Business asked GAO to review SBA's liquidation of loan collateral for defaulted loans, including losses on liquidated loans; the adequacy and valuation of collateral; and collateral recovery efforts by SBA and private lenders.

Background

SBA provides or guarantees loans to businesses that are unable to obtain other financing. The Small Business Act of 1953 requires that all loans be of sound value or be secured to reasonably ensure repayment. SBA seeks as much collateral as possible for loans. However, in providing or guaranteeing loans SBA emphasizes that borrowers must show repayment ability. As a result, its loans involve a degree of risk that must balance providing needed credit assistance with protecting the government's, and ultimately the taxpayer's, interests.

When a borrower fails to repay a direct or guaranteed loan, the collateral provided for the loan may be liquidated to obtain loan repayment. Collateral for direct loans is liquidated by SBA; however, collateral for guaranteed loans may be liquidated by either SBA or the private lender that provided the loan. For guaranteed loans, SBA and lenders share in the collateral proceeds and any additional liquidation expenses. Generally, if collateral proceeds are insufficient, SBA may pursue personal guarantees or obligations provided by business owners or others in support of the loan. This activity sometimes results in compromise settlements between SBA and the guarantor.

Results in Brief

SBA is experiencing substantial losses in liquidating loans because (1) collateral is insufficient to cover the costs incurred when loans are liquidated and (2) SBA does not maximize recoveries on existing loan collateral.

GAO estimates that SBA lost $153.5 million on loans liquidated in three SBA regions during fiscal year 1989. These regions accounted for about 46 percent of all SBA loans liquidated in fiscal year 1989. Collateral for

these liquidated general business loans was insufficient because its value dropped by two-thirds between the time loans were made and the time they were liquidated. This decrease occurred primarily because SBA accepts collateral that declines in value or that is depleted in the normal course of business. Further decreases occurred because initial collateral values may be overstated and some types of collateral are not specifically identified and valued when a loan is made. In addition, loan collateral may be lost or sold by the borrower without SBA's knowledge or consent. When a loan is liquidated, one or more of these factors may reduce the value of collateral available to SBA to offset unpaid debt.

Losses occur not only because of insufficient collateral but also because SBA does not maximize recoveries on existing collateral. Specifically, when a loan goes into liquidation, SBA does not identify, inventory, and value loan collateral in a timely manner; neither SBA nor private lenders prepare adequate liquidation plans; and SBA has inadequate procedures for monitoring the liquidation activities of private lenders. As a result, the recovery rate on existing collateral may be low, and SBA sometimes must pursue the loan guarantor's personal assets, such as the equity in the guarantor's home, to repay the debt.

Principal Findings

Significant Losses Incurred on Liquidated SBA Loans

For liquidated 7(a) general business loans in the three SBA regions reviewed, GAO estimates that SBA incurred total cash outlays or costs of $216.8 million but recovered $63.3 million—resulting in estimated net losses of $153.5 million. SBA outlays are primarily for guaranteed amounts paid to private lenders. SBA recoveries come from two main sources—the sale of collateral and the assets of personal guarantors. The estimated value of collateral at the time of liquidation was $136.1 million. SBA recovered about 46 percent of this amount.

Insufficient Collateral Exists at Liquidation

A major reason SBA experiences substantial loan losses is that insufficient collateral exists at liquidation. For the three regions GAO reviewed, the estimated market value of the collateral when the loans were made was $428.4 million, but when the loans were liquidated, the value of the collateral was estimated at $136.1 million—68 percent less.

Declines in the value of collateral occur because the initial value assigned to collateral when a loan is made is often determined by the business owner applying for the loan. This valuation is usually not independently verified by SBA or some other source, and as a result, the collateral value may be overstated. In addition, the actual collateral items available to SBA at loan liquidation may not be known.

Furthermore, collateral that is part of the businesses' assets, such as equipment and furnishings, may be lost or sold, or in the case of accounts receivable, may be used by borrowers during the normal course of business. According to SBA, verifying the existence of collateral throughout the term of a loan is not a priority because of insufficient personnel and time constraints. Furthermore, if borrowers are intent on selling collateral without authorization, it is very difficult for SBA to stop them. As a result of these and other factors, such as the normal depreciation of collateral and overall economic conditions, the liquidation value of collateral is generally far less than the estimated market value determined at the time the loan was made.

SBA recognizes that, for most loans, collateral will be insufficient upon liquidation. However, SBA is willing to accept less collateral than are private lenders would for loans without an SBA guarantee. SBA is willing to do so to make loans available to eligible borrowers.

Recoveries on Existing Collateral Are Not Maximized

Maximum collateral recoveries are not obtained because collateral is not always identified in a timely manner, as SBA procedures require. For 16 percent of the loans GAO reviewed, no visits were made by SBA or private lenders to identify, inventory, and value collateral at the time a loan was placed in liquidation because of shortages of personnel, time, or travel funds or because other duties had higher priority. Without timely identification, collateral may be sold or may disappear without SBA's knowledge. Similarly, liquidation plans required by regulations were not prepared for 25 percent of the loans. For the 75 percent that had liquidation plans, 67 percent of the plans were incomplete. Without an adequate plan, the liquidation process lacks direction, and there is no basis for controlling liquidation actions taken by private lenders.

Collateral recoveries are also not maximized because private lenders have limited financial incentive to maximize recoveries. Private lenders recovered approximately 27 percent of the value of collateral liquidated in GAO's sample, while SBA recovered approximately 68 percent. For defaulted loans, private lenders usually receive their guarantee payments from SBA before collateral liquidation, and any subsequent

recovery a lender receives from the sale of collateral is minor compared with SBA's share. Furthermore, SBA standard operating procedures do not detail what specific monitoring actions SBA should take to ensure that private lenders are properly liquidating loans. As a result, SBA's monitoring of lenders' liquidation actions is limited, and actions are sometimes taken without SBA approval.

Recommendations

To improve recoveries on defaulted loans, GAO recommends that the Administrator, SBA, take actions to (1) independently verify the existence and value of collateral when loans are made or guaranteed, or obtain additional supporting information; (2) identify, inventory, and value collateral in a timely manner at liquidation; (3) ensure preparation of liquidation plans that specify liquidation steps, time frames, and estimated costs; and (4) revise SBA procedures to provide for adequate oversight of private lenders' liquidation actions.

Matter for Congressional Consideration

GAO recognizes that balancing the role of SBA as both a source of high-risk credit to small businesses and a loan-making agency requires basic policy decisions that can be made only by the Congress. Currently, SBA emphasizes repayment ability in providing or guaranteeing loans. It also recognizes that for most loans the liquidation value of collateral will be less than its initial market value and thus, if liquidation occurs, significant losses may be incurred.

To help reduce losses on liquidated loans, the Congress may wish to consider mandating that SBA require stronger collateral, in amounts that reflect anticipated declines in value, when a loan is made or guaranteed. Requiring stronger collateral, however, could preclude some potential borrowers from getting a loan.

Agency Comments

GAO discussed the information presented in this report with SBA officials, who generally concurred with the findings, conclusions, and recommendations. However, SBA believes that the matter for congressional consideration, which suggests that the Congress require stronger loan collateral, will preclude some borrowers who have repayment ability from getting a loan. GAO believes that if the Congress wants to increase recoveries on SBA defaulted loans, requiring stronger collateral will help achieve this goal and better protect the government's, and ultimately the taxpayer's, interests. As requested, GAO did not obtain written agency comments on a draft of this report.

