



U.S. Department of Agriculture  
Office of Inspector General  
Audit Report

RURAL BUSINESS-COOPERATIVE SERVICE  
NATIONAL OFFICE PROCESSING IN THE  
BUSINESS AND INDUSTRY LOAN PROGRAM



Report No.  
34-001-03-HQ  
JANUARY 2001



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL



DATE: January 22, 2001

REPLY TO

ATTN OF: Audit No. 34-001-03-HQ

SUBJECT: Rural Business-Cooperative Service  
National Office Processing in the Business and Industry Loan Program

TO: Blaine Stockton  
Acting Under Secretary  
Rural Development

ATTN: Leroy Jones  
Acting Director  
Financial Management Division  
Rural Development

This report represents the results of the subject audit. The written response, dated November 30, 2000, has been incorporated into the Findings and Recommendations section of the report. The complete text of the response is attached as exhibit B. The responses and our comments are presented in the Findings and Recommendations section of the report. We have accepted the management decision for Recommendations Nos. 1 and 2. Management decision can be reached for Recommendations Nos. 3, 4, and 5 when target dates are provided for the proposed actions.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the specific corrective action taken or planned and the timeframes for implementation of the recommendations for which management decision has not yet been reached. Please note that the regulation requires management decisions to be reached on all findings and recommendations within 6 months from the date of report issuance. Follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

We appreciate the assistance you and your staff provided to us during our review.

ROGER C. VIADERO  
Inspector General

Washington D.C. 20250

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## EXECUTIVE SUMMARY

### RURAL BUSINESS COOPERATIVE SERVICE NATIONAL OFFICE PROCESSING IN THE BUSINESS AND INDUSTRY (B&I) LOAN PROGRAM AUDIT REPORT NO. 34-001-03-HQ

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#### RESULTS IN BRIEF

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Our audit was initiated in response to a hotline complaint alleging that the Administrator, Rural Business-Cooperative Service (RBS) had issued Administrator's waivers so that RBS could guarantee a group of seven interrelated

Business and Industry (B&I) loans totaling \$32.4 million. We issued a Management Alert concluding that the Department would risk financial loss and forfeit program integrity if the loans were issued as proposed by the lender. As a result of our work, the Undersecretary directed the Administrator to rescind the improper waivers, thus preventing issuance of \$32.4 million in loan guarantees that did not meet legal or regulatory standards and that would not further the goals of the B&I loan program.

In the process of evaluating the hotline complaint, we identified serious internal control weaknesses warranting an audit of RBS national office processing of B&I loans. During the course of our review, we received additional hotline complaints that were addressed as part of our audit.

The B&I loan program was weakened due to noncompliance with established internal controls at the national office level. Although the system of internal controls, as designed, was generally adequate to protect the integrity of the program, deviations, exceptions, and non-standard treatment of specific loans increased the likelihood that the program would not achieve its objective of promoting the health of rural America's business economy. Indeed, some of the actions taken at the national office level harmed the economy and residents of rural America.

For loan applications totaling over \$80 million, regulations intended to protect the Government's interest were bypassed through application of the Administrator's Exception Authority.<sup>1</sup> This occurred even though the

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<sup>1</sup> A total of 59 separate waivers were issued for 23 loans totaling \$80 million. Some loans

Administrator did not actually have the regulatory authority for the type of waivers he granted. Important provisions relating to credit quality and basic eligibility were waived, generally without documented findings made by the Administrator and often in direct opposition to the advice of experienced underwriting staff. Further, the factual basis of many waivers was unclear; in some instances waivers were granted based on incorrect or unsupported data. As a result, the Government's risk of default and loss was increased. This practice also exposed the Department to charges of favoritism or unfair treatment.

The National Office Executive Loan Committee (NOEL) was unilaterally dissolved by the Administrator in July 1999. This longstanding committee comprised of experienced senior managers had traditionally served as an advisory body to review the underwriting and analysis performed by professional staff. The NOEL process functioned as an internal control to ensure that only quality B&I loans were approved and that regulations were applied equitably. However, the Administrator abolished the NOEL Committee, "in an effort to improve the efficiency in the decision making process." After a review of the circumstances surrounding abolition of the NOEL Committee, we concluded that the result was the loss of a potentially effective internal control to ensure quality loan making. We saw no credible evidence that the elimination of the committee had increased efficiency or resulted in any other benefit to RBS.

The Administrator explained orally that his decision to dissolve the NOEL Committee was based on his personal belief that staff did not prepare adequate loan analyses and that staff raised trivial or unwarranted objections to proposed loans. However, we were unable to confirm his assertion that staff had not performed well. We noted that the cited staff had received recent outstanding performance appraisals. Further, the Administrator had not taken action to document problems, to provide additional training, to re-engineer business processes, or to do anything else aimed at improving the skill level or performance of his staff.

In at least 10 loan applications, important decisions were reached without competent supporting analysis. This occurred because the Administrator sometimes required national office staff to develop the rationale or support for a position ~~after~~ a decision had already been made by the Administrator; since the initial decisions were made without benefit of the required underwriting analyses, the decisions reached were sometimes faulty. This "post decision" justification gave the appearance that waivers, loan

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had multiple waivers.

approvals, and other administrative actions were not the result of a reasoned process. In other instances, no competent support was ever developed for important decisions. The haphazard nature of the Administrator's actions resulted in inconsistent decisions that could expose the Department to charges of favoritism or discrimination. The Administrator stated "When I make decisions as Administrator, they may or may not adversely impact Rural Business program operations."<sup>2</sup>

In one instance, the Administrator advised a borrower of his approval of a loan guarantee several days before he instructed staff to develop support for his decision. In other cases, the Administrator simply directed that a loan be made or guaranteed. Based on our interviews with national office staff and with selected State Directors, this practice damaged program integrity, particularly when decisions were not consistent with regulations or were based on incomplete or incorrect information. In most cases, State Directors had already documented different conclusions, sometimes rejecting loans outright for noncompliance with regulatory and legal requirements.

