The Commonwealth of Massachusetts
Office of the Inspector General

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Robert Nelson
District Director
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Dear Mr. Nelson:

The Massachusetts Office of the Inspector General (OIG) conducted a risk assessment of the U.S. Small Business Administration's (SBA) $4 million American Recovery and Reinvestment Act of 2009 (ARRA) funded Microloan Program in Massachusetts.[1]

The OIG has reviewed ARRA-related grants and projects to identify potential vulnerabilities for fraud, waste, and abuse and other risks that could negatively influence the accountability, transparency, and anti-fraud mandates contained in the statutory language and interpretive guidance of ARRA. SBA should not construe this review as an audit, investigation, or comprehensive review of the program or of a particular lending intermediary

The OIG reviewed lender compliance with applicable SBA program regulations and guidance including compliance with both SBA and lender loan documentation requirements. The OIG review did not include an evaluation of lending policies, loan underwriting criteria, or how lenders determine borrower creditworthiness. However, the OIG did review whether lenders used such policies and criteria.

SBA's Microloan Program provides short-term loans of up to $50,000 to small businesses. According to the SBA, the average microloan is about $13,000 and may be used for working capital, or the purchase of inventory/supplies, furniture/fixtures, or machinery/equipment. Borrowers may **not** use microloan proceeds to pay existing debts or to purchase real estate. Borrowers can receive loan terms of up to six years at interest rates based on a discounted five-year U.S. Treasury "T-Bill" rate.

[1] SBA also awarded $626,134 in technical assistant grants to program lenders but, the OIG did not include these funds in its review. Lenders use these technical assistance grants to provide training to potential borrowers regarding business planning, the loan process, and any other issue that could assist in the launch or expansion of a business.

To administer this program, the SBA uses specially designated intermediary lenders, usually not-for-profit community-based organizations. These lenders must meet SBA's three eligibility criteria including: 1) being organized as either a not-for-profit or quasi-governmental agency, 2) having made or serviced small short-term fixed rate loans to newly established or growing small businesses for at least a year, and 3) having at least one year of experience providing technical assistance to borrowers. Massachusetts currently has six SBA-approved intermediary lenders for microloans. As of June 30, 2011, the six intermediaries had issued $1.1 million (28%) of the total $4 million program award.

Table 1: SBA Microloan Awards in Massachusetts as of June 30, 2011

Microloan Intermediaries	Tax Status	Grant Amount	Amount Disbursed (3/31/11)	Percent Disbursed
City of Lynn, Economic Development & Industrial Corp. (Lynn EDIC)	M.G.L. c.121A[2]	$750,000	$ 135,000	18%
Fall River Office of Economic Development[3] (FROED)	501(c)(4)[4]	750,000	225,000	30%
New Bedford Economic Development Council, Inc. (NBEDC)	501(c)(3)[5]	750,000	85,000	11%
RCAP Solutions Financial Services, Inc. (RCAP)	501(c)(3)	250,000	250,000	100%
South Eastern Economic Development Corp. (SEED)	501(c)(4)	750,000	245,000	33%
Western Massachusetts Enterprise Fund, Inc.(WMEF)	501(c)(3)	750,000	192,246	19.3%
Total ARRA Grant		4,000,000	1,132,246	28%

Source: Prepared by the Office of the Inspector General.

[2] An organization established under M.G.L c.121A is a public instrumentality created as an urban development corporation to engage in redevelopment activity in a designated urban area.

[3] Formerly Jobs for Fall River, Inc.

[4] According to the Internal Revenue Service (IRS), a 501(c)(4) is a tax-exempt not-for-profit organization similar to a 501(c)(3) charitable organization except that it may engage in unlimited lobbying activities, may engage in political campaign activity, and donations made to it, unless it is a public entity using the donations for a "public purpose," *are not tax deductible*.

[5] According to the IRS, a 501(c)(3) is a tax-exempt organization operated exclusively for "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals." All donations to a 501(c)(3) are tax deductible to the extent allowed by law.

The OIG notes that pursuant to SBA guidelines, “no disbursement on this loan shall be made after twenty four (24) months from the date of … authorization.” These lenders have approximately one year remaining to draw down the remaining funds from the SBA and lend these funds to eligible borrowers. There is a significant risk that some of the lenders will be unable to lend the remaining funds given lender performance to date and the authorization timetable.

