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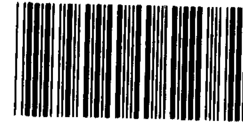
Report to the Chairman, Committee on Small Business, U.S. Senate

April 1992

SMALL BUSINESS

Losses on Individual SBA Loan Programs Are Not Fully Disclosed



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Resources, Community, and
Economic Development Division

B-244259

April 17, 1992

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

Dear Mr. Chairman:

This report responds to your concerns about how the Small Business Administration (SBA) accounts for loan collateral it acquires when borrowers default on general business loans made under section 7(a) of the Small Business Act. The 7(a) general business loan program, SBA's largest financial assistance program, was created to provide financial assistance to eligible small businesses that cannot obtain credit at reasonable terms from conventional lenders without government assistance.

In our testimony before your Committee in June 1991[1] and in our December 1991 report,[2] we reported on problems we found with the adequacy of collateral or security for 7(a) general business loans and the recovery efforts made by SBA and private lenders when loan collateral is liquidated. As a result of that work and your continuing concern about losses in the business loan program, we agreed to determine how SBA accounts for acquired collateral in reporting loan program losses and whether SBA assigns proper value to collateral from defaulted loans when making acquisition decisions.

Results in Brief

Reported losses for SBA's 7(a) business loan program do not include the actual results of the sale of acquired loan collateral or all associated costs. SBA reports its loan program losses in an annual loss study, which includes estimated rather than actual gains or losses from the sale of acquired collateral. However, the study does not include all costs associated with managing and selling acquired collateral. Rather than reporting in the loss study the actual gain or loss that occurs when collateral is sold, SBA records the difference in separate asset disposition accounts, which are not included in the loss study. The asset disposition accounts are combined with the profits and losses of other SBA loan programs and

[1]Small Business: SBA Incurs Substantial Losses on Liquidated Loans (GAO/T-RCED-91-64, June 4, 1991).

[2]Small Business: Improving SBA Loan Collateral Liquidations Would Increase Recoveries (GAO/RCED-92-5, Dec. 19, 1991).

reported to the Department of the Treasury in SBA's overall financial operation reports.

When SBA receives less from collateral sales than it estimated in the annual loss study, loan program losses are understated. According to SBA, since the inception of the 7(a) business loan program through fiscal year 1989, total actual losses from the sale of acquired collateral were about $168 million greater than reported in the annual loss study for the 7(a) business loan program. This loss represents about 5 percent of the 7(a) program total cumulative losses of $3.3 billion for the same period.

In addition to having problems associated with reporting loan program losses, SBA does not consistently assign proper value to the collateral it acquires from defaulted loans. Not assigning proper value to the collateral occurs, in part, because loan liquidation staff do not consistently comply with SBA standard operating procedures for acquiring loan collateral at forced liquidation sales. Specifically, not all expenses associated with acquiring and managing collateral are accurately estimated or accounted for when a decision is being made whether to acquire collateral. As a result, SBA sometimes overvalues collateral and spends more on its acquisition than it is worth. In addition to not being cost-beneficial, overvaluing collateral inappropriately reduces borrowers' debt because SBA credits borrowers' accounts using estimated value rather than actual collateral sale results.

Background

The Congress created SBA through the Small Business Act of 1953 (67 Stat. 232) to assist, counsel, and advocate the interests of small business. One of the key ways that SBA accomplishes its mission is through section 7(a) of the act, which authorizes the business loan program. The 7(a) business loan program consists of one major loan program—for general business loans—and a number of smaller, specialized loan programs, the most significant of which are the handicapped assistance, economic opportunity, energy, veterans, and minority business loan programs. Through these programs, SBA provides financial assistance to businesses with direct (government-funded) loans or loans made by private lenders with the support (guarantee) of the federal government. As of December 31, 1991, general business loans accounted for about 76 percent of the total $16.1 billion SBA business loan portfolio.

To ensure that the government's financial interest is reasonably protected, the Small Business Act requires that all loans have sound value or be

secured with adequate collateral as to reasonably ensure repayment. This security or collateral consists of certain assets the borrower must pledge in support of the loan, which may include real estate, machinery and equipment, furniture and fixtures, accounts receivable, and inventory.