Contents

Executive Summary		2
Chapter 1 Introduction		8
	Nature and Significance of Collateral	9
	Liquidation Procedures	9
	Objectives, Scope, and Methodology	11
Chapter 2 Significant Losses Are Incurred on Liquidated SBA Loans		15
	Loan Liquidations Result in Losses	15
	Sources of SBA Recoveries	15
	Conclusions	17
Chapter 3 Collateral Values Decrease Significantly Before Liquidation		18
	Weak Initial Collateral Declines Significantly in Value Between Loan Approval and Liquidation	18
	Collateral Declines Further Because of SBA, Lender, and Borrower Practices	22
	Conclusions	24
	Recommendations to the Administrator of SBA	25
	Matter for Consideration by the Congress	25
	Agency Comments	25
Chapter 4 SBA Collateral Recoveries Are Not Maximized		27
	SBA Collateral Liquidation Efforts Are Not Adequate	27
	Collateral Management Is Minimal	32
	Conclusions	34
	Recommendations to the Administrator of SBA	35
Appendixes	Appendix I: Loans in Liquidation in Selected Field Offices, Fiscal Year 1989	36
	Appendix II: Statistical Estimates and Associated Sampling Errors	37
	Appendix III: Major Contributors to This Report	42
Tables	Table 2.1: Sources of Recoveries on SBA Loans	16
	Table 3.1: Value of Collateral at Loan Approval and at Liquidation	19
	Table 3.2: Use of SBA Loan Proceeds	21

Table II.1: Statistical Estimates of Losses Incurred on SBA Liquidated Loans 37
Table II.2: Statistical Estimate of Value of Collateral at Liquidation 38
Table II.3: Statistical Estimates of Collateral Not Always Identified in a Timely Manner 38
Table II.4: Statistical Estimates of Liquidation Plans Not Prepared/ Completed by SBA or Private Lenders 38
Table II.5: Statistical Estimates of SBA and Private Lenders' Recoveries and Frequency of Private Lender Liquidations 38
Table II.6: Statistical Estimates of SBA Monitoring of Private Lender Liquidation Actions 38
Table II.7: Statistical Estimates of Borrower Cooperation When SBA Takes Possession of Borrowers' Collateral 38
Table II.8: Percent of Collateral Available at Liquidation Taken Into SBA Possession 39
Table II.9: Statistical Estimates of the Decrease in Collateral Values From Loan Approval to Liquidation 39
Table II.10: Statistical Estimates of the Collateral Value at Loan Approval and at Liquidation 39
Table II.11: Statistical Estimates of the Use of SBA Loan Proceeds 40
Table II.12: Statistical Estimates of the Guarantee Purchase Amount as Percent of Outlays and SBA Recoveries as Percent of Collateral Value 40
Table II.13: Statistical Estimates of Private Lender Liquidation Legal Expenses 40
Table II.14: Statistical Estimates of Average Loss on Loans Liquidated by SBA and Private Lenders 40
Table II.15: Statistical Estimates of Average Time for Foreclosures Compared to Voluntary Conveyance and Peaceful Possession 40
Table II.16: Statistical Estimates of Machinery and Equipment Identified at Liquidation and Reasons for SBA Not Taking Possession 41

Abbreviations

DCI	data collection instrument
GAO	General Accounting Office
SBA	Small Business Administration
SOP	standard operating procedure

Introduction

The Small Business Administration (SBA) was created to aid, counsel, assist, and protect the interests of small businesses. SBA's mission is to help people establish a business and stay in business through financial, business development, and contract procurement assistance. Section 7(a) of the Small Business Act authorizes the general business loan program—SBA's principal lending program. Through this program, SBA either provides direct loans or guarantees private lender loans to small businesses. Under the guarantee program, if a borrower defaults on a loan, SBA is obligated to purchase the guaranteed percent—not to exceed 90 percent—of the outstanding loan balance and accrued interest. As of June 30, 1991, the 7(a) program accounted for 90 percent of the total 108,775 loans outstanding and 84 percent of the total $13.7 billion in SBA's business loan portfolio.

As of June 30, 1991, over 85 percent of SBA's 7(a) loans were guaranteed loans. The three principal parties to an SBA guaranteed loan are SBA, the loan applicant, and the private lender, with the lender playing a central role in providing the loan. The loan applicant submits the loan application to the lender, who makes the initial review and, if approved, forwards the application to the local SBA office. If the loan is approved by SBA, the lender finalizes the loan and disburses the funds. The lender pays SBA 2 percent of the guaranteed portion of the loan amount for the guarantee.

Upon request by the lender, generally after a loan payment is at least 60 days overdue, SBA will reimburse the lender for up to 90 percent of the outstanding principal and interest. Subsequent recoveries and expenses are shared by SBA and the lender in the same proportion as their respective pro rata share of the guarantee percentage. For example, after SBA purchases the guaranteed portion of a loan, it would receive 90 percent of the recoveries and pay 90 percent of the expenses. The lender's share would be 10 percent of the recoveries and expenses. SBA's share of a guaranteed general business loan may not exceed $750,000.

Besides guaranteeing loans, SBA also makes direct loans at a current maximum loan limit of $150,000. Direct loans are available only to applicants unable to secure an SBA-guaranteed loan. Before applying for an SBA direct loan, an applicant must first seek and be denied financing from a lender, and in cities of over 200,000 residents, from at least two lenders. Funds for direct loans under the general business loan program have not been available since fiscal year 1985. However, SBA does make a limited number of direct loans under special loan programs targeted to

the needs of particular groups or types of businesses, such as handicapped individuals and/or minority businesses.

Nature and Significance of Collateral

Federal regulations (13 CFR Ch.1, 120.103-2) require that SBA loans have adequate collateral to reasonably protect the interest of the government. Collateral includes all items pledged in support of the loan: primary items are real estate, machinery and equipment, furniture and fixtures, accounts receivable, and inventory. According to SBA loan liquidation officials, real estate is generally considered the strongest form of collateral. The amount of collateral needed to obtain an SBA general business loan depends in part on other credit factors, such as repayment ability, and is determined on a case-by-case basis. Inadequate collateral is not normally used as the sole reason for loan disapproval unless the applicant refuses to pledge whatever worthwhile collateral is available.

For SBA loans, both direct and guaranteed, personal guarantees for loan payment are required from all principal owners and from the chief executive officer of the business. These guarantees make individuals personally liable for loan repayment; as a result, SBA may pursue personal assets, such as residences, for repayment.

In a borrower's loan agreement with SBA, collateral is usually described in general terms, such as inventory, machinery, and equipment. The description is general so that any assets falling into these general categories acquired subsequent to loan approval can legally be considered collateral. Other loan documents, such as an attachment to the loan agreement or the loan application, may contain a more specific listing of collateral. SBA standard operating procedures (SOPs) require that when a loan is placed in liquidation, the major items of collateral securing the loan should be identified, inventoried, and valued as soon as possible. According to SBA's Director of Portfolio Management, without this information it is difficult to determine if a reasonable recovery is made on the collateral.

Liquidation Procedures

According to SBA's procedures, liquidation steps should be implemented only after all other options to keep a borrower in business have been explored or the borrower has refused to cooperate. However, the procedures state that once a decision to liquidate is made, prompt action must be taken to preserve the interest of the government by assuring maximum recovery in the minimum time. Generally, a loan is transferred to "liquidation" status, and to an SBA loan liquidation officer, when it

becomes apparent that the borrower cannot repay the loan. Loans in default because of any type of insolvency proceedings, such as foreclosure or bankruptcy, are also placed in liquidation. Authority for placing a loan in liquidation lies with SBA's Chief of Portfolio Management in the respective district office. As of June 30, 1991, SBA had over $1.2 billion of general business loans in liquidation.

About two-thirds of SBA loans are liquidated by SBA and about one-third by the lender making the loan. However, liquidation by the borrower is authorized in selected cases to increase recoveries. When a loan is classified in liquidation, SBA's procedures, which apply both to SBA and private lenders, state that certain actions must occur to protect the government's interest. One is that a liquidation plan must be prepared that discusses the planned course of action to liquidate the loan and estimated time frames and costs. Also, the individual responsible for performing the liquidation should make a field visit to identify, inventory, and value the collateral. This could be an SBA loan liquidation officer, private lender official, and/or an appraiser acting on behalf of SBA or the private lender.

When SBA decides whether to acquire a defaulted borrower's loan collateral, it must determine whether the revenue generated by the collateral sale will offset the costs of acquiring, managing, and selling the collateral. For example, in acquiring collateral SBA often pays other creditors to remove their claims or liens against the borrower's collateral title. A title free of liens is usually needed for SBA to sell the collateral. SBA considers the amounts of these liens and other expenses in its acquisition decision. The amount of time required to take physical control of collateral after a loan is placed in liquidation varies considerably, depending on such factors as the cooperation of the borrower and applicable state laws.

When SBA obtains title to collateral, it is put in the agency's collateral purchased (COLPUR) account. SBA also reduces the borrower's debt by an amount equal to the collateral purchase price. If the purchase value does not fully satisfy the borrower's debt, SBA may take legal or administrative collection actions or compromise to recover the balance. However, if the balance of the loan is uncollectible, SBA may, and often does, charge off the remaining amount as a loss.

SBA loan liquidation procedures require that proper maintenance and security measures be taken to recover the maximum amount for collateral. When SBA acquires property, an assessment to determine the extent

of protection, maintenance, and repairs necessary to preserve the property's resale value is required. Protective measures might include changing locks, hiring a caretaker, performing maintenance, and/or posting no trespass signs.

Objectives, Scope, and Methodology

The Chairman, Senate Committee on Small Business, requested that we assess the management of SBA's 7(a) general business loan portfolio, particularly with respect to loans in liquidation. As agreed with the Chairman, our objectives were to determine

- how the amount SBA receives for collateral compares to the collateral value at the time the loans were placed in liquidation;
- whether collateral pledged as security for loans is being properly identified, inventoried, and valued at the time the loans are placed in liquidation;
- the amount of time required to take physical control of collateral after loans are placed in liquidation;
- whether SBA properly manages the collateral it acquires, including the adequacy of safeguards against waste or deterioration of property; and
- the adequacy of SBA's procedures for acquiring collateral.

