SBA INSPECTOR GENERAL

WHITE PAPER: RISK AWARENESS AND LESSONS LEARNED FROM AUDITS AND INSPECTIONS OF ECONOMIC INJURY DISASTER LOANS AND OTHER DISASTER LENDING

April 3, 2020

EXECUTIVE SUMMARY

RISK AWARENESS AND LESSONS LEARNED FROM AUDITS AND INSPECTIONS OF ECONOMIC INJURY DISASTER LOANS AND OTHER DISASTER LENDING

Report Number 20-12

April 3, 2020

Why We Did This?

The Small Business Administration's (SBA's) Disaster Assistance Program is the Federal Government's primary program for providing disaster assistance to businesses. SBA provides up to $2 million in Economic Injury Disaster Loans (EIDLs) for substantial economic injury loss to small businesses and most private nonprofit organizations to help meet financial obligations and operating expenses.

In response to the Coronavirus (COVID-19) pandemic, the Coronavirus Preparedness and Response Supplemental Appropriations Act (CVPR Act) deemed COVID-19 a disaster and authorized SBA to provide EIDLs to businesses and nonprofits affected by COVID-19. In addition, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provided $10 billion to SBA to provide emergency EIDLs. This is a significant increase compared to prior major disasters. For example, SBA approved approximately $1.1 billion combined in disaster loans to businesses and nonprofits in response to Hurricanes Harvey, Irma, and Maria. For Hurricane Sandy, SBA approved approximately $527 million in disaster loans to businesses and nonprofits. Only a portion of the business and nonprofit loans for these hurricanes were EIDLs. As of April 1, 2020, SBA received more than 94,000 EIDL applications for the COVID-19 pandemic.

We prepared this memorandum to provide SBA information regarding lessons learned and identified risks from prior audits and inspections that it should consider in managing and mitigating the risk of loss for COVID-19 related loans.

What We Reviewed

The Office of Inspector General (OIG) has regularly conducted audits and inspections to evaluate management controls and to assess program integrity, efficiency, and effectiveness of the Disaster Assistance Loan Program. We compiled findings from those audits and evaluations that identified significant issues and relevant risks.

Identified Areas of Risk

Prior audits and inspections identified that SBA:

- Issued EIDLs and non-EIDLs without fully vetting the borrowers' credit or their ability to repay the loans
- Issued EIDLs and non-EIDLs to businesses that did not suffer an economic loss or to businesses outside the timeframe of the disaster
- Encountered challenges with having experienced or well-trained staff to provide accurate and appropriate assistance to borrowers during large-scale disasters

The expected increase in loan volumes and amounts and expedited processing timeframes will place additional stress on existing controls. This document is intended to assist SBA with ensuring program integrity, program goals and objectives are met, and managing lending risk.

Key Considerations for SBA

In summary, to ensure program integrity and mitigate the risk of financial loss, SBA should ensure that loans are provided to eligible applicants timely, that borrowers meet all eligibility requirements, and that it has experienced or well-trained personnel to provide appropriate assistance and handle the increased loan volume and expedited processing timeframes.

Office of Inspector General
U.S. Small Business Administration

DATE: April 3, 2020

TO: Jovita Carranza
Administrator

FROM: Hannibal "Mike" Ware
Inspector General



SUBJECT: Risk Awareness and Lessons Learned from Audits of Economic Injury Disaster Loans and Other Disaster Lending

The Small Business Administration (SBA) Office of Inspector General (OIG) prepared this memorandum to provide SBA with examples of prior audit and inspection findings that SBA should consider in managing and mitigating the risk of financial loss for Coronavirus (COVID-19) pandemic related loans. This memorandum provides an overview of applicable Federal statutes, regulations, and guidelines for disaster assistance; the audit process and frequent audit findings; and key points to remember when administering disaster loans.

Background

Like other nations, the United States is dealing with the devastating effects of the COVID-19 pandemic, which has significantly impacted countless small businesses across the country. Temporary business closings and layoffs could have a lasting negative impact on local economies if these entities don't survive. The Coronavirus Preparedness and Response Supplemental Appropriations Act (CVPR Act) provided $20 million to SBA for administrative expenses and deemed the COVID-19 pandemic a disaster.[1] The disaster declaration made economic injury from the COVID-19 pandemic an eligible Economic Injury Disaster Loan (EIDL) expense. In addition, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provided an additional $10 billion to SBA to provide Emergency EIDLs (COVID-19 EIDLs).[2]

EIDLs and COVID-19 EIDLs for up to $2 million are to help small businesses, small agricultural cooperatives, and most nonprofit organizations recover from substantial economic injury. The CARES Act also expands access to EIDLs under Section 7(b)(2) of the Small Business Act to include sole proprietors, independent contractors, and employee stock ownership plans (ESOPs). EIDLs are for these entities who have suffered substantial economic injury in declared disaster areas. Substantial economic injury means that these entities cannot meet their obligations or pay their ordinary and necessary operating expenses. EIDLs provide necessary working capital to help these entities survive until normal operations resume after the disaster.

