

**DOCUMENT RESUME**

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[Small Business Administration's Compliance with Comptroller General's Decision on Purchase of Guaranteed Loans]. CED-77-26; B-181432. January 26, 1977. 11 pp.

Report to Mitchell P. Kobelinski, Administrator, Small Business Administration; by Henry Eschwege, Director, Community and Economic Development Div.

Contact: Community and Economic Development Div.

Budget Function: Commerce and Transportation: Other Advancement and Regulation of Commerce (403).

Congressional Relevance: House Committee on Small Business; Senate Select Committee on Small Business.

The Small Business Authority (SBA) lacks authority to purchase guaranteed loans from banks which have not complied with SBA regulations requiring notification of a borrower's delinquency within 30 days. The files for 80 guaranteed loans purchased and four loans rejected for purchase at SBA's Boston, Kansas City, and San Francisco district offices were examined, as were 106 randomly selected loan authorization purchases to determine the extent of compliance with this regulation.

Findings/Conclusions: The Boston and Kansas City District Offices had not made a satisfactory analysis of possible harm to the Government from late delinquency notices. The loan specialists at these offices were unable to explain their serious harm determinations and were uncertain about requirements for these determinations. The failure of SBA procedures to instruct loan officers on how to determine the effects of late delinquency notices may have contributed to the inadequacy of these determinations. Twenty five loan purchases were approved at Washington headquarters without evidence of compliance. Recommendations: The Administrator of the SBA should review purchase documents in the Accounting Operations Division to determine whether an initial review for serious harm was made by district offices, and reexamine the effects of late delinquency notice for all loans. (RRS)

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

COMMUNITY AND ECONOMIC  
DEVELOPMENT DIVISION

JAN 26 1977

B-181432

The Honorable Mitchell P. Kobelinski  
Administrator, Small Business  
Administration

Dear Mr. Kobelinski:

We recently completed a review of the Small Business Administration's (SBA's) compliance with the Comptroller General's decision of February 19, 1976 (B-181432), on the purchase of guaranteed loans. This decision requires, in part, that before purchasing a guaranteed loan which became delinquent before February 19, 1976, SBA must determine that a participating bank's failure to give SBA timely notice of a borrower's delinquency did not cause serious harm to the Government.

We reviewed the files for 80 guaranteed loans purchased and 4 loans rejected for purchase from February 19, 1976, through May 31, 1976, at SBA's Boston, Kansas City, and San Francisco district offices. These 80 purchased loans represent about 7.6 percent of the 1,056 loans purchased at all district offices during this period. We also examined 106 loan purchase authorizations selected at random from the files maintained by the Accounting Operations Division at SBA headquarters for all SBA regions. We also interviewed officials at the SBA headquarters and at the Boston, Kansas City, and San Francisco district offices.

We found that the Boston and Kansas City district offices had not made a satisfactory analysis of possible harm to the Government from late delinquency notices and that the Accounting Operations Division had certified to the propriety of loan purchases without evidence that the analysis required by the Comptroller General's decision had been made.

BACKGROUND

As a result of our review of the SBA's 7(a) loan program, we reported to the Congress, among other things, that banks which had made loans guaranteed by SBA often did not comply with a requirement that they notify SBA of a borrower's

CED-77-26

delinquency within 30 days. <sup>1/</sup> Even though SBA's regulations and guarantee agreement made compliance with this provision a condition of SBA's liability to honor its guarantee, we found that SBA was purchasing defaulted loans from banks which had not notified SBA of borrowers' delinquency until an average of almost 4 months had elapsed.

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

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

After considering the legal issues involved in this situation, the Comptroller General ruled on February 19, 1976, that SBA lacked authority to purchase guaranteed loans from banks which had not complied with SBA's regulations requiring banks to notify SBA of a borrower's delinquency within 30 days.

The Comptroller General's decision advised SBA that

--in view of SBA's long-standing practice of not insisting on strict compliance with the notification requirement, GAO would not take exception to purchases of loans made before February 19, 1976 (the date of the decision);

--GAO would not take exception to purchases of loans which became delinquent before February 19 but which had not been purchased by that date if SBA made a case-by-case determination that the Government had not

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<sup>1/</sup>"The Small Business Administration Needs to Improve Its 7(a) Loan Program" (GGD-76-24, Feb. 23, 1976).

been seriously harmed by failure to give timely notice; and

--GAO would take exception to purchases of loans which became delinquent on or after February 19 if the notice requirement had not been strictly complied with.

