BETTER MANAGEMENT OF COLLATERAL CAN REDUCE LOSSES IN SBA'S MAJOR PROGRAMS.
Better Management Of Collateral Can Reduce Losses In SBA's Major Loan Program.

In recent years, the Small Business Administration's 7(a) program, the agency's principal business loan program, has experienced increasing loan losses. As of April 1981, 14.4 percent ($1.3 billion) of the outstanding 7(a) loans were delinquent or in liquidation. SBA could reduce its losses on defaulted loans by adhering to procedures which provide a sound basis for managing collateral.
The Honorable Michael Cardenas
Administrator, Small Business Administration

Dear Mr. Cardenas:

This report evaluates the adequacy of the control and disposition of collateral under the Small Business Administration's (SBA's) 7(a) loan program. Our report suggests ways to reduce loan losses through better management of collateral. The review was made because of our concern with increasing loan losses and the large number of loans in liquidation. Our review was limited to SBA Region III, but we believe the issues identified would be typical of problems found in other SBA regions.

The report contains recommendations to you on page 20. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

In addition to the committees mentioned above, we are sending copies of this report to the Director, Office of Management and Budget; the House Committee on Small Business; and the Senate Select Committee on Small Business.

Sincerely yours,

Henry Eschwege
Director
DIGEST

The 7(a) loan program, the Small Business Administration's principal business loan program, makes or guarantees loans to small businesses that are unable to obtain financial assistance from other sources such as private lending institutions. In recent years, the 7(a) program has experienced increasing losses. As of April 1981, 14.4 percent ($1.3 billion) of the outstanding loans were delinquent or in liquidation. As loans face possible liquidation, the collateral pledged in support of these loans gains greater significance as a means of reducing losses. GAO wanted to know if SBA's liquidation policies and practices for 7(a) business loans have minimized Federal losses which have increased over recent years.

SBA's standard operating procedures generally provide a sound basis for managing collateral during loan servicing and liquidation. If these procedures are followed, the losses on defaulted loans can be minimized.

GAO's review of 22 charged-off 7(a) loans in SBA Region III showed that these procedures were not regularly followed by the district offices. Insufficient staff resources appear to be the primary reason SBA is unable to fully comply with the procedures. During servicing, SBA's collateral position is often unnecessarily jeopardized because of weaknesses in verifying the use of loan proceeds and monitoring collateral. Moreover, at liquidation SBA's recovery on defaulted loans may not have been maximized because liquidation plans were not prepared and weaknesses existed in the inspection and appraisal of collateral and the financial investigation of obligors. As a result, losses on the loans reviewed may not have been minimized.

Although the collateral pledged to secure the 22 loans was initially valued at about $2.3 million, SBA recovered only about $0.3 million to cover outstanding loan balances totaling $1.6 million. As a result, SBA incurred losses of about $1.3 million.
The bank certification program is a major effort by SBA to streamline the loan delivery system. The program's aim is to shorten the time required for SBA to review and approve guaranty loan applications by increasing the lending institution's role. The bank certification program may provide some relief to the staff problems plaguing the servicing and liquidation of loans.

While GAO's review was limited to Region III, SBA officials generally agreed that the issues GAO identified would be typical of the collateral problems found in other SBA regions.

To reduce loan losses and improve the management of collateral, GAO recommends that the SBA Administrator:

--Determine those aspects of the District Office's Portfolio Management Division's workload where it is essential that the Government's interest be protected and align existing staff accordingly.

--Modify the standard operating procedures to

--require spot checks of collateral during discretionary field visits to delinquent borrowers;

--require evidence from the participating bank of the existence, condition, and location of collateral before the loan guaranty is honored;

--clarify the requirement for and stress the importance of liquidation plans;

--require that the financial condition of loan obligors be determined as soon as a loan is placed in liquidation; and

--stipulate a time frame for making a liquidation field visit to inventory and inspect collateral.

--Reassign staff made available as a result of the Bank Certification Program to duties in the Portfolio Management Division.
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## Abbreviations

<table>
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<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>GAO</td>
<td>General Accounting Office</td>
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<tr>
<td>SBA</td>
<td>Small Business Administration</td>
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<tr>
<td>SOPs</td>
<td>standard operating procedures</td>
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CHAPTER 1
INTRODUCTION

The Small Business Administration (SBA) under section 7(a) of the Small Business Act guarantees and makes direct loans to small businesses. The 7(a) loan program is SBA's principal business loan program. In April 1981, the program accounted for 124,268 (85 percent) of the total business loans outstanding at that date. The program also accounted for $9.4 billion (92 percent) of the dollar value outstanding at that date.

It is SBA's policy to accept loans of higher risk and weaker credit than conventional lenders. The Small Business Act authorized SBA to make loans to small businesses that were unable to obtain financial assistance at reasonable terms from other sources such as private lending institutions. The SBA borrower will typically possess less business experience, provide weaker collateral, and demonstrate less business acumen.

The 7(a) program has incurred increasing losses in recent years. Loans "in trouble"—those delinquent more than 60 days and in liquidation—have almost doubled since September 1977. As more and more loans face possible liquidation, the collateral pledged in support of these loans gains greater significance when defaulted borrowers' assets must be sold to recoup outstanding balances and avert losses.