In addition to addressing these objectives, we estimated the losses that SBA incurred when liquidating loans.

To answer these questions and to specifically determine SBA's procedures for acquiring and selling collateral, we interviewed SBA headquarters, regional, and district personnel about loan collateral and liquidation practices. We also reviewed SBA regulations, standard operating procedures, and other documents to determine the procedures used in the acquisition of loan collateral. We reviewed reports by the SBA's Office of Inspector General and others that addressed collateral and the 7(a) loan program; SBA's loan liquidation procedures; and implementation of the Federal Managers' Financial Integrity Act of 1982.

To specifically determine SBA practices in collateral identification, possession, management, and liquidation, we developed a data collection instrument (DCI) to collect standardized information from SBA loan files. To develop the DCI, we visited five SBA district offices—Chicago, Dallas, Denver, Indianapolis, and Minneapolis. These offices were selected because of their geographical dispersion. At these offices we interviewed SBA officials and reviewed judgmentally selected loan files to identify standardized information to be gathered from each loan file,

including both general information on loans and specific information related to loan collateral. The DCI was then used to gather information on loan collateral at nine SBA offices included in our sample.

To determine whether collateral pledged as security is being properly identified, inventoried, and valued, we developed a standard DCI format to record and categorize the collateral provided when loans are made and how each category of collateral was initially identified, inventoried, and valued, and by whom. We then recorded similar information when loans were placed in liquidation to identify both changes in SBA's collateral position and actions taken at that point to identify, inventory, and value collateral.

To determine the amount of time required to take physical control of collateral after loans are placed in liquidation, we recorded the dates when loans were placed in liquidation and when collateral possession occurred and calculated the time between these dates. In addition to the time elapsed, we also recorded the type of collateral and the possession method—such as foreclosure. Furthermore, to determine the effectiveness of SBA's collateral management, we recorded both actions taken and expenditures incurred for each type of collateral taken into possession. We also recorded any deterioration or theft of collateral and asked SBA officials if these occurrences could have been avoided.

To compare the amount that SBA received for collateral to the value of collateral when the loans were placed in liquidation, we recorded the value of collateral at both of these points. We then compared the proceeds received from the sale of the collateral to the value assigned to the collateral when it was placed in liquidation. We also calculated the change in collateral values from the time loans were made to the time they were placed in liquidation, to quantify the decrease in collateral values prior to liquidation. To calculate a gain or loss on individual loans, we computed the total outlays for individual loans and compared them to the total recoveries. Included in the recoveries was the fee received by SBA for guaranteeing the loan. If total outlays exceeded recoveries, we categorized this as a "loss." We also determined what factors are considered in SBA's decisions to acquire collateral.

Sampling Methodology

Because of the large number of loans in liquidation, we could not review each loan. Instead, we developed a DCI to use for a sample of liquidated 7(a) loans. To obtain our sample, we first identified a universe of loans in liquidation status during fiscal year 1989 that were either charged off

(loss incurred) or paid in full. This universe included loans that were placed in liquidation status prior to 1989. As a result, liquidation actions may have been taken prior to 1989; however, SBA's liquidation procedures have remained unchanged for several years. The total number of loans in this universe was 4,552, valued at $656.4 million.

At the Chairman's request, we focused our review on three specific SBA regions—Chicago, Dallas, and Denver. These three regions had 2,019 (44 percent) of the 4,552 subject loans and $299,811,244 (46 percent) of the total loan amount. Within these three regions, 27 field offices had business loans in liquidation during fiscal year 1989. (App. I presents the number and dollar amounts of these loans for the three selected SBA regions, as well as the number and dollar amounts of loans in liquidation for the 27 field offices within the three selected regions.) All estimates included in this report refer only to the three regions as a group for fiscal year 1989. They do not represent the nation or individual regions.

Of the 27 SBA field offices, we judgementally selected 3 field offices. And from the remaining 24 offices, we randomly selected 6 field offices proportional to their disbursal amount relative to the total disbursal amount for all 24 field offices. The three judgmentally selected field offices were located in Chicago, Dallas, and Denver. The other six offices selected were located in Houston, Indianapolis, Little Rock, Minneapolis, Oklahoma City, and Sioux Falls. Within each of the nine SBA offices, we reviewed a sample of 20 loans. To obtain our loan sample, we first listed the loans from each location in ascending order by loan number. We then selected a simple random sample of loans at each location. Our total sample size for all nine offices consisted of 180 loans. For each selected loan, we completed a DCI. Our selection procedure excluded approximately the last third of the loans on the list. However, SBA officials told us that for the items we reported on, they did not expect differences between the first two-thirds and the last one-third of the listed loans. As a result, we used our sample to provide estimates for the entire universe of liquidated loans in fiscal year 1989 for three regions.

Because this review relied on a sample of total loans in liquidation, sampling errors occurred. A sampling error indicates how closely we can reproduce from a sample the results that we would obtain if we were to take a complete count of the universe using the same measurement methods. By adding the sampling error to and subtracting it from the estimate, we can develop upper and lower bounds for each estimate. This range is called a confidence interval. Sampling errors and confidence intervals are stated at a certain confidence level—in this case, 95

percent. For example, a confidence interval, at the 95-percent confidence level, means that in 95 out of 100 instances the sampling procedure we used would produce a confidence interval containing the universe value we are estimating. The estimates and upper and lower bounds are contained in appendix II.

We also contracted with a consultant—a former SBA Associate Administrator for Finance and Investment—familiar with SBA operations to assist in reviewing our assignment methodology and interim and final written products.

This review was conducted from February 1990 through June 1991 in accordance with generally accepted government auditing standards. Major contributors to this report are listed in appendix III.

Significant Losses Are Incurred on Liquidated SBA Loans

In the three regions we reviewed, SBA incurred significant losses when its 7(a) general business loans were liquidated. In fiscal year 1989, we estimate that SBA lost about $153.5 million on loans liquidated in these three regions. As discussed in chapters 3 and 4 of this report, these losses result from insufficient collateral when loans are liquidated and liquidation actions that do not maximize recoveries.

Loan Liquidations Result in Losses

In the three regions we reviewed, liquidating an SBA loan almost always results in a loss because outlays—including guarantee amounts paid to private lenders—usually exceed recoveries. We estimate that losses for the three SBA regions were $153.5 million on liquidated loans with balances that were either declared as losses—charged off—or paid in full in fiscal year 1989. This resulted from total cash outlays or costs of $216.8 million and total recoveries of $63.3 million. An estimated $209.7 million, or 97 percent of the costs associated with liquidating loans, consists of principal and interest paid to lenders for guaranteed loans, or outstanding direct loan principal and interest at the time of liquidation. The remaining costs are primarily collateral-related expenses, such as payment of taxes or payments to prior lien holders.

Even with a complete recovery of the collateral pledged on outstanding loans, SBA would not have been able to recover the $216.8 million in loan outlays because the value of the collateral at the time of liquidation was only 63 percent of these outlays. Consequently, when SBA's actual recoveries of $63.3 million are compared to the $136.1 million value of collateral at the time of liquidation, SBA recovered about 46 percent of the collateral value.

Sources of SBA Recoveries

Recoveries on SBA loans came from two main sources, sale of collateral and recoveries from personal guarantors. As table 2.1 shows, an estimated $46.4 million came from the sale of collateral; approximately $21.9 million of this amount was credit sales.[1] Credit sales, as opposed to cash sales, involve SBA's taking a note receivable for collateral sold. For guaranteed loans the private lender and SBA share the proceeds of collateral sales and the proceeds of notes as payments are received.

[1]This estimate does not include the Chicago district office because none of the loans we reviewed from that office were the result of credit sales.

Table 2.1: Sources of Recoveries on SBA Loans

Dollars in millions

	Amount	Percent
Sale of collateral	$46.4	73.3
Recovery from personal guarantors	8.9	14.0
Miscellaneous recoveries[a]	5.1	8.1
Additional sources of revenue[b]	2.9	4.6
Total	**$63.3**	**100.0**

[a]Miscellaneous recoveries include releases of SBA's liens for cash or other considerations and SBA's share of liquid collateral, such as bank accounts and certificates of deposit.

[b]Additional sources of revenue that offset liquidation costs are guarantee fees paid for obtaining an SBA loan and revenue from leasing collateral that SBA had acquired.

