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Southwest Region
Audit Report

RURAL DEVELOPMENT
RURAL BUSINESS-COOPERATIVE SERVICE
NATIONAL REPORT ON THE
BUSINESS AND INDUSTRY
LOAN PROGRAM



**Report No.
34601-15-Te
SEPTEMBER 2003**



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington, D.C. 20250



DATE: September 30, 2003

REPLY TO

ATTN OF: 34601-15-Te

SUBJECT: Rural Development, Rural Business-Cooperative Service (RBS),
National Report on the Business and Industry Loan Program

TO: John Rosso
Administrator
Rural Business-Cooperative Service

THROUGH: John Purcell
Director
Financial Management Division

This report presents the results of our audit of the Rural Development Business and Industry (B&I) Loan Program. The RBS Administrator's response to the draft report, dated September 4, 2003, is included in exhibit H with excerpts and the Office of Inspector General's (OIG) position incorporated into the relevant sections of the report.

Based on the response, management decisions could not be reached on any of the recommendations. Documentation and/or actions needed to reach management decisions for the recommendations are described in the OIG Position section of the report.

Please furnish the information needed to reach agreement on the management decisions for the recommendations within 60 days. Please note that Departmental Regulation 1720-1 requires a management decision for all recommendations within a maximum of 6 months from the date of report issuance, and final action to be taken within 1 year of each management decision.

We appreciate the courtesies and cooperation extended to us by members of your staff during the audit.

/s/ R. D. Long
RICHARD D. LONG
Assistant Inspector General
for Audit

EXECUTIVE SUMMARY

RURAL DEVELOPMENT RURAL BUSINESS-COOPERATIVE SERVICE NATIONAL REPORT ON THE BUSINESS AND INDUSTRY LOAN PROGRAM

AUDIT REPORT NO. 34601-15-Te

RESULTS IN BRIEF

Rural Development administers the B&I Direct and Guaranteed Loan Programs to improve business, industry, and employment in rural areas. This report summarizes the results of

21 audits we performed in 16 States, as well as the results of our review of the agency's reporting of guaranteed loan activity as required by the Government Performance and Results Act (GPRA). We summarized our results of the 21 audits to report recurring issues that needed to be addressed by the agency's national office. We examined 38 guaranteed loans totaling over \$125 million and 18 direct loans totaling over \$14 million.

We performed this audit primarily to determine if Rural Development and the RBS were making sound direct loans and properly servicing those loans, and to determine if lenders participating in the B&I Guaranteed Loan Program were servicing loans in accordance with agency requirements. We expanded our objective to include management controls over loan making and agency oversight in the B&I Guaranteed Loan Program because of concerns that arose while reviewing lender-servicing activities.

Rural Development needs to take immediate action to reduce losses in the B&I Guaranteed Loan Program. We identified instances where Rural Development had guaranteed questionable loans, failed to identify lender negligence in servicing existing loans, and honored guarantees in situations where lenders had not fulfilled loan obligations. Because of these conditions, we questioned almost \$58 million of the \$125 million in guaranteed loan funds included in our review. (See exhibit A.)

We attributed these conditions to inappropriate appraisal methods used to determine the value of loan collateral, and with inadequate lender assessments of borrowers' financial conditions when loans were guaranteed and on an annual basis thereafter. Rural Development also lacked effective procedures to enforce compliance when lenders failed to meet agency requirements. In addition, Rural Development officials had

not always verified that lenders had complied with agency requirements prior to honoring loan guarantees. As a result, agency officials were unaware of some lender negligence until our review. This included instances where lenders (1) misrepresented borrower financial conditions to Rural Development, (2) failed to obtain the required security interest, (3) allowed borrowers to use funds for unauthorized purposes, and (4) certified that stipulations in conditional commitments were met when, in fact, they were not met.

The table below provides the number of deficiencies by type for the 38 guaranteed loans in our review. (See exhibit C for additional details.)

LENDER DEFICIENCIES	NUMBER OF OCCURRENCES BY DEFICIENCY
Inadequate Appraisals of Collateral	11
Missing or Unaccounted-For Collateral	9
Not Performing Collateral Inspections	6
Inadequate Analysis of Financial Condition	6
Misuse of Loan Funds	14
Not Obtaining/Submitting Financial Statements	14
Violations of Conditional Commitment	13
Violations of Loan Agreement	9
Unauthorized Loans to Borrower	1

Rural Development and OIG have identified conditions in the past that are similar to those uncovered during our current review. Since 1980, OIG has issued 46 audit reports with monetary findings of over \$224 million. These conditions, if left unabated, could increase Government losses in the future.

With over \$4.7 billion in loan guarantees, Rural Development needs to ensure that lenders are making sound loans and properly monitoring borrower financial conditions to reduce the risk of significant losses to the Government. However, the results of our review may not be indicative of the extent of problems in the B&I Guaranteed Loan Program because 55 percent of the loans in our review were delinquent.

Rural Development's Annual Performance Reports also inaccurately depict the number of jobs created and saved by the B&I Guaranteed Loan Program. The agency reports program results based on borrower projections, rather than the actual number of jobs created and saved by the program. In addition, the agency's data collection and input controls do not ensure the accuracy of reported results.

For the B&I Direct Loan Program, we determined that Rural Development's management controls in the loan-making area were weak.

Specifically, we identified weaknesses in collateral appraisals, procedures to verify the existence of collateral, and in procedures to file required legal documents. However, since the B&I Direct Loan Program is no longer being funded, we are not recommending any corrective action for direct loan making.

Rural Development's controls in the direct loan-servicing area were generally adequate and functioning as intended by management. We did conclude that Rural Development lacked effective measures to enforce borrower compliance with agency requirements. Almost 40 percent of the borrowers in our review had not submitted current financial statements, and over 22 percent of the borrowers had not submitted evidence of current insurance coverage.

KEY RECOMMENDATIONS

We recommended that Rural Development establish guidelines to (1) better identify the most appropriate appraisal methods used to value collateral, (2) verify that lenders use the most appropriate appraisal method, (3) require that lenders use audited financial statements to perform financial analyses of borrowers, (4) enforce lender compliance with critical agency oversight controls, (5) require annual lender visits for all new and delinquent borrowers, and biennial lender visits for current borrowers, and (6) define deficiencies that classify loans in significant nonmonetary default, and require acceleration of all loans in that classification. We also recommended that the agency require loss claims be evaluated by State loan committees. Further, we recommended specific procedures that would improve the accuracy of Rural Development's Annual Performance Report.

AGENCY RESPONSE

The agency's response dated September 4, 2003, is included as exhibit H of the report. We have incorporated applicable portions of the response along with our position in this section and in the Findings and Recommendations sections of the report. In summary, the agency did not address our recommendations to identify and use the most appropriate appraisal methods to value collateral, and one of the recommendations for procedures to improve the accuracy of Rural Development's Annual Performance Report. The agency also misinterpreted one recommendation indicating that the recommendation would require additional lender visits when we were recommending fewer visits and, at the same time, concentrating on lenders with delinquent borrowers. The agency agreed with other recommendations and proposed corrective action through issuing additional temporary procedures; however, we believe the action should be more timely and of a more permanent nature.

OIG POSITION

Based on the agency response and proposed corrective actions, we cannot reach management decisions on any of the recommendations. The documentation and/or actions needed to reach management decisions are described in the OIG Position section of the report for the recommendations.

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INTRODUCTION

BACKGROUND

RBS is an agency of the United States Department of Agriculture's (USDA) Rural Development mission area. The mission of RBS is to enhance the quality of life for all

rural residents by assisting new and existing businesses and cooperatives through partnerships with rural communities. RBS accomplishes this, in part, through the B&I Guaranteed and Direct Loan Programs.

Guaranteed Loans

The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities with a population of less than 50,000. The program achieves this purpose by bolstering the existing private credit structure through the guarantee of quality loans, which provide lasting community benefits. RBS is not to use its guarantee authority for marginal or substandard loans or for the relief of lenders having such loans.

Generally, the agency cannot guarantee more than \$10 million in loans to one borrower. This limit includes the guaranteed and nonguaranteed portions, the outstanding principal, and the interest balance for any new loan requests. The RBS Administrator, with the concurrence of the Under Secretary for Rural Development, may grant an exception to the \$10 million limit under certain circumstances. Total guaranteed loans to one borrower may not exceed \$25 million under any circumstances. Generally, the maximum guaranteed percentages are 80 percent for loans of \$5 million or less, 70 percent for loans between \$5 million and \$10 million, and 60 percent for loans exceeding \$10 million.

The lender is responsible for servicing the entire loan and for taking all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. The loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes, negligent servicing, or failure to obtain the required security interest regardless of the time at which the agency acquires knowledge of the foregoing. The agency is responsible for ensuring that the lender is servicing the loan in a prudent manner as required by the lender's agreement, the Rural Development instructions governing the program, and loan documents.

As of January 30, 2003, Rural Development had guarantee obligations on over 3,000 loans valued at over \$4.7 billion.

Direct Loans

The B&I Direct Loan Program provides loans to public entities and private parties who cannot obtain credit from other sources. However, the program is not intended for marginal or substandard loans. Program funding was terminated for the B&I Direct Loan Program since fiscal year (FY) 2002. Direct loans were made primarily to finance sound business projects that created or retained jobs for businesses located in rural areas with populations less than 50,000. The maximum direct loan amount to any one borrower is \$10 million with maturities of 7, 15, or 30 years, depending on the collateral.

The responsibilities of the State office staff include collecting payments, obtaining compliance with covenants and provisions of the loan documents, obtaining and analyzing financial statements, verifying payment of taxes and insurance premiums, obtaining and maintaining liens on collateral, and ensuring sufficient collateral is pledged to secure the entire debt to the Government. As of January 30, 2003, Rural Development's portfolio consisted of 214 loans totaling about \$124 million.

Government Performance and Results Act (GPRA) Review

GPRA requires Federal agencies to prepare an annual performance plan that sets out measurable goals that define what will be accomplished during an FY. The Office of Management and Budget (OMB) Circular A-11, section 220.12, states that the annual performance plan must include an identification of the means the agency will use to verify and validate the measured performance values. The circular further states that the means the agency intends to use should be sufficiently credible and specific to support the general accuracy and reliability of the performance information that is recorded, collected, and reported.

The purpose of GPRA is to focus on the results of activities, such as real gains in employment, safety, responsiveness, and program quality. To measure the success of the B&I Guaranteed Loan Program and satisfy GPRA requirements, Rural Development reports jobs created and saved by the program in its Annual Program Performance Report to Congress.

The data in the annual performance report is obtained from the Rural Community Facilities Tracking System (RCFTS). RCFTS provides Rural Development management with information on current rural community facilities and historical data on each applicant or borrower. Information from the RCFTS is also used to provide statistical data to Rural Development and

members of Congress. This system enables Rural Development to obtain information on the status of any facility, borrower, or loan, with minimum disruptions of normal work activities.

Past OIG Audit and Investigation Reports

Since the start of the B&I Guaranteed Loan Program in FY 1974, OIG has been reporting significant problems, especially in the areas of lender servicing and agency monitoring. Of the 76 audit reports we reviewed, 46 had monetary findings of over \$224 million. Of the 44 Semiannual Reports to Congress (SARC) issued since September 1979, 25 have included summaries of OIG audits and investigations of the B&I Guaranteed Loan Program. As of January 25, 2002, there were 13 ongoing investigations.

Negligent servicing by lenders and inadequate agency monitoring have increased losses in this program. Since the start of the program in FY 1974 through February 2001, B&I loans of about \$9.4 billion to 1,678 businesses have been liquidated, and RBS has paid losses of about \$1.1 billion. With annual funding increasing from just \$100 million in FY 1993 to \$1.16 billion in FY 2001, the Government is at risk for greater losses.

Of the findings addressed in the 76 audit reports mentioned above, we determined that previous B&I findings were in 2 main categories: lender servicing and agency servicing or monitoring. We found that the lender-servicing findings were in four main areas: inadequate or missing collateral (38 findings), untimely or missing financial statements and reports (30 findings), misuse of loan funds (24 findings), and other lender-servicing problems (105 findings). The other lender-servicing problem areas consisted of findings such as conflicts of interest; improper waivers; and violations of the conditional commitment, loan note guarantee, or the lender's agreement. The agency servicing or monitoring category had 49 findings.

In the 25 SARC summaries reviewed, 17 findings involved lender servicing including collateral problems, 21 involved other lender-servicing problems, and 13 involved agency monitoring. For example, in the September 1979 SARC, we reported that, "FmHA (the precursor agency to RBS) had paid the guaranteed portion of losses to lenders who had not performed required servicing." In March 1981, we reported that, "inadequate monitoring of loan closing and lender servicing by FmHA continues to be a serious problem in the management of this program." In March 1983, we reported that, "lender servicing still remains a problem according to the audits that we conducted."

In the September 1988 and September 1989 SARC's, we reported that, "Lender Violations May Make Business and Industry Loan Guarantees Unenforceable" and "Improper Lender Servicing Actions of Business and Industry (B&I) Loans Contribute to Dollar Losses," respectively. In September 1996, we reported, "Better Bank Oversight of Guaranteed Business Loans Needed." In the March and September 2000 SARC's, we reported that, "Lender Hid Financial Condition of Borrower Who Defaulted in 16 Days" and "Lender Did Not Obtain Sufficient Collateral to Secure B&I Loan."

Agency Review Found Problems With Monitoring of the B&I Program

RBS found many of the same problems when they completed a Business Programs Assessment Review (BPAR) in Puerto Rico in June 2001, as we identified during this and past audits. Due to serious deficiencies, RBS restricted Puerto Rico's approval and servicing authorities. This was followed by a file review of 72 guaranteed loans and 35 direct loans in January 2002 by RBS National officials that disclosed the following lender-servicing deficiencies.

- Lender Loan Servicing: "We (RBS) found little evidence that guaranteed lenders were performing routine servicing activities required by the lender's agreement, agency instructions, and prudent lending practices."
- Status Reports and Default Status Reports: In 42 percent of the cases, the lenders were not regularly submitting the required reports.
- Annual Financial Statements: In 64 percent of the cases, the agency was not receiving annual financial statements from borrowers and guarantors.
- Ineligible Loan Purposes: In 15 percent of the cases, loan funds were used for ineligible purposes. In 69 percent of the cases, either the funds were not used in accordance with the letter of conditions or conditional commitment, or it could not be determined how the funds were actually used.
- Collateral: Collateral was found to be a serious weakness. In 72 percent of the cases, the collateral was not discounted. When properly discounted, the value was insufficient to cover the loan in 62 percent of the cases. It appears that some lenders considered the guarantee itself to be collateral.