SBA's disaster loan programs suffer increased vulnerability to fraud and unnecessary losses when loan transactions are expedited to provide quick relief and sufficient controls are not in place. The

[1] Public Law 116-123.
[2] Public Law 116-136.

expected increase in loan volume and amounts, and expedited processing timeframes will place additional stress on existing controls. Therefore, it is important to provide SBA with risk information from prior audits and inspections related to increased loan volumes and amounts processed in expedited timeframes.

In response to the COVID-19 pandemic, SBA is expected to quickly issue $10 billion—an amount significantly higher than prior disasters—in COVID-19 EIDLs. For comparison, SBA approved approximately $1.1 billion combined in disaster loans to businesses and nonprofits in response to Hurricanes Harvey, Irma, and Maria. For Hurricane Sandy, SBA approved approximately $527 million in disaster loans to businesses and nonprofits. Only a portion of the business and nonprofit loans for these hurricanes were EIDLs. As of April 1, 2020, SBA received more than 94,000 COVID-19 EIDL applications; SBA received only 32,000 business and nonprofit loan applications, some of which contained an EIDL component, and almost 8,000 EIDL applications for Hurricanes Harvey, Irma, and Maria. SBA's oversight of loan applications will be unprecedently stretched as a result of the increased loan volume and expedited timeframes.

Prior Audit Findings

In fulfilling our responsibility to oversee the disaster loan program, we have issued numerous audit and inspection reports. The following is a compilation of some of the significant findings and relevant risks from the prior audits and inspections. Although SBA addressed recommendations from these reports, actions SBA has taken may have since been revised due to program changes over time. SBA must reevaluate the current effectiveness of its internal controls used to address the risks to avoid a recurrence of these issues and to mitigate the risk of financial loss for COVID-19 EIDLs.

Lack of Repayment Ability/Creditworthiness

Our audit work found that SBA issued EIDLs and non-EIDLs without fully vetting the borrowers' credit or their ability to repay the loans. Without full evaluation of the borrower's credit and their current financial situation, the risk of default on these loans increases. Specifically, 13 C.F.R. 123.6 requires that there must be reasonable assurance that a borrower can repay their loan based on SBA's analysis of their credit or their personal or business cash flows and they must also have satisfactory character.

OIG Report 16-18: Early-Defaulted Hurricane Sandy Disaster Loans, August 2016.

In this report, we found that the overall early default rate on Hurricane Sandy loans was relatively low when compared to loans made for other disasters. In 17 of the 21 loans reviewed, the Office of Disaster Assistance (ODA) approved loans without verifying borrower's eligibility, or approved loans to borrowers who lacked creditworthiness or repayment ability. Due to the significance of the errors in the areas of creditworthiness and repayment ability, we projected our results to the universe of early-defaulted loans. As a result, we estimated that at least 361 of the 501 early-defaulted loans, totaling $4.3 million, were not approved according to SBA or Federal requirements. We noted borrower creditworthiness as the most prevalent area of concern on the early-defaulted loans; in most loans reviewed, SBA approved loans to borrowers with unsatisfactory credit histories. In addition, we determined that while ODA routinely analyzed disaster loan portfolio risks, SBA could make improvements to reduce the rate of early defaults.

OIG Report 15-05: SBA's Evaluations of Principal's Repayment Ability for Hurricane Sandy Business Loans, February 2015

This report found that loan officers did not have guidance for performing the financial analysis to determine whether Hurricane Sandy business loan applicants had repayment ability. SBA Standard Operating Procedures (SOP) 50 30 7 stated, ". . . for business loans, we determine repayment ability by the results of the financial analysis performed on the business." The SOP, however, provided no additional guidance regarding how to perform the financial analysis. In the absence of guidance, loan officers used inconsistent methodologies when evaluating Hurricane Sandy business loans for repayment ability. We estimated that SBA approved at least 537 Hurricane Sandy disaster business loans, totaling at least $17.9 million, without sufficiently considering principals' living expenses when determining repayment ability. Therefore, SBA did not have reasonable assurance that the borrowers had repayment ability, and these loans were at a higher risk of default.