Because of this increasing significance of collateral in the 7(a) program, SBA's effort to manage collateral deserves greater attention. We define the management of collateral to include all servicing and liquidation practices for controlling and disposing of all items pledged as security on a loan. Opportunities exist to improve SBA's control and disposition of collateral, and thereby enhance its prospects for recovery if liquidation is necessary.

This report highlights deficiencies in SBA's management of collateral, a secondary source of repayment, if the borrower is unable to repay the debt from the cash flow of the business.

NATURE AND SIGNIFICANCE OF COLLATERAL

The Small Business Act, as amended, provides that all 7(a) loans made shall be of such sound value or so secured as to reasonably assure repayment. SBA's standard operating procedures (SOPs) state that a loan should be secured by collateral of a type, amount, and value which, considered with other factors such as the character and ability of the management and prospective earnings, will afford the required assurance of repayment. It is not intended that there always be collateral pledged which would provide full recovery upon liquidation. Collateral is considered a secondary means of repayment, and inadequate collateral alone would not warrant declining a loan.
Collateral includes all items pledged in support of the loan, for example; real estate, machinery and equipment, furniture and fixtures, accounts receivable, inventory, etc. Nonbusiness assets pledged as collateral often include the borrower's personal residence. Real estate is generally considered the strongest form of collateral, while inventory and accounts receivable are the weakest. The collateral pledged on SBA loans is usually of the weaker type--machinery and equipment, furniture and fixtures, inventory, or accounts receivable.

GROWTH OF TROUBLE LOANS AND LOAN LOSSES

SBA considers trouble loans to be both those over 60 days delinquent or "in liquidation." A loan will be transferred to in liquidation when it is necessary to sell the collateral to repay the debt. In April 1981, the 7(a) loan program had 124,268 loans outstanding of which 18,499 (14.9 percent), were trouble loans. The trouble loans accounted for $1.3 billion (14.4 percent) of the dollar value outstanding on 7(a) loans at that date. The following table shows the number and dollar amounts of trouble 7(a) loans and the percent of trouble loans to the total 7(a) loan portfolio.

| End of period | Trouble loans | | Trouble loans as a percent of total loans |
|--------------|---------------|-----------------|
|              | Number | Amount     | Number | Amount     |
|              | (millions) |           |         |           |
| Sept. 1977   | 10,337 | $ 613.2   | 11.1  | 11.3           |
| Sept. 1978   | 11,186 | 698.5     | 11.1  | 10.9          |
| Sept. 1979   | 11,926 | 763.1     | 11.3  | 10.7          |
| Sept. 1980   | 15,896 | 1,123.5   | 13.7  | 13.4          |
| Apr. 1981    | 18,499 | 1,351.5   | 14.9  | 14.4          |

From September 1977 to September 1979, the number of trouble loans as a percent of the total 7(a) loan portfolio remained relatively constant. However, a significant increase in trouble loans took place between September 1979 and September 1980. An Assistant Regional Administrator in Region III attributed this increase to the depressed economic conditions in the United States that were causing increasing numbers of small businesses to fail.

Since the beginning of fiscal year 1976, losses on the 7(a) loan program have more than tripled. A loss represents the loan balance outstanding after all remedies to effect repayment, including the sale of collateral, have been exhausted. At the beginning of fiscal year 1976, cumulative loan losses totaled $229.5 million. By the end of fiscal year 1980, cumulative losses amounted to $733.2 million, representing an average loss over the 5 fiscal years of about $100 million a year. SBA's loss figures for fiscal years 1975-80 follow:
Cumulative losses as a percent of cumulative disbursements

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Cumulative Losses (Millions)</th>
<th>Cumulative Losses as a Percent of Cumulative Disbursements</th>
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<tbody>
<tr>
<td>1975</td>
<td>$229.5</td>
<td>2.66</td>
</tr>
<tr>
<td>1976</td>
<td>315.2</td>
<td>3.12</td>
</tr>
<tr>
<td>1977</td>
<td>433.6</td>
<td>3.51</td>
</tr>
<tr>
<td>1978</td>
<td>524.8</td>
<td>3.64</td>
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<tr>
<td>1979</td>
<td>638.9</td>
<td>3.79</td>
</tr>
<tr>
<td>1980</td>
<td>733.2</td>
<td>3.98</td>
</tr>
</tbody>
</table>

Although the growth in trouble loans and loan losses may seem alarming, it must be viewed in light of SBA's legislative mandate to assist qualified small business borrowers who could not otherwise obtain funds from conventional lending sources. It does point out the increasing role that collateral must play in the repayment of a loan. As the borrower falls behind on loan payments, collateral takes on added importance. At liquidation, collateral becomes very important because it may be the only means of recovering the unpaid loan balance.

**OBJECTIVE, SCOPE, AND METHODOLOGY**

We conducted this review to determine whether SBA's liquidation policies and practices for 7(a) business loans have minimized Federal losses which have increased over recent years. By directing our analysis toward charged-off loans, we intended to identify opportunities to improve the control and disposition of collateral during servicing and liquidation. A charged-off loan is one on which SBA incurred a loss because of the borrower's inability to repay the loan.