- **Conditional Commitment and Letter of Conditions:** RBS found problems in 30 percent of the cases. For the most part, the conditional commitments and letters of conditions were “canned” documents that addressed all the required issues. However, some of the conditions were vague, conflicting, or meaningless. In addition, the documents were typically not tailored to the borrowing entity. In some cases, the ratios were inconsistent with ratios identified in the loan agreements. Several of the conditional commitments had expired, with no documentation to suggest that they had been extended when the agency issued the loan note guarantee.
- **Loan Agreements:** In 48 percent of the cases, the loan agreements were inadequate. They were missing entirely, missing regulatory requirements, lacked substance, predominately boilerplate, or not signed.
- **Appraisals:** In 51 percent of the cases, the appraisals were inadequate. Real estate appraisals did not meet Uniform Standards of Professional Appraisal Practices and Financial Institutions Reform, Recovery, and Enforcement Act standards. The qualifications of the appraisers were usually not provided. Generally, appraisals did not include consideration of the potential effects on the market value from a release of hazardous substances or other environmental hazards. In addition, appraisals were often incomplete, inadequate, or more than a year old. Chattel appraisals were very rarely found to document the value of machinery and equipment.

OBJECTIVES

Our objectives for reviewing the B&I guaranteed loans were to determine if (1) lenders were properly servicing loans by monitoring collateral and submitting required documents to the agency timely, (2) loan proceeds were used as specified in the loan agreement, and (3) the agency established adequate controls over lender-servicing activities. We also evaluated agency oversight of B&I direct loans. Specifically, we determined if (1) direct loans were properly made and serviced, and (2) loan proceeds were used as specified in the application. In addition, we assessed agency compliance with GPRA requirements.

SCOPE

We reviewed 38 guaranteed loans totaling \$125 million to 27 lenders in 14 States. With funds totaling \$91.1 million, 35 of these loans were judgmentally selected for our nationwide review of the B&I Guaranteed Loan Program. Rural Development requested that we review the other three loans with funds totaling \$34 million. Based on a hotline complaint, we also performed a review of the agency's approval process for loan guarantees made to members of a sugar cooperative. (See exhibit D.)

The 35 guaranteed loans for our nationwide audit were selected from a universe of 2,420 unpaid loans totaling \$3.2 billion that were issued since January 1, 1990, and still showed activity during FYs 1998 through 2000.

We also reviewed 18 direct loans totaling \$14.1 million in 3 States. These loans were judgmentally selected from a universe of 192 loans totaling \$77.8 million that were all the loans issued from October 1, 1996, through April 14, 2001.

Fieldwork for our review was conducted from November 2000 until October 2002. (See exhibit D.)

To evaluate the agency's Annual Performance Report to satisfy GPRA requirements, we judgmentally selected 46 guaranteed loans to 37 borrowers in 6 States, which accounted for 5,013 of the 29,118 total reported jobs for FY 2000. (See exhibit E.)

We conducted this audit in accordance with the Government Auditing Standards issued by the Comptroller General of the United States.

METHODOLOGY

We interviewed national and State office personnel to determine policies and procedures for approving and servicing B&I loans. We also obtained and reviewed loan files and selected the loans to be reviewed. For guaranteed loans, we interviewed lender personnel, reviewed files, and performed borrower visits as deemed necessary.

The States and guaranteed loans included in our nationwide audit were selected from the B&I guaranteed loan database that listed all unpaid loans since January 1, 1990. We judgmentally selected 12 States based on (1) the number of loans outstanding and the total dollar value of those loans, (2) the total delinquent amount, and (3) the total loss payments paid. At the State level, we judgmentally selected 78 loans (a minimum of 5 loans per State) for file review based primarily on loans over \$1 million

that were delinquent. If there were not five loans in that category, we generally selected large-dollar loans that were delinquent or only had small amounts paid on the principal. These categories accounted for 72 (over 92 percent) of the 78 loans. (See exhibit G.) We then performed a file review and selected 35 loans (at least 2 of the 5 loans per State indicating the highest potential for problems) for an indepth review. For the special request cases, the borrowers had defaulted under suspicious circumstances and agency officials wanted assurance that lenders had properly serviced loans before honoring Government guarantees.

For the direct loans, we selected the three States based on loan portfolio size and problems identified during our audit survey. For two States, we reviewed all the loans in their portfolios. For the other State, we selected 5 of the 10 loans in the State's portfolio. (See exhibit D.) Two loans were delinquent, two were the largest loans most recently funded, and one loan was reviewed during the survey.

For our review of the agency's reporting to satisfy GPRA requirements, we selected States based on guaranteed loans with a large number of projected jobs and where the agency had verified zero or very few jobs. In addition, we considered loans where the agency's verification date was prior to the loan closing date. Further, we selected borrowers with multiple loans where the jobs saved and created appeared to be duplicated. We reviewed loan files at State offices to validate GRPA data in Rural Development's RCFTS. We conducted field visits to some borrowers and obtained job confirmation from other borrowers through requested documents and interviews. Agency personnel accompanied us on some of the field visits.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1

ENHANCED CONTROLS COULD REDUCE LOSSES IN THE GUARANTEED LOAN PROGRAM

Rural Development guaranteed questionable loans, failed to identify lender negligence in servicing existing loans, and honored guarantees in situations where lenders had not fulfilled loan obligations. We attributed these conditions to weak management controls in the loan-making and loan-servicing areas. As a result, we questioned almost \$58 million in loan funds. While these losses are significant, they may not be indicative of the overall extent of problems in the B&I Guaranteed Loan Program because we primarily selected borrowers that were delinquent on loans. However, with over \$4.7 billion in loan guarantees, Rural Development needs to improve its management controls to reduce the risk of significant losses in the future.

In the loan-making area, we identified control weaknesses with appraisals used to determine the value of loan collateral and with lender assessments of borrowers' financial conditions. In the loan-servicing area, we determined that lender controls such as annual analyses of borrower financial statements and borrower visits were not functioning as intended by Rural Development. In addition, Rural Development has no procedures to enforce compliance by lenders that fail to perform these functions. The agency also needs to improve its monitoring controls over lender activities and its controls over ensuring that lenders comply with all agency requirements before honoring loan guarantees.

Rural Development and OIG have identified conditions in the past that are similar to those uncovered by our current review. These conditions, if left unabated, could increase Government losses. The issues presented in this chapter illustrate our conclusions regarding borrower defaults for the loans in our review and the corrective actions necessary to ensure that similar problems can be avoided in the future.

FINDING NO. 1 – COLLATERAL APPRAISALS AND LENDER ANALYSES WERE INADEQUATE

We identified 11 instances where loans in our review were questionable due to one or both of the following reasons: 1) there was insufficient collateral to secure the loan, and (2) the borrowers should have been classified as substandard because of poor financial

conditions. Rural Development relied on faulty appraisals obtained by lenders and inadequate analyses performed by lenders in approving the loan guarantees for these loans. The agency implemented these controls to provide reasonable assurance that borrowers were creditworthy and that assets pledged as collateral for loans were sufficient to protect the Government's security interests.

Rural Development instructions require that lenders perform specific analyses to determine the financial conditions of borrowers before a loan will be guaranteed, and ensure the sufficiency of collateral to protect the Government's security interest.¹ The instructions also state that loan guarantees are not to be made to substandard borrowers.²

The losses paid for the loans in our review were significant and generally occurred soon after the loans were made. For example, a sugar processing company that received a \$20 million B&I guaranteed loan defaulted after only 6 months in operation. The agency had guaranteed 70 percent of the loan and incurred a \$12 million loss. In another case, the borrower defaulted on a \$2 million B&I guaranteed loan only 4 months after loan closing. We found that the loan should have been classified as substandard. The borrower had been having financial problems for years and had delinquent Federal debt, as well as a significant amount of existing personal debt with the lender at the time the loan was made.

To determine why lenders and Rural Development had not detected the deficiencies cited above, we evaluated the agency's loan-making controls as they functioned for the loans in our review. We determined that two controls, collateral appraisals and lender analyses of borrower financial condition, did not always function as intended by the agency to identify questionable loans and substandard borrowers. The following sections describe our results and concerns with agency controls related to the loans in our review.

Appraisals Did Not Accurately Value Collateral

We identified 11 instances where appraisals were inadequate to protect the Government's security interests. (See exhibit C.) Rural Development

¹ Rural Development Instruction 4279-B, section 4279.131, dated December 23, 1996.

² Rural Development Instruction 4279-B, section 4279.101(b), dated December 23, 1996.

relies on lenders to obtain independent appraisals of assets to ensure that borrowers have sufficient collateral to secure the loan. Agency instructions state that the lender is responsible for ensuring that appraised values accurately reflect the value of collateral. The agency's only requirement is that appraisals be performed in accordance with applicable industry standards.³ However, Rural Development provides no guidance on appraisals such as requirements that specify methods to be used for certain types of assets or loans.

We found that appraisers generally use several different methods each time they perform an appraisal to determine the fair market value of an asset. For example, an appraiser might use the direct sale, income, and cost methods to estimate the fair market value of an asset. The appraiser would then determine the appropriate method and recommend the fair market value to the lender. However, the lender is not required to use the value recommended by the appraiser. The ability to use the results from any of the methods used by an appraiser could be beneficial to a lender, such as when one method establishes a higher value than the recommended method. For instance, an appraiser might recommend the value determined by the cost method, but the lender may elect to use the income method because the value is more in line with the amount needed to justify the loan.

The lack of guidance contributed to the questionable loans identified during our review. The most prevalent problem we identified was that an improper method was used to value assets based on the circumstances involving the loan. For example, an "in-place, in-use" appraisal method, which considers the business to be a going concern, was used in several instances even though manufacturing facilities had not been constructed, or it was clear that the business was not operating in this manner. In these instances, we questioned whether using a going-concern method of appraising the assets was appropriate. Therefore, we concluded that the use of the fair market value "in-place, in-use" method may be acceptable for appraising the value of an existing business, but inappropriate for determining the future value of collateral that may have a special use, is located in a rural area, or places a value on a business that is not operating as a going concern.

In one instance, a borrower's equipment for use in a sawmill was valued at over \$8.6 million using an "in-place, in-use" appraisal method when the loan was made. However, the borrower was never able to make the sawmill fully functional and defaulted on the loan 10 months after it was made. The sawmill equipment sold for \$513,000. The lender had a second appraisal performed during the liquidation process that valued the

³ Rural Development Instruction 4279-B, section 4279.144, dated December 23, 1996.

equipment at \$709,000. An official with the firm that performed the appraisal informed us that an “in-place, in-use” appraisal is not usually performed when a business is not operating as a going concern. He stated that he had informed the lender of this and had explained the various methods for appraising these types of assets. However, the lender had stated that the business had to be valued as a going concern in order to make the loan.

We also identified instances where a “desktop” appraisal was used to value collateral. In those instances, the appraiser never inspected the equipment. An appraiser described his “desktop” appraisal to us as follows: “A desktop appraisal is based upon information supplied which we cannot guarantee as to the accuracy of age, model, serial number, type of machine or manufacturer. We have based our values on the assumption that the information furnished is valid and the machines are operable and in a condition that would be consistent with ordinary wear and tear as defined by industry standards.”

We question the adequacy of this type of appraisal because it relies on borrowers to provide an accurate description of the asset and lender diligence to verify the existence and accuracy of borrower statements. Thus, since the appraiser would not physically inspect the asset, borrowers could create fictitious assets or overstate the condition of assets. In fact, our review disclosed instances where this might have occurred. For example, we visited one borrower’s facility to inspect the machinery and equipment appraised at \$4.2 million and discovered that some of the equipment was missing. The missing collateral consisted of heavy construction equipment such as excavators, loaders, and trucks. The lender had not checked for missing equipment on the appraisal list because the primary collateral for the loan was real estate. However, the missing equipment comprised over \$1.7 million of the collateral securing the loan. In this instance, there was no way to verify that the collateral existed when the appraiser valued the assets.

Another issue uncovered during our review involved the comparison of dissimilar property to establish the appraised value of collateral. In one instance, an appraiser used property that was not representative of the land securing the loan to value collateral at \$1.05 million when the loan was made. However, a second appraiser valued the land at only \$566,000 when the loan was later liquidated. The land eventually sold for just over \$500,000. In a letter to Rural Development, the lender admitted that the original appraiser had used dissimilar properties to value the collateral.

Officials from more than one State informed us that they generally do not question appraisals unless the value of assets appears clearly misstated.

These officials also confirmed that there are no guidelines outlining specific appraisal methods to be used for certain assets and loan conditions. In response to two of our State reports where this issue was reported, Rural Development issued Administrative Notice (AN) 3798, dated October 22, 2002, to address RBS' appraisal requirements. The AN requires that appraisals meet Standards I and II of the Uniform Standards of Professional Appraisals Practices (USPAP) and employ the use of specialized appraisers. Although RBS' prompt action satisfied the recommendations in the State reports, it did not provide guidance that specifically identifies the most appropriate appraisal method to use when appraising the various types of collateral used to secure B&I loans.

Since a number of appraisal methods are available, Rural Development needs to establish such guidelines to ensure a more accurate assessment of asset value. These guidelines should provide instruction on the most appropriate method to value businesses and real property used as collateral for guaranteed loans. This would include when it is appropriate to use the cost method, the replacement cost method, or the market value method to value collateral being used to secure the guaranteed loans. The guidelines should identify the appraisal method normally used, and appropriate for, any type of asset being used as collateral for guaranteed loans. We recognize that in some instances a deviation to the normally used appraisal method for a particular asset may be necessary. In those instances, the State office should determine whether the lender had a valid reason for using an appraisal method not normally used for that particular asset, or assets.

Rural Development should also implement procedures to verify that lenders used the most appropriate method to value collateral securing a guaranteed loan. Currently, the certified appraisers on staff at State offices, or certified appraisers available through contracts, do not perform this procedure. Our analysis and discussions with agency officials disclosed that State appraisers only review real estate appraisals provided with guaranteed loan packages; they do not review appraisals to value businesses. Further, their review primarily consists of ensuring that the appraisal report complies with industry standards, and not that the method used to value collateral was the most appropriate method for the circumstances.

Inadequate Analysis of Borrower Financial Condition

Our review disclosed that lenders had used incomplete, inaccurate, or misleading financial data provided by borrowers to calculate compliance with established financial criteria. (See exhibit C.) Rural Development requires that lenders analyze the financial condition of borrowers to

ensure that they are creditworthy and have the ability to repay the loan.⁴ Rural Development established this control to ensure that it does not guarantee loans made to substandard borrowers. However, Rural Development does not require that borrower financial data be verified before lenders analyze it.

In one case, a lender used unaudited financial data for a 2-month period to calculate that a borrower's debt-service ratio was 1.29, which met agency requirements. However, our analysis of the borrower's audited financial statements disclosed that the borrower's debt-service ratio was actually a negative 1.56 for the 2-month period. We determined that the borrower had overstated revenue, overstated depreciation expense, and understated management fee expenses in the financial data it provided to the lender. The lender did not identify these misstatements because it had not verified the data, or ensured that it was using independently reviewed data, to perform its analysis. The Government incurred a loss of over \$3.5 million on this loan guarantee.