When borrowers cannot repay their loans and no viable alternatives exist for repayment, SBA can transfer the loan to liquidation status and collateral can be liquidated by either SBA or the private lender who provided the guaranteed loan.

SBA can obtain collateral voluntarily from a borrower who defaults or involuntarily through a forced sale or foreclosure. In a voluntary conveyance, the borrower voluntarily assigns the collateral title to SBA, while in a foreclosure, SBA "purchases the collateral" through a protective bid. This protective bid may not involve any direct outlay of funds but rather can be an amount that SBA believes will protect its interest in the property at a foreclosure or other forced liquidation sale. If the proceeds received from the sale of the collateral do not satisfy the outstanding balance of the loan, SBA may take legal or administrative collection actions to recover the remaining debt. Generally, however, the balance of the loan is uncollectible, and SBA charges off the remaining debt as a loss.

SBA reports losses on individual loan programs in an internal annual loss study provided to, among others, SBA program managers and interested congressional committees and members. SBA initially developed this annual study to estimate an allowance for bad debts in individual loan programs and detail cumulative loan amounts made by SBA—both direct and guaranteed—and the amounts charged off since each loan program's inception. SBA program managers and congressional committees and members are currently using the study to examine the effect of policy decisions on various loan programs and to provide information on the costs of these programs. As of September 30, 1990, SBA reported that its total cumulative net losses for the 7(a) program were about $3.6 billion, or a loss rate of about 9 percent, for loans totaling about $41 billion.

SBA does report the actual overall profit and loss on the sale of collateral in its annual financial operation reports to the Department of the Treasury. However, these reports combine the actual gains or losses on collateral sales with the profits and losses of other SBA programs. Thus, the reports do not provide details for any of the 7(a) business loan programs.

In our December 1991 report, we reported that SBA and private lenders take physical possession of major types of collateral only about one-third of the time it is available. However, when SBA does acquire collateral, the agency uses separate accounts to record the value of the collateral and the subsequent gains and losses from its sale. Expenses associated with managing and selling the acquired collateral are also recorded in a separate general expense account.

Individual Program Losses Are Not Fully Disclosed

SBA does not include actual gains or losses on acquired collateral and costs associated with the management and sale of acquired collateral in its annual loan loss study. As a result, actual losses on SBA's individual lending programs, including SBA's largest financial assistance program—the 7(a) general business loan program—are not fully disclosed. By not including actual collateral losses and gains, as well as any associated costs, SBA does not provide a complete picture of losses incurred by the 7(a) business loan programs.

Reported Program Losses Do Not Include Losses on Liquidated Collateral

Once SBA acquires and assigns an estimated value to collateral obtained from liquidated loans, it credits this amount to the borrower's outstanding loan balance. This assigned value is also used as the recovery amount of the collateral for calculating loan program losses in the annual loss study. However, the actual gains and losses realized from the sale of collateral are recorded in separate asset disposition accounts and are not included in the study. As a result, loan program losses are understated in the annual loss study because SBA generally realizes less from the actual sale of acquired collateral than it estimated as a recovery amount.

SBA uses separate accounts to record and account for the acquisition and final sale of acquired collateral because the final sale of collateral may take several months and SBA can resolve borrowers' loan accounts in a more timely manner by using an assigned collateral value rather than actual liquidation receipts. However, for individual loans, the final collateral sale amount may be significantly less than the assigned value. For example, SBA began liquidation actions in August 1986 on a $270,000 guaranteed loan provided to an Oklahoma realty company in July 1984. The outstanding loan balance was $262,419 when liquidation actions began, and SBA bid $210,000 for the collateral at a foreclosure sale. The bid amount was credited as debt recovery to the borrower's individual account and to the loan program. Fifteen months later, SBA sold the collateral for $140,000, and the resulting loss of approximately

$80,000—including costs associated with the collateral acquisition and sale—was not included in the annual loss study for the 7(a) general business loan program.