Eligibility

We also found that SBA issued EIDLs and non-EIDLs to businesses that did not suffer an economic loss or to businesses outside the timeframe of the disaster. SBA must ensure it provides the COVID-19 related EIDLs to eligible businesses that have suffered economic loss due to the pandemic. Specifically, 13 C.F.R. § 123.303 states applicants may only use EIDL proceeds for working capital necessary to carry the applicant until normal operations resume for expenditures necessary to alleviate the specific economic injury.

OIG Report 14-20: Controls Governing Economic Injury Disaster Loan Approval Need Improvement, September 2014

One example from this report found that a borrower received a $384,300 EIDL loan but did not demonstrate the business had experienced an economic loss. In fact, a review of the file showed that the borrower experienced increased sales in the 27 months following the disaster, proving that economic injury did not occur; sales increased by 19.8 percent in the first 12 months following the disaster and continued to increase by 10.3 percent in the next 12 months. The applicant provided these increases to SBA, but the Agency approved the requested EIDL. The Disaster Credit Management System records did not contain adequate and supporting documentation to substantiate the remaining financial needs, which SBA used to justify its approval. Therefore, the report concluded that the business did not experience an economic loss and was ineligible for the EIDL loan.

OIG Report 15-13: Hurricane Sandy Expedited Loan Processes, July 2015

On December 7, 2012, ODA issued Memorandum 12-47, *Modified Phase II EIDL Processing Procedures for Hurricane Sandy Loans*, which expedited processing EIDLs for Hurricane Sandy. The modified method was intended to reduce processing time spent estimating disaster related economic injury losses.

In this report example, we found that 15 of the 40 modified Phase II loan applications reviewed incorrectly applied the modified procedures used to determine the eligible loan amount. These 15 loans totaled $1,060,300. Specifically, loan officers approved loans for ineligible businesses that did not suffer an economic loss or to businesses outside the timeframe of the disaster.

Staffing Concerns During Major Disasters

Finally, prior audits found that SBA experienced challenges with having experienced staff to provide the appropriate and accurate assistance needed to respond to large-scale disasters. Experienced or well-trained staff are necessary to provide assistance and accurate counseling to disaster victims in filing applications and providing the required supporting documentation to facilitate timely and accurate disbursement of loans.

OIG Report 18-19: Inspection of SBA's Initial Disaster Assistance Response to Hurricane Maria, July 20, 2018

One example from this report found that when Hurricane Maria made landfall in Puerto Rico, it created an unprecedented demand for Spanish translation services. Although SBA hired staff, it needed additional Spanish translation services to assist these staff in communicating with disaster survivors regarding their disaster loan applications. The new translation service contractor SBA hired could not handle the call volume from disaster survivors. As a result, some survivors experienced estimated wait times longer than 45 minutes or dropped calls.

OIG Report 18-10: Inspection of SBA's Initial Disaster Assistance Response to Hurricane Harvey, January 2018

This report found the SBA Customer Service Center (CSC) significantly increased its staff from 17 to 146 to respond to calls related to Hurricanes Harvey, Irma, Maria, and other disasters. Despite continuously increasing the number of available agents, a significant number and percentage of calls went unanswered. Specifically, from September 2, 2017, to October 28, 2017, the CSC weekly call volume ranged from 11,051 to 65,160. For this same period, the weekly percentage of unanswered calls ranged from 14 percent (6,957 of 49,864) to 37 percent (15,847 of 42,789). We also found the longest wait time was approximately 26 minutes.

Key Points To Remember When Administering EIDLs

In summary, to ensure program integrity and mitigate the risk of financial loss, SBA must ensure that loans are timely provided to eligible applicants, that borrowers meet all eligibility requirements, and that it has experienced or well-trained personnel to provide appropriate assistance and handle the increased loan volume and expedited processing timeframes.

Fraud Hotline

The SBA OIG also aggressively investigates allegations of fraud, waste, abuse, or mismanagement. Please report fraud, waste, abuse, or mismanagement of Federal funds involving SBA programs, operations, or personnel to the SBA OIG hotline. To submit a complaint, please visit https://www.sba.gov/about-sba/oversight-advocacy/office-inspector-general/office-inspector-general-hotline or call 1-800-767-0385.

Disclaimer

This White Paper contains findings from prior audits and reviews. It is intended solely to provide risk information from those prior audits that the SBA should consider to ensure program integrity and to mitigate lending risk for COVID-19 related loans. It is not an audit performed under

Generally Accepted Government Auditing Standards and is not an inspection, evaluation, or review performed under the Council of Inspectors General on Integrity and Efficiency CIGIE Quality Standards for Inspection and Evaluation.

If you have any questions, please contact me at 202-205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at 202-205-6616.

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