In another case, a lender used unaudited financial statements to calculate that a borrower's tangible balance sheet equity was 14 percent, well above the 10 percent required by Rural Development. However, our review of the audited financial statements, which were provided to the lender 2 months after loan closing, disclosed that the borrower's actual equity was less than 2 percent. We determined that the unaudited financial statements had improperly accounted for a \$10 million reduction in debt and, therefore, did not comply with Generally Accepted Accounting Principles (GAAP). The mistreatment of that transaction resulted in an overstatement of equity on the borrower's financial statements. The borrower defaulted on the loan 6 months after it was made, and the Government incurred a \$12.1 million loss.

Since our review disclosed instances where lenders had not identified substandard borrowers, we examined agency instructions to determine if additional requirements were necessary to improve program controls. We concluded that while the instructions require certain financial analyses and prohibit guarantees to substandard borrowers, they do not require that lenders use audited financial statements prepared in accordance with GAAP. In cases of new businesses, lenders should be required to have independent public accountants perform attestation engagements to verify the accuracy of borrower financial data. As illustrated in our examples, the lack of these requirements resulted in inaccurate assessments of borrower creditworthiness and significant losses to the Government.

⁴ Rural Development Instruction 4279-B, section 4279.131, dated December 23, 1996.

RECOMMENDATION NO. 1

Establish guidelines that identify the most appropriate appraisal method to value different types of assets that are used as collateral for guaranteed loans.

Rural Development Response

The existing regulations (sections 4279A and 4279.144) specify that appraisals must meet the Financial Institutions Reform and Recovery Enforcement Act of 1989 (FIRREA) and practitioners must follow the USPAP requirements. These are the same standards required by bank insurers and bank examiners. It is unlikely many lenders would participate in the B&I program, should we attempt to expand the RBS appraisal criteria from the industry standard. We issued AN 3798 on October 22, 2002, to guide States in appropriate use of real property appraisals to support valuation of collateral for B&I loans. Also, an unnumbered letter, "Business and Industry Guaranteed Loan Program Appraisals and Appraisal Review Checklist," dated November 14, 2002, was issued that addressed appropriate appraisal review techniques and included a checksheet for reviewing submissions. We are in the process of issuing another AN to clarify the intent of our appraisal regulations, and alerting staff that they are to confirm that appraisals meet both FIRREA and USPAP standards. The AN will also clarify that lenders and appraisers are to enter into engagement letters and that staff review the letter as part of underwriting the loan. The AN will also clarify that appraisals are to show results of all three methodologies of computing current value. We anticipate the AN will be issued by December 31, 2003. We request management decision.

OIG Position

The agency response does not address the recommendation. The response addresses actions to ensure that industry and lender standards are followed in performing appraisals. Our finding did not involve adherence to appraisal standards. Instead, the finding related to lenders not always using the most appropriate appraisal method for the type of business and collateral being appraised. For example, an "in-place, in-use" appraisal method, which considers the business to be a going concern, was used in several instances even though manufacturing facilities had not been constructed, or it was clear that the business was not operating in this manner. Our point is that even though the proper standards are followed for appraisals, the lender has not always chosen the most appropriate method for the loan being processed. In some instances, we found that the lender selected the appraisal method that gave the collateral the highest dollar value, thereby increasing the amount of B&I loans they could attain, but at the same time undercollateralizing

the B&I loans. Simply following industry standards (FIRREA and USPAP) would not always ensure that lenders do not inflate collateral values. To reach management decision, we need documentation that the agency has established permanent guidelines to identify the most appropriate appraisal method to value the various types of businesses and assets used as collateral for guaranteed loans.

RECOMMENDATION NO. 2

Implement procedures to verify that lenders use the most appropriate appraisal method to value assets.

Rural Development Response

The existing regulations (sections 4279A and 4279.144) specify that appraisals must meet the FIRREA and practitioners must follow the USPAP requirements. These are the same standards required by bank insurers and bank examiners. It is unlikely many lenders would participate in the B&I program, should we attempt to expand the RBS appraisal criteria from the industry standard. An unnumbered letter, "Business and Industry Guaranteed Loan Program Appraisals and Appraisal Review Checklist," dated November 14, 2002, was issued that addressed appropriate appraisal review techniques and included a checksheet for reviewing submissions. We are in the process of issuing an AN to clarify the intent of our appraisal regulations, and alerting staff that they are expected to confirm that appraisals meet both FIRREA and USPAP standards. The AN will also clarify that lenders and appraisers are to enter into engagement letters and that staff review the letter as part of the loan underwriting. The AN will also clarify that appraisals are to show results of all three methodologies of computing current value. We anticipate the AN will be issued by December 31, 2003. We request management decision.

OIG Position

As with Recommendation No. 1, the agency does not address the finding or the recommendation. To reach management decision, we need documentation that procedures have been implemented to ensure that lenders use the most appropriate appraisal method to value businesses and assets, or that lenders provide sufficient documentation to support the use of an appraisal method that has not been identified as the most appropriate.

RECOMMENDATION NO. 3

Require that lenders use audited financial statements, prepared in accordance with Generally Accepted Accounting Principles, to perform financial analyses of existing borrowers, and financial statements examined in accordance with an attestation engagement for new businesses.

Rural Development Response

There is no evidence presented in the audit that audited financial statements either better predict business success or limit agency loss. Further, the cost benefit ratio is not productive for small businesses.

We have relied on earlier recommendations made in OIG Audit No. 32600-2-SF which included the statement that “larger borrowers should continue to submit audited financial statements, but that smaller borrowers are not complying with the audit requirement due to the financial impact on operations.” Based on that audit on December 23, 1996, we amended our regulations (sections 4279B and 4279.137(b)) to read, “If specific circumstances warrant and the proposed guaranteed loan will exceed \$3 million, the Agency may require annual audited financial statements . . .” The cost of an audit is an even greater reality today for businesses in rural communities where shrinking populations and below-average incomes are a reality. Many rural borrowers are small and family-run businesses servicing small local markets. We continue to observe that the expense of an audit (or attestation review) would close down many small borrowers. The extra expense would absorb a high percent of cashflow, increasing overhead at the expense of operations and rendering the business nonviable. We, therefore, request that OIG reconsider its position and remove this recommendation from the audit.

OIG Position

Our February 1995 Audit Report No. 32600-2-SF stated that borrowers with larger loans should continue to submit annual audited financial statements, and that borrowers with smaller loans are not complying with the audit requirement due to the financial impact on their operations. Our audit never stated that borrowers with smaller loans should not submit audited financial statements. We recommended that RBS perform a review of past B&I loans to determine whether the requirement for audited financial statements was feasible and if it affected loan performance for borrowers with B&I loans of \$1 million or less. If warranted by its review, RBS may waive the requirement for audited financial statements for borrowers with smaller loans and use other financial information to verify

the borrowers' financial statuses. RBS amended its regulations in December 1996 to address our recommendations.

As stated in our recommendation, we believe that lenders should use audited financial statements to perform financial analyses of existing borrowers and should use financial statements examined in accordance with an attestation engagement for new businesses. However, for existing borrowers, we would consider reaching management decision if Rural Development provides (a) support for removing regulatory requirements that borrowers with smaller loans obtain audited financial statements, (b) support that Rural Development's observation that the expense of an audit (or attestation) would close down many small borrowers, and (c) an explanation why the definition of a borrower with smaller loans was changed from less than \$1 million to \$3 million or less.

**FINDING NO. 2 – AGENCY
CONTROLS OVER LOSS
PAYMENTS WERE
INEFFECTIVE**

Rural Development honored guarantees even though the lenders had not complied with provisions of conditional commitments, loan agreements, and agency instructions. This occurred because agency officials had either not completed, or had not properly completed, the "Business and Industry Guaranteed Loan

Final Loss Settlement Checklist." This checklist is the agency's primary management control for ensuring lender compliance prior to honoring a loan guarantee.

Rural Development instructions state that loan guarantees are unenforceable by lenders to the extent that losses are the result of negligent servicing, regardless of when the agency becomes aware of the occurrence.⁵ To ensure that lenders have complied with loan requirements, agency officials are required to complete the "Business and Industry Guaranteed Loan Final Loss Settlement Checklist" prior to payment of a loan guarantee.⁶

During the course of our review, we identified instances where lenders had not complied with provisions of conditional commitments, loan agreements, and agency instructions. In some cases, the violations were serious, such as when lenders misled agency officials about the financial condition of borrowers, and that collateral existed when, in fact, it did not exist. We also uncovered instances where lenders allowed borrowers to use loan funds for unauthorized purposes and failed to disclose this fact to agency officials. In most instances, agency officials were unaware of these conditions until we brought them to their attention. Nonetheless, we considered the problems to be so egregious that, had agency officials

⁵ Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996.

⁶ Rural Development Instruction 4287-B, section 4287.158(c)(1), dated December 23, 1996.

been aware of them, they would not have honored the guarantees. The following examples illustrate some of the violations uncovered during our review.

- Rural Development incurred \$5.5 million in losses due, in part, to a lender knowingly approving an appraisal that inflated the true value of assets used as collateral. Agency officials were unaware that equipment included in the appraisal was in poor condition, or that the lender knew, but failed to disclose, this fact during the loan-closing process.
- Rural Development incurred over \$3.7 million in losses after a lender falsely certified that a borrower's sawmill was complete and ready for operation. We determined that the sawmill was only partially completed, and that the completed part had not been designed to acceptable architectural and engineering standards. Thus, the sawmill could not produce the quantity and quality of lumber projected in the loan application. Also, the lender had not performed physical inspections to ensure that interim loan disbursements equaled construction progress. Further, the lender misrepresented the use of loan funds when it paid off a prior loan it had made to the borrower.
- A lender's failure to accurately determine a borrower's debt-service ratio and identify questionable transactions resulted in a loss of over \$4 million to Rural Development. Our analysis disclosed that the borrower's debt-service ratio at loan closing exceeded agency guidelines and that there were questionable transactions and computations used to arrive at these figures.
- Rural Development approved two guaranteed loans totaling \$2.7 million to construct a hotel. We determined that the hotel was structurally compromised after meeting with the architect and the structural engineer. They informed us that the hotel would never be certified as safe for occupancy and, in all likelihood, would have to be torn down. We recommended that the agency rescind the guarantee because the lender had not ensured that provisions of the conditional commitments, such as requiring building inspections, had been met. The State office agreed to rescind the loan note guarantee to eliminate any future loss claims by the lender.

The agency's primary management control for ensuring lender compliance with agency requirements prior to honoring a loan guarantee is the "Business and Industry Guaranteed Loan Final Loss Settlement Checklist." Agency officials complete the procedures in this checklist prior

to paying lenders for any loss claims. Therefore, we reviewed the checklist, and the agency's process for completing the checklist, to determine if it was adequate and that the agency was paying loss claims only to lenders that had complied with agency requirements.

Our examination of the checklist disclosed that its procedures were sufficient to ensure lender compliance with conditional commitments, lender agreements, and agency instructions. The lack of verification generally occurred, in our view, because of improper execution of the checklist. One agency official informed us that they did not always have the time and resources available to properly complete the checklist. The official added that the checklist was usually completed in a perfunctory manner to merely fulfill the requirement. An official from the national office confirmed our conclusion and stated that agency BPAR reports often note this same problem.

Even though we did not perform an analysis of the agency's resources, we concluded that the current control process is not adequately verifying lender compliance with agency requirements. Since many loans in default involve substantial losses, Rural Development needs to thoroughly evaluate loss-claim requests to ensure that lenders have complied with agency requirements and reduce unnecessary losses. One alternative may be to have State loan committees evaluate the circumstances of each loss claim. In this way, the committees would ensure that State officials perform a thorough review of lender activities.

RECOMMENDATION NO. 4

Require that loss claims be evaluated by State loan committees.

Rural Development Response

We agree with this recommendation. Currently, many State offices have implemented this procedure and refer loss claims to their loan committee for evaluation. We will revise the administrative provision of Rural Development Instruction 4279-B by September 30, 2004, to require loan committee evaluation of loss claims. We request management decision.

OIG Position

We agree with the planned action; however, we do not understand why the revisions to the administrative provision of the Rural Development instruction cannot be made before September 30, 2004. To reach management decision, we need documentation to show a more timely revision, no later than December 31, 2003, to the administrative provision

of the Rural Development instruction. Subsequently, the agency must incorporate the interim revisions to a permanent revision to Rural Development regulations.

**FINDING NO. 3 – LENDERS
HAD NOT COMPLIED WITH
SERVICING PROCEDURES**

Lenders had not obtained and analyzed financial statements from all borrowers after loans were made and had not visited some borrowers to inspect the collateral. While these deficiencies violated terms of lender agreements and instructions, agency officials

had no means to enforce lender compliance with program requirements. Agency officials informed us that generally they were unable to rescind or decrease loan guarantees under these circumstances because there was no clear monetary connection between the loss and lender negligence.

Rural Development instructions state that the loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes, negligent servicing, or failure to obtain the required security interest, regardless of the time at which the agency acquires knowledge of the foregoing. This responsibility includes but is not limited to the collection of payments, obtaining compliance with the covenants and provisions in the loan agreement, obtaining and analyzing financial statements, checking on payment of taxes and insurance premiums, and maintaining liens on collateral.⁷ There are no provisions in the instructions to sanction noncompliant lenders unless a loss can be attributed to negligent servicing by the lender.

We identified 20 instances where lenders had failed to obtain and analyze borrowers' financial statements for the 38 loans in our review. (See exhibit C, footnote 17.) In addition, we found that lenders had not always visited borrowers to ensure that collateral existed and was being maintained in the condition required to secure the loan. (See exhibit C, column 3.) The lender's agreement requires the lender to inspect the collateral as often as necessary to properly service the loan. (See exhibit F.) These management controls are essential for ensuring that borrowers are financially sound and are properly maintaining loan collateral. According to the lender's agreement, a lender's failure to perform these functions would be considered negligent servicing. (See exhibit F for excerpts from the lender's agreement.) The following examples illustrate the potential losses that can occur when lenders do not comply with these requirements.

⁷ Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996.

- We examined the financial statements for one borrower and uncovered over \$1.2 million in unauthorized distributions of retained earnings. The lender had not obtained and analyzed the financial statements for this borrower in over 3 years. Fortunately, the loan guarantee was terminated based on our findings without loss to the Government.
- One lender failed to obtain and analyze the financial statements for a borrower until 12 months after loan closing. When the lender finally did complete its analysis, the borrower was in default on its loan and was in the process of closing operations. The lender's analysis disclosed that the borrower never had sufficient working capital to operate the business. The Government incurred a \$4 million loss on the loan.
- One lender did not physically account for pledged collateral during visits to the borrower. When we visited the borrower, we discovered that \$1.7 million in equipment used as collateral was missing.
- A recent investigation disclosed that a borrower had fraudulently claimed to purchase almost \$3 million in processing equipment that was to be used as collateral for a guaranteed loan. The lender had never visited the borrower to verify the existence of the equipment.