Our principal source of information came from a detailed review of selected charged-off 7(a) loan files from Region III's district offices. We also reviewed pertinent legislation, procedures, studies, and reports. We interviewed officials at SBA headquarters; its Region III in Philadelphia, Pennsylvania; and its district offices in Philadelphia and Pittsburgh, Pennsylvania; Clarksburg, West Virginia; and Washington, D.C.

SBA Region III was selected for review because of the large percentage of outstanding 7(a) loans in its liquidation portfolio. We randomly selected 30 loans from the 271 7(a) loans charged-off during the 12-month period ended June 30, 1980. We selected for detailed review a 10-percent random sample, minimum of four loans, for each district office in Region III. After reviewing in detail 22 loans, we determined that deficiency patterns had been clearly established, and a detailed review of the remaining loans would not be necessary. A cursory review of the remaining loans showed that these loans did not differ significantly from those previously reviewed in terms of the kinds of problems experienced. (See table on p. 4.)
<table>
<thead>
<tr>
<th>District office</th>
<th>Number sampled</th>
<th>Detail review</th>
<th>Cursory review</th>
<th>Eliminated from sample</th>
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<tbody>
<tr>
<td>Philadelphia, Pa.</td>
<td>7</td>
<td>7</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Pittsburgh, Pa.</td>
<td>4</td>
<td>3</td>
<td>-</td>
<td>a/l</td>
</tr>
<tr>
<td>Clarksburg, W. Va.</td>
<td>5</td>
<td>5</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Baltimore, Md.</td>
<td>5</td>
<td>2</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Washington, D.C.</td>
<td>4</td>
<td>4</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Richmond, Va.</td>
<td>5</td>
<td>1</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>30</strong></td>
<td><strong>22</strong></td>
<td><strong>7</strong></td>
<td><strong>1</strong></td>
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</table>

a/Case eliminated because SBA chose not to take liquidation actions against the borrower, so that the borrower could continue to operate as an 8(a) minority small business contractor.

The loan files were reviewed in detail to determine compliance with selected SBA SOPs. We did not attempt to determine whether the incidence of noncompliance disclosed by our review in Region III was representative of the conditions in other SBA regional offices. However, we discussed the results of our review with the Director of the Office of Portfolio Management, SBA, and his staff who generally agreed that the issues we identified in Region III would be typical of the collateral problems found in the other regions.

Our previous reports 1/ on the 7(a) program have focused on SBA's procedures and practices for approving and servicing loans. In contrast, our current review was primarily directed at how loans were liquidated and how collateral was managed.

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CHAPTER 2
WEAKNESSES EXIST IN THE
MANAGEMENT AND DISPOSITION OF COLLATERAL

SBA can reduce 7(a) loan losses if loan specialists comply with servicing procedures for controlling pledged collateral and liquidation procedures for disposing of collateral. Insufficient staff resources, in the past and present, appear to be the primary reason loan specialists are unable to fully comply with procedures. Weaknesses in servicing practices may result in the unnecessary deterioration of SBA's collateral position, and weaknesses in liquidation practices may not assure maximum recovery.

In the 22 loans we reviewed, we found certain procedures were inadequately performed for all loans, and in all cases, the collateral value at foreclosure was less than at loan approval. Overall, SBA realized only about $0.3 million from collateral initially valued at about $2.3 million to cover outstanding loan balances of about $1.6 million, excluding interest. As a result, SBA incurred losses of about $1.3 million.

Opportunities exist, however, to improve SBA's collateral management practices in order to maximize recovery on collateral securing 7(a) loans. These opportunities are discussed in the following sections.

OPPORTUNITIES EXIST TO IMPROVE MONITORING OF COLLATERAL

SBA's collateral position is often unnecessarily jeopardized by weaknesses in the agency's loan servicing practices. Our review of 22 charged-off loans showed that SBA did not:

--Verify use of proceeds earmarked for acquiring assets pledged as collateral.

--Maintain control over collateral throughout loan servicing.

As a result, less collateral than anticipated may exist at liquidation, and losses may result.

Unauthorized use of loan proceeds can weaken SBA's collateral position

SBA's collateral position can be weakened if loan proceeds are not used as authorized. Often, collateral pledged as security for a loan includes items to be acquired with loan proceeds. If these items are not acquired, the collateral available to secure the loan is reduced, and losses may result.
Of the 22 loans we reviewed, 17 were loans where the collateral pledged included items to be acquired with loan proceeds. In our opinion, the collateral position was weakened when collateral items were not acquired or their acquisition was questionable for 6 of 17 loans. On three loans, SBA approved a reduction in the amount of collateral to be acquired and the reallocation of these funds to noncollateral uses. The documentation in the loan files for the remaining three loans does not substantiate that authorized collateral items were acquired.

SBA procedures provide two ways to ensure that loan proceeds have been used for authorized purposes: (1) banks submit settlement sheets for SBA District Counsel review showing to whom loan proceeds were disbursed and (2) the loan specialist checks use of loan proceeds during an initial field visit to the borrower.

In 3 of the 12 (25 percent) bank-serviced loans in our sample, we found the settlement sheets and/or initial field visit reports did not substantiate that collateral items to be acquired were purchased as authorized. In two of three cases, the settlement sheets do not indicate who received the loan proceeds. About $100,000 of the proceeds were to be used to acquire items pledged as collateral. Apparently, the proceeds were disbursed directly to the borrower. This reduces SBA's control of the loan funds and there is no assurance that the funds were used as authorized. In the remaining case, the settlement sheet did show who received the proceeds but did not clearly indicate whether collateral items to cost almost $68,000 were purchased. Further, initial field visit reports in all three cases did not indicate that proper use of loan proceeds was verified.