The second main source of recoveries was an estimated $8.9 million obtained from individuals who were personally obligated or had provided a personal guarantee for payment of an SBA loan. When collateral was insufficient to recover the outstanding loan balance, SBA pursued the guarantor's personal assets. Pursuing personal guarantors often involves an offer-in-compromise. For example, SBA and the guarantor will negotiate a cash payment based on the equity in the guarantor's home. The personal guarantor often obtains funds by refinancing his/her home or borrowing from friends or relatives. All of the loans in the three SBA regions we reviewed had guarantors—usually the business owner or the owner's spouse.

The following example illustrates how SBA increased recoveries by pursuing guarantors. A $424,500 loan provided to an Indiana skating rink owner in August 1980 was originally collateralized at $583,600. Collateral consisted of $452,400 in real estate and $131,200 worth of machinery and equipment. At the time of liquidation in March 1984, the outstanding principal was $412,000, and the collateral was valued at $250,000. The eventual recovery on the collateral was $144,063. Three partners had provided personal guarantees for the loan. SBA pursued these guarantors through the offer-in-compromise process and increased recoveries by $48,600 (34 percent). These compromise offers were based on the guarantors' residences or other assets.

In addition to selling collateral and pursuing guarantors, SBA had other recoveries totaling an estimated $5.1 million. These included recoveries

from such sources as releases of SBA's liens for cash or other considerations and SBA's share of liquid collateral, such as bank accounts and certificates of deposit. Other sources of revenue that offset liquidation costs totaled $2.9 million and included the guarantee fees paid for obtaining an SBA loan and revenue from leasing collateral that SBA had acquired.

Conclusions

Significant losses occur on SBA loans because collateral is inadequate to cover outlays when loans are liquidated. These outlays primarily consist of the guaranteed portion of loans—principal and interest—paid to lenders. While private lenders receive a guaranteed recovery amount, SBA must rely on liquidating collateral for recoveries. Because of inadequate collateral, recoveries are supplemented by pursuing guarantor's personal assets. However, these supplemental amounts do not provide sufficient revenue to cover the losses resulting from inadequate collateral.

Collateral Values Decrease Significantly Before Liquidation

In the three regions we reviewed, SBA experienced substantial losses because insufficient collateral existed when loans were placed in liquidation. While the market value of collateral on SBA loans generally appears to equal or exceed the loan amount when they are made, the liquidation value of remaining collateral at the time of liquidation is significantly less. We estimate that for loans valued at $300.3 million in the three regions collateral dropped 68 percent from an initial market value of $428.4 million to a estimated liquidation value of $136.1 million. Although the liquidation value of collateral is generally less than the market value, various other factors—including poor economic conditions or collateral that either declines in value or is used during the course of business—further contribute to this decline.

In addition, certain practices by SBA, private lenders, and borrowers add to the decline of collateral value. These practices include inadequate identification and valuation of collateral when loans are made, the unauthorized sale of collateral before liquidation, and the subordination of SBA's lien position—its right to claim funds from the sale of liquidated collateral. As a result, loans that may have been fully collateralized at approval are usually undercollateralized at the time of liquidation. This significantly limits SBA's ability to recover the amount due to the government.

Weak Initial Collateral Declines Significantly in Value Between Loan Approval and Liquidation

The collateral provided for SBA loans in the three regions we reviewed was often weak, dropping significantly in value before liquidation or being consumed in the normal course of business. We estimate that the three major types of collateral securing SBA loans—real estate, machinery and equipment, and inventory—declined in value by 41 percent, 77 percent, and 88 percent, respectively. When SBA makes or guarantees loans, collateral is of secondary importance to other credit factors, such as the borrower's projected earnings. As a result, SBA is willing to accept weaker types of collateral, including items purchased with loan proceeds. This collateral, such as inventory, is often sold to pay outstanding debt before the loan is placed in liquidation.

Weak Collateral Is Accepted for SBA Loans

Weak collateral—collateral that depreciates or is used during the course of business—is commonly accepted for SBA loans. This occurs because SBA approves loans based on the borrower's ability to repay the debt rather than on the value of the borrower's loan collateral. The Small

Business Act requires that all loans be of sound value or secured to reasonably ensure repayment. While SBA seeks as much collateral as possible for loans, it emphasizes repayment ability in providing or guaranteeing loans. SBA is willing to accept less collateral than a private lender would without an SBA guarantee and recognizes that for most loans collateral will be insufficient if liquidation occurs.

According to SBA, it intentionally takes greater risks than private lenders. SBA-guaranteed loans are usually longer term, and more likely to be made to new businesses, than private lender non-SBA business loans. In addition, private lenders may require that the value of collateral be 150 percent of the loan amount or that the value of various types of collateral be reduced to allow for depreciation or use during the course of business. For example, they may allow 80 percent of the cost or appraised value for real estate and only about 20 to 30 percent for inventory. Table 3.1 shows the estimated decline in the value of the major types of collateral between the time the loan was made and the time the loan was placed in liquidation for the three regions we reviewed.

Table 3.1: Value of Collateral at Loan Approval and at Liquidation

Dollars in millions

Collateral category	Market value at loan approval	Value at liquidation	Collateral decrease	(percent)
Real estate	$158.5	$94.1	$64.4	(41)
Machinery and equipment	108.2	24.6	83.7	(77)
Inventory	91.0	11.4	79.6	(88)
Other[a]	70.7	6.1	64.6	(91)
Total	**$428.4**	**$136.1[b]**	**$292.3**	**(68)**

[a]Includes trucks and autos; furniture and fixtures; and accounts receivable.

[b]Total does not add because of rounding.

As shown in the table, except for real estate, other collateral used for SBA loans lost at least 75 percent of its value from the time the loan was made to the time the loan was liquidated. However, real estate accounted for only 37 percent of the total collateral value at the time of loan approval. The following is an example of a loan that had a significant collateral value when approved but, because of the type of collateral provided, was significantly undercollateralized at the time of liquidation.

In May 1986 SBA guaranteed a $450,000 loan to a Chicago restaurant. Collateral consisted of furnishings valued at $200,000, machinery and equipment at $185,000, and equity in the borrower's residence at $55,000. Of the $450,000 in loan proceeds, $32,846 was used for debt repayment, $145,000 for renovations, $127,154 for working capital, and $145,000 for machinery and equipment. The use of the loan proceeds, except for machinery and equipment, added little to the collateral provided for the loan. When the loan was placed in liquidation in November 1987, outstanding principal and interest was about $418,000 and collateral was valued at $118,000. This consisted of machinery and equipment, and furniture and fixtures, valued at $61,000; equity in the borrower's residence was valued at $57,000. SBA recovered about $30,000 from the sale of machinery and equipment and about $47,000 from an offer-in-compromise on the borrower's residence.

Collateral Dissipates Before Liquidation

Collateral such as materials or supplies may dissipate before liquidation because it is used in the course of business. In the case of inventory or accounts receivable, collateral may decline as business activity declines before liquidation. Any non-real estate items, such as machinery and equipment, or inventory, can easily be sold by a borrower who is facing liquidation. Also, according to SBA, inventory is seldom worth more than scrap value if it is not used in the business operations.

The following three examples illustrate how collateral can dissipate before loan liquidation.

- In March 1980 a Chicago wholesaler of used printing equipment obtained a $550,000 guaranteed loan, providing collateral valued at $585,700. However, $300,000 of this collateral was accounts receivable and $220,000 was inventory. The loan officer commented on the inadequacy of collateral but made the loan based on reasonable assurance of repayment, experienced management, and projected earnings. At the time of liquidation in May 1982, the remaining collateral was declared to have no value by the bankruptcy trustee, and SBA sustained a $547,492 loss.
- In October 1983 SBA guaranteed a $440,000 loan to a Texas oil distributor. All loan proceeds were used for debt repayment. At the time of loan approval, the market value of the collateral was valued at $560,000 ($130,000 for machinery and equipment, $259,000 for accounts receivable, and $171,000 for inventory). After the economic downturn following the oil and gas industry decline, the loan was placed in liquidation in November 1986, and in February 1987 an appraiser

valued the remaining collateral at about $25,000. The owners filed bankruptcy and in the subsequent bankruptcy settlement, which considered the remaining collateral, the court ruled that SBA was entitled to $75,000. A note receivable for that amount was then obtained from the owner. SBA incurred a loss of about $260,000 on this loan.

- The owner of an Indiana valve manufacturing company obtained a $350,000 loan to purchase machinery and equipment. The collateral consisted of the $350,000 worth of machinery and equipment purchased with the loan proceeds--and a second mortgage on the borrower's home. Within 2 years this loan was in liquidation. SBA could recover only $91,529 from the sale of collateral and another $9,000 offer-in-compromise on the mortgage. The total net loan loss to SBA was $236,458. The SBA loan servicing officer noted in the file that the loan was undercapitalized and "in trouble from day one." The borrower basically brought nothing to the loan other than the loan proceeds provided by SBA.