Agency officials informed us that they do not have the authority to take action against lenders that fail to comply with program requirements unless there is a clear relationship between the negligent servicing and a loss to the Government. However, Rural Development officials need some control in order to ensure lender compliance with loan agreements and agency regulations.

One measure that could be effective would be to reduce the loan guarantee percentage when a lender fails to comply with agency requirements (e.g., from 80 percent to 70 percent, etc.). While there may be some challenges in implementing this measure, it would likely be the most effective action that the agency could take to ensure lender compliance.

This measure would ensure the effectiveness of management controls designed to protect loan collateral and identify borrowers with deteriorating financial conditions. Agency instructions state that loan servicing is intended to be preventive rather than curative, and that early recognition of potential problems is critical to maintaining the financial health of

borrowers.⁸ Thus, the agency needs measures that will ensure lender compliance with these critical oversight controls.

RECOMMENDATION NO. 5

Develop procedures to enforce lender compliance, such as reducing the loan guarantee.

Rural Development Response

We do not believe we have the ability to change or add terms to a guarantee ex post facto. However, we have begun to consult with the Office of the General Counsel (OGC) as to available options and will follow their guidance. We request that OIG amend this recommendation to allow guidance from OGC.

OIG Position

To reach management decision, we need support documentation that the agency cannot change or add terms to a guarantee ex post facto in order to reduce the loan guarantee, as opposed to RBS' mere belief that they do not have this authority. If it is shown that the agency does not have the authority to reduce the loan note guarantee, reasonable alternatives must be developed to enforce lender compliance and be scheduled for implementation in order to reach management decision.

**FINDING NO. 4 – AGENCY HAD
NOT ADEQUATELY
MONITORED LENDERS AND
BORROWERS**

Rural Development State officials had not performed all required visits of lenders and borrowers. According to State and national officials, there is insufficient staff available to perform all required visits. However, these visits are a critical agency management control to monitor compliance with program

requirements. The lack of monitoring increases the risk that borrowers are not adhering to agency requirements and lender-servicing actions are not detecting deficiencies that could undermine the agency's guaranteed loans.

Agency officials are required to visit lenders annually, and borrowers once during the first year of the loan and every 3 years thereafter⁹, to ensure that they are servicing loans in a prudent manner.¹⁰ During these visits, agency officials ascertain if lenders are adequately servicing loans and are ensuring that borrowers are complying with requirements in loan

⁸ Administrative procedure to Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996.

⁹ Rural Development Instruction 4287-B, section 4287.107(c), dated December 23, 1996.

¹⁰ Rural Development Instruction 4287-B, section 4287.107(a), dated December 23, 1996.

agreements. Agency officials accomplish this by (1) ensuring that lenders have obtained borrower financial statements and evaluating the lenders' analyses of those statements, (2) confirming that lenders verified the existence and condition of collateral, and (3) determining that lenders had confirmed compliance with stipulations in loan agreements. While visiting borrowers, agency officials check the condition of collateral and observe how the borrower is maintaining and using that collateral.¹¹

We examined agency visits because it is a critical oversight management control implemented to ensure that lenders and borrowers are complying with program requirements. Our review disclosed that State offices were not performing all required visits. In one State, agency officials had not visited lenders for 33 percent (22 of 67) of the borrowers with guaranteed loans. All of the visits were overdue for more than a year. The total guaranteed loan amount for these 22 borrowers was over \$62 million. At least four of these borrowers were delinquent at the time of our review. In these instances, lender visits are especially important to adequately service the loan and reduce the risk of loss.

In some instances, an agency visit could have detected problems disclosed by our review. For example, from our review of collateral listed for liquidation, we discovered that collateral valued at almost \$1.9 million was missing. The agency had not visited this borrower to verify that all collateral was present during the life of the loan, which was over 3 years. The borrower has since defaulted on one loan, and the agency's share of the loss is estimated at over \$1.2 million.

The RBS National Office monitors State office compliance with these requirements through management control reviews and BPARs. These monitoring controls have identified conditions similar to those disclosed by our review. One official informed us that the national office follows up with States that have not performed all required lender visits; however, the problem persists.

State officials stated that the lack of staff prevented them from completing required visits to lenders and borrowers. Although we did not evaluate the staffing of the State offices, national office staff confirmed this problem and further stated that it is often noted in agency BPARs. Since this is an important management control for monitoring compliance with program requirements, additional procedures are needed to ensure that, at a minimum, new and delinquent borrowers are visited each year. Borrowers that are current on payments could be visited on a biennial basis.

¹¹ Rural Development Instruction 4287- B, section 4287.107(c)-(f), dated December 23, 1996.

RECOMMENDATION NO. 6

Require annual lender visits for all new and delinquent borrowers, and biennial lender visits for all borrowers that are current on payments.

Rural Development Response

The B&I Guaranteed Loan Program is lender driven. The agency currently performs annual lender visits for all loans and borrower visits the first year of operation, thereafter, annually until the loan is seasoned, at which time the borrower visits are every 3 years. Lenders are required to report problem (nonmonetary default) and delinquent (monetary) borrowers to the agency. Lender failure to prudently service these loans could result in the inability to enforce the guarantee, to the extent a loss is occasioned by the lender's negligence. Recently, the agency made an increased effort to deny all or a part of the loan under the terms of the loan note guarantee and took actions to remind the lenders of their responsibilities.

We are of the opinion that more frequent lender/borrower visits are not productive or cost-effective uses of economic and human resources when there are other opportunities to work with lenders and borrowers in order to hold them accountable under the terms of the loan note guarantee. The findings do not clearly demonstrate that more frequent visits would result in a significant savings to the Government when there are other tools that can be used to accomplish the same end. We, therefore, request this recommendation be deleted from the report since it is inconclusive and based on a limited and somewhat skewed sample of the portfolio.

OIG Position

The agency response misinterprets our recommendation to require more frequent lender and borrower visits. Our recommendation addresses only lender visits by the agency, not borrower visits. Currently, the agency requirement is to visit all lenders each year, whether or not they have current, delinquent, and new borrowers. Our recommendation requires that only lenders with delinquent and new borrowers be visited each year by the agency. Lenders with current borrowers should only be visited once every 2 years, not every year as is now the agency requirement. Therefore, our report recommends fewer lender visits each year in order to focus the agency's self-admitted limited resources on annual visits to those lenders that have at-risk new and delinquent borrowers. Based on our analysis and observation, the agency was not performing the required number of lender visits. According to State officials, the State offices lacked the staff to visit every lender every year. The national office staff confirmed this problem and further stated that it is often noted in agency

BPARs. The agency response also mentions other opportunities and tools that can be used to accomplish the same end. However, none of these other opportunities or tools was described in the agency response. During our audit, agency personnel confirmed that these visits are a critical agency management control to monitor compliance with program requirements. To reach management decision, we need documentation showing the agency's commitment to address this recommendation.

FINDING NO. 5

Rural Development's Annual Performance Reports inaccurately depict the number of jobs created and saved by the B&I Guaranteed Loan Program. The agency reports program

results based on borrower projections, rather than the actual number of jobs created and saved by the program. In addition, the agency's data collection and input controls do not ensure the accuracy of reported results. As a result, Congress is using inaccurate and misleading information to make program-funding decisions.

GPRA requires that agencies prepare Annual Performance Reports that describe program accomplishments based on predetermined goals. OMB Circular A-11, section 220.12, states that agencies must have a system for verifying and validating performance information and ensuring that information that is collected, recorded, and reported is accurate and reliable.

We evaluated Rural Development's compliance with these requirements by examining agency management controls, interviewing agency officials, and verifying the accuracy of data in the agency's RCFTS. The RCFTS is the agency's data system that provides information on the status of any facility, borrower, or loan, and provides statistical data to the agency and members of Congress. The data in the RCFTS was used to prepare the agency's Annual Performance Report. We concluded that the agency's method of reporting jobs created and saved is misleading. In addition, the RCFTS contained inaccurate data as a result of input errors and the duplication of some information. These factors resulted in an overstatement of program accomplishments in agency reports. The following sections describe the results of our review.

Presentation of Program Results is Misleading

Rural Development includes what is termed as "actual" jobs created and saved by the B&I Guaranteed Loan Program in its Annual Performance Report to Congress. However, our review disclosed that Rural Development uses borrower projections originating from loan applications, and not the actual number of jobs created and saved as presented in the report. This presentation is misleading and, based on our tests, misrepresents the number of jobs created and saved by the program.

When we questioned agency officials about the misleading nature of this presentation, they stated that the projected figures would become reality when businesses were fully functional; therefore, the job data in agency reports was not misleading. We disagree with this conclusion because, as one official informed us, it could take as long as 3 to 5 years for a business to become fully functional. More importantly, projected figures are not actual figures and should not be represented as such in agency reports, especially reports used by Congress to make program-funding decisions. In our view, Rural Development should revise its current presentation of “actual” jobs created and saved to “projected” in its Annual Performance Reports.

We also concluded that using projected data misrepresents job data because these numbers will vary from the actual jobs created and saved by program funds. We verified data included in a recent annual report for 33 borrowers in 3 States. Those borrowers had projected that over 4,000 jobs would be created or saved with guaranteed loan funds. Unfortunately, we were only able to verify 2,262 actual jobs at the time of our review. (See exhibit E.) Thus, borrower projections were overstated by over 1,700 jobs, or 44 percent of the total reported. Several borrowers had defaulted and gone out of business shortly after Rural Development had guaranteed the loans. For example, one borrower who had projected creating and saving over 100 jobs had gone out of business 7 months after obtaining the loan guarantee. At the time of our visit, the facility built with guaranteed loans funds was vacant, and there were no actual jobs that could be attributed to the loan.

Rural Development State officials also periodically verified job data, but the results were not used to adjust the original projections input into RCFTS. Thus, there was no effect on the number of jobs included in agency reports even though data that is more current was available. These efforts should be reflected in the agency’s systems, and ultimately the annual report, because they would more accurately represent the accomplishments of the program.

Agency Systems Contain Inaccurate Data

Rural Development does not have adequate management controls, such as second-party reviews and system edit checks, to prevent and detect errors entered into its systems. We identified inaccuracies in the RCFTS that were the result of input errors and other mistakes. In addition, we discovered that agency officials had input job data twice for some loans. This duplication occurred when borrowers were obtaining multiple loans and agency officials input the same job data for each loan. We determined that these errors had overstated the RCFTS by 534 jobs.

Agency officials agreed that these types of errors could overstate the number of jobs created and saved by the program. National office officials added that the agency acknowledged these problems in the FY 2000 Annual Performance Report and examined the system in that year to identify and correct these deficiencies. However, the agency did not implement any controls at that time to prevent or detect input and duplication errors in the future. Consequently, the value of agency reports is diminished because of errors in the system.

In August 2002, Rural Development implemented the Rural Development Application Processing System. Agency officials maintained that job data in this system would be more accurate and reliable than in the past. Because of the timing of our review, we did not verify data in the system. However, we did question agency officials about management controls related to preventing and detecting errors. Based on our discussions, we concluded that the new system has the same control weaknesses as the previous system.

RECOMMENDATION NO. 7

Revise the presentation in the Annual Performance Reports from actual to projected jobs created and saved by the program.

Rural Development Response

The agency agrees in principle with this recommendation. We have changed the nomenclature of our Annual Performance Reports to include, "Computed jobs created or saved." We believe that this is both an accurate description and does not confuse readers with the other contemporaneous uses of the word "projected." Currently, the agency and others use the word "projected" in many places in budget and performance reports where the word means the best estimate of the future results (financial or performance) of a future period. An example would be: "2nd Quarter Projected Year-end Program Level." We request management decision and closure of this recommendation.

OIG Position

We do not agree with the nomenclature "Computed" jobs created or saved. This wording is misleading. These numbers are the borrowers' projections or estimates at the time of loan application of the number of jobs that will be created or saved by the B&I loans. Based on the agency response, the word "Computed" as reported in the Annual Performance Plan would still only be a summation of the borrowers' projections or estimates. To reach management decision, the agency must fully disclose whether the reporting of the jobs created or saved is actual or projected

numbers, including the identification of the source of this information in its Annual Performance Reports.

RECOMMENDATION NO. 8

Establish procedures to update the number of jobs created and saved in the agency's system based on job data verified by agency staff.

Rural Development Response

Jobs related to guaranteed loans are entered into the Guaranteed Loan System (GLS) when the loan closes, which may be over a year after the initial application that first identified the job information was approved. Applications reflect a job number that is a good-faith prediction of employment on the date the business becomes fully operational. During scheduled visits to borrowers, the agency staff documents the number of jobs reported by the borrower on Rural Development Form 4279-15, Business and Industry Visit Review Report, and then enters the updated data into the GLS. This information is generally based on personnel records of the borrower. The number of jobs created and/or saved cannot be reconciled with the information presented at the time the application was filed due to a myriad of external factors and variations in conditions present at the time the loan was submitted/approved. For instance, a business may still be under construction the next year and, therefore, has no current employees, but construction is on schedule, and full operations are imminent. There might be a seasonal upturn with many more, albeit temporary, employees than projected. Another business might be outsourcing some of its production or sales, so direct employment numbers would not reflect the job impact on the community. We, therefore, cannot assure that all employment data is verifiable at a specific time; however, we can compute the number of jobs created and saved using the best available information at the time.

The BPAR process monitors the status of the GLS to determine the level of field office compliance with the reporting requirements of the system. This is another internal control in addition to the State Internal Control Review (SIR) and the program Management Control Review.

We can, and will, include in the next revision of the SIR process, scheduled for May 2004, a segment that addresses alternative verifications of the initial job data as presented by lenders. We request management decision.

OIG Position

We understand there are various factors that do not allow for a full and accurate reporting of jobs created or saved. We also understand that the timing of the agency's Annual Performance Report to satisfy GPRA reporting deadlines adversely affects the ability of the agency to accurately report the number of jobs created or saved by guaranteed loans approved in any specific year. However, if the best available information at the time was used in the Annual Performance Report, a more accurate picture could be presented for the GPRA requirements. In our report, we pointed out that some businesses failed months after loan approval; therefore, none of the projected jobs to be created or saved was ever realized. To reach management decision, we need documentation describing what procedures and controls the agency will implement to update the Annual Performance Report with the most current, available, and verified job data, including the specific dates for implementation of these procedures and reporting.

RECOMMENDATION NO. 9

Develop management controls that ensure data entered into the agency's system is accurate.

