U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

Advisory Report
No. 2-31
September 30, 2002

To: James E. Rivera, Associate Administrator
for Financial Assistance

[FOIA Ex. 6]

From: Robert G. Seabrooks, Assistant Inspector General
for Auditing

Subject: Impact of Loan Splitting on Borrowers and SBA

The purpose of this memorandum is to alert you to several issues identified during a review based on a referral from the [FOIA Ex. 6] regarding a practice that we refer to as "loan splitting." The loan splitting that we observed occurred when a single loan is split into two loans to the same borrower for the benefit of the lender. The objective of our review was to determine if split loans were originated in accordance with program regulations and assess the impact of split loans on the borrowers and the Agency.

Background and Scope

The loans were split so that one loan could be used to acquire or refinance real estate and the other loan to finance the construction of a new building or improvements to existing structures located on the acquired real estate. According to the lender, this was done so the acquisition portion of a borrower financing could be sold as a separate loan on the secondary market sooner then if the two loans were combined. Under SBA regulations, loans can not be sold until fully disbursed. Improvements loans, which are usually disbursed incrementally over time, generally take longer to sell than do acquisition loans which are fully disbursed at settlement.

We examined 12 loans totaling $ 4.3 million to six borrowers that received two loans each. All 12 loans had maturities of 25 years and were approved during FY 2001. The loans were selected from a list of approximately 858 section 7(a) loans that were approved by a single PLP lender mostly during the period of FY 1996 to FY 2002.

RESULTS

Loan splitting as described herein does not appear to violate program regulations. There are, however, some negative aspects to this practice that impact both the borrowers and the Agency. Also, two of the loans we reviewed did not conform to program term limits.

Finding 1. Increased Closing Costs

The closing costs charged to the borrowers that received split loans increased as much as $200 because of the filing fees associated with the additional set of documents necessary for the second real estate loan, such as deeds, certifications, and assignments. Due to a lack of documentation in the lender's loan files, we were not able to determine if there were any additional attorneys' fees for the preparation of documents for the second loan which had to be tied in and subordinated to the first loan.

Although the additional closing fees and expenses may be nominal, we believe it is inappropriate for a lender to charge the borrowers for any additional expenses incurred for the sole benefit of the lender.

Recommendation

We recommend that the Office of Financial Assistance:

1A. Implement a procedure to require that lenders absorb all additional costs associated with loans that are split into multiple loans for the benefit of the lender.

Finding 2. Inflated Loan Production Performance Data

The reported number and average size of 7(a) loans approved during a given period may be misleading. The method used by SBA to calculate loan production and performance measures does not take into consideration the number of loans that were split into multiple loans. This results in an inflated number of reported approved 7(a) loans and a reduction in the average size of the approved loans. Similarly affected by this method of calculation are the number of loans approved for women, minorities, and veterans.

Recommendation

We recommend that the Office of Financial Assistance:

2A. Adopt a method for counting split loans as one rather than two loans to improve the accuracy of reporting 7(a) loan productivity.

Finding 3. Maturity Limits Exceeded

Two of the twelve split loans we examined exceeded the maturity limits allowed under program regulations. Pursuant to 13 CFR 120.212, the term of a loan shall be ten years or less, unless it is used to finance real estate or equipment with a useful life exceeding ten years. A maximum of 25 years is allowed for loans used to acquire or improve real property. The SOP 50 10 (4), subpart B, provides that improvement expenses qualify for a 25-year maturity period only if they cost one-third or more of the purchase price or current appraised value of the real estate.

The two split loans we examined were used to finance improvements to the buildings that were purchased with acquisition loans. Both improvement loans were given the same 25-year maturity period as the acquisition loans, even though the amounts of the improvement loans were far less then 33 percent of the purchase price of the buildings. In one case, the acquisition loan used to purchase a building was $1,164,000 and the improvement loan was $55,000, or 4.7 percent of the building purchase price. In the other case, the acquisition loan was $495,000 and the improvement loan was $76,500, or 15.4 percent. Consequently, the improvement loans did not meet the 33 percent requirement to qualify for a 25-year maturity period and should have been limited to 10 years or less, depending on the expected economic life of the improvement.

Recommendation

We recommend that Office of Financial Assistance:

3A. Remind all participating lenders to ensure that the appropriate loan maturity limits are observed for all loans made under the 7(a) loan program.

Management Response

SBA officials in the [Ex. 6] District Office and Office of Financial Assistance were briefed on the results of the audit and generally agreed with the findings and recommendations.

Appendix

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