SBA loan proceeds can also be used to repay existing debt, or for working capital. While this is a principal financing need for businesses, it does not generally increase assets that could be used as collateral. Table 3.2 shows the major use of loan proceeds for the cases in our sample.

Table 3.2: Use of SBA Loan Proceeds

Dollars in millions

Use	Amount[a]	Percent[b]
Debt repayment	$98	33
Machinery and equipment	45	15
Working capital	40	13
Inventory	36	12
Renovation	10	3
Other[c]	72	24
Total	**$301**	**100**

[a]Rounded to nearest million.

[b]Rounded to nearest percent.

[c]Includes new construction and purchase of real estate and existing businesses.

As shown in the table, about 33 percent of loan proceeds were used for debt repayment and about 13 percent for working capital. These uses add little to the collateral base and are basically unrecoverable in the event of liquidation. For example, a Colorado car dealership obtained a $400,000 loan that was used for debt repayment ($167,598) and working capital ($232,402). The collateral provided for the loan was

real estate, machinery and equipment, furnishings, and a parts inventory with a total value of $176,094. At the time of liquidation, this collateral was valued at $75,000, and SBA lost $277,871 on the loan.

Collateral Declines Further Because of SBA, Lender, and Borrower Practices

Further declines in SBA's collateral position occur because of certain practices by SBA, lenders, and borrowers. These practices include a lack of specific information on the valuation and identification of collateral when loans are made; the unauthorized sale of collateral before loans are placed in liquidation; and the subordination of SBA's lien position on collateral before liquidation. These practices facilitate the further decline in the collateral value.

Collateral Identification and Valuation May Not Accurately Portray SBA's Collateral Position

When loans are made, certain types of collateral are often not specifically identified or valued; as a result, when collateral is to be liquidated, SBA is uncertain what collateral is available or what value it has. In addition, collateral that is specifically identified is usually valued by the business applying for the loan rather than by an independent source. According to SBA, the values assigned when loans are made usually are market values rather than liquidation values. SBA further stated that reliable liquidation values can only be determined by an appraiser independent of the loan applicant. However, this is not being done because of resource limitations. As a result, collateral may be overvalued when a loan is made.

The identification and valuation of collateral depends heavily on the type of collateral. Some collateral, such as real estate, is almost always specifically identified and valued; other collateral, such as machinery and equipment, is not. For some types of collateral—inventory and accounts receivable—specifically identifying collateral when the loan is made would have limited usefulness because the collateral items change during the course of business.

When loans are made, collateral values are frequently provided by borrowers. For example, for the three regions we reviewed, borrowers provided values for real estate collateral 66 percent of the time. Lenders, appraisers, and others provided real estate values in the other instances. For other types of collateral, such as machinery and equipment, borrowers provided values more frequently. According to SBA district office officials, collateral valued by a borrower is likely to be overvalued to demonstrate that the loan will be adequately collateralized.

Unauthorized Sale of Collateral Before Liquidation

Servicing a loan includes monitoring the progress of a borrower's business operations, including prudent lender controls over collateral items securing the loan. Verifying major collateral and its condition is a requirement of the initial loan servicing field visit. However, updating collateral listings throughout the course of the loan is not required and is usually not done. As a result, collateral items that are part of the business assets and SBA loan collateral may disappear or be sold by the borrower before loan liquidation without SBA's knowledge. This further reduces the collateral available for SBA to recover.

SBA procedures allow for release and sale of collateral in amounts up to 20 percent of the original loan amount. However, in the cases we reviewed, collateral amounts over this limit were sometimes sold without SBA's permission before liquidation. Loan servicing specialists are directed to target their collateral monitoring efforts to problem loans rather than attempting to monitor all cases. SBA district officials told us that reviewing collateral is not a priority activity in loan servicing because of lack of personnel and time constraints. Furthermore, they stated that if borrowers are intent on selling collateral, it is very difficult to stop them. As a result, SBA and private lenders often do not know exactly what collateral is available when a loan is placed in liquidation. The following three examples illustrate the unauthorized sale of collateral before loan liquidation.

In October 1983 SBA guaranteed a $500,000 loan to a Texas manufacturing company that was secured by machinery and equipment, furniture and fixtures, and inventory. The borrower valued the inventory at $335,000, the furniture and fixtures at $16,500, and machinery and equipment at $651,742. When the loan was placed in liquidation in May 1987, the only remaining collateral was machinery and equipment, which SBA later sold at public auction for $176,645. Before loan liquidation, the borrower sold the entire inventory and furniture and fixtures without SBA's consent. SBA incurred a loss of $261,148 on this loan.

In January 1981 SBA made a $58,000 direct loan to a Minnesota windmill manufacturer. The borrower valued the collateral at $102,400. The loan was placed in liquidation in October 1986. However, before that time the borrower sold all business collateral except real estate without SBA's consent. The loan officer's report in the file stated that no money was ever applied to the SBA loan from the sale of collateral. SBA did recover $54,000 on an offer-in-compromise on the borrower's home, reducing the loan loss to about $9,000.

In January 1984 SBA guaranteed a $45,000 loan to a Minnesota construction firm. Collateral for the loan was machinery and equipment valued at about $82,000. During the course of the loan, no visit was made to verify that the collateral still existed. The loan was placed in liquidation in May 1986. Subsequently, the lender attempted, but failed, to locate any of the collateral. The borrowers denied knowing the whereabouts of the collateral, and the case was referred to the Federal Bureau of Investigation and the SBA Inspector General for investigation. When their efforts failed to locate the collateral, they suspected that the borrowers had sold the equipment. SBA was successful in collecting a $5,400 judgment against the borrower before the borrower filed for bankruptcy. The loss on this loan was about $10,000.

SBA May Limit Collateral Recoveries by Subordinating Its Collateral Position

To assist borrowers in obtaining additional credit from private lenders, SBA may subordinate its lien against the borrower's collateral, i.e., obtain a secondary claim on the collateral. SBA procedures provide for subordination after a full review of the benefits and risks associated with subordinating the agency's lien position, and additional private lender credit must be provided to improve the borrower's overall condition. If the collateral is sold, the first or primary lien holder must be satisfied before any of the remaining collateral proceeds are available to SBA. While subordination may be successful in saving a failing business, if it does not work, it can have adverse consequences by reducing SBA's collateral position, increasing risk, and reducing recoveries.

As an example of subordination, in August 1981, 2 months before the liquidation of an Illinois furniture manufacturer's collateral, SBA and the lender subordinated all of their collateral to another business on the condition that up to $150,000 would be loaned to the failing manufacturer. As agreed, this business provided about $150,000 in working capital to the furniture manufacturer, but the business did not improve and in November 1981 the loan was placed in liquidation. The collateral was liquidated for about $93,000—all of which went to the business that had loaned the $150,000 to the manufacturer. No collateral proceeds remained for either SBA or the original lender. SBA lost approximately $300,000 on the loan.

Conclusions

Collateral is of secondary importance when SBA makes or guarantees a loan. As a result, the identification, valuation, and quality of collateral is not a priority item when loans are made. Likewise, after loans are made,

because collateral is not a priority item, its use during the course of business or unauthorized sale occurs. As further evidence of collateral's secondary importance, SBA is willing to subordinate its lien position to assist financially troubled borrowers. Because of these policies and practices, loans that appear to be fully collateralized at the time of approval are usually undercollateralized at the time of liquidation. As a result, on liquidated loans in the regions we reviewed, SBA recoveries were low and losses substantial. SBA can obtain reasonable recoveries only if worthwhile collateral exists to liquidate.

Recommendations to the Administrator of SBA

To ensure that the initial loan collateral offered by a loan applicant exists and is properly valued, we recommend that the Administrator take action to have collateral independently verified and valued. However, we recognize that because of SBA's limited staff resources and funds, independent appraisals may not always be feasible. Therefore, in the absence of independent verification, we recommend that the Administrator require loan applicants to provide additional supporting information, such as tax information for real estate or sales receipts for machinery and equipment, to confirm the existence and value of collateral.

Matter for Consideration by the Congress

To provide assistance to small businesses, while at the same time protecting the government's, and ultimately the taxpayer's, financial interests, the Congress may wish to consider mandating that SBA require stronger collateral, in amounts that reflect anticipated declines in value, at the time a loan is made or guaranteed. This may be accomplished by discounting the value of collateral when loans are made to reflect their liquidation value instead of their market value. However, requiring additional collateral will preclude some potential borrowers who have repayment ability from getting a loan.