Rural Development Response

Currently, all information from compliance visits is to be entered into GLS. However, the structure of GLS will allow an update to the financial and performance records of borrowers without job information being updated. This is not comparable to the control mechanism used when the job number is required to close the loan in GLS. GLS could be improved to require updated job information as part of field visit updates. We will make a Request for Automation to the Office of the Chief Information Officer by December 31, 2003. We request management decision.

OIG Position

The agency response does not address the recommendation. We found that inaccuracies in the RCFTS had resulted from input errors. We stated in the report that controls such as second-party reviews and system edit checks could be additional controls to ensure accurate data is entered into the RCFTS. To reach management decision, we need documentation that the agency will develop and implement such management controls within a specified date.

FINDING NO. 6

Borrowers participating in the B&I Direct Loan Program had not always submitted required financial statements and proof of insurance for loan collateral. Rural Development's

management controls had identified these borrowers, and agency officials had contacted them to request the required information. Yet, the borrowers remained noncompliant. The agency's only recourse was to accelerate the loans, which it does not do for loans considered to be in nonmonetary default status. As a result, Rural Development's direct loan portfolio, totaling almost \$124 million, is susceptible to unnecessary losses.

Rural Development inputs financial statement and insurance coverage due dates into its RCFTS to monitor borrowers and protect agency interests. We concluded that this was an effective management control and that it was functioning properly and as intended by the agency. We also determined that agency officials were properly following up with borrowers identified as noncompliant by the RCFTS. However, despite the fact that the agency had effective controls to identify noncompliant borrowers, almost 40 percent of the borrowers in our review had not submitted current financial statements, and over 22 percent of the borrowers had not submitted evidence of current insurance coverage.

We attributed this problem to the agency's lack of measures to enforce agency requirements. The only measure that we identified was a provision in loan agreements that gave Rural Development the authority to accelerate loans in nonmonetary default. However, agency officials had not used this authority to accelerate any of the noncompliant borrowers in our review. Several officials stated that agency policy prohibited acceleration of an account in nonmonetary default based on matters such as not submitting financial statements and proof of insurance. This statement contradicts the loan agreements.

Our analysis of the loan agreements and agency regulations was unable to uncover any guidance on the types of deficiencies that were considered to be significant and what would constitute a significant nonmonetary default. Agency officials stated that they did not consider the lack of financial statements and proof of insurance to be significant deficiencies that warranted accelerating loans.

We understand agency officials' reluctance to accelerate loans in nonmonetary default. Nevertheless, the agency needs to be able to ensure borrower compliance with provisions in loan agreements and agency regulations. Without such measures, Rural Development will not have the information it needs to determine if a borrower's financial condition is deteriorating or if a borrower has adequately insured collateral for a loan.

RECOMMENDATION NO. 10

Define deficiencies that classify loans in significant nonmonetary default. The definitions must address all types of nonmonetary defaults and provide acceptable justification for their classification as significant or nonsignificant, including their correlation to the soundness and safety of the repayment ability and security of the loan.

Rural Development Response

GLS currently contains the same deficiency codes as those used by banking regulators and insurers. Significant defaults of a nonmonetary nature are serious, and the agency intends to take whatever steps are necessary to protect the Government. Nonmonetary noncompliance needs to be viewed in light of all the other loan factors. We will issue an unnumbered letter that will include a schedule that ranks direct loans by size, performance, and risk by March 31, 2004. Performance factors will include nonmonetary deficiencies, and servicing actions and responses. This unnumbered letter will instruct States to take continuing servicing actions with the highest-risk direct loans. We request management decision.

OIG Position

The agency responded that significant borrower defaults of a nonmonetary nature are serious. We agree that such defaults are serious because they affect Rural Development's ability to adequately service loans and safeguard the Government's interest. However, the instructions do not define "significant." We agree with your planned actions to be released in an unnumbered letter by March 31, 2004. To reach management decision, we need documentation that "significant" will be defined as it pertains to nonmonetary defaults, and that instructions must be issued in something more permanent than an unnumbered letter.

RECOMMENDATION NO. 11

Require the acceleration of all loans with a significant nonmonetary default classification.

Rural Development Response

There are several concerns with this recommendation. First, the term “significant” as used in the recommendation is ambiguous, leaving a considerable amount of doubt as to its interpretation. The agency needs more specific guidance if it is expected to communicate this matter to its field staff and the borrowers. Secondly, existing borrowers have already signed agreements in place and those agreements are based on regulations in place at the time the loans were made. These agreements may preclude the agency from pursuing liquidation for the reasons OIG feels are significant nonmonetary default. We have limited, if any, rights to make material changes in those terms ex post facto. Thirdly, we have been verbally advised by OGC that liquidation of a borrower who is current on loan payments or has agreed upon workout in place would be difficult to defend in court, unless the agency could clearly demonstrate that the nonmonetary default would cause harm to the agency (e.g., the borrower’s failure to maintain the collateral). Finally, there may be other options that could cure the default and protect the Government. We request OIG to clarify or withdraw its recommendation.

OIG Position

The agency response states that the term “significant” as used in Recommendation No. 11 is ambiguous, leaving a considerable amount of doubt as to its interpretation. This is precisely our point in Recommendation No. 10. Rural Development instructions use the wording “significant” nonmonetary defaults; however, the instructions do not define or give guidelines on what is considered “significant.” The loan agreements give Rural Development the authority to accelerate loans in nonmonetary default. However, the loan agreements do not qualify nonmonetary defaults with the word “significant.” To reach management decision, we need further documentation that specific penalties will be applied to ensure compliance with loan agreements and agency regulations for lenders that have borrowers that are in “significant” nonmonetary default.

GENERAL COMMENTS

B&I Direct Loan Program

Our review of the B&I Direct Loan Program disclosed that 2 States had made loans to 11 borrowers without assurance that there was adequate collateral to secure the loans. Specifically, the States had not obtained sufficient collateral to secure nine loans totaling over \$5.3 million and failed to obtain first-lien positions on collateral securing two loans totaling over \$1.9 million. Agency officials had not verified the existence of the assets being pledged and had relied on the borrowers' attorneys to file the required closing documents. As a result, we question whether nine of the loans should have been made and determined that two loans were undercollateralized by \$472,202.

An agency BPAR completed in January 2000 reported that one State had not properly discounted collateral. Moreover, even when collateral had been properly discounted, the coverage was insufficient to secure the loan. These findings were similar to the conditions noted in our review.

While we identified problems in the loan-making area, we are not recommending any corrective action because program funding was terminated in FY 2002.

Use of Exception Authority

Rural Development officials have used exception authority to waive management controls designed to ensure that borrowers were creditworthy and that lenders had complied with agency servicing requirements. These controls were critical in protecting the Government's security interests. We attributed this problem to external influences involving Rural Development managers. We have reported this matter to agency officials several times recently, and they have taken measures that should ensure that it does not continue in the future. However, since the misuse of exception authority has been a recurring problem, it needs to be monitored closely by agency officials to maintain the integrity of the B&I Guaranteed Loan Program.

Rural Development's instructions are clear regarding the circumstances when agency officials can use exception authority. They state that agency

officials may use exception authority to waive program requirements provided the waiver does not violate any law, and provided that without the waiver the Department would suffer an adverse impact.

Rural Development's implementation and continual use of the National Office Executive Loan Committee and OGC's reviews should prevent further misuse of exception authority. Rural Development officials have recently stated their commitment to these procedures and this support is critical to effective management controls.

EXHIBIT A – SUMMARY OF MONETARY RESULTS FROM INDIVIDUAL AUDIT REPORTS

Audit No.	State	Date Final Report Issued	Questioned or Unsupported Costs/Loans – Recovery Recommended	Questioned Costs/Loans – No Recovery	Funds To Be Put To Better Use	Totals
AUDIT REPORTS FOR GUARANTEED LOANS						
34004-03-Ch	OH	10/01				
34601-02-KC	MO	04/01				
34601-02-KC	MT	03/01				
34601-02-SF	AZ	08/01	^{1/} \$2,350,965			\$2,350,965
34601-03-At	FL	01/02	\$1,536,060			\$1,536,060
34601-03-SF	CA	12/01				
34601-04-At	GA	01/03	\$3,766,908			\$3,766,908
34601-04-SF	AZ	09/01	^{1/} \$2,365,000			\$2,365,000
34601-05-SF	CA	06/01				
34601-06-Te	MA	11/01			\$2,400,000	\$2,400,000
34601-08-Te	SC	02/02	\$7,353,018		\$3,519,375	\$10,872,393
34601-09-Te	ME	11/01		\$4,000,000		\$4,000,000
34601-10-Te	LA	07/03	\$1,663,865			\$1,663,865
34601-11-Te	TX	12/01	\$5,316,184			\$5,316,184
Subtotals			\$24,352,000	\$4,000,000	\$5,919,375	\$34,271,375
SPECIAL REQUEST AUDIT REPORTS						
34099-02-At	GA	09/01	\$4,052,351			
34099-05-Te	LA	09/03	\$1,382,301	\$4,202,835		
34601-03-Ch	CO	03/03				
34601-07-SF	WA	12/02			\$14,000,000	
Subtotals			\$5,434,652	\$4,202,835	\$14,000,000	\$23,637,487
TOTAL FOR ALL GUARANTEED LOANS						\$57,908,862
AUDIT REPORTS FOR DIRECT LOANS						
34601-06-SF	HI	09/02		\$5,355,000		
34601-13-Te	TX	03/02				
34601-14-Te	AR	09/02		\$ 472,202		
Subtotals				\$5,827,202		\$5,827,202
TOTAL MONETARY RESULTS REPORTED IN STATE REPORTS			\$29,786,652	\$14,030,037	\$19,919,375	\$63,736,064

^{1/} Represents Unsupported Costs/Loans totaling \$4,715,965.

Other Recovery Recommended amounts represent Questioned Costs/Loans totaling \$19,636,035.

EXHIBIT B – SUMMARY OF DEFICIENCIES FOR GUARANTEED LOANS FROM STATE REPORTS

NUMBER OF REPORTS	REPORT NUMBER	LENDER DEFICIENCIES ¹²							AGENCY DEFICIENCIES		
		MISUSE OF LOAN FUNDS	INSUFFICIENT/ MISSING COLLATERAL	NO ANALYSIS OF FINANCIAL CONDITION	FINANCIAL STATEMENTS NOT OBTAINED	CONDITIONAL COMMITMENT VIOLATIONS	LOAN AGREEMENT VIOLATIONS	UNAUTHORIZED LOANS	LENDER VISITS NOT PERFORMED	MISUSE OF WAIVERS	SUBSTANDARD BORROWERS
1	34601-6-Te		X		X		X				
2	34601-5-SF										
3	34601-2-SF		X								X
4	34601-4-SF					X	X				
5	34004-3-Ch			X	X						
6	34601-9-Te				X		X			X	
7	34601-11-Te	X ¹³	X		X	X	X				X
8	34601-8-Te	X	X		X	X		X			X
9	34601-3-At	X	X		X	X	X		X		
10	34601-4-At	X	X		X	X			X		X
11	34601-10-Te		X		X ¹⁴	X					X
12	34601-3-SF										
13	34601-2-KC (MO)				X						
14	34601-2-KC (MT)										
15	34601-7-SF		X	X						X	X
16	34601-3-Ch									X	
17	34099-2-At	X	X	X	X	X	X				X
18	34099-5-Te	X	X								X
Total No. of Reports by Deficiency		6	10	3	10	7	6	1	2	3	8
Percentage of Total Number of Reports		33	55	16	55	38	33	5	11	16	44

¹² This column includes lenders not performing collateral inspections. (See exhibit C, column 3.)

¹³ Each X represents at least one occurrence of the deficiency noted in the report.

¹⁴ The report did not include a finding for this deficiency; however, it was a deficiency noted during the audit.

EXHIBIT C – NUMBER OF TIMES DEFICIENCIES OCCURRED IN STATE REPORTS FOR GUARANTEED LOANS

NUMBER OF REPORTS			NO. LOANS REVIEWED IN DEPTH	NUMBER OF OCCURRENCES BY DEFICIENCY FOR GUARANTEED LOANS REVIEWED ¹⁵												
	REPORT NUMBER	STATE		1	2	3	4	5	6	7	8	9	10	11	12	13
1	34601-6-Te	MA	2	1	1	1			1		1					
2	34601-5-SF	CA	2													
3	34601-3-SF	CA														
4	34601-2-SF	AZ	3	1											1	
5	34601-4-SF	AZ								1	1					
6	34004-3-Ch	OH	2				2		2							
7	34601-9-Te	ME	3						1		1			1		
8	34601-11-Te	TX	4	1	1	3		3	3	2	2				1	
9	34601-8-Te	SC	9	1				1	1	2					1	1
10	34601-3-At	FL	2		2	2		1	1	1	2	1	1			
11	34601-4-At	GA	2	1	1			1	1	2		1	1		1	
12	34601-10-Te	LA	2	1					2 ¹⁶	1					1	
13	34601-2-KC	MO	2						1				1			
14	34601-2-KC	MT	2													
15	34601-7-SF	WA	1	1			1							1	1	
16	34601-3-Ch	CO												1		
17	34099-2-At	GA	1	1	1		3	3	1	4	2		1		1	
18	34099-5-Te	LA	1	3	3			5							1	
Total			38													
Total # of Occurrences by Deficiency for Guaranteed Loans Reviewed				11	9	6	6	14	14¹⁷	13	9	2	4	3	8	1

KEY TO DEFICIENCIES (By Column Number):

1. Lender obtained inadequate appraisals for collateral securing the loans.
2. Missing or unaccounted-for collateral.
3. Lenders not performing collateral inspections.
4. Lender analysis of borrower's financial condition is inadequate.
5. Misuse of loan funds, including collateral proceeds.
6. Lenders did not obtain/submit financial statements to Rural Development and/or financial statements did not comply.
7. Lender and/or borrower violated provisions of the conditional commitment.
8. Lender and/or borrower violated provisions of the loan agreement.

¹⁵ For columns 1-13, multiple occurrences of a deficiency do not necessarily equate to multiple loans. For example, audit number 34099-5-Te involved only one loan, but column one shows three occurrences of inadequate appraisal deficiencies for the loan.

¹⁶ The report did not include a finding for this deficiency; however, it was a deficiency noted during the audit.

¹⁷ Total number of times that financial statements were not obtained and/or analyzed by lenders = 20 (col. 4 + col. 6).

EXHIBIT C – NUMBER OF TIMES DEFICIENCIES OCCURRED IN STATE REPORTS FOR GUARANTEED LOANS (CONT.)

- 9. Rural Development did not perform annual lender and/or borrower visits.
- 10. Rural Development did not receive or did not timely receive financial statements.
 Poor evaluation of creditworthiness.
- 11. Rural Development's use of waivers or exception authority was inappropriate.
- 12. Rural Development should have classified the loan as substandard.
- 13. Lender made unauthorized loans to borrower.