Control of collateral on problem loans is weak

Loan servicing is defined as (1) recognizing early that a problem or potential problem exists, (2) identifying the basic underlying cause, (3) determining the solution, and (4) taking appropriate action. It begins at the time of initial disbursement.

A major function of the SBA servicing effort is to assure that the interest of the agency is protected through maintenance of responsible control over collateral items pledged to support the loan. Field visits to the borrower and periodic review of borrower financial statements are methods of providing control. Once a problem loan (delinquent, failure to submit financial statements, etc.) is detected, we believe the loan specialist must act to protect the Government's interest.

We found that field visits to borrowers and review of borrower financial statements were not fully used as a means of controlling collateral on problem loans. As a result, only minimal collateral may remain on which to effect repayment of the outstanding loan balances.
Field visits do not adequately address collateral

SBA loan specialists often do not review the status of collateral after the initial field visit. Procedures in effect before May 14, 1979--most of the borrowers whose loans we reviewed were visited before this date--stated that field visits, subsequent to the initial field visit, should include consideration of the adequacy of collateral and any changes in collateral position. Under current procedures, the scope of such field visits is to be determined by the circumstances leading to the visit. District portfolio management officials informed us that the scope of these subsequent field visits is generally limited to the identified problem which often is the delinquent status of the borrower's loan.

SBA's procedures provide that field visits, subsequent to the initial field visit, are made at the discretion of the loan servicing activity. These visits are often referred to as subsequent or discretionary field visits. For direct loans, SBA has servicing responsibility. For guaranty loans, the participating lender services the loans until the guarantee is honored, when servicing responsibility is usually assumed by SBA. Portfolio management officials at SBA district offices informed us that because of a heavy workload, subsequent field visits by SBA loan specialists are limited to problem loans.

Our review of 22 charged-off loans disclosed that subsequent field visits often do not address the existence and condition of collateral pledged to secure the loan. During the 12-month period prior to liquidation classification, 15 of 22 loans were serviced by SBA. We found that subsequent field visits were made on 9 of 15 loans, but the field visit reports indicated that collateral was reviewed in only two cases. The primary purpose for most of these visits was to review the delinquent status of the borrower's loan.

Clearly, SBA is not availing itself of the opportunities that field visits present to check the current status and condition of collateral. SBA Region III officials commented that field visits may not be made due to work load, time, and travel fund constraints. SBA headquarters' officials believe that discretionary field visits could easily include an evaluation of the collateral position.

Failure to consider collateral, when making a field visit to a borrower, may permit the dissipation of collateral to go unnoticed. For example, SBA made a $15,600 loan to an operator of a Philadelphia area riding stable. Collateral consisted primarily of machinery and equipment and inventory, horses, valued at about $90,000. On May 30, 1979, an SBA loan specialist made a field visit to the borrower who was 7 months delinquent. The field visit report does not show that the status of collateral
was reviewed during this visit. When the business closed 2 months later, no collateral remained. An outstanding principal balance of $14,516 was subsequently charged off.

When a borrower falls behind on loan payments, we believe it is essential that a field visit be made to the borrower and it should include a review of collateral. Deteriorating collateral situations could be readily identified and the necessary action taken to protect the Government's interest.

**Financial statements not received**

Financial statements are another important means of controlling collateral pledged to secure a loan. They provide valuable information about borrowers' compliance with loan terms. SBA did not receive financial statements for the direct loans in our sample.

SBA procedures require that financial statements should be obtained from borrowers at regular intervals as stated in the loan authorization. Borrowers of direct loans are required to submit financial statements directly to SBA. The statements should normally be reviewed to identify any adverse trends and/or conditions. For the 10 direct loans in our sample, financial statements were not received as required by the loan authorization. For example, one borrower, over a 2-year period, should have submitted four financial statements; the loan file contained no statements.

SBA considers the failure to submit financial statements as an early warning signal that the borrower is experiencing problems. District portfolio management officials told us that if financial statements are not received on a problem loan, the borrower will be contacted by telephone or mail and requested to submit the statements. Generally, these efforts have not been effective. The Acting Regional Administrator for Region III agreed that receipt of financial statements is a problem but felt that little can be done to force a delinquent borrower to submit statements.

**Bank monitoring of pledged collateral is questionable**

SBA routinely honors the guarantee agreement with participating banks without knowing the existence, condition, and location of collateral pledged to secure the loan. SBA procedures for honoring the guarantee agreement require the participating bank to provide evidence that the necessary and appropriate liens have been obtained against the pledged collateral. Procedures do not require the bank to provide an itemized list of existing collateral. A loan specialist from one district office informed us that the district office routinely requests the participating bank to
give it an itemized list of all collateral and its present location. The list is seldom received.

A purchase examination and report by the loan specialist, on the note and related instruments and servicing rendered by the participating bank, is mandatory and will be made on all participation loans. Of major importance in the examination is a review to determine the existence, condition, and location of collateral.