On March 8, 1976, in response to the decision, SBA revised its regulations governing purchase of guaranteed loans. The regulations provided that SBA would not purchase defaulted loans from a participating bank when the bank fails to notify SBA of a borrower's delinquency within 90 days of the beginning of such delinquency and that it would not pay interest accrued on a loan when a bank fails to notify it of delinquency within 45 days. The effective date of the regulation was made retroactive to February 19, 1976. SBA made conforming changes to its loan guarantee agreement. Although retroactive changes in statutory regulations are generally not permissible, we concurred in this instance. We reasoned that the retroactivity here would not affect the basic legal status of loans going into default on or after the date of our decision but before actual adoption of the amendments since the time lapse involved--February 19 to March 8--was less than the 30 days required for notice under the prior regulations.

On August 10, 1976, after our fieldwork was completed, SBA again changed its delinquency notice regulations to remove the forfeiture of the guarantee penalty, which it had established in March, for not reporting a delinquency within 90 days. Instead, the new regulations provide that, if notice is delayed beyond 45 days after the date of delinquency, SBA should not purchase the loan until a serious harm determination is made. Thus, if SBA determines there was no serious harm to the Government because of late notification of default, the only penalty remaining for a late notification is the loss of accrued interest.

In an October 29, 1976, letter we informed you of how our General Counsel believes the revised regulations affect the purchase of guaranteed loans. In summary, our General Counsel considers the following standards to be applicable to loans in various categories:

1. SBA may not purchase a guaranteed loan which became delinquent prior to February 19, 1976 (but was not purchased by that date), unless it determines that

the participating bank's failure to provide a delinquency notice within 30 days did not cause serious harm to the Government.

2. SEA may not purchase a guaranteed loan which became delinquent on or after February 19, 1976, but before August 10, 1976, unless it has received a delinquency notice within 90 days of default.
3. SBA may not pay interest accrued on loans which became delinquent on or after February 19, 1976, unless notice is received within 45 days of default.
4. SBA must make a serious harm determination on loans which became delinquent on or after August 10, 1976, unless notice is received within 45 days of default.

After SBA revised its regulations on March 8, 1976, it also revised its Standard Operating Procedure for loan servicing to instruct loan officers on how to conform to the Comptroller General's decision and its own regulations. These procedures in effect at the time of our review listed five factors which loan officers should consider in determining whether a bank's slow reporting of a borrower's delinquency had seriously harmed the Government. These five factors were:

- "1) Deterioration or disposition of collateral
- 2) Intervening liens, judgments, taxes, etc.
- 3) Disposal of borrower/guarantor assets
- 4) Lapse of hazard, flood, or life insurance
- 5) Bankruptcy proceedings"

The procedures required loan officers to indicate on documents relating to loan purchase that either notice was received as required or that after a careful review the loan officer has determined that a late notice did not cause the Government serious harm. These procedures, although modified in August 1976, remained basically the same.

#### EFFECTS OF LATE NOTICES NOT FULLY DETERMINED

At the Boston and Kansas City district offices, loan specialists had not adequately considered whether late delinquency notices had harmed the Government's interests. This was evident from the following:

--69 of the 84 loans we reviewed became delinquent prior to February 19, 1976. The files for 30 of these 69 loans did not indicate that loan officers had done any analysis or investigation to support their determinations that the Government had not been harmed by late delinquency notices.

--10 of these 69 loan files did not contain even the minimal evidence of a serious harm determination required by SBA procedures--the loan specialist's certification that such a determination had been made.

--Some loan specialists who recommended purchase of loans were unable to explain to us how they reached their findings on serious harm or they did not understand the circumstances in which this determination was required or the nature of the review to be performed.

Loans may have been purchased at other SBA district offices without a satisfactory analysis of whether late delinquency notice harmed the Government. This is indicated by the failure of SBA procedures to adequately instruct loan specialists on how to determine the effects of late notice, and by the absence of evidence of a serious harm analysis in purchase documents we reviewed at SBA headquarters. We found at the headquarters that, of 106 randomly selected purchase authorizations, 25 did not contain the statement required by SBA procedures that the delinquency notice was timely or that a careful review had been made of the effects of late notice.

The following chart highlights the scope of our review at the SBA district offices and some of the deficiencies noted.