EXHIBIT D – SCOPE OF REVIEW BY STATE

Audit Report Title	Audit Report No.	No. of Loans		No. of Lenders Selected for Review	Period Fieldwork Conducted
		Judgmentally Selected for Review	Selected For Indepth Review		
AUDIT REPORTS FOR GUARANTEED LOANS					
South Carolina	34601-8-Te	9 of 60	9	3	01/01-10/02
Arizona–Lender A	34601-2-SF	9 of 42	3	2	11/00-03/01
Arizona–Lender B	34601-4-SF				
CA-Lender A	34601-3-SF	8 of 135	2	2	12/00-06/01
CA-Lender B	34601-5-SF				02/01-03/01
Texas	34601-11-Te	6 of 67	4	3	01/01-03/01
Ohio	34004-3-Ch	5 of 69	2	2	12/00-04/01
Massachusetts	34601-6-Te	6 of 49	2	2	11/00-04/01
Maine	34601-9-Te	8 of 56	3	1	02/01-03/01
Florida	34601-3-At	5 of 67	2	2	11/00-06/01
Missouri	34601-2-KC	5 of 72	2	2	11/00-03/01
Montana	34601-2-KC	5 of 89	2	2	11/00-01/01
Georgia	34601-4-At	3 of 73	2	1	02/01-01/02
Louisiana	34601-10-Te	9 of 76	2	2	04/01-10/01
Total States Audited = 12	Total Reports = 14	78 of 855	35	24	11/00-10/02
SPECIAL REQUEST AND HOTLINE COMPLAINT AUDIT REPORTS					
Georgia	34099-2-At	1 of 1	1	1	10/99-01/01
Louisiana	34099-5-Te	1 of 1	1	1	02/01-05/01
Colorado	34601-3-Ch	18		19	05/02-08/02
Washington	34601-7-SF	1 of 1	1	1	07/01-10/01
Total States Audited = 4	Total Reports = 4	3 of 3	3	3	10/99-08/02
NATIONWIDE DIRECT AUDIT REPORTS					
Hawaii	34601-6-SF	11 of 11		N/A	06/01-09/01
Texas	34601-13-Te	2 of 2		N/A	04/01-11/01
Arkansas	34601-14-Te	5 of 10		N/A	05/01-11/01
Total States Audited = 3	Total Reports = 3	18 of 23	38 Loans	27 Lenders	04/01-11/01
GRAND TOTAL OF STATES AUDITED = 16 ²⁰	GRAND TOTAL OF REPORTS = 21	99 of 881			11/00–10/02 ²¹

¹⁸ Cooperative with 467 loan note guarantees. Did not review specific loans – reviewed overall use of waiver authority.

¹⁹ Cooperative with 467 loan note guarantees. Did not review specific lenders – reviewed overall use of waiver authority.

²⁰ The number of States audited was 16; however, the aggregate number of States was 19. (The States of AR, GA, LA, and TX are included in multiple categories – Guaranteed, Special Request, or Direct.)

²¹ Represents earliest and latest dates fieldwork was conducted. (Nationwide fieldwork began 11/00; however, a special request audit that began in 10/99 was also included.)

EXHIBIT E – SUMMARY OF RESULTS FOR AGENCY GPRA REPORTING

PER THE RCFTS DATABASE							
STATE	BORROWER	JOB CREATED	JOB SAVED	TOTAL JOBS	JOB VERIFIED 1/	JOB VERIFIED 2/	Duplicate Jobs 3/
Arizona	Borrower A	100	2	102	100	0	
	Borrower B	136	414	550	400	602	
	Borrower C	250	0	250	0	394	
		6	15	21	31	149	
	Borrower D	10	10	20	40	32	
	Borrower E	4	22	26	16	18	
	Borrower F	17	68	85	85	0	
Arkansas	Borrower G	8	25	33	0	0	
	Borrower H	36	179	215	0	262	
	Borrower I	4	11	15	0	0	
	Borrower J	40	532	572	0	0	
	Borrower K	0	0	0	0	23	
		0	0	0	0	0	
Montana	Borrower L	9	6	15	18	0	
	Borrower M	40	85	125	0	93	
	Borrower N	5	23	28	41	41	
	Borrower O	48	36	84	30	6	
	Borrower P	6	102	108	145	134	
	Borrower Q	2	10	12	0	15	
	Borrower R	1	1	2	1	1	
	Borrower S	0	40	40	12	44	
	Borrower T	6	6	12	8	6	
	Borrower U	0	52	52	48	34	
	Borrower V	23	0	23	17	22	
	Borrower W	700	512	1212	84	0	
	Borrower X	15	19	34	20	32	
	Borrower Y	0	2	2	2	2	
	Borrower Z	18	30	48	0	24	
		0	102	102	0	0	
	Borrower AA	2	2	4	4	0	48
	Borrower BB	8	29	37	0	56	
	Borrower CC	12	0	12	5	6	
	Borrower DD	0	67	67	0	91	
	Borrower EE	17	83	100	0	100	
	Borrower FF	6	2	8	3	3	
		5	0	5	0	0	
	Borrower GG	12	8	20	0	72	
	Subtotals	1,546	2,495	4,041	1,110	2,262	
California	Borrower HH	6	168	174			
	Borrower II (Borrower HH)	6	168	174			174
Hawaii	Borrower JJ	189	0	189			
		0	189	189			189
Pennsylvania	Borrower KK	6	0	6			
		6	0	6			6
	Borrower LL	40	77	117			
		40	77	117			117
	TOTALS	1,839	3,174	5,013			534

1/ Jobs verified by Rural Development. Verified figures do not affect job count as reported to Congress.

2/ Jobs verified by OIG during the review.

3/ Rural Development State Office personnel confirmed duplication.

EXHIBIT F – EXCERPTS FROM THE LENDER’S AGREEMENT REGARDING SERVICING REQUIREMENTS

Lender’s servicing responsibilities include but are not limited to:

- Obtaining compliance with the covenants and provisions in the note, loan agreement, security instruments, and any supplemental agreements, and notifying in writing USDA and the borrower of any violations. None of the aforesaid instruments will be altered without USDA’s prior written concurrence. The lender must service the loan in a reasonable and prudent manner.
- Inspecting the collateral as often as necessary to properly service the loan.
- Assuring that adequate insurance is maintained. This includes hazard insurance obtained and maintained with a loss payable clause in favor of the lender as the mortgagee or secured party.
- Assuring that taxes affecting collateral are paid; the loan and collateral are protected in foreclosure, bankruptcy, etc.; and proceeds from the sale or other disposition of collateral are applied in accordance with the lien priorities on which the guarantee is based.
- Assuring that if personal or corporate guarantees are part of the collateral, current financial statements from such loan guarantors will be obtained and copies provided to USDA at such time and frequency as required by the loan agreement or conditional commitment for guarantee. In the cases of guarantees secured by collateral, assuring the security is properly maintained.
- Obtaining the lien coverage and lien priorities specified by the lender and agreed to by USDA, and properly recording or filing lien or notice instruments to obtain or maintain such lien priorities during the existence of the guarantee by USDA.
- Assuring that the borrower obtains marketable title to the collateral.
- Assuring that any party liable is not released from liability for all or any part of the loan, except in accordance with USDA regulations.
- Obtaining from the borrower periodic financial statements as required in the loan agreement with the borrower. At a minimum, annual financial statements must be forwarded by the lender, with a credit analysis, to the USDA servicing office within 120 days of borrowers’ fiscal yearend.

EXHIBIT G – SELECTION CRITERIA FOR REVIEWING GUARANTEED LOANS

Selection Criteria	No. of Loans Meeting This Selection Criteria	Percent of Total Guaranteed Loans Selected for Review	Loan Selection Summary	
>\$1 million, small amount of principal paid, and delinquent	32	41.0	43 of 78 loans (55.1%) were large-dollar loans and delinquent	72 of 78 loans (92.3%) were large-dollar loans that were either delinquent or with small amount of principal paid
<\$1 million, small amount of principal paid, and delinquent	7	8.9		
<\$1 million and delinquent	4	5.1		
>\$1 million and small amount of principal paid	29	37.2	29 of 78 loans (37.2%) were large-dollar loans with small amount principal paid	
>\$1 million	4	5.1		
<\$1 million and small amount of principal paid	2	2.6		
TOTALS	78	100.0		

EXHIBIT H – RURAL DEVELOPMENT’S RESPONSE TO DRAFT REPORT



United States
Department of
Agriculture

SEP 05 2003

Rural Development

Operations and
Management

Washington, DC
20250

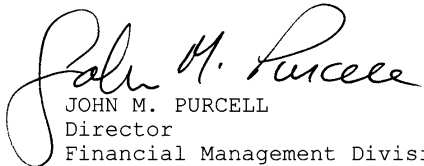
SUBJECT: Office of Inspector General
Rural Business-Cooperative Service
Lender Servicing of Business and Industry
Guaranteed Loans in Georgia
(Audit No. 34601-015-TE)

TO: Richard D. Long
Assistant Inspector General
for Audit
Office of Inspector General

Attached for your review is the Rural Business-Cooperative Service's response to the official draft for the subject audit.

This response is being submitted for inclusion in the final report and your consideration to reach management decision on the recommendations.

If you have any questions, you may contact La'Shonda DeBrew of my staff at 692-0086.


JOHN M. PURCELL
Director
Financial Management Division

Attachment

Rural Development is an Equal Opportunity Lender. Complaints of discrimination should be sent to: Secretary of Agriculture, Washington, DC 20250





United States Department of Agriculture
Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

SEP 4 2003

SUBJECT: Rural Business-Cooperative Service
National Report on the Business and Industry Loan Program
Audit Report No. 34601-15-TE

TO: John M. Purcell
Director
Financial Management Division

This is in response to the official draft findings and recommendations of the above-captioned audit. We are concerned that readers will not understand the conclusions, scope or conditions. We specifically request that the Executive Summary clearly state that these findings and recommendations have been reported in the other 21 referenced audits, and that the Agency has agreed to take remedial action in response to those audits. Given that the audit began over 34 months ago, the reader needs to be brought up to date. Also, the reader needs to be informed that Appendix A is redundant of the Appendices A in the other 21 audits.

Next, there is inadequate discussion and perspective about the scope of the audit and the highly selective sample. A better discussion is necessary as the title includes the word "national," but the audit fails to deliver any pertinent "national" information. Buried on page six is the disclosure of the total portfolio size, but no further description of the kinds of industries, numbers of lenders, average length of loan, historic delinquency or losses, etc. Of equal concern is the brief reference that the audit was based on a "judgmental sample." The fact is, the Agency participated in a material way in identifying "high risk" portfolio characteristics as well as requesting specific loans to be included causing the sample to be highly skewed, not merely "judgmental." It was from the "high risk" segment of the portfolio that the sample was selected. Without fuller discussion the current statements are simply misleading. There needs to be complete disclosure and a clear and early statement that any implied or explicit conclusions of generalized risk to the total portfolio based on the cases reviewed is not supportable.

Also, the audit fails to adequately disclose or discuss material facts about some of the loans. The audit fails to report material subsequent events that, to date, have rendered some of the underlying recommendations moot. For instance, in at least three of the audits covered, (which were also issued as individual audits prior to being included here) numerous recommendations were to "rescind or reduce loan note guarantees", in whole and in part generally based on appraisals being inadequate, or inaccurate financial ratios. To date, we have attempted, but have not been successful in collecting those funds. Hearing Officers, rather than accepting Office of

Rural Development is an Equal Opportunity Lender
Complaints of discrimination should be sent to:
Secretary of Agriculture, Washington, DC 20250

Inspector General (OIG) audits as determinative, have relied on defenses raised in testimony by lenders and borrowers. We believe it is neither helpful nor accurate to continue to report on recommendations that are repeatedly negated in established administrative and legal settings. We have communicated with OIG concerning the difficulties we have had in recoveries or rescissions. One of three such recommendations could not be implemented as Office of the General Counsel (OGC) determined it to be unsupportable by law; two were not supported in the Departmental Appeals process.

Finally, the report does not identify an acceptable loss percentage or a comparable loss percentage that would be the target for this \$4 billion portfolio. On the other hand, the audit does include the misleading and incorrect statement, "Since 1980, OIG has issued 46 audit reports with monetary findings of over \$224 million. These conditions if left unabated could increase Government losses in the future." Without updating the findings (by adjusting the dollars that were actually collectable, not the \$224 million) and noting the vast changes in program regulations and administration that has taken place over the past 23 years, the statement is gratuitous and prejudicial. Also, both that statement and the audit imply that a *de minimus* loss is possible but both fail to identify an ideal target: either an objective percentage or an amount met by similar USDA or other government agencies.

Our response to specific recommendations are as follows:

Recommendation No. 1:

Establish guidelines that identify the most appropriate appraisal method to value different types of assets that are used as collateral for guaranteed loans.

Agency Response:

The existing regulations (sections 4279A and 4279.144) specify that appraisals must meet the Financial Institutions Reform and Recovery Enforcement Act of 1989 (FIRREA) and practitioners must follow the Uniform Standards of Professional Appraisal Practices (USPAP) requirements. These are the same standards required by bank insurers and bank examiners. It is unlikely many lenders would participate in the B&I program, should we attempt to expand the RBS appraisal criteria from the industry standard. We issued an Administrative Notice (AN) AN 3798 on October 22, 2002, to guide States in appropriate use of real property appraisals to support valuation of collateral for B&I loans. Also, an unnumbered letter, "Business and Industry Guaranteed Loan Program Appraisals and Appraisal Review Checklist," dated November 14, 2002, was issued that addressed appropriate appraisal review techniques and included a check sheet for reviewing submissions (copy attached). We are in the process of issuing another AN to clarify the intent of our appraisal regulations, and alerting staff that they are to confirm that appraisals meet both FIRREA and USPAP standards. The AN will also

clarify that lenders and appraisers are to enter into engagement letters and that staff review the letter as part of underwriting the loan. The AN will also clarify that appraisals are to show results of all three methodologies of computing current value. We anticipate the AN will be issued by December 31, 2003. We request management decision.

Recommendation No. 2:

Implement procedures to verify that lenders use the most appropriate appraisal method to value assets.

Agency Response:

The existing regulations (sections 4279A and 4279.144) specify that appraisals must meet the FIRREA and practitioners must follow the USPAP requirements. These are the same standards required by bank insurers and bank examiners. It is unlikely many lenders would participate in the B&I program, should we attempt to expand the RBS appraisal criteria from the industry standard. An unnumbered letter, "Business and Industry Guaranteed Loan Program Appraisals and Appraisal Review Checklist," dated November 14, 2002, was issued that addressed appropriate appraisal review techniques and included a checklist for reviewing submissions (copy attached). We are in the process of issuing an AN to clarify the intent of our appraisal regulations, and alerting staff that they are expected to confirm that appraisals meet both FIRREA and USPAP standards. The AN will also clarify that lenders and appraisers are to enter into engagement letters and that staff review the letter as part of the loan underwriting. The AN will also clarify that appraisals are to show results of all three methodologies of computing current value. We anticipate the AN will be issued by December 31, 2003. We request management decision.