Our review of 11 guaranteed loans disclosed only one instance where the purchase examination report addressed the existence of collateral. In eight other cases, collateral was primarily examined from the standpoint of whether or not the bank had properly recorded and maintained liens on collateral. In the remaining two cases, a purchase review was not made.

We question how SBA can honor the guarantee agreement without obtaining from the bank evidence of the existence, condition, and location of collateral. When the guarantee is honored, the borrower has usually defaulted on loan payments, and the possibility exists that collateral will have to be sold to repay the loan. For the 11 guaranteed loans in our sample, we found that only 4.6 percent of the stated value of collateral at application was recovered.

Existence and value of collateral often unknown prior to transfer to liquidation

A loan will be transferred to the in liquidation classification when it is necessary to use the collateral to repay the loan or when SBA's interest in the collateral may be in jeopardy. When transferring a loan, the loan specialist often does not know what collateral still exists.

SBA procedures require that loan specialists prepare a liquidation report on business loans when they recommend a loan for liquidation. One factor in this report should ordinarily itemize existing collateral by category and indicate the current value. We found that, generally, the reports did not reflect the current status of collateral. In 11 of 22 loans, the report merely restated what the collateral position was at application or made no comment on collateral. In the remaining cases, the report commented on the existence and/or value of collateral, but in most cases, we were unable to determine from the loan files how this information was developed.

IMPROVED LIQUIDATION PRACTICES COULD INCREASE RECOVERIES

Prompt, aggressive, well-organized liquidation action is necessary to ensure maximum recovery in minimum time once the borrower's deteriorated condition has removed any reasonable
hope of curing the delinquent loan. SBA's SOPs generally provide a comprehensive framework for liquidation action which, if followed, can provide assurance of maximum recovery on the collateral items that remain. Key elements of an effective liquidation action include

--preparing a liquidation plan to ensure timely and orderly disposition of collateral;

--promptly and thoroughly inspecting and evaluating collateral and initiating protective measures if necessary;

--appraising the collateral's liquidating value by a qualified appraiser to ascertain potential recovery and formulate protective bids; and

--pursuing obligors' personal assets to recoup remaining loan balances.

These essential elements of an effective liquidation action are enumerated in SBA's procedures. However, we found that loan specialists responsible for liquidating loans often do not follow the established procedures, thereby omitting or inadequately performing critical steps in the process. Omitted, untimely, or inadequate liquidation actions can result in unnecessary dissipation of collateral and failure to maximize recovery to its full potential.

More specifically, we found that liquidation loan specialists

--were not preparing liquidation plans as required;

--often did not inspect and evaluate collateral in a timely, thorough manner;

--often did not obtain qualified appraisals to determine realistic collateral values; and

--did not always pursue obligors' personal assets in a timely, thorough manner in seeking recovery of deficiency balances.

Liquidation plans could help ensure prompt, organized action necessary to maximize recovery

SBA loan specialists are not preparing liquidation plans as required by the agency's SOPs. We believe liquidation plans are fundamental to a disciplined approach to liquidating and disposing of collateral. They would make liquidation officials accountable for their actions or inactions and should ultimately result in higher recoveries for SBA.
SBA's SOPs stress the importance of planning liquidation action, stating that it is

"...highly desirable that the liquidating loan specialist put together his plan of action as soon after receipt and review of a case as possible."

The plan should be formulated, in part, on

--a review of all collateral documents,
--an inspection and inventory of all collateral, and
--an investigation of the financial condition of obligors.

The plan should address, among other things, the feasibility of workout, possibility of peaceful possession of collateral, need for updated collateral values, inventory of collateral, and conclude with a practical plan of action.

We found that liquidation plans had not been prepared for any of the 22 loan cases that comprised our sample. District portfolio management officials do not view liquidation plans as a firm requirement. They considered the documentation of liquidation plans to be burdensome and redundant. One district portfolio management official commented that, because of the heavy liquidation caseload, he is considering developing a checklist to assure that all liquidation requirements are met. We believe that well-planned actions yield better results by lessening the chances of delays, errors, and omissions in implementation similar to those discussed later in this chapter concerning collateral inspections, appraisals, and pursuit of obligors' assets.

SBA headquarters' portfolio management officials interpreted the SOPs to mean liquidation plans should, rather than must, be prepared. As a result, the practice of preparing plans is inconsistent throughout SBA. However, they consider liquidation plans necessary to ensure that loans are liquidated in a prompt and orderly manner and recovery is maximized. Consequently, headquarters' portfolio management officials told us they are planning a series of seminars for field personnel that would stress the importance of preparing liquidation plans.

More timely and thorough inspections could help curb collateral dissipation

SBA loan specialists are not consistently making prompt, thorough field visits to inspect and inventory collateral for loans placed in liquidation. SBA's SOPs require that unless recently accomplished, the major items of collateral securing the loan will be inspected and evaluated as soon as possible after an account is placed in liquidation. Such inspection
visits are an integral part of the liquidation process. It is essential that the loan specialist ascertain the composition, condition, location, and approximate value of the collateral to (1) identify missing collateral items and (2) determine the proper level of protection needed to preclude further dissipation. SOPs set no time frame for visits, but the Philadelphia district office requires that the visit be made within 30 days.