We reviewed 38 cases in which SBA acquired and sold collateral. These 38 cases were part of a random selection of 180 loans from a universe of 2,019 7(a) loans that were in liquidation during fiscal year 1989 in 3 SBA regions—Chicago, Dallas, and Denver.

For the 38 cases, SBA assigned an aggregate value of approximately $3.9 million to the collateral, or over $102,000 per case. This amount was then recorded as a loan program recovery—which was reflected in the annual loss study—and used to reduce the borrowers' outstanding loan balances—which is a general practice in government loan programs. Upon selling the collateral, however, SBA actually received only about $3.1 million. This collateral was about $800,000 less than the assigned value, or 21 percent less than the reported amount recovered. The difference between the assigned value and the actual amounts received was recorded in separate collateral sale accounts. This difference is not reflected in the annual loss study.

According to an SBA estimate, aggregate collateral sale losses, since the inception of the 7(a) business loan program, totaled about $168 million at the end of fiscal year 1989—the latest data available. None of this amount is reflected in SBA's annual loan loss study. Overall, the $168 million represents about 5 percent of all SBA 7(a) business loan program losses of $3.3 billion.

So far, collateral losses have not been significant when compared with total cumulative losses or total cumulative 7(a) loan program disbursements. Therefore, according to SBA's Director of Accounting Operations, it was not necessary to include collateral sale results in the annual loss study. However, as a result of our work, SBA is reconsidering this position and according to its Director of Financial Management, who is responsible for preparing the annual loss study, SBA is considering including collateral sales results in the 1991 loss study.

Additional Collateral Expenses Are Also Not Included in Reported Study Losses

In addition to not including collateral sale losses in the annual loss study, SBA does not include additional expenses it incurs while managing and selling acquired collateral, such as real estate taxes and payments to prior lienholders, in collateral sale accounts or in the annual loss study. These

expenses are recorded separately in general expense accounts and cannot be readily identified for each SBA loan program. For the 38 cases we reviewed, general expenses totaled about $411,000, or an average of about $11,000 per case.

SBA considers collateral expenses either legally "recoverable" from the borrower or "nonrecoverable." Recoverable expenses, such as the cost of an appraisal and litigation expenses, are those incurred on behalf of the borrower and are charged to the borrowers' loan account, increasing the amount owed SBA. On the other hand, nonrecoverable expenses, such as expenditures on acquired properties, are recorded as general expenses. Nonrecoverable expenses include items such as property taxes, repair expenses, and the payment of prior liens after the property is acquired. The agency expects that these expenses will be estimated and deducted from the value assigned to the collateral when it is acquired; however, this is frequently not done.

By not specifically accounting for nonrecoverable expenses in the collateral sales accounts, actual losses on the sale of collateral are understated. For example, in March 1983 SBA began liquidation actions on a $400,000 guaranteed loan provided about 3 years earlier to a Colorado car dealership. SBA acquired the business property in January 1986 to prevent foreclosure by the first lienholder and valued the property at $38,000. In acquiring the property, SBA incurred expenses, including real estate taxes, totaling about $3,400. It also paid the first lienholder about $8,400 in mortgage payments due between May and November 1986. As a result, total general expenses of approximately $11,800 were incurred but not reflected in the collateral sale account or reported in the annual loss study. In November 1986 the property was auctioned and the highest bid received was only $12,000 because of the property's deteriorated condition and a weak real estate market. After the auction, the prior lienholder proposed that, in lieu of initiating foreclosure actions, SBA should sell to the prior lienholder the agency's interest in the property for $500. SBA subsequently accepted this proposal because it would gain less from the sale of the property.

SBA headquarters officials stated that they have recognized the need to identify all costs and expenses associated with individual loans and have proposed an automated system for tracking this information. However, as of January 1992 this system had not been developed because of other higher priorities.

Inappropriate Amounts Are Used for Protective Bids and Values

SBA's bids for acquiring collateral at foreclosure sales are often not developed in accordance with SBA standard operating procedures. These bids—referred to as protective bids—frequently do not reflect additional expenses associated with acquiring collateral and, as a result, SBA sometimes overvalues collateral and makes acquisition decisions that are not advantageous to the government. Furthermore, if SBA's bid is too high, it inappropriately reduces a borrower's outstanding debt.