Recommendation No. 3:

Require that lenders use audited financial statements, prepared in accordance with Generally Accepted Accounting Principles, to perform financial analyses of existing borrowers, and financial statements examined in accordance with an attestation engagement for new businesses.

Agency Response:

There is no evidence presented in the audit that audited financial statements either better predict business success or limit Agency losses. Further, the cost benefit ratio is not productive for small businesses.

We have relied on earlier recommendations made in OIG Audit No. 32600-2-SF which included the statement that "larger borrowers should continue to submit audited financial statements, but that smaller borrowers are not complying with the audit requirement due to the financial impact on operations." Based on that audit on December 23, 1996, we amended our regulations

(sections 4279B and 4279.137(b) to read, "If specific circumstances warrant and the proposed guaranteed loan will exceed \$3 million, the Agency may require annual audited financial statements. . . ." The cost of an audit is an even greater reality today for businesses in rural communities where shrinking populations and below average incomes are a reality. Many rural borrowers are small and family-run businesses serving small local markets. We continue to observe that the expense of an audit (or attestation review) would close down many small borrowers. The extra expense would absorb a high percent of cash flow, increasing overhead at the expense of operations, rendering the business non-viable. We therefore request that OIG reconsider its position and remove this recommendation from the audit.

Recommendation No. 4:

Require that loss claims be evaluated by State loan committees.

Agency Response:

We agree with this recommendation. Currently, many State Offices have implemented this procedure and refer loss claims to their loan committee for evaluation. We will revise the administrative provisions of RD Instruction 4279-B by September 30, 2004 to require loan committee evaluation of loss claims. We request management decision.

Recommendation No. 5:

Develop procedures to enforce lender compliance, such as reducing the loan guarantee.

Agency Response:

We do not believe we have the ability to change or add terms to a guarantee *ex post facto*. However, we have begun to consult with OGC as to available options and will follow their guidance. We request that OIG amend this recommendation to allow guidance from OGC.

Recommendation No. 6:

Require annual lender visits for all new and delinquent borrowers, and biennial lender visits for all borrowers that are current on payments.

Agency Response:

The B&I Guaranteed Loan program is lender driven. The Agency currently performs annual lender visits for all loans and borrower visits the first year of operation, thereafter, annually until the loan is seasoned, at which time the borrower visits are every three years. Lenders are required to report problem (non-monetary default) and delinquent (monetary) borrowers to the Agency. Lender failure to prudently service these loans could result in the inability to enforce the guarantee, to the extent a loss is occasioned by the lender's negligence. Recently the Agency

made an increased effort to deny all or a part of the loan under the terms of the Loan Note Guarantee and took actions to remind the lenders of their responsibilities.

We are of the opinion that more frequent lender/borrower visits are not productive or cost-effective uses of economic and human resources when there are other opportunities to work with lenders and borrowers in order to hold them accountable under the terms of the Loan Note Guarantee. The findings do not clearly demonstrate that more frequent visits would result in a significant savings to the Government when there are other tools that can be used to accomplish the same end. We therefore request this recommendation be deleted from the reports since it is inconclusive and based on a limited and somewhat skewed sample of the portfolio.

Recommendation No. 7:

Revise the presentation in the Annual Performance Reports from actual to projected jobs created and saved by the program.

Agency Response:

The Agency agrees in principle with this recommendation. We have changed the nomenclature of our Annual Performance Reports to include, "Computed jobs created or saved." We believe that this is both an accurate description and does not confuse readers with the other contemporaneous uses of the word "projected." Currently, the Agency and others use the word "projected" in many places in budget and performance reports where the word means the best estimate of the future results (financial or performance) of a future period. An example would be: "2nd Quarter Projected Year-end Program Level." We request management decision and closure of this recommendation.

Recommendation No. 8:

Establish procedures to update the number of jobs created and saved in the Agency's system based on job data verified by Agency staff.

Agency Response:

Jobs related to guaranteed loans are entered into the Guaranteed Loan System (GLS) when the loan closes, which may be over a year after the initial application that first identified the job information was approved. Applications reflect a job number that is a good faith prediction of employment on the date the business becomes fully operational. During scheduled visits to borrowers, the Agency staff documents the number of jobs reported by the borrower on RD Form 4279-15, "Business and Industry Visit Review Report," and then enters the updated data into the GLS. This information is generally based on personnel records of the borrower. The number of

jobs created and/or saved cannot be reconciled with the information presented at the time the application was filed due to a myriad of external factors and variations in conditions present at the time the loan was submitted/approved. For instance, a business may still be under construction the next year and therefore has no current employees, but construction is on schedule, and full operations are imminent. There might be a seasonal upturn with many more, albeit temporary employees, than projected. Another business might be outsourcing some of their production or sales so direct employment numbers would not reflect the job impact on the community. We therefore cannot assure that all employment data is verifiable at a specific time; however, we can compute the number of jobs created and saved using the best available information at the time.

The Business Programs Assessment Review (BPAR) process monitors the status of the GLS to determine the level of field office compliance with the reporting requirements of the system. This is another internal control in addition to the State Internal Control Review (SIR) and the program Management Control Review.

We can, and will, include in the next revision of the SIR process, scheduled for May 2004, a segment that addresses alternative verifications of the initial job data as presented by lenders. We request management decision.

Recommendation No. 9:

Develop management controls that ensure data entered into the agency's system is accurate.

Agency Response:

Currently, all information from compliance visits is to be entered into GLS. However, the structure of GLS will allow an update to the financial and performance records of borrowers without job information being updated. This is not comparable to the control mechanism used when the job number is required to close the loan in GLS. GLS could be improved to require updated job information as part of field visit updates. We will make a Request for Automation to the Office of the Chief Information Officer by December 31, 2003. We request management decision.

Recommendation No. 10: [DIRECT LOAN]

Define deficiencies that classify [sic: direct] loans in significant non-monetary default. The definitions must address all types of non-monetary defaults and provide acceptable justification for the classification as significant or non significant, including their correlation to the soundness and safety of the repayment ability and security of the loan.

Agency Response:

GLS currently contains the same deficiency codes as those used by banking regulators and insurers. Significant defaults of a non-monetary nature are serious, and the Agency intends to take whatever steps are necessary to protect the government. Non-monetary non-compliance needs to be viewed in light of all the other loan factors. We will issue an unnumbered letter which will include a schedule that ranks direct loans by size, performance and risk by March 31, 2004. Performance factors will include non monetary deficiencies, and servicing actions and responses. This unnumbered letter will instruct States to take continuing servicing actions with the highest risk direct loans. We request management decision.

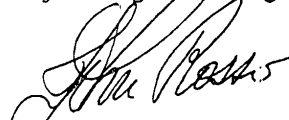
Recommendation No. 11: [DIRECT LOAN]

Require the acceleration of all [sic: direct] loans with a significant non-monetary default classification.

Agency Response:

There are several concerns with this recommendation. First, the term "significant" as used in the recommendation is ambiguous, leaving a considerable amount of doubt as to its interpretation. The Agency needs more specific guidance if it is expected to communicate this matter to its field staff and the borrowers. Secondly, existing borrowers have already signed agreements in place and those agreements are based on regulations in place at the time the loans were made. These agreements may preclude the Agency from pursuing liquidation for the reasons OIG feels are significant non-monetary default. We have limited, if any, rights to make material changes in those terms *ex post facto*. Thirdly, we have been verbally advised by OGC that liquidation of a borrower who is current on loan payments or has an agreed upon work-out in place would be difficult to defend in court, unless the Agency could clearly demonstrate that the non-monetary default would cause harm to the Agency; e.g., the borrower's failure to maintain the collateral. Finally, there may be other options that could cure the default and protect the Government. We request OIG to clarify or withdraw its recommendation.

If you have any questions or concerns, please contact Virginia Hammell, Loan Specialist, Special Projects/Programs Oversight Division, (202) 690-3805.



JOHN ROSSO
Administrator

November 14, 2002

SUBJECT: Business and Industry Guaranteed Loan Program
Appraisal; and Appraisal Review Checklist

TO: State Directors, Rural Development

ATTN: Business Programs Directors

This Unnumbered Letter is intended to help ensure that appraisals meet Standards I and II of the Uniform Standards of Professional Appraisal Practices (USPAP). We are also providing a mechanism for completing administrative reviews of all real property appraisals for the Business and Industry Guaranteed Loan (B&I) Program. Appraisal reviews must meet Standard III of USPAP, and this checklist will accomplish that.

Appraisals

An appraisal is an estimate of market value. Market value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably, and assuming neither party is under duress. Implicit in this definition is the consummation of a sale as of a specified date. It is prudent to consider any alternative uses for the facility. All appraisals should consider the potential effects from a release or presence of hazardous substances or petroleum products or other environmental hazards on the market value of the collateral. Thus, you should be aware of the prior use(s) of the property. When visiting the facility, look around for evidence of environmental hazards.

There are concerns that the appraisal valuations are not well documented to support the collateral valuation. Based on reviews of some appraisals, it appears that the documentation in the appraisals does not meet USPAP standards. In some cases, the appraiser does not meet the competency requirements in accordance with USPAP. In other cases, the appraiser is not using the proper, required approaches to determine the fair market valuation of the real property offered for collateral. We are concerned that the appraisals of collateral are not adequate to support the valuation estimates provided.

EXPIRATION DATE:
Discard when no longer necessary.

FILING INSTRUCTIONS:
Community/Business Programs

Review the approaches used in the appraisal to determine if the income approach was utilized, the appraisal is properly documented, and the appraiser has the qualifications to complete the appraisal. It is an accepted industry standard that the income approach and at least one of the other two approaches should be used on every appraisal. If your State has an Agency staff appraiser, that person should review the appraisal prior to loan approval.

An appraisal report should include:

- a definition of the appropriate value used,
- the date of value,
- the legal description and ownership rights,
- any limiting conditions and pre-existing easements,
- the highest and best use,
- at least two of the three approaches to value, and
- any appraisal requirements (i.e., "as will be") and a certification of the appraiser.

There are three approaches to establishing market value: the cost approach, the sales comparison approach, and the income approach.

The cost approach would be the cost of the real estate plus the cost of all improvements less all forms of depreciation: physical depreciation, functional depreciation, and economic obsolescence.

The sales comparison approach compares the subject property to similar properties (sales) located in relatively close proximity. Properties should be of similar size and utility. The properties should have sold within the past 24 months in arm's length transactions. Comparisons should be made on the basis of conditions of sale, financing terms, market conditions, location, physical characteristics, and income characteristics.

The income approach is a determination of value based upon a discount (or capitalization) of some measure of income. This measure could be book or taxable net income, gross revenues, gross profit, cash flows, or any of numerous ways to define income. Properties must be generating net operating income in order to use the income approach. There must be market sales of similar properties. It is essential that the business is a going concern.

Chattel Appraisals

Chattel evaluations are more frequently found on short- and intermediate-term loans. Loans with short or intermediate terms generally rely on chattel and personal property as primary collateral. Any disappearance of chattel collateral may result in a loss on the loan. Compared to the real estate appraisal process, the chattel evaluation is usually simpler and easier. The eight critical elements of chattel inspections are existence, ownership, location, number or amount, condition, value, attachment, and perfection. Each piece of chattel collateral should be listed in the chattel appraisal. Pay particular attention to specialized equipment. This type of equipment may be unique to the area and operation of the business. Be cognizant of potential teardown or reconstruction costs. Consideration should be given to not only the life expectancy of the equipment, but also to the impact of new technology. You should discount specialized equipment more than standard industrial equipment. Impacts to the value of industrial equipment include size and utility, condition (hours used), brand of the equipment, and the dealers and servicing available.

B&I Servicing

Appraisals are required on transfers and assumptions for less than the full amount of debt.

In accordance with RD Instruction 4287-B, section 4287.157(d)(13), in a liquidation scenario, an appraisal is required if the principal and interest balance is \$200,000 or more. The appraisal should be included as part of the liquidation plan and must comply with the requirements set forth in this AN. Thoroughly document any substantial decrease from the appraised value at approval versus the liquidation sales price.

RD Instruction 4287-B, section 4287.113(a), also requires an appraisal on any collateral released with a value greater than \$100,000. At its discretion, the Agency may require an appraisal on the remaining collateral if it is determined that the Agency may be adversely affected by the release of collateral.

The appraiser should be an independent third party to avoid any conflict of interest issues. If the appraisal has problems or is misleading, you are within your rights to require a new appraisal. If you have concerns or red flags are present, discuss the appraisal with or have the appraisal reviewed by the State review appraiser. That individual may decide that a technical review, in the form of a desk or field review as appropriate, is necessary. Field reviews should be requested for loans: with above average risk; in excess of \$5 million; secured by specialized or unique collateral; with highly depreciable collateral; collateral where the "highest and best use" is not typical for the property; or where collateral is valued on an "as will be" basis.

Appraisal Reviews

There are two types of appraisal reviews, administrative and technical. As loan officers, you are expected to be able to perform an administrative review. Attached is a suggested appraisal review form that can be used for conducting administrative reviews of real property appraisals. The administrative review should be completed by the Agency loan approval or servicing official. Any problems noted during an administrative review of real estate appraisals should be discussed with the State appraisal staff, directed to the lender, and resolved before the credit transaction is approved. We are trying to determine if the final value conclusion is reasonable, based on subject data facts, market data facts, and physical characteristics. Does the net income support the value?

There are a number of red flags to look for when reviewing appraisals:

- ensure that the appraisal report is clear and complete;
- check the report for math and calculation errors;
- review sales comparables to ensure that they are not outdated;
- make sure the appraiser is using the price actually paid and not the listing or sales price;
- pay attention to excessive adjustments in value;
- look for inconsistencies between the cost, sales comparison, and income approaches;
- use your experience to ensure that the appraisal is typical for the industry or area;
- make sure the appraiser has the necessary experience to appraise the real estate or machinery and equipment being appraised. If the assets are specialized, the appraisal must be completed by an appraiser certified in that specialty area; and
- make sure the appraiser has the proper certification.

Specific questions about appraisals should be directed to Kenneth E. Hennings, Specialty Lenders Division Servicing Branch Chief and Certified General Appraiser, (202) 690-3809. Please address B&I program questions to Fred Kieferle, Business and Industry Division Processing Branch Chief, (202) 720-7818.