Our review showed that in 12 of the 22 cases examined, collateral inspections were inadequate to assure maximum recovery, as the following table illustrates:

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<tr>
<th>Description</th>
<th>Count</th>
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</thead>
<tbody>
<tr>
<td>Liquidation cases examined</td>
<td>22</td>
</tr>
<tr>
<td>Cases in which no inspection was warranted</td>
<td>4</td>
</tr>
<tr>
<td>Cases warranting inspection</td>
<td>18</td>
</tr>
<tr>
<td>Cases in which no inspection was made</td>
<td>4</td>
</tr>
<tr>
<td>Cases in which the inspection was not prompt or thorough</td>
<td>8</td>
</tr>
<tr>
<td>Inspection not made within 30 days</td>
<td>6</td>
</tr>
<tr>
<td>Collateral not identified or evaluated</td>
<td>5</td>
</tr>
<tr>
<td>Total inadequate inspections</td>
<td>12</td>
</tr>
<tr>
<td>Cases with adequate collateral inspections</td>
<td>6</td>
</tr>
</tbody>
</table>

\(a/11\) Includes three cases in which inspections were neither prompt nor thorough.

Failure to adequately inspect collateral promptly may lead to dissipation or a lack of assurance of maximum recovery. For example:

--A Philadelphia discount store was 6 months delinquent on its loan, and the participating lender repeatedly recommended liquidation to protect the remaining collateral. As a result, SBA placed the loan in liquidation. At that time, collateral, equipment, and inventory were
valued at about $6,000. However, a field visit was not made until 6 months after the loan was placed in liquidation, when the collateral was found to be of insufficient value to warrant sale and was ultimately abandoned with no recovery.

--A West Virginia sewing firm ceased operations and was placed in liquidation. Within 15 days, a field visit was made but collateral was not inspected and inventoried. Subsequently, SBA suspected that one of the firm's officers had removed some of the remaining collateral equipment. Without documentation of the composition of collateral the items missing could not be identified. Sale of the remaining equipment returned only 14 percent of its original cost.

--A Maryland carpet installation firm went out of business and was given permission by SBA and the participating lender to self-liquidate its remaining business collateral. The loan had not yet been placed in liquidation, and neither SBA nor the participating lender made an attempt to inspect and evaluate the collateral. Hence, there was no assurance that maximum recovery had been obtained through self-liquidation.

--A Philadelphia area laundromat was placed in liquidation in December 1978. A field visit was not made until March 20, 1979, and the inspecting loan specialist was unable to gain access to the premises. From outside the premises, he observed that there were 20 washers in place. Returning several weeks later to inventory the collateral, he found the borrower had removed 10 washers.

Because SBA did not inspect and inventory collateral promptly and thoroughly and take appropriate protective measures, collateral was permitted to dissipate.

These examples clearly illustrate the potential for dissipation that may develop, if collateral is not promptly and thoroughly inspected and evaluated.

Better use of appraisals would help maximize proceeds of sale of business collateral

SBA frequently fails to obtain adequate appraisals to establish the value of business collateral before sale. As a result, realistic values may not be established for use in formulating protective bids, and recoveries may not be maximized.
When a loan account is classified in liquidation and collateral will be disposed of, SBA procedures provide that an appraisal, generally, should be made unless current appraisal and liquidating values are already available. Such values are of the utmost importance and must be established for guidance in disposing of collateral through judicial foreclosure, summary sale, voluntary liquidation, trustee's sale, and insolvency proceedings.

Appraisals on loans of small values and with limited collateral, generally, should be made by a loan specialist. SBA procedures provide that the appraisal should not be made by the same loan specialist who will ultimately handle the sale of these assets.

In larger more complex liquidation situations, a professional appraiser should be used. For situations involving uncooperative borrowers, potentially disputable values, or protective bids, expert appraisal should be obtained.

For selected loan liquidation cases, we examined the adequacy of the appraisal methodology used for business collateral. Of our sample of 22 cases, we believe 17 warranted an appraisal of the business collateral. In 8 of these 17 instances, the collateral was of sufficient value or of such a specialized nature to warrant a professional appraisal. In the remaining nine cases, collateral was of limited value or of such a general nature that would permit an appraisal by a loan specialist. Our review of the 17 cases warranting appraisal showed that:

-- In five cases, collateral was not appraised before the sale.

-- In seven cases, the appraisal was inadequate for a variety of reasons, for example,

-- the appraisal was at market rather than liquidating value (one case);

-- the appraisal was not current, having been made about 21 months before sale (one case);

-- the appraisal was not made by an independent professional (two cases); and

-- the appraisal was made by the loan specialist handling the sale (three cases).

-- In five cases, business collateral appeared to have been adequately appraised.

Inadequate or omitted appraisals may lead to failure to obtain fair value for the collateral liquidated and a lack of assurance of maximum recovery. For example:
--A West Virginia sewing firm with a $100,000 loan went out of business and was placed in liquidation. Collateral included the business premises valued at application at $110,000. In anticipation of a public auction and the need to formulate a protective bid, the loan specialist requested a local real estate broker to provide a liquidation value appraisal. The broker appraised the property at market rather than liquidating value. The loan specialist recognized the $100,000 market value appraisal was not an appropriate basis for a protective bid but did not request the broker to provide the correct appraisal. Lacking a professional liquidating value appraisal, the loan specialist made an estimate of liquidation value which he used as a basis for formulating a $25,000 protective bid. SBA elected to enter a protective bid and acquired the property for $22,000 after the bidding reached $21,000. SBA's subsequent attempts to sell the acquired collateral through negotiated sale yielded $6,000 less than what could have been obtained at auction.