Agency Comments

As requested, we did not obtain written agency comments on a draft of this report. However, we discussed the information presented in this report with SBA officials who generally concurred with our findings, conclusions, and recommendations in this chapter as well as chapter 4. However, SBA believes that our matter for congressional consideration, which suggests that the Congress require stronger loan collateral, will preclude some borrowers who have repayment ability from getting a loan. Moreover, SBA officials believe that their current emphasis of a prospective borrowers estimated business cash flow in loan-making

decisions is consistent with the Congress' intent for the agency. We believe that, while it is important to assess a borrower's ability to repay a loan, if the Congress wants to increase recoveries on SBA defaulted loans, requiring stronger collateral will help achieve this goal and better protect the government's, and ultimately, the taxpayer's interests. GAO has incorporated agency comments where appropriate.

SBA Collateral Recoveries Are Not Maximized

In addition to inadequate collateral, SBA experienced significant losses in the three regions we reviewed because its loan liquidation activities did not maximize recoveries on collateral. SBA provides minimal effort in areas such as identifying collateral and preparing or approving liquidation plans. As a result, collateral can be sold or disappear without SBA's knowledge or approval.

Recoveries are also not maximized because SBA sometimes relies on private lenders to liquidate collateral, and oversight of lender liquidation activities is often inadequate. Private lenders have limited incentive to maximize recoveries on SBA-guaranteed loans because their share of the collateral proceeds is minimal, and they usually have already received the guaranteed portion of the loan proceeds. In addition, SBA's monitoring of private lender liquidation activities is limited because current procedures, written when nearly all liquidation activities were performed by SBA, are outdated.

SBA and private lenders usually do not take physical possession of collateral, but when they do, efforts to manage the collateral are limited. The time required to obtain possession varies depending upon the method used and the cooperativeness of the borrower. SBA management expenditures on acquired collateral were less than 1 percent of its total collateral value at the time of liquidation.

SBA Collateral Liquidation Efforts Are Not Adequate

SBA's efforts to liquidate collateral do not ensure that collateral recoveries are maximized. When loans are liquidated, SBA does not identify collateral in a timely manner, does not prepare liquidation plans, and uses private lenders to liquidate collateral who have little incentive and are not adequately monitored. Because collateral recoveries fall short, SBA frequently pursues personal guarantors to increase recoveries.

Collateral Is Not Always Identified in a Timely Manner

To maximize recoveries, collateral should be identified in a timely manner once SBA decides to liquidate a loan. Without timely identification SBA does not know with any certainty what collateral actually exists at the time of liquidation. SBA standard operating procedures state that "unless recently accomplished," the major items of collateral securing the loan or guaranty must be inspected and evaluated "as soon as possible" by the lender after a loan is placed in liquidation. Procedures do not define "as soon as possible" or specify how soon this initial visit must be made. However, the potential for disappearance or devaluation of collateral increases the longer this visit is delayed. Collateral

identification is necessary to plan liquidation actions and evaluate recovery efforts. SBA's Director of Portfolio Management believes this visit is so important that, if possible, it should be made when SBA is even considering placing a loan into liquidation.

We estimate that in the three SBA regions we reviewed, visits were not made about 16 percent of the time. Where visits were made, they were made more than 2 weeks after the loan was placed in liquidation in 38 percent of the cases. According to SBA loan liquidation officials, a good criterion is to conduct the initial liquidation visit within 2 weeks of a loan's being placed in liquidation. If the collateral has not been identified and secured within 2 weeks, these officials said it may be sold without SBA's knowledge or may disappear.

Reasons provided by SBA district office officials for not making visits or not making visits in a timely manner—within 2 weeks of liquidation—included shortages of personnel, time, or travel funds and other duties that were viewed as higher priority.

To illustrate how collateral can disappear without SBA's permission if timely action is not taken, in September 1981 SBA guaranteed a $78,600 loan to a crop spraying business for debt repayment, machinery and equipment, and working capital. In June 1986 the loan was placed in liquidation after workout attempts failed. The outstanding loan principal at the time was about $45,500. When the loan was made, collateral consisted of real estate, machinery and equipment, trucks and autos, furniture and fixtures, and accounts receivable valued at about $95,000. When the loan was placed in liquidation, an appraiser hired by SBA valued the machinery and equipment at $14,900 using available loan file information. However, the appraiser did not make a site visit to inspect, inventory, and safeguard the collateral. Similarly, an SBA loan officer valued the real estate at the time of liquidation at about $42,000 without inspecting the property. According to the loan officer, SBA had last inspected the property about 2 years earlier. Subsequently, SBA discovered that the borrowers had moved out of state, taking the personal property with them. SBA did not recover any of these assets. For the real estate, SBA assumed that it had a first lien on the property but later discovered that two prior liens existed. These prior liens made SBA's lien valueless and, as a result, SBA dropped its claim. The loss on this loan was about $41,000.

Liquidation Plans Are Not Always Prepared by SBA or Private Lenders

SBA's required liquidation plans for loans are often not prepared by SBA or private lenders or are deficient in some key elements. Without an adequate plan, the liquidation process lacks direction, and liquidation actions may be taken that are not well thought out and may not maximize recoveries. In the case of private lender liquidations, plans also provide a basis for SBA to supervise and control liquidation actions.

SBA procedures require that when a defaulted loan is placed in liquidation, prompt action must be taken to organize liquidation information into a well-developed action plan. Plans for liquidations performed by private lenders are to be pre-approved by SBA. Liquidation plans are designed to establish a uniform and systematic means for action, document important elements of a case, and establish a basis for supervisory overview and control. Plans are also, according to SBA procedures, important in preventing "drift"—letting time elapse without taking action or taking it haphazardly.

In practice, liquidation plans are frequently not prepared or, if prepared, often lack critical elements. SBA procedures also require that liquidation plans contain several basic elements, including planned liquidation actions, estimated liquidation costs, and time frames for liquidation. In the regions we reviewed, most plans do not contain one or more of these critical elements. For an estimated 25 percent of the loans, no liquidation plans were prepared. For the remaining 75 percent of these loans that had liquidation plans, we estimate that 67 percent were lacking more than one of the critical elements—time frames for liquidation, estimated liquidation expenses, or steps for liquidation.

SBA officials said that often they do not have the time or personnel to enforce and monitor liquidation plan requirements. They added that they do not always require plans or prepare plans for their own liquidations for the same reasons. One SBA district official said that the district receives plans for only about one-half of the lender liquidations.

Private Lenders Make Limited Recoveries on Collateral

When recoveries are compared to the value of collateral at the time the loan is placed in liquidation, private lenders recover approximately 27 percent of the value of collateral compared to 68 percent for SBA-performed liquidations that we reviewed. Private lenders have limited financial incentives to maximize recoveries on liquidated collateral for a number of reasons. First, SBA usually pays lenders for the guaranteed portion of the loan before liquidation of loan collateral. Second, the lender's pro-rata share of recoveries is based on the guaranteed portion

of the loan. After SBA purchases the guaranteed portion of the loan, the lender's share is minimal. For example, if a loan was guaranteed by SBA at 90 percent, the lender will receive payment from SBA for 90 percent of the outstanding principal and interest. The lender then receives only 10 percent of the recoveries from collateral. Additional expenses, such as outside attorneys' fees incurred by the lender, are similarly prorated—SBA reimburses the lender for 90 percent of allowed expenses. However, lenders are not reimbursed for internal liquidation costs, such as staff time spent by lender attorneys or loan officers.

For the regions we reviewed, we estimated that liquidation by private lenders occurred for about 35 percent of the loans. According to SBA district officials, there are no criteria for selecting which loans should be liquidated by either private lenders or SBA. In a continuing effort to privatize lending functions and reduce the need for limited federal resources, SBA has encouraged its district offices to have private lenders handle liquidations. Loans liquidated by SBA or private lenders are quite similar in amount, terms, and use of funds.

SBA Monitoring of Lender Liquidation Actions Is Limited

Although SBA may rely on private lenders to liquidate collateral, it is also required to oversee the liquidation process. For the three SBA regions we reviewed, this oversight was limited, and liquidation actions were sometimes taken without SBA's knowledge or approval.

Most SBA procedures on liquidation were prepared in the late 1970s or early 1980s when nearly all liquidation actions were performed directly by SBA. SBA standard operating procedures do not specifically detail actions for private lender liquidations; rather, they state that all actions required when SBA liquidates a loan are applicable to private lender liquidations. Current procedures do specify that liquidation plans are to be prepared by private lenders when they liquidate a loan and that these plans must be approved by the SBA district office before they are implemented. However, procedures do not detail what specific monitoring actions SBA should take to ensure that private lenders are properly liquidating loans. SBA's Director of Portfolio Management and other SBA officials agreed that SBA's current standard operating procedures for loan liquidation are outdated and should be revised to include SBA monitoring of private lender-serviced liquidations.