The OIG review also identified the following program risks for fraud, waste, or abuse:

1. **SBA does not require lenders to follow any established underwriting or documentation standards.**

The SBA does not provide or require Microloan Program lenders to follow uniform underwriting and loan documentation standards. The OIG review identified that lenders use diverse and inconsistent underwriting and documentation standards. According to the Federal Deposit Insurance Corporation (FDIC):

> Underwriting is the process by which the lender decides whether an applicant is creditworthy and should receive a loan. An effective underwriting and loan approval process is a key predecessor to favorable portfolio quality, and a main task of the function is to avoid as many undue risks as possible.

Underwriting is an essential process in the determination of borrower risk to state and federal loan programs, private lenders or other entities that extend credit. Lenders usually maintain underwriting standards. As an example, the FDIC provides guidance to the lenders it insures. FDIC underwriting standards for its Small Business Lending Program state: “extend credit in a safe and sound manner with prudent risk selection and credit risk management processes.” Although the FDIC gives “considerable latitude” to lenders in formulating underwriting standards, the FDIC requires lenders to follow “minimum guidelines” as set in federal law for underwriting. These guidelines help to establish “standards for prudent credit underwriting practices” that are “commensurate with the loan types” offered, consider the “nature” of the loan market, consider the “borrower’s willingness and ability to repay”, “establish a credit review process”, take adequate account of risk, and are “appropriate” for the lender’s size and business activity. The FDIC also offers that prudent small business underwriting should “reflect all relevant credit factors” including the borrowers ability to service debt from income, value of collateral, borrower creditworthiness, borrower equity investment in the business, other sources of repayment, any other “collateral or credit enhancements.”

The Microloan Program should have uniform underwriting standards since SBA’s intermediary lenders are essentially acting as commercial banks/lenders. The key difference is that SBA lenders operate with minimal regulation, without standard banking and underwriting requirements, and with minimal oversight. According to the FDIC: “To be effective, the underwriting and loan approval process should establish minimum requirements for information and analysis upon which the credit is to be based." The requirements should set the criteria under which lenders approve and deny credit. Exceptions to or overrides of these requirements could then be identified and subject to oversight review. Underwriting standards need not be onerous but they should be substantial enough to protect program integrity, and offer safeguards against fraud. use.

The OIG also identified a lack of uniform loan documentation standards. These documentation standards would provide for uniform loan applications and supporting documentation that would explain and support the lender's decision to approve or deny an application. Examples of supporting documentation include, but are not limited to, completed loan applications, verification of borrower identity, verification of borrower's financial capacity, collateral evaluation, and financial statements, etc.

The OIG believes that a lack of uniform standards contributes to potential oversight and audit difficulty (lender actions may lack accountability and transparency), creates a risk for fraud, waste, and abuse (a lack of standards leaves room for rule exceptions and subjectivity) and could create inequitable access to funds (a borrower might qualify for a loan at one lender but not the other).

Recommendation: SBA should develop uniform underwriting and documentation standards for the Microloan Program. SBA lender reviews should focus on any overrides or exceptions to either SBA or lender standards.

2. SBA does not review loans for underwriting or credit worthiness.

The SBA, with the exception of the SBA Office of the Inspector General, is the only federal agency with oversight authority of Microloan Program lenders. In contrast, banks and their loan portfolios are reviewed by federal, state, and private bank funded oversight authorities. According to SBA program guidelines, it does not review issued loans for adherence to lender underwriting criteria or for borrower creditworthiness. As a result, there is little, if any, oversight or scrutiny of lender practices. Without oversight, lenders could violate their own practices, engage in lending to related or favored parties, or violate sound banking practices. Any of these actions could undermine the intent of this ARRA-funded program and are at high risk for fraud, waste, or abuse. Unscrupulous parties could also use the loan program to obtain funds and then default on these loans, which would then become a liability for the not-for-profit lender. For example, a lender employee could use a shell or straw company to obtain loan funds. The company could then default on the loan. The lender employee has, in effect, "laundered" loan funds through the lender. The employee keeps the loan proceeds and the "loss" becomes the lender's debt to the SBA. Microloan defaults are not uncommon.