When SBA acquires collateral through a foreclosure sale, its procedures require that the agency's protective bid for the collateral be based on a sound liquidating value less deductions for certain expenses, such as liquidation costs, appraisal fees, payments for prior liens, taxes, and assessments. In addition, if a lengthy period of time has elapsed since the last appraisal or if the collateral is of a type that significantly changes in value, it is supposed to be reappraised. However, SBA often does not follow these procedures in developing bids.

For the 38 cases we reviewed in which SBA acquired and later sold the borrower's collateral, 29 involved foreclosure and 9 involved voluntary conveyance. Of the 29 foreclosure cases, bids were developed for 28 cases—in one case a bankruptcy court determined the collateral value rather than SBA. For the 28 cases, only two bids were based on a liquidating value that reflected deductions for expenses in accordance with SBA procedures. For two additional cases, SBA did not compute a collateral liquidating value, and for one case, we could not determine if a collateral liquidating value was computed. For the remaining 23 cases, a liquidating value was determined, but deductions for other estimated expenses were not made. For example, in August 1980 SBA provided a $424,500 guaranteed loan to an Indiana skating rink business. In March 1984, when SBA placed the loan in liquidation, the outstanding principal totaled approximately $412,000. Four years later, SBA foreclosed on the collateral, a commercial building, and entered a protective bid of $280,000 at the liquidation sale based on 80 percent of the building's estimated $350,000 market value. However, when preparing the protective bid, SBA did not consider additional expenses it might incur. In fact, while liquidating the collateral, SBA incurred legal expenses of approximately $13,500 and paid property taxes totaling about $46,300. In August 1988 the property was sold for $127,500.

Furthermore, by not considering all expenses when formulating protective bids, SBA may acquire collateral that is later abandoned or ultimately sold with SBA's costs exceeding the sales proceeds and other revenue. For

example, SBA began liquidation actions in June 1987 on a $60,000 guaranteed loan to an Arkansas soft water service company, whose outstanding principal totaled $50,332. During foreclosure proceedings in April 1989, SBA developed a protective bid of $6,000 for the real estate collateral. This bid was based on a value provided by a local bank that valued the property at between $3,500 and $6,000 and SBA's belief that the property could be sold for $10,000. However, the property was also subject to a prior lien of approximately $7,300. SBA credited the borrower's account for the protective bid amount—$6,000—and paid property taxes and other expenses of approximately $670. In August 1989 SBA abandoned the property because it believed that its equity in the property after the prior lien was not sufficient to offset the expenses associated with a sale.

Similar cases of overvaluation of collateral were separately reported[3] in July 1990 by SBA's Office of Inspector General (OIG), which conducted an audit of the acquisition and sale of collateral by SBA district offices during March 1988 through February 1989. On the basis of an examination of 42 loan files, the OIG found that SBA was acquiring collateral at a premium (exceeding liquidating values), selling it for less than fair market value, and not always establishing protective bids based on liquidation values. Moreover, the study found that the aggregate difference in the purchase and sale amounts of the acquired collateral was $5.9 million, or $135,000 per transaction. In 37 cases in which SBA should have formulated protective bids, the OIG concluded that 12 were correctly formulated on the basis of liquidating values. For the remaining 25 cases, 14 had no bids formulated, and 11 bids were based on some other value. The total values assigned in the 11 bids exceeded the total liquidation value by approximately $2 million.

SBA liquidation officials stated that protective bids do not always consider all expenses because SBA personnel have not had formal training since 1985 in the liquidation area. Training is provided on the job, and if the official providing the training is not familiar with SBA procedures, such as valuation procedures, individuals may not be trained properly.

