



U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Eric R. Zarnikow
Associate Administrator, Office of Capital Access

Date: September 22, 2010

From: Debra S. Ritt /S/ **Original Signed**
Assistant Inspector General for Auditing

Subject: Notice of Finding and Recommendation on Lender-Approved ARC Loans to
Affiliates
ROM 10-18

The Office of Inspector General (OIG) conducted an audit of the America's Recovery Capital (ARC) Loan Program to determine whether SBA: (1) implemented adequate program guidance to achieve the ARC Loan Program's legislative goals; and (2) conducted effective oversight of the ARC Loan Program. This Notice of Finding and Recommendation (NFR) is intended to provide the Agency with early notification of findings and recommendations related to the approval of ARC loans to potentially affiliated companies. We identified 38 lender-approved ARC loans made to apparently affiliated companies that were not approved by SBA, as required by the ARC Loan Program procedural guide.

We made three recommendations to the Associate Administrator for Capital Access to: (1) review each of the 38 identified loans to determine if they were made to eligible companies; (2) for any loans that SBA determines were made to ineligible companies, cancel the loan guaranties and collect any associated interest paid to the lenders; and (3) conduct additional reviews of ARC loans outside the scope of this NFR (for example, loans disbursed after April 30, 2010 and/or undisbursed loans) to identify other ARC loans made to affiliated companies that were inappropriately approved under delegated authority.

On August 24, 2010, we provided a draft of this NFR to SBA management for comment. On September 17, 2010, SBA submitted its formal comments, which are contained in their entirety in Appendix II. SBA agreed with all three recommendations. A summary of SBA's comments and the OIG's response is provided below.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

Recommendation 1

SBA agreed to review the 38 identified loans and determine if they were made to eligible companies. SBA also noted that an affiliate of an existing ARC borrower is not an ineligible company, and that the ARC loan to the affiliate was required to be processed by the 7(a) Loan Guaranty Processing Center. To the extent an identified loan was made to an affiliate of an existing ARC borrower, SBA will review the affiliation issue under the same standards used by the Center for non-delegated processing of such loan applications. If the Center would not have approved the loan on a non-delegated basis based on its review of the affiliation issue, then the Agency will find the loan ineligible.

SBA's proposal to determine whether these loans were made to affiliates and review them under the LGPC's processing standards for non-delegated ARC loans were responsive to recommendation 1.

Recommendation 2

SBA agreed to cancel the loan guaranties and collect the associated interest paid to lenders for any loans determined to have been made to ineligible companies. SBA's proposed actions were responsive to recommendation 2.

Recommendation 3

SBA agreed to conduct an analysis of loan data for ARC loans made between April 30, 2010 and September 30, 2010, to identify other possible lender-approved ARC loans that may have been made to affiliated companies and to take appropriate action. SBA's proposed actions were responsive to recommendation 3.

ACTION REQUIRED

Please provide your management response for recommendations 1, 2 and 3 on the attached SBA Forms 1824, Recommendation Action Sheet, within 30 days from the date of this report. Your responses should identify the specific actions taken or planned to fully address each recommendation and the target dates for completion.

We appreciate the courtesies and cooperation of the Office of Capital Access. If you have any questions concerning this NFR, please contact me or Debra Mayer, Director, Recovery Oversight Group, at 202-205- [FOIA ex. 2]

Attachment

U.S. Small Business Administration

Office of Inspector General

Notice of Finding and Recommendation

Audit Location/Division	<u>Office of Capital Access</u>
Date	<u>September 22, 2010</u>
Description of Issue	<u>Lender-Approved ARC Loans to Affiliates</u>

BACKGROUND:

The purpose of this Notice of Finding and Recommendation (NFR) is to inform you of an issue that was identified during our audit of the America's Recovery Capital (ARC) Loan Program. As part of this audit, we reviewed SBA's loan database to test controls related to the approval of loans to affiliated businesses. For the purposes of this analysis, we reviewed data on ARC loans, which had been disbursed by April 30, 2010.

CONDITION:

We identified 38 lender-approved ARC loans, valued at \$1.2 million, made to what appear to be affiliated companies that were not approved by SBA, as required by the ARC Loan Program procedural guide. Of the 38 loans, 29 were identified as potentially affiliated loans due to common social security numbers. The remaining nine loans were initially identified as potentially affiliated loans due to common addresses. An additional review of SBA's Electronic Loan Information Processing System revealed further evidence of affiliation for these loans, such as familial relationships between the business' owners. Furthermore, two of these loans appear to have been made to apartment buildings, and as such would be ineligible as passive businesses.

See Appendix I for a listing of the loans discussed in this NFR.

CRITERIA:

ARC Procedural Guide item 3.i., “Multiple ARC Loans,” states that: a small business concern must not receive more than one ARC loan. The ARC loan can be used to make payments of principal and/or interest on more than one qualifying small business loan. Additional ARC loans may be made to affiliated entities, but must be processed through the Loan Guaranty Processing Centers. Loans to affiliates cannot be submitted under any delegated authority.

13 CFR § 121.103 provides SBA’s general criteria for determining affiliation. It states that concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both. It further states that SBA considers factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships, in determining whether affiliation exists.

Under SOP 50 10 5(A), Chapter 2, Section III.D., apartment buildings are considered ineligible passive businesses.