Microloans have a default rate of around 15%. A high default rate is expected since the program is intended to provide loans to high-risk borrowers. Due to this risk, the SBA requires lenders to maintain a loss reserve of 15% compared to 1 or 2% for traditional bank-issued commercial loans. A loan loss reserve fund (LLRF) is used to pay any shortage in the amount owed to the SBA caused by loan delinquencies, losses or defaults. The loss reserve is based on a percentage, set by the SBA, of the outstanding balance of all receivables owed by borrowers to the lender. According to the SBA, the source of funds for the loss reserve must be from non-federal sources (with certain exceptions) and must not be from borrowed funds.

Recommendation: To mitigate risk, the SBA should review the underwriting and borrower credit worthiness process/standards used by lenders and test these standards against issued loans.

3. There are no established professional or educational requirements for lending "officers."

The OIG review noted that the SBA does not have professional or educational requirements for intermediary lending officers. According to banking industry representatives the OIG spoke with, lending officers responsible for commercial loans should have at least minimal lending expertise. In the Microloan Program, lending officers are responsible for reviewing loan applications, performing credit and cash flow analyses, establishing borrower creditworthiness, reviewing financial statements and other documents, calculating interest rates and for communicating effectively with small business owners and others who may be finding themselves in difficult financial straits. Although lenders may hire staff with lending experience, they are not required to do so.

According to the U.S. Bureau of Labor and Statistics (BLS): "Commercial loan officer positions often require a bachelor's degree in finance, economics, or a related field." BLS states that commercial loan officers often analyze business finances, cash flow, and credit through knowledge of business accounting and financial statements. No certification/licensure requirements exist for loan officers (except for mortgage lenders.

To help foster program success and to help ensure consistency between lenders, SBA should require minimum standards for loan officers as well as consistent hiring practices. For example, prior to hiring, intermediaries should perform background and reference checks on loan officers and other staff involved in the lending process. The OIG understands that not having standards may not inhibit intermediary lender performance. However, the OIG believes that not having consistent standards is a risk for fraud, waste, and abuse. The FDIC underwriting standards for small business loans states: "Participating institutions should ensure that their management, lending, and credit administration functions have sufficient experience and resources to successfully conduct small business lending." Although FDIC standards are not applicable to the Microloan Program, small business lending guidance offered by the SBA, FDIC and other federal agencies could provide useful guidance for a program with few standards.

Recommendation: The SBA should develop hiring and job title standards for the program. At a minimum, SBA should provide guidance on this subject to lenders. These lenders are generally not-for-profit organizations with limited banking experience that are not usually required to adhere to any national or state-level banking, lending, or underwriting standards. As a result, if SBA is entrusting these organizations with safeguarding millions of dollars in taxpayer funds, then SBA should develop minimum risk mitigation measures.

4. In violation of SBA rules, a lender granted a $4,800 microloan to pay a debt.

SBA regulation (24 CFR §120.130) states: "[the] proceeds from a microloan cannot be used to pay existing debt or to purchase real estate." The OIG identified that RCAP Solutions Financial Services (RCAP)[6] issued a $4,800 microloan to a borrower to pay an existing debt the borrower had with *North Central Massachusetts Development Corporation*[7] (NCMDC). RCAP loan file notations indicated the borrower's "payment history with NCMDC has been lack [sic]." The loan file also indicated that the borrower in question had a prior history of loan problems with RCAP. In response to OIG questions regarding the issuance of a loan to pay a debt in violation of SBA rules, RCAP staff claimed ignorance of the SBA rules regarding debt payments.

The OIG did not review RCAP's underwriting standards to determine if the borrower's prior loan problems with RCAP should have disqualified the borrower from receiving a microloan. As noted previously, the SBA has not issued underwriting guidelines for the Microloan Program. However, the OIG notes that according to SBA underwriting guidelines for another loan program, its small business-lending program, the borrower's loan history should be considered and that the lender's credit analysis "must conclude…that there is a reasonable expectation that the borrower will repay the loan in a timely manner…."

The OIG also noted that RCAP issued the loan disbursement check to the borrower only and not the borrower and NCMDC jointly or to NCMDC directly even though RCAP issued this loan to pay a debt. The OIG asked RCAP staff if the borrower had paid the debt as intended. RCAP staff stated that the borrower informed RCAP staff that the debt had been paid, but loan files contained no information to that effect and RCAP staff stated that they did not confirm with NCMDC that the debt had been paid; they simply took the word of the borrower.