If SBA had had the benefit of an expertly prepared liquidation value appraisal, the loan specialist might have (1) more accurately formulated his protective bid, (2) realized an additional $6,000 by accepting the high bid at auction, and (3) avoided the expenditure of time and costs associated with collateral purchase.

In another case:

--A Maryland utility contractor with an outstanding loan balance of $75,000 ceased operations and was placed in liquidation. Two pick-up trucks were among the collateral to be liquidated. SBA permitted the borrower to self-liquidate by selling the trucks to his current employer without inspection or appraisal for $3,000, or about $1,500 less than the value tentatively placed on the vehicles by SBA. SBA's acceptance of the lesser value was based on unverified assurances by the borrower that the vehicles were in poor condition.

As a result, SBA lacked assurance that it was receiving fair value for its collateral and may have failed to maximize recovery by as much as $1,500.

More thorough and aggressive pursuit of obligators' personal assets could enhance recoveries

SBA loan specialists may be able to achieve greater recoveries from obligors by
-- more thoroughly investigating the financial condition of obligors to determine collectibility and
-- making greater use of independent appraisals of obligors' real property to determine collectibility and evaluate offers in compromise.

Once business collateral has been disposed of and a deficiency balance remains, SBA must seek recovery from the obligors. While full recovery remains the primary objective, it may be necessary to seek a compromise settlement.

The initial step in ascertaining potential collectibility is to investigate the financial condition of the obligors. This investigation normally includes (1) reviewing existing financial information, (2) soliciting current financial information from the obligors, and (3) if necessary, obtaining credit reports on obligors through private credit investigation services under contract with SBA. Once the obligors' major assets have been identified—usually their personal residences—an appraisal may be necessary to accurately determine value and potential collectibility. If obligors are unable to pay the deficiency balance in full, the loan specialist should solicit a compromise settlement.

Financial investigations of obligors lack thoroughness and promptness

SBA loan specialists often do not investigate the financial condition of obligors thoroughly to ascertain their ability to repay deficiency balances. SBA's prescribed procedure is to initiate its investigation of the obligors' current financial condition upon completion of business asset liquidation. SBA's Form 770 "Financial Statement of Debtor" is the vehicle provided to the obligor to obtain the necessary information. Alternate sources of financial information include credit reports from credit services under contract to SBA.

We found that SBA loan specialists often did not thoroughly investigate the financial condition of obligors. We noted that in 7 of 16 liquidation cases in which a financial investigation appeared warranted, no evidence existed that the obligors had been investigated through acquisition of either financial statements or credit reports.

-- In four of the seven cases, financial information was not solicited from all the obligors.
-- In three of the seven cases, financial information was solicited by SBA but not furnished by the obligors. In these instances, SBA did not attempt to obtain financial data from credit reporting services.
Lack of thoroughness in the financial investigation of guarantors can result in the underestimation of the obligors' ability to repay the deficiency balance.

SBA's practice of delaying solicitation of current financial information on obligors until business collateral is liquidated may afford obligors an opportunity to place their assets beyond SBA's reach. Investigations initiated promptly when it becomes clear that a deficiency balance will remain could help to limit obligors' opportunities to conceal assets.

Independent appraisals of obligors' real property could enhance recoveries

The obligor's primary residence will ordinarily represent the major item of value in determining collectibility. Any determination of the obligor's ability to repay or compromise the deficiency loan balance depends on a correct evaluation of the obligor's assets. To properly value real property, SBA's SOPs recommend that an appraisal be obtained from an accredited appraiser, local bank, realtor, or residential appraiser.

Of our sample of 22 loan cases, 14 involved nonbusiness real property that warranted appraisal:

--In four cases, a fee appraisal was obtained.

--In one case, the property was valued jointly by the loan specialist and a bank representative.

--In the remaining nine cases, no independent appraisal of the real property was obtained. In three of these cases, a compromise settlement was made without an independent appraisal.

Without an independent appraisal, SBA cannot determine, with certainty, the acceptability of the obligors' offers in compromise or whether further pursuit of obligors' personal assets is warranted. For example, a Washington, D.C., borrower's restaurant ceased operations and the business collateral was liquidated. A deficiency balance of about $34,000 remained. The loan was further secured by the obligor's rental income-producing real estate. The loan specialist's financial investigation showed that the obligor also had substantial equity in his personal residence. In evaluating a compromise offer of $18,000, SBA relied upon an appraisal of the rental property provided by the obligor rather than seeking its own independent appraisal, even though conflicting information existed as to value and equity. The value of the obligor's substantial equity in his personal residence was not confirmed by independent appraisal nor considered in evaluating the compromise offer which was far less than the deficiency balance. In this case, independent appraisals of the rental property and the borrower's personal residence were clearly necessary to provide assurance of maximum recovery.
Failure to obtain a qualified appraisal leaves a degree of uncertainty as to whether recovery has been maximized. The cost of appraisals of residential properties may range from $75 to $200—a small expense when compared to the potential loss that undocumented estimates of value may foster.