Inappropriate protective bids can not only result in poor collateral acquisition decisions but also improperly reduce a borrower's outstanding debt. The amount determined for a protective bid is also the value assigned to acquired collateral and used by SBA to reduce the borrower's outstanding loan amount. While a borrower's outstanding loan amount is

[3]Audit Report on Review of Selected Aspects of the Acquisition and Sale of Collateral by District Offices (Audit Report No. 0-2-9-003-153, July 18, 1990).

usually charged off by SBA after collateral is acquired, overvaluing collateral and subsequently reducing or eliminating the borrower's debt generally precludes any future collection opportunity by SBA.

Conclusions

Losses for the 7(a) business loan program are not fully disclosed in SBA's annual loss study because the actual results from the sale of acquired collateral are not included. In addition, expenses incurred in managing and selling collateral are not included in collateral sales accounts nor in the annual loss study. While these unreported losses may not be considered by SBA as significant when compared with total cumulative loan program losses or program disbursements, they do amount to millions of dollars and should be disclosed so that individual 7(a) loan program losses are more accurately reported to SBA program managers and the Congress.

In formulating protective bids to acquire collateral, SBA does not consistently comply with its standard operating procedures for determining collateral values and sometimes acquires collateral that costs the taxpayers more than it is worth. Furthermore, the assigned collateral values may provide borrowers excessive debt relief and preclude SBA from future collection opportunities.

Recommendations

To fully disclose individual loan program losses to the Congress and others, we recommend that the SBA Administrator direct the Comptroller to include the losses or gains from the sale of collateral and all expenses incurred from the management and sale of acquired collateral in the annual loss study. In addition, to increase compliance with SBA procedures for determining bid amounts and assigning collateral liquidation values, we recommend that the Administrator ensure that all SBA liquidation personnel receive formal training in the valuation of collateral and SBA operating procedures.

Agency Comments

We discussed the information presented in this report with SBA officials, who generally concurred with our findings, conclusions, and recommendations. We have incorporated their comments where appropriate. As requested, we did not obtain written agency comments on a draft of this report.

Scope and Methodology

To evaluate how SBA reports loan losses for the 7(a) program, we reviewed the annual loss studies for fiscal years 1989 and 1990. We also interviewed SBA officials and discussed the contents of these reports and the methodology used in preparing the reports.

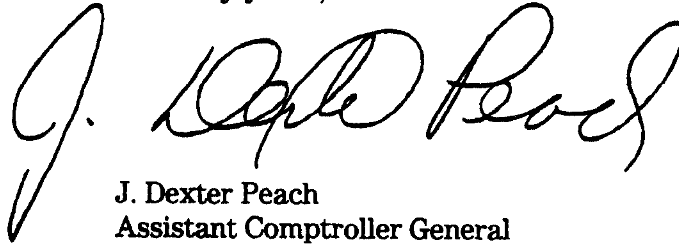
To develop information on how SBA values and records acquired collateral, we reviewed 38 cases in which SBA acquired and sold collateral. These 38 cases were part of a random selection of loans from a universe of 7(a) loans in liquidation during fiscal year 1989 that were either charged off (loss incurred) or paid in full. These 38 loans were made at nine SBA field offices—Chicago, Dallas, Denver, Houston, Indianapolis, Little Rock, Minneapolis, Oklahoma City, and Sioux Falls. The 38 cases and examples that appear in this report were located at the following SBA field offices: Dallas-5; Denver-7; Houston-3; Indianapolis-1; Little Rock-11; Minneapolis-2; Oklahoma City-4; and Sioux Falls-5. Because of the small sample size, we did not project our results to the universe of liquidated loans.

To determine how SBA assigns collateral values and records gains and losses on subsequent sales, we reviewed accounting and loan records for selected cases and conducted interviews with SBA headquarters and field office officials. We also reviewed other information on collateral, including SBA regulations and standard operating procedures; reports by SBA's OIG; and other documents that addressed collateral and the 7(a) loan program. This review was conducted from May 1991 through December 1991 in accordance with generally accepted government auditing standards.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will provide copies of the report to the Administrator, SBA; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

This work was performed under the direction of Judy A. England-Joseph, Director, Housing and Community Development Issues, who can be reached at (202) 275-5525. Other major contributors to this report are listed in appendix I.

Sincerely yours,



J. Dexter Peach
Assistant Comptroller General

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