According to SBA operating procedures, when a lender performs a liquidation, SBA's monitoring actions could include (1) approving the lender's liquidation plan, (2) monitoring liquidation actions according to the

plan, (3) accompanying lender officials on site visits, and (4) taking other monitoring actions, such as telephone calls or written correspondence. In the three regions we reviewed, lenders liquidated 35 percent of the loans. We estimate the following in terms of SBA's monitoring actions:

- For 40 percent, SBA approved the lender's liquidation plan.
- For 37 percent, SBA either monitored liquidation actions according to the private lender's plan or accompanied private lenders on site visits.
- For 45 percent, SBA took other monitoring actions, such as telephone calls or written correspondence.

SBA district officials stated that they did not approve all lender liquidation plans or perform other monitoring activities because of shortages of personnel and time and because other duties were viewed as higher priority.

The following examples illustrate liquidation actions taken without SBA's knowledge or approval.

- In December 1983 an SBA district office relied on a lender to liquidate collateral securing a $300,000 loan to a manufacturing corporation made in November 1981. The collateral, at the time of liquidation, consisted of real estate, machinery and equipment, furnishings and fixtures, and inventory valued at a total of $163,392. Despite a written memorandum of understanding requiring the lender to submit a liquidation plan to SBA and obtain SBA's written approval before selling any collateral, the lender did not submit a liquidation plan and sold the collateral without SBA's consent. SBA lost about $140,000 on the loan.
- In December 1987 a lender liquidated a $103,000 loan to a pet store and, again, SBA did not closely monitor the lender's liquidation actions. At the time of liquidation, the loan was secured by supplies, fixtures, and inventory originally valued at $83,000. After submitting a liquidation plan, the lender took appropriate actions to move small animals, such as puppies and kittens, to another pet store. However, the pet store's fish remained on the premises, and the lender paid a law firm almost $1,000 (at a rate of $40 per hour) to feed the fish and maintain them over a 2-month period. SBA first became aware of these charges when the lender submitted a detailed invoice for reimbursement of expenses. SBA reimbursed about $3,000 for payments the lender made to the law firm, including the $1,000 to feed the fish. SBA lost about $49,000 on the loan.

Collateral Management Is Minimal

The limited recovery efforts by SBA and private lenders and the lack of available collateral when loans are liquidated are reflections of the minimal collateral management efforts by SBA and private lenders. SBA and private lenders usually do not take physical possession of collateral. When they do, the time required to obtain possession varies depending upon the method used to obtain possession and the cooperativeness of the borrower. When SBA does take possession of collateral, its management expenditures are relatively low—less than 1 percent of the total value of acquired collateral.

SBA and Private Lenders Seldom Take Possession of Loan Collateral

We found that SBA and private lenders take physical possession of major types of collateral only about one-third of the time it was available. Of the cases we reviewed, lenders actually took possession of real estate 41 percent of the time;[1] machinery and equipment 35 percent of the time; and inventory 38 percent of the time.

Lenders infrequently take possession of collateral because it is (1) usually sold by someone else, (2) stolen or lost, or (3) judged not worth pursuing. For example, at the time of liquidation, machinery and equipment was originally available for 63 percent of the loans we reviewed. However, before the private lender or SBA could take possession, the owner or someone else sold the collateral in 20 percent of these cases; in 14 percent, the machinery and equipment was either stolen or lost or judged not worth pursuing.

In several cases, collateral was not pursued by SBA. For example, a $150,000 loan was approved for an Indiana construction company in October 1983. The company used the money to repay prior debts. Three months later, in January 1984, the loan was placed in liquidation. Collateral values declined from $276,500 at the time the loan was made to about $19,000 at the time of liquidation. SBA officials believed that these assets were not worth pursuing because they were of little value. SBA did recover about $15,000 in cash from the borrower, but the net loss on the loan, including accrued interest, was about $174,000.

Another example occurred when, in April 1984, SBA guaranteed a $155,000 loan to a Texas building foundation drilling company—$80,000 for machinery and equipment, $30,000 for construction,

[1]Excludes the Chicago district office because none of the loans we reviewed contained real estate as collateral that was available when the loan was placed in liquidation.

$25,000 for prior debt repayment, and $20,000 for working capital. Collateral at the time the loan was made was valued at about $169,000. When the loan went into liquidation in October 1986, collateral consisted only of real estate, which was valued at about $9,000. Machinery and equipment originally valued at $129,000 had deteriorated or disappeared. SBA abandoned the real estate because it did not believe it could sell the property.

Time Required to Take Possession of Collateral Varies

The time it takes for SBA or lenders to obtain possession of collateral depends heavily on the method used and the cooperativeness of the borrower. The possession method differs depending on the type of collateral. For non-real estate collateral, possession is frequently obtained by "peaceful possession." However, SBA cannot simply confiscate the owner's property. If the borrower will not voluntarily give peaceful possession, judicial means must be used.

For real estate collateral, SBA and other lenders use foreclosure or voluntary conveyance to obtain possession. In voluntary conveyance, the borrower voluntarily transfers the property title to the lenders. Foreclosure involves the forced sale of property used as security with the proceeds being applied to the debts owed secured creditors in lien position order.

The time required to take possession of collateral—calculated from the date the loan was placed in liquidation to the date of physical possession—varied by both the type of collateral and the possession method. However, foreclosure took significantly longer than voluntary conveyance or peaceful possession. For example, the average time required to take possession of real estate, machinery and equipment, and furniture and fixtures by foreclosure was 648 days.[2] The average time required to take possession of the same type of collateral by voluntary conveyance or peaceful possession was 164 days.

In general, lenders prefer voluntary or cooperative means of obtaining possession to judicial actions from both timeliness and cost perspectives. According to SBA district officials, it is easier to liquidate collateral if the borrower cooperates and "turns the keys over" to SBA or the lender. In the three SBA regions we reviewed, SBA district officials estimated that 55 percent of the borrowers whose loans were liquidated cooperated in the liquidation process. On the other hand, an estimated 33 percent were

[2]Estimate excludes the Chicago district office because of the absence of foreclosure actions for the loans we reviewed.

uncooperative. For the remaining borrowers, the level of cooperation varied between these two positions.

Minimum Expenditures Are Incurred for Collateral Management

Collateral management expenditures are minimal because SBA and private lenders usually do not take physical possession of collateral. For three major types of collateral—real estate, machinery and equipment, and inventory—physical possession was taken only about one-third of the time. These three types of collateral accounted for 96 percent of the $136.1 million total value of collateral at liquidation. However, total management expenditures for all collateral was about $487,000, or less than 1 percent of the total value of acquired collateral.

As discussed previously, at the time of liquidation SBA often does not identify collateral or does not identify it promptly. Identification must be made before efforts can be taken to safeguard the collateral or determine if it has been lost, stolen, or vandalized. SBA often relies on auctioneers, private lenders, landlords, and bankruptcy trustees to safeguard collateral. The most common measures taken to safeguard against waste and deterioration include maintenance, changing building locks where collateral was stored, and paying utility bills.

SBA officials at the nine district offices we reviewed cited various reasons for their relatively minor management expenditures. One chief of loan liquidation did not use guard services or insure collateral as a means of protection because these measures were too costly. Another district liquidation officer expressed the view that it is better to spend resources on a well-advertised sale than on safeguarding collateral. Other liquidation officers said that the best way to protect collateral is to sell it as quickly as possible.

Conclusions

One major reason SBA experiences significant losses in its loan liquidation activities is that it does not maximize recoveries on collateral. The untimely identification of collateral and SBA's liquidation efforts do not ensure maximum recoveries. Further supporting this lack of concern is SBA's inattention to planning and monitoring private lender liquidation actions. Inadequate oversight by SBA indicates that it is not fully in control of the liquidation process. We believe SBA can take several steps to improve its liquidation process and increase collateral recoveries.

Recommendations to the Administrator of SBA

To maximize recoveries on collateral, we recommend that the Administrator, SBA, take action to ensure that SBA field offices comply with existing loan liquidation and acquired property procedures. Specifically, when a loan is placed in liquidation, the Administrator should require that (1) collateral be specifically identified, inventoried, and valued in a timely manner, within 2 weeks, and (2) liquidation plans be prepared by, or in the case of private lenders, approved by, SBA. These plans should specify the liquidation steps to be taken, set time frames, and estimate costs. Finally, to maximize recoveries on private lender liquidations of SBA loans, we recommend that the Administrator revise and update the loan liquidation and acquired property procedures to include adequate monitoring and oversight of these activities. At a minimum this should include SBA's prior approval and active monitoring of private lender liquidation actions.