	<u>Boston</u>	<u>Kansas City</u>	<u>San Francisco</u>	<u>Total</u>
Total loans reviewed	<u>22</u>	<u>37</u>	<u>25</u>	<u>84</u>
Loans delinquent before February 19, 1976	<u>19</u>	<u>32</u>	<u>18</u>	<u>69</u>
No deficiencies noted	2	9	18	29
Certification made but not documented	13	17	0	30
Required certification not made	4	6	0	10

Loan specialists unable to explain serious harm determinations and uncertain about requirements for these determinations

At the Kansas City district office, we reviewed 17 loans which involved a late notice of a borrower's delinquency beginning prior to February 19, 1976, and which contained no documentation in the files as to a serious harm analysis. We discussed each of these loans with the responsible loan specialists. They were able to specify some basis for their opinion that the Government was not seriously harmed by the late notices for 12 of the 17 loans. They were not able to explain satisfactorily how they reached this conclusion on the other five loans.

At the Boston district office, three loan specialists told us they did not know they were required to consider the five possible causes of injury to the Government before certifying that the Government had not been seriously harmed by late delinquency notice.

The Assistant District Director for Finance and Investment and the Chief of the Portfolio Management Division at the Boston district office acknowledged that the district office was not complying with SBA Headquarters' directives on determining whether the Government was harmed by late delinquency notices. We also discussed our finding with the Assistant Regional Director for Finance and Investment in Boston who subsequently sent a memorandum to district directors which stated, in part:

"It is not enough to simply state the 'no serious harm' disclaimer. The loan officer must review the five items [listed in SEA procedures] concerning collateral, liens, guarantors, insurance and bankruptcy and state the results of his review of those minimum items."

Loan specialists at the Boston district office had also misinterpreted SBA's procedures implementing the Comptroller General's decision. They believed that reporting a delinquency within 45 days was allowed for all loans purchased on or after February 19, 1976, regardless of the date of delinquency. However, this belief was in contravention to established procedures. These procedures provide that a bank has 45 days to report a delinquency occurring on or after February 19, 1976, but only 30 days to report a delinquency occurring prior to that date. As a result of this misunderstanding,

three loans were purchased without the required serious harm determination. We reported our findings to a regional office official who directed that all purchases be reviewed for compliance with SBA procedures and that loan specialists make the serious harm determination in accordance with the procedures.

Inadequate procedures for  
determining serious harm

The failure of SBA procedures to instruct loan officers on how to determine the effects of late delinquency notices may have contributed to the inadequacies of these determinations. The procedures also do not require a reexamination of serious harm determinations at the completion of loan liquidation (the process of resorting to collateral or otherwise enforcing collection) although the effects of late notice may sometimes not be fully determinable until then.

SBA procedures in effect at the time of our review did not instruct loan specialists how to determine whether a late delinquency notice seriously harmed the Government. The procedures stated that a review for serious harm should be made and listed examples of harm (e.g., deterioration of collateral) but did not advise loan specialists on the nature or extent of the investigation they should perform.

An SBA headquarters official told us that if documents in the loan file do not indicate that the Government was harmed by a late notice, physical inspection of the borrower's place of business and collateral was not required. In our opinion, a reliable determination of whether a late notice caused serious harm to the Government cannot be made without such an inspection. Officials of the SBA Kansas City region agreed that a thorough analysis of the effect of a late delinquency notice would require an inspection of the borrower's collateral. In addition, a site inspection of collateral would provide SBA an opportunity to evaluate the business and decide on a proper course of action; e.g., to provide further assistance or secure the collateral to protect the Government's interest.

The need for onsite inspection of collateral is illustrated by two loans we reviewed at the Kansas City district office. These loans were made to one borrower. SBA's share of outstanding balances totaled about \$14,500. The loans were delinquent 129 and 90 days before SBA was notified. A loan officer recommended purchase of these loans on May 7, 1976, based on his review of documents in the loan files and

his conclusion that the late delinquency notices had not seriously harmed the Government. About 2 months later a loan specialist visited the borrower's place of business and found that much of the collateral was missing.

SBA procedures require that a review for serious harm be made at the time a bank requests purchase of a loan. There is no explicit requirement that the serious harm determination be reexamined after loan liquidation even though a final determination of the effects of a late notice may be possible only after liquidation has occurred and the borrower's collateral has been sold. The Chief of the Portfolio Management Division at the San Francisco district office said that an important element in assessing the impact of a late delinquency notice was its effect on collateral but that the sufficiency of a borrower's collateral was often not established until after liquidation.