(Signed by John Rosso)

JOHN ROSSO
Administrator
Rural Business-Cooperative Service

Attachment

USPAP COMPLIANCE CHECKLIST:
ADMINISTRATIVE AND TECHNICAL REVIEWS

Attachment

Appraiser	Appraisal Date:
Borrower/Lender	
Property Address	
Review Appraiser	
Date of Inspection	Date of Review

SUMMARY APPRAISAL REPORT

	YES	NO
1. Did the appraiser state the identity of the client and any intended users by name or type?	<input type="checkbox"/>	<input type="checkbox"/>
2. Did the appraiser state the intended use of the appraisal?	<input type="checkbox"/>	<input type="checkbox"/>
3. Did the appraiser summarize information sufficient to identify the real estate or personal property involved in the appraisal, including the relevant physical and economic property characteristics?	<input type="checkbox"/>	<input type="checkbox"/>
4. Did the appraiser state the property interest appraised?	<input type="checkbox"/>	<input type="checkbox"/>
5. Did the appraiser state the purpose of the appraisal, including the type of definition of value and its source?	<input type="checkbox"/>	<input type="checkbox"/>
6. Did the appraiser state the effective date of the appraisal and the date of the report?	<input type="checkbox"/>	<input type="checkbox"/>
7. Did the appraiser summarize sufficient information to disclose to the client and any intended users of the appraisal the scope of work used to develop the appraisal?	<input type="checkbox"/>	<input type="checkbox"/>
8. Did the appraiser state all assumptions, hypothetical conditions, and limiting conditions that affected the analyses, opinions, and conclusions?	<input type="checkbox"/>	<input type="checkbox"/>
9. Did the appraiser summarize the information analyzed, note that appraisal procedures were followed; and include the reasoning that supports the analyses, opinions, and conclusions?	<input type="checkbox"/>	<input type="checkbox"/>
10. Did the appraiser state the use of the property as of the date of value; reflect that use of the real estate in the appraisal; and, when the purpose of the assignment is market value, summarize the support and rationale for the appraiser's opinion of the highest and best use of real estate or personal property?	<input type="checkbox"/>	<input type="checkbox"/>
11. Did the appraiser state and explain any permitted departures from specific requirements of STANDARD 1 or 7 of USPAP and the reason for excluding any of the usual valuation approaches?	<input type="checkbox"/>	<input type="checkbox"/>
12. Did the appraiser include a signed certification in accordance with Standards Rule 2-3 or 8-3 of USPAP, and was the appraiser qualified to do the assignment (i.e., over \$100,000 transaction, Certified General Appraiser required)?	<input type="checkbox"/>	<input type="checkbox"/>

COMMENTS:

1

USPAP APPRAISAL REVIEW

Property Owner:

Interest Appraised: Fee simple estate

Appraisal Client: Rural Housing Service, USDA ☐
Rural Business-Cooperative Service, USDA ☐

Intended Purpose: The intended purpose of this appraisal review is to assess the adequacy and relevance of data, the propriety of any adjustments to that data, the appropriateness of the appraisal methods and techniques used to develop the appraisal report and to evaluate compliance with all relevant USPAP requirements. It is not to develop the reviewer's own opinion of value about the subject property.

Intended Use: The intended use of this appraisal review is to develop an opinion about the quality of the work completed by the above appraiser in his/her real property appraisal assignment of the above mentioned property.

Intended User: Rural Housing Service, USDA ☐
Rural Business-Cooperative Service, USDA ☐

Date of Review:

Effective Date of Review:

Nature, Extent and Detail of Review Process: field inspection ☐
exterior only of subject and comps ☐
desk review of complete appraisal and MLS books ☐

Review Appraiser's Summary of Opinions, Reasons and Conclusions:

Completeness of the report within scope of work:

Adequacy and relevance of data and adjustments:

Analyses, opinions and conclusions in report reasonable and develop reasons for disagreement:

Appropriateness of the appraisal methods and techniques used:

General Requirement		USPAP Requirement	Appears to be in Compliance		
1.	If Limited Appraisal, has appraiser correctly invoked and reported departure?	Departure Rule 2-2(xi)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
2.	If Jurisdictional Exception has been exercised in the development of the appraisal, has the appraiser correctly invoked and reported?	Jurisdictional Exception	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
3.	Has appraiser prominently stated the report option used?	2-2	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
4.	Has appraiser identified and correctly interpreted the appraisal problem?	1-1(a)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
5.	Has appraiser considered and identified the purpose of the appraisal?	1-2(a) 2-2(v)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
6.	Has appraiser considered and identified the intended use of the appraisal?	1-2(a) 2-2(ii)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
7.	Has appraiser considered and identified the real property interest to be appraised?	1-2(e)(ii) 2-2(iv)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
8.	Has appraiser identified the effective date of the appraisal?	1-2(d) 2-2(vi)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
9.	Has the appraiser dated the report?	2-2(vi)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
10.	Has the appraiser provided a definition of value?	1-2(c), 2-2(v)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
11.	If market value has been estimated, has the appraiser indicated whether the estimate is in terms of cash, or terms equivalent to cash, or other precisely defined terms?	1-2(c) 2-2(v)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>
12.	Has appraiser considered and reported the extent of the process of collecting, confirming, and reporting data (scope)?	1-2(f) 2-2(vii)	Yes <input type="checkbox"/>	No <input type="checkbox"/>	N/A <input type="checkbox"/>

13. Has appraiser considered and stated all assumptions and limiting conditions that affect the analysis and conclusions of the appraisals? 1-2(g) 2-2(viii) Yes ☐ No ☐ N/A ☐

COMMENTS:

Property Description

14. Has appraiser considered and stated all special or extraordinary assumptions and hypothetical and limiting conditions? 1-2(g) 1-2(h) 2-1(c) 2-2(viii) Yes ☐ No ☐ N/A ☐
15. Has appraiser adequately identified and reported the site description? 1-2(e)(i)(iv) 2-1(a)(iii) Yes ☐ No ☐ N/A ☐
16. Has appraiser adequately identified and reported improvement(s) description? 1-2(e) 2-2(iii) Yes ☐ No ☐ N/A ☐
17. Has appraiser adequately identified and reported the physical, functional, and external market factors as they may affect the appraisal? 1-4(b) 2-2(ix) Yes ☐ No ☐ N/A ☐
18. Has appraiser considered and reported any anticipated public and private improvements located on or off the site? 1-4(f) 2-2(viii) Yes ☐ No ☐ N/A ☐
19. Has appraiser considered and reported easements, restrictions, or other items of a similar nature? 1-2(e)(iv) 2-2(ix) Yes ☐ No ☐ N/A ☐
20. Has appraiser identified and considered the effect on value of any personal property, trade fixtures, or intangible items that are not real property but is included in the appraisal? 1-2(e)(iii) 2-2(ix) Yes ☐ No ☐ N/A ☐

- | | | | |
|-----|---|------------------|---|
| 21. | Has appraiser considered and reported the highest and best use of the site? (Highest and best use is determined by an appraiser that meets USPAP competency requirements, i.e., as a specialized appraiser having the qualifications to appraise the property.) | 1-3(b)
2-2(x) | Yes <input type="checkbox"/> No <input type="checkbox"/> N/A <input type="checkbox"/> |
| 22. | Has appraiser considered and reported the highest and best use as improved? | 1-3(a)
2-2(x) | Yes <input type="checkbox"/> No <input type="checkbox"/> N/A <input type="checkbox"/> |

COMMENTS:

VALUATION METHODS

Cost Approach

- | | | | |
|-----|--|-------------------------------------|---|
| 23. | Has appraiser explained and supported the exclusion of the cost approach? (If cost approach is not considered, documentation must be provided explaining why not.) | 2-2(xi) | Yes <input type="checkbox"/> No <input type="checkbox"/> N/A <input type="checkbox"/> |
| 24. | Has appraiser appropriately valued the site? | 1-4(b)(i), 2-2(ix) | Yes <input type="checkbox"/> No <input type="checkbox"/> N/A <input type="checkbox"/> |
| 25. | Has appraiser collected, verified, analyzed, and reconciled the cost of new improvements? | 1-4(b)(ii)
2-2(viii)
2-2(ix) | Yes <input type="checkbox"/> No <input type="checkbox"/> N/A <input type="checkbox"/> |
| 26. | Has appraiser collected, verified, analyzed, and reconciled accrued depreciation? | 1-4(b)(iii)
2-2(viii)
2-2(ix) | Yes <input type="checkbox"/> No <input type="checkbox"/> N/A <input type="checkbox"/> |

COMMENTS:

Sales Comparison Approach

27. Has appraiser explained and supported the exclusion of the Sales Comparison Approach? (If sales approach is not considered, documentation must be provided explaining why not.) 2-2(xi) 1-4(a) Yes ☐ No ☐ N/A ☐
28. Has appraiser collected, verified, analyzed, and reconciled comparable sales adequately identified and described? 1-4(a) 2-2(ix) Yes ☐ No ☐ N/A ☐

COMMENTS:

Income Approach

29. Has appraiser explained and supported the exclusion of the Income Approach? (If income approach is not considered, documentation must be provided explaining why not.) 2-2(xi) Yes ☐ No ☐ N/A ☐
30. Has appraiser collected, verified, analyzed, and reconciled comparable rental data for subject rent? 1-4(c)(i) 2-2(ix) Yes ☐ No ☐ N/A ☐
31. Has appraiser collected, verified, analyzed, and reconciled comparable operating expenses? 1-4(c)(ii) 2-2(ix) Yes ☐ No ☐ N/A ☐
32. Has appraiser collected, verified, analyzed, and reconciled comparable data to estimate capitalization/discount rate? 1-4(c)(iii) 2-2(ix) Yes ☐ No ☐ N/A ☐

COMMENTS:

Reconciliation and Final Estimate of Value

33. Has appraiser considered, analyzed, and reported any current sale, option, or listing of the property being appraised? 1-5(a) 2-2(ix) Yes ☐ No ☐ N/A ☐
34. Has appraiser considered, analyzed, and reported any prior sales; 1 year 1-4 family, 3 years all others? 1-5(b) 2-2(ix) Yes ☐ No ☐ N/A ☐
35. Has appraiser considered the quality and quantity of the data in the approaches, and the applicability of the approaches and commented on the reconciliation? 1-5(c) 2-2(ix) Yes ☐ No ☐ N/A ☐
36. Does the appraisal report contain sufficient information to enable the person(s) who are expected to receive or rely on the report to understand it properly? 2-1(b) Yes ☐ No ☐ N/A ☐
37. Does the appraisal report state the use of the real estate as of the existing date of value? 2-2(x) Yes ☐ No ☐ N/A ☐

COMMENTS:

Certification

38. Does the report include a signed certification in accordance with Standards Rule 2-3? 2-3 2-2(xii) Yes ☐ No ☐

SIGNATURE: _____ TITLE: _____ DATE: _____

NOTE: Stop here for an Administrative Review of Appraisal.

NOTE: For Technical Reviews, complete this section.

REVIEWER ASSUMPTIONS & LIMITING CONDITIONS

1. The Appraisal review documentation attached is based on information & data contained in the appraisal report that is the subject of this review. Data and information from other sources may be considered. If so, they are identified and noted as such.
2. It is assumed that such data and information is factual and accurate.
3. The REVIEWER reserves the right to consider any new or additional data or information that may subsequently become available.
4. Unless otherwise stated, all assumptions and limiting conditions contained in the appraisal report, which is the subject of this appraisal review, are also conditions of this review.

REVIEWER CERTIFICATION

I, the undersigned, certify to the best of my knowledge and belief:

1. The facts and data reported by the reviewer and used in the review process are true and correct.
2. The analyses, opinions, and conclusions in this review report are limited only by the assumptions and limiting conditions stated in this review report and are my personal, impartial, and unbiased professional analyses, opinions, and conclusions.
3. I have no present or prospective interest in the property that is the subject of this report and no personal interest with respect to the parties involved.
4. I have no bias with respect to the property that is the subject of this report or to the parties involved with this assignment.
5. My compensation is not contingent on an action or event resulting from the analysis, opinion, or conclusion in, or the use of, this report.
6. My engagement in this assignment was not contingent upon developing or reporting predetermined results.
7. My analysis, opinions, and conclusions were developed, and this review report has been prepared in conformity with the Uniform Standards of Professional Appraisal Practice.
8. No one provided significant professional assistance to the person signing this review report.
9. I do not authorize the out-of-context quoting from or partial reprinting of this review report. Further, neither all nor any part of this review report shall be disseminated to the general public by the use of media for public consumption or public communication without prior written consent of the review appraiser signing below.
10. I did personally inspect the subject property of the report under review.

This appraisal review is to be used in conjunction with the Appraisal Report under review, without the accompanying report this review report is not to be relied upon.

Review Appraiser

Date

Supervisory Appraiser (If Required)

Date

ABBREVIATIONS

AN	Administrative Notice
B&I	Business and Industry
BPAP	Business Programs Assessment Review
FIRREA	Financial Institutions Reform and Recovery Enforcement Act
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principals
GLS	Guaranteed Loan System
GPRA	Government Performance and Results Act
OGC	Office of the General Counsel
OIG	Office of Inspector General
OMB	Office of Management and Budget
RBS	Rural Business-Cooperative Service
RCFTS	Rural Community Facilities Tracking System
SARC	Semiannual Report to Congress
SIR	State Internal Control Review
USDA	United States Department of Agriculture
USPAP	Uniform Standards of Professional Appraisal Practices

GLOSSARY

Conditional Commitment. Rural Development's commitment to guarantee a loan subject to the lender's completion of all conditions and requirements set forth by the agency.

Credit Quality. A measurement of the borrower's ability to repay the loan. The lender is required to provide the agency with a written credit analysis of the borrower's financial stability. The agency reviews the lender's analysis to determine if the borrower meets minimum credit measurements.

Government Performance and Results Act (GPRA). This act requires Federal agencies to prepare an annual performance plan that sets out measurable goals that define what will be accomplished during a fiscal year. The purpose of GPRA is to focus on the results of activities such as real gains in employment, safety, responsiveness, and program quality.

Lender (For Guaranteed Loans). The financial institution making, servicing, and collecting the loan that is guaranteed by the Government.

Lender's Agreement. An agreement between the agency and the lender setting forth the lender's contractual responsibilities in making and servicing the loan.

Loan Agreement. The agreement between the borrower and lender (the agency for direct loans) containing the terms and conditions of the loan and the responsibilities of the borrower and lender.

Loan Note Guarantee. The agency's agreement with the lender to pay any loss sustained by the lender on the guaranteed portion of the loan in accordance with the conditions and terms of the loan note guarantee.

Marginal or Substandard Loan. OIG defines a marginal or substandard loan as a loan that does not meet the minimum credit-quality measurements that are used to determine the borrower's ability to repay the loan. (Note: Rural Development instructions do not directly define a marginal or substandard loan. The instructions state only that it is not intended that the guarantee authority will be used for marginal or substandard loans or for the relief of lenders having such loans.)

Negligent Servicing. The lender's failure to perform required services to ensure the security of the guaranteed loan.

Rural Community Facilities Tracking System (RCFTS). The agency's data system that provides information on the status of any facility, borrower, or loan, and provides statistical data to the agency and members of Congress.