Loans in Liquidation in Selected Field Offices, Fiscal Year 1989

Field office	Number of loans in liquidation	Dollar amount of loans in liquidation
Chicago Region		
1. Chicago	153	$27,362,933
2. Minneapolis	81	10,448,650
3. Detroit	82	11,605,820
4. Springfield	74	11,886,079
5. Milwaukee	20	2,646,700
6. Cincinnati	2	100,000
7. Cleveland	75	8,691,693
8. Indianapolis	69	12,299,730
9. Madison	41	7,346,631
10. Columbus	100	13,489,558
Total	**697**	**$105,877,794**
Dallas Region		
11. Dallas	128	$23,674,764
12. Corpus Christi	42	7,675,699
13. Harlingen	63	8,393,034
14. Little Rock	42	6,167,132
15. Houston	138	17,743,650
16. El Paso	49	4,767,110
17. Lubbock	103	14,393,793
18. New Orleans	84	14,244,300
19. Oklahoma City	56	9,773,861
20. San Antonio	129	17,713,244
21. Albuquerque	40	6,217,147
Total	**874**	**$130,763,734**
Denver Region		
22. Denver	104	$15,497,165
23. Fargo	46	6,420,144
24. Sioux Falls	56	6,316,400
25. Salt Lake City	68	9,504,146
26. Helena	131	15,807,463
27. Casper	43	9,624,398
Total	**448**	**$63,169,716**
Total for regions reviewed	2,019	$299,811,244
Total nationwide	4,552	$656,383,493

Statistical Estimates and Associated Sampling Errors

This appendix provides the sampling errors associated with our statistical sample of Small Business Administration general business loans in liquidation status during fiscal year 1989 that were either charged off (loss incurred) or paid in full for three SBA regions. The methodology used to select this sample is described in chapter 1.

Because we used a sample (called a probability sample) of general business loans in SBA's inventory to develop our estimates, each estimate has a measurable precision, or sampling error, which may be expressed as a plus/minus figure. A sampling error indicates how closely we can reproduce from a sample the results that we would obtain if we were to take a complete count of the universe using the same measurement methods. By adding the sampling error to and subtracting it from the estimate, we can develop upper and lower bounds for each estimate. This range is called a confidence interval. Sampling errors and confidence intervals are stated at a certain confidence level—in this case, 95 percent. For example, a confidence interval at the 95-percent confidence level means that in 95 out of 100 instances, the sampling procedure we used would produce a confidence interval containing the universe value we are estimating.

We calculated the sampling error for those statistical estimates that are relevant to the main issues of this report. These estimates and their associated sampling errors at the lower and upper boundary limits for the 95-percent confidence level are shown on the following pages.

Table II.1: Statistical Estimates of Losses Incurred on SBA Liquidated Loans

Dollars in millions

Variable	Estimated value	Sampling error
Net loan loss	$153.5	29.4
SBA outlays or costs	216.8	30.7
SBA recoveries	63.3	11.5
SBA guarantee purchase amount	209.7	27.8
Collateral value at liquidation	136.1	58.3
Recoveries from sale of collateral	46.4	14.2
Recoveries by credit sales[a]	21.9	17.3
Recoveries from personal guarantors	8.9	6.4
Miscellaneous recoveries	5.1	4.0
Additional sources of revenue	2.9	1.0

[a]This estimate excludes the Chicago district office because none of the loans we reviewed from that office had credit sales.

Table II.2: Statistical Estimate of Value of Collateral at Liquidation

Variable	Percent estimate	Sampling error
Collateral value at liquidation compared to loan outlays	63	21

Table II.3: Statistical Estimates of Collateral Not Always Identified in a Timely Manner

Variable	Percent estimate	Sampling error
Visits		
Not made	16	9
Made more than 2 weeks after placed in liquidation	38	16

Table II.4: Statistical Estimates of Liquidation Plans Not Prepared/Completed by SBA or Private Lenders

Variable	Percent estimate	Sampling error
Liquidation plans		
Not prepared	25	18
Prepared	75	18
Prepared, but missing more than one element	67	19

Table II.5: Statistical Estimates of SBA and Private Lenders' Recoveries and Frequency of Private Lender Liquidations

Variable	Percent estimate	Sampling error
Private lender recoveries of collateral value at liquidation	27	12
SBA recoveries of collateral value at liquidation	68	25
Private lender liquidations	35	25

Table II.6: Statistical Estimates of SBA Monitoring of Private Lender Liquidation Actions

Variable	Percent estimate	Sampling error
SBA		
Approved lenders' liquidation plans	40	28
Either monitored lenders' liquidation plans or accompanied lender on site visits	37	36
Took other monitoring actions[a]	45	36

[a]We could not obtain information for all the loans we sampled.

Table II.7: Statistical Estimates of Borrower Cooperation When SBA Takes Possession of Borrowers' Collateral

Variable	Percent estimate	Sampling error
Cooperative or somewhat cooperative	55	11
Uncooperative or somewhat uncooperative	33	15

Table II.8: Percent of Collateral Available at Liquidation Taken Into SBA Possession[a]

Variable	Percent estimate	Sampling error
Real estate[b]	41	21
Machinery and equipment	35	16
Inventory	38	29

[a]Includes voluntary conveyance, foreclosures, or peaceful possession.

[b]This estimate includes only 26 of the 27 offices in the three regions we reviewed.

Table II.9: Statistical Estimates of the Decrease in Collateral Values From Loan Approval to Liquidation

Dollars in millions

Variable	Estimated value	Sampling error
Value of loans	$300.3	63.8
Initial collateral for loans	428.4	82.8
Collateral at liquidation	136.1	58.3
Collateral decrease at liquidation	292.3	51.4

Table II.10 Statistical Estimates of the Collateral Value at Loan Approval and at Liquidation

Dollars in millions

Type of collateral	Value at loan approval	Value at liquidation	Collateral decrease	Collateral decrease percent
Real Estate				
Estimate	$158.5	$94.1	$64.4	−41
(Sampling error)[a]	(69.6)	(52.5)	(26.6)	(12)
Machinery & Equipment				
Estimate	108.2	24.6	83.7	−77
(Sampling error)[a]	(32.0)	(19.3)	(25.1)	(15)
Inventory				
Estimate	91.0	11.4	79.6	−88
(Sampling error)[a]	(34.8)	(6.9)	(33.7)	(8)
Other[b]				
Estimate	70.7	6.1	64.6	−91.4
(Sampling error)[a]	(9.8)	(3.3)	(9.8)	(4.5)
Total				
Estimate	**$428.4**	**$136.1**	**$292.3**	**−68**
(Sampling error)[a]	(82.8)	(58.3)	(51.4)	(10)

[a]Sampling errors at the 95-percent level of confidence.

[b]Includes trucks and autos, furniture and fixtures, and accounts receivable.

Table II.11: Statistical Estimates of the Use of SBA Loan Proceeds

Dollars in millions

Use	Amount[a]	Sampling error	Percent[b]	Sampling error
Debt repayment	$98	36	33	15
Machinery & equipment	45	13	15	3
Working capital	40	12	13	4
Inventory	36	21	12	7
Renovation	10	8	3	2
Other[c]	72	50	24	13
Total	**$301**		**100**	

[a]Rounded to nearest million.

[b]Rounded to nearest percent.

[c]Includes new construction and purchase of real estate and existing businesses.

Table II.12: Statistical Estimates of the Guarantee Purchase Amount as Percent of Outlays and SBA Recoveries as Percent of Collateral Value

Variable	Percent estimate	Sampling error
Guarantee purchase amount of outlays	96.7	1.7
SBA recoveries as percent of collateral value	46.5	18.4

Table II.13: Statistical Estimates of Private Lender Liquidation Legal Expenses

Variable	Estimated expense[a]	Sampling error[a]
Legal expenses	$1,276	1,269

[a]This estimate excludes the Denver district office because none of the loans liquidated by private lenders we reviewed from that office had legal expenses.

Table II.14: Statistical Estimates of Average Loss on Loans Liquidated by SBA and Private Lenders

Variable	Estimated loss	Sampling error
SBA liquidation	$71,286	14,866
Private lender liquidation	91,642	25,331

Table II.15: Statistical Estimates of Average Time for Foreclosures Compared to Voluntary Conveyance and Peaceful Possession

Category	Estimated days	Sampling error
Foreclosure[a]	648	204
Voluntary conveyance/ peaceful possession[b]	164	73

[a]The estimate excludes the Chicago district office, because none of the loans we reviewed had real estate, machinery and equipment, or furniture and fixture foreclosures.

[b]When voluntary conveyance or peaceful possession of the collateral occurred before the loan was placed in liquidation, the number of days between the two dates is included in these estimates as a negative number of days.

Table II.16: Statistical Estimates of Machinery and Equipment Identified at Liquidation and Reasons for SBA Not Taking Possession

Variable	Percent possession estimate	Sampling error
Machinery and equipment		
Frequency of availability at liquidation	63	12
Sold before possession	20	14
Stolen/lost/not worth pursuing	14	5

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