A final review of the effects of a late delinquency notice after liquidation would be useful since, even after purchase of a guaranteed loan, SBA has the right to recover losses attributable to the lender.

LOAN PURCHASES APPROVED IN WASHINGTON  
WITHOUT EVIDENCE OF COMPLIANCE WITH THE  
COMPTROLLER GENERAL'S DECISION

As noted earlier, we found that the loan files and purchase authorizations for 10 of the 59 loans we examined at the Boston and Kansas City district offices did not contain a certification by a loan specialist that a serious harm determination had been made. The purchase of these loans was approved by certifying officers in the Accounting Operations Division, SBA headquarters. Although payment had already been made on these loans, the chief of the division told us that they would be referred back to the district offices for a determination.

In addition, in our review of 106 loan purchase authorizations at SBA headquarters we found that 25 loans had been approved for payment by certifying officers despite a lack of evidence that they were approving payments lawful under the Comptroller General's decision and SBA's own regulations. The purchase documents submitted by district offices for these 25 loans did not show that delinquency notices were submitted on time or that no serious harm resulted from late submissions.

Since these 25 loans included loans from each of the 10 SBA regions, the problem of inadequate serious harm determinations may be common throughout SBA offices.

PURCHASE OF LOANS SUBJECT TO THE  
45- AND 90-DAY NOTICE REQUIREMENTS

As indicated on page 3, SBA revised its regulations on March 8, 1976, to permit banks 45 days within which to report a borrower's delinquency. Under the revised regulations SBA would not pay accrued interest to a bank which did not report within 45 days and would consider its guarantee commitment to be terminated if a delinquency was not reported within 90 days. The new regulations applied to loans which became delinquent on or after February 19, 1976.

Our review included 12 such loans. In each case the bank reported the borrower's delinquency within 45 days.

CONCLUSIONS

A Comptroller General's decision and SBA procedures implementing this decision require that before purchasing a guaranteed loan which became delinquent prior to February 19, 1976, SBA determine whether a bank's failure to provide a timely notice of a borrower's delinquency seriously harmed the Government. These determinations were often not made satisfactorily at SBA's Boston and Kansas City district offices. The same problem may exist at other SBA offices.

Loan purchase authorizations did not indicate the basis for loan specialists' conclusions that the Government was not seriously harmed by late delinquency notices. Some loan specialists could not explain their determinations to us.

Inadequate serious harm determinations resulted in part from misunderstanding by loan specialists about when the determination was required and how it should be performed. Although SBA procedures recognize that harm to the Government can result from deterioration or dissipation of collateral, loan specialists were not required to physically inspect collateral. Site inspection of collateral would also give SBA information on how to further service the loan.

Certifying officers in Washington have approved the purchase of loans without evidence that the Comptroller General's decision was followed.

Even though a final determination of the effects of a late notice may be possible only after the loan has been through liquidation and the borrower's collateral has been sold, SBA procedures do not require that serious harm determinations be reevaluated at this time.

RECOMMENDATIONS TO THE ADMINISTRATOR

To insure that determinations of the effects of late delinquency notices were made reliably by district offices on loans already purchased and to enable SBA where appropriate to exercise its right to recover losses attributable to the lender, we recommend that SBA

--review purchase documents in the Accounting Operations Division to determine whether an initial review for serious harm was made by district offices and resubmit loans to these offices where no determination is evident and

--reexamine the effects of late delinquency notice for all loans at the completion of liquidation.

SBA With regard to loans not yet purchased, we recommend that

--insure that loan specialists clearly understand when a review for serious harm should be made;

--provide additional instructions to district offices on methods of determining serious harm, including the need to physically inspect loan collateral;

--require loan specialists to document the basis for their determinations of serious harm; and

--instruct loan specialists to make a final evaluation for serious harm at the completion of loan liquidation.

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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House and Senate Committees on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the

B-181432

agency's first request for appropriations made more than 60 days after the date of the report.

Copies of this report are being sent to the aforementioned four committees; the applicable legislative committees; and the Director, Office of Management and Budget.

Thank you for the cooperation given to our staffs.

Sincerely yours,

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

Henry Eschwege  
Director