The OIG is concerned that RCAP issued a loan for a purpose not allowed under SBA rules to a borrower with prior loan problems and failed to ensure that loan proceeds had been used as intended. This type of lending process, aided by a lack of

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[6] RCAP Solutions is headquartered in Gardner, Massachusetts and has offices in nine states, Puerto Rico and the U.S. Virgin Islands. It's mission is providing safe affordable housing; building and managing water and wastewater facilities; helping communities develop the critical infrastructure they need to thrive; advocating on their behalf; and providing the training and education that helps build capacity.

[7] NCMDC is a 501(c)(3) organization that provides resources, information and technical support to help establish and expand businesses in North Central Massachusetts.

uniform SBA underwriting guidelines and program standards, creates a high risk for fraud, waste, and abuse as well as a risk for a programmatic failure to achieve goals.

Recommendation: SBA rules are clear: "loan proceeds cannot be used to pay down existing debt." RCAP staff claimed an ignorance of these rules. It is also unclear why RCAP issued a loan to a borrower with a history of loan "problems" with RCAP. The OIG understands that by its nature, the Microloan Program issues loans to high-risk borrowers and is essentially the lender of "last resort." However, a known problem borrower may exceed even this program's high-risk threshold. SBA and RCAP should consider reviewing RCAP underwriting practices and providing additional training and/or technical assistance to mitigate any lack of understanding of SBA rules by RCAP staff. SBA should also review the loan in questions for compliance with program rules.

The OIG also notes that RCAP issued a loan to another borrower at a 9% interest rate. Based on our understanding of SBA loan interest calculation guidance, RCAP could only charge a maximum interest rate of 8.65%. This is a small difference, but perhaps worthy of review by the SBA as this could indicate a need for policy clarification.

5. Lenders are at risk for fraud, waste, and abuse.

Intermediary lenders are usually small local not-for-profit organizations. Some are involved in other "banking" activity besides the Microloan Program and by virtue of their tax status, could be involved in lobbying and political activity. The lenders, as small businesses themselves, often have relationships with other small businesses, local leaders and others. Lender employees may also be local citizens.

These lenders are also unregulated, lack uniform underwriting standards, are not subject to routine external oversight and internal audit of their loan operations, and are not required to adhere to strict control standards. Minimal oversight and controls and potential affinity relationships between lenders and borrowers creates a high risk for fraud, waste, and abuse.

Recommendation: The SBA should require intermediary lenders to adopt codes of conduct and ethics policies and require lenders to regularly train staff in these areas. SBA should review lender adherence to control environment practies during its periodic lender reviews. SBA should also consider reviewing lender loan documentation more frequently or consider having lenders provide a "peer review" of loan documentation on a sample basis. It is impossible to reduce all risk, but SBA should seek to reduce some of the program risks. To assist in this effort, the SBA should conduct a fraud risk assessment of the program and a select sample of lenders to identify program risks.

Conclusion

The OIG review, although limited in scope and focusing on a program that had expended less than 30% of its loan funds at the time of the review, identified program elements at high risk for fraud, waste, and abuse. Additionally, the SBA Office of the Inspector General (SBAIG) issued a recent report concluding that SBA's "Oversight activities are not sufficient to ensure effective operation of the microloan program." Another SBAIG review, although focused on a different ARRA-funded SBA loan program, found that "material lender noncompliance in originating, closing, and servicing early-defaulted loans in accordance with SBA requirements and prudent lending practices, which resulted in an increased risk of loss to the SBA." These findings could be instructive to the Microloan Program for risk mitigation.

The OIG is concerned that public, quasi-public, and not-for-profit intermediary lenders may not be provided with adequate guidelines and controls and that there is not adequate oversight of the guidelines and controls that exist in the program. The OIG recommends that the SBA increase its oversight of these unregulated lenders to address vulnerability to fraud, waste and abuse and to prevent missteps that may occur because lenders may have too much discretionary authority under the current program. The OIG also recommends that the SBA clarify its loan guidelines for intermediaries and require intermediaries to review their respective loan portfolios to identify and inform SBA of any loans that may violate the restriction against using loan proceeds to pay down existing debt. SBA may then determine proper corrective action.

Please do not hesitate to contact us if you have any questions or concerns.

Sincerely

Gregory W. Sullivan

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Inspector General

cc: Peggy Gustafson, SBA Inspector General
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