CAUSES:

Lenders did not comply with SBA requirements for ARC loan approval, indicating a lack of due diligence and a lack of appropriate control procedures to ensure compliance.

Appropriate system controls were not in place to automatically identify affiliated companies applying for ARC loans to ensure that loans to affiliates are not approved under delegated authority.

EFFECT:

Inadequate safeguards for preventing ineligible businesses from receiving ARC loans may have resulted in misuse of Recovery Act funds.

RECOMMENDATIONS:

We recommend that the Associate Administrator for Capital Access:

1. Review each of the 38 identified loans to determine if they were made to eligible companies.

2. For any loans that SBA determines were made to ineligible companies, cancel the loan guaranties and collect any associated interest paid to the lenders.
3. Conduct additional reviews of ARC loans outside the scope of this NFR (for example, loans disbursed after April 30, 2010 and/or undisbursed loans) to identify other ARC loans made to affiliated companies that were inappropriately approved under delegated authority.

APPENDIX I. LENDER-APPROVED ARC LOANS TO APPARENT AFFILIATES

Loan Numbers	Borrower(s)	Approval Date	Lender	Issues
[FOIA ex. 4]		12/3/09 12/8/09	United Community Bank	Same SSN
		8/17/09 8/17/09	Virginia Company Bank	Same SSN
		7/13/09 7/21/09	Cornerstone Community Bank	Same SSN
		10/27/09 11/20/09	Traditional Bank, Inc. Whitaker Bank, Inc.	Same SSN, different lenders
		9/2/09 9/2/09 9/15/09	Peoples Bank	Same SSN
		12/15/09 12/15/09	Flathead Bank of Bigfork	Same SSN
		8/10/09 9/3/09	Viking Savings Bank	Same SSN Loans to apartment buildings are ineligible
		10/29/09 10/29/09	Flathead Bank of Bigfork	Same SSN
		8/6/09 9/11/09	Virginia Company Bank	Same SSN and address
		12/24/09 2/10/10	Peoples Bank	Same SSN
		11/17/09 11/23/09	North American Banking Company	Same SSN
		10/30/09 10/30/09	Peoples Bank	Same SSN and address
		3/18/10 3/18/10 3/19/10	Security State Bank – Fergus Falls	Same SSN and address (3 rd loan is under 50% owner family member's SSN, same address)

APPENDIX I. LENDER-APPROVED LOANS TO APPARENT AFFILIATES (continued)

Loan Numbers	Borrower(s)	Approval Date	Lender	Issues
[FOIA ex. 4]		3/4/10 3/4/10	Peoples Bank	Same SSN and address
		9/18/09 10/6/09	State Bank of Southern Utah	Same address; family members appear to own businesses separately
		12/23/09 12/24/09	Peoples Bank	Same address; family members appear to own businesses separately
		9/15/09 11/30/09	Regions Bank	Same address and ownership group
		9/23/09 9/30/09	Peoples Bank	Same address; family members appear to own businesses separately

APPENDIX II. AGENCY COMMENTS



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

MEMORANDUM

September 17, 2010

TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: Eric R. Zarnikow /S/ **Original Signed**
Associate Administrator for Capital Access

SUBJ: Draft Notice of Finding and Recommendation on Lender-Approved
ARC Loans to Affiliates
Project Number 10506A

Thank you for the opportunity to review the subject report. As you know, the Recovery Act created the America's Recovery Capital Loan program to provide loans to viable small businesses experiencing economic hardship. SBA is proud of its record of implementing the ARC Loan program in a prudent and expeditious manner in order to support small businesses as part of the economic recovery. We appreciate the role the Office of Inspector General (OIG) plays in assisting management in ensuring that these programs are effectively managed. Management's response to the recommendations included in the draft report is as follows:

1. Review each of the 38 identified loans to determine if they were made to eligible companies.

SBA agrees with the recommendation to review the 38 identified loans and determine if they were made to eligible companies. We note, however, that an affiliate of an existing ARC borrower is not an ineligible company, rather the ARC loan to the affiliate was required to be processed by the 7(a) Loan Guaranty Processing Center (7(a) LGPC). To the extent an identified loan was made to an affiliate of an existing ARC borrower, we will review the affiliation issue under the same standards used by the 7(a) LGPC for non-delegated processing of such loan applications. If the 7(a) LGPC would not have approved the loan on a non-delegated basis based on its review of the affiliation issue, then we will find the loan ineligible.

2. ***For any loans that SBA determines were made to ineligible companies, cancel the loan guaranties and collect any associated interest paid to the lenders.***

SBA agrees with the recommendation that any loans determined to have been made to ineligible companies should have the loan guaranties cancelled and the associated interest paid to the lenders collected.

3. ***Conduct additional reviews of ARC loans outside the scope of the NFR (for example, loans disbursed after April 30, 2010, and/or undisbursed loans) to identify other ARC loans made to affiliated companies that were inappropriately approved under delegated authority.***

SBA agrees with the recommendation to conduct an analysis of loan data for ARC loans made between April 30, 2010 and September 30, 2010 to identify other possible lender-approved ARC loans that may have been made to affiliated companies and take appropriate action.

Again, thank you for the opportunity to review the draft report. Please let us know if you need additional information or have any questions regarding our response.