**INSUFFICIENT STAFF INHIBITS COMPLIANCE WITH SOPs**

Insufficient staff resources appear to be the major reason that Region III is unable to comply with the procedures. If loan losses are to be reduced, SBA must decide how to effectively manage the loan program within current staffing constraints.

Recent SBA studies show the Portfolio Management Division (servicing and liquidation) for each district office in Region III is understaffed. These studies compared actual staff to needed staff as determined from staff guidelines. Over the last 3 fiscal years, 1978-80, actual staff in the district offices has been significantly less than required. As of December 1980, the district offices were operating at about 57 percent of the needed staff. The following table shows, for each district office in Region III by period ending, the actual and needed number of staff.

<table>
<thead>
<tr>
<th>District Office</th>
<th>September 1978</th>
<th>September 1979</th>
<th>September 1980</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Need</td>
<td>Actual</td>
</tr>
<tr>
<td>Philadelphia, Pa.</td>
<td>46</td>
<td>73</td>
<td>44</td>
</tr>
<tr>
<td>Pittsburgh, Pa.</td>
<td>8</td>
<td>18</td>
<td>10</td>
</tr>
<tr>
<td>Clarksburg, W. Va.</td>
<td>8</td>
<td>15</td>
<td>9</td>
</tr>
<tr>
<td>Baltimore, Md.</td>
<td>10</td>
<td>25</td>
<td>11</td>
</tr>
<tr>
<td>Washington, D.C.</td>
<td>9</td>
<td>18</td>
<td>10</td>
</tr>
<tr>
<td>Richmond, Va.</td>
<td>16</td>
<td>27</td>
<td>17</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>97</td>
<td>176</td>
<td>101</td>
</tr>
</tbody>
</table>

Actual staff as a percent of need 55.1 58.4 57.7

Our previous reports cited that SBA was not following its own procedures for approving and servicing loans under the 7(a) program. Although SBA agreed with the initial report that more personnel were needed to process loans in accordance with procedures, the followup report showed that its attempts had not significantly increased staffing.

SBA internal reports (Aug. 1, 1973, and June 4, 1976) showed that SBA was not following selected liquidation procedures. SBA officials cited insufficient staff as the reason for not adhering to the requirements.

SBA's staffing problem was further highlighted in a January 1979 report prepared by a national public accounting firm. This report presented the results of a study of portfolio management (servicing and liquidation of loans) at selected SBA district offices. This study concluded that the Portfolio Management Division is significantly understaffed and is unable to fully comply with the SOPs.

SBA's Bank Certification Program may provide some relief to the staff problems in the Portfolio Management Division. The certification program is a major effort by SBA to streamline the loan delivery system. The program's aim is to shorten the time required for SBA to review and approve guaranty loan applications by increasing the lending institution's role. As of June 1980, SBA had certified 251 banks to participate in the program. In November 1980, the SBA Administrator indicated the program was being expanded to include additional banks. SBA plans to have as many as 2,000 banks certified by 1985.

Within a district office, the Finance Division is responsible for reviewing and approving guaranty loan applications. Our report showed that SBA's application review process took an average of 23 days. During the pilot study of the certification program most applications were reviewed by SBA within 5 days, which would represent a 78-percent decrease in SBA's review time. We believe that this decrease should make some personnel available for reassignment to other areas within SBA, such as servicing and liquidation.

CONCLUSIONS

SBA's SOPs provide a sound basis for managing collateral during loan servicing and liquidation and, if properly implemented, should reduce loan losses. However, our review showed that procedures were not being performed or were being performed to a lesser degree than described by the SOPs. Insufficient staff resources appear to be the primary reason SBA Region III is unable to fully comply with the SOPs.

While full compliance with SOPs may not be possible within the existing staff resources, we believe that modifying selected procedures could enhance the management of collateral and reduce loan losses. Procedures need to be modified to

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--require spot checks of collateral during discretionary field visits to delinquent borrowers;

--require evidence from the participating bank of the existence, condition, and location of collateral before the loan guaranty is honored;

--clarify the requirement for and stress the importance of liquidation plans;

--require that the current financial condition of loan obligors be determined as soon as a loan is placed in liquidation; and

--stipulate a time frame for making a liquidation field visit to inventory and inspect collateral.

Further, the Bank Certification Program, conceptually, should reduce the number of staff required to review and approve loans, making staff available for reassignment to other areas within SBA, such as servicing and liquidation.

RECOMMENDATIONS

To reduce loan losses and improve the management of collateral, we recommend that the SBA Administrator:

--Determine those aspects of the District Office's Portfolio Management Division's workload where it is essential that the Government's interest be protected and align existing staff accordingly.

--Modify the SOPs to

--require spot checks of collateral during discretionary field visits to delinquent borrowers;

--require evidence from the participating bank of the existence, condition, and location of collateral before the loan guaranty is honored;

--clarify the requirement for and stress the importance of liquidation plans;

--require that the current financial condition of loan obligors be determined as soon as a loan is placed in liquidation; and

--stipulate a time frame for making a liquidation field visit to inventory and inspect collateral.

--Reassign staff made available as a result of the Bank Certification Program to duties in the Portfolio Management Division.