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## **KEY RECOMMENDATIONS**

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We recommend that the Under Secretary for Rural Development require the Administrator, RBS, to make formal written findings each time the Administrator's exception authority is exercised. Copies of the decision, and an explanation of any underlying rationale, should be provided to the Office of the Under Secretary and to the Office of the General Counsel (OGC). If the decision contradicts the recommendations of State Directors or national office staff, the Administrator should include his reasons for reaching a contrary conclusion and his plan for resolving any conflicts of fact that may be contained in the loan docket.

Decisions about loan making should be based on objective analysis. If justification must be developed "after the fact," decisions should be considered provisional, until fully supported. A forum should be developed for the resolution of legitimate professional differences. We also recommend that the reestablished NOEL Committee continue as an internal control to ensure loan quality and that management control reviews be expanded to incorporate an assessment of the documentation of Administrator's waivers and other high risk transactions.

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<sup>2</sup> Letter from Administrator to Assistant Administrator, Business Programs, dated September 28, 1999.

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## **AGENCY RESPONSE**

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presented in exhibit B.

In its November 30, 2000, response to the official draft report, Rural Development officials agreed with the findings and recommendations as presented. Applicable portions of their response are incorporated, along with our position, in the text of the report. The full text of Rural Development's response to this audit is

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## **OIG POSITION**

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We accept the management decision for Recommendations Nos. 1 and 2 related to the Administrator's waivers. Management decision can be reached for Recommendations Nos. 3, 4, and 5 when target dates are provided for the proposed actions.

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# INTRODUCTION

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## BACKGROUND

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The Rural Business-Cooperative Service (RBS), which succeeded the Rural Business and Cooperative Development Service and Rural Development Administration, was established by Public Law 103-354, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994. The mission of the 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. This mission is accomplished, in large part, through the Business and Industry (B&I) Loan Program.

The B&I Loan Program is decentralized and administered by 47 Rural Development State Offices (SO) and the RBS national office. The purpose of the B&I Loan Program is to improve the economic and environmental climate in rural communities. This purpose is achieved by bolstering existing private credit through making and guaranteeing of quality loans that will provide lasting community benefits. The program is not intended for marginal or substandard loans

The FY 2000 program level is \$1 billion for guaranteed loans and \$50 million for direct loans.

Guarantees are provided on loans made by traditional lenders (e.g., commercial banks) and nontraditional lenders (e.g., entities financed by investment capital and not subject to bank examination). The loans are made to most types of legal entities, to include for-profit and nonprofit cooperatives, corporations, partnerships, individuals, public bodies, and Indian tribes. The maximum guaranteed loan currently is \$25 million.

Direct B&I loans are loans made by the Federal Government. The maximum direct loan currently allowed by RBS is \$10 million.

The RBS national office is responsible for providing overall direction, assuring the consistency of program delivery, and providing administrative and program support nationwide. National office staff provide technical assistance to states on issues of underwriting and servicing loans. The national office allocates appropriated budget authority to each State as well as preparing budget proposals and reports for Congress.

There are three divisions in the national office (1) the Processing Division is responsible for developing and maintaining loan processing regulations and directs the processing and approval of guaranteed and direct B&I loans. This division develops approval criteria and analytical performance standards for loan applicants, (2) the Servicing Division is responsible for directing, developing, and maintaining loan servicing regulations. The division reviews large, complex, or potentially controversial loan and grant dockets related to loan servicing and recommends servicing plans, programs, and activities, (3) the Specialty Lenders Division handles regulations and processing of all lending and grant programs other than B&I loans. These include the grant and loan programs meant to engage rural communities and organizations in providing facilities, technical assistance, and relending to encourage businesses to locate or grow in these rural communities.

Total guaranteed loans to one borrower may exceed \$10 million only with the concurrence of the Under Secretary. Total loans to a single borrower cannot exceed \$25 million under any circumstances. Regulations describing eligible lenders and loan purposes, eligibility and servicing requirements are found at RD 4279 Part A, RD 4279 Part B and RD 1980.

When underwriting a loan application for guarantee under the B&I program, lenders are expected to perform prudently, regardless of the Government's possible guarantee. Also, lenders are to service loans through periodic verification of financial statements and review of business operations. Among the regulatory criteria for an eligible borrower are: rural location, measures of fiscal solvency, and reasonable financial projections comparable to published industry standards. Applicants and borrowers are encouraged to make a "pre-application" which is an abbreviated application form. The pre-application process can and does include States' staff consulting with national office, both by phone and in writing.

The B&I loan program is administered by the States. The national office allocates to each State a total dollar amount of guarantee authority for the year. In general, State Directors are authorized to approve loan guarantees of up to \$5 million.

State staff follow loan underwriting procedures and processes in accordance with regulations and associated administrative guidance disseminated from the national office. When an application is approved, a Conditional Commitment is issued to the lender. This document sets out the agreed upon loan amounts and percentages of guarantee, as well as any additional conditions that must be met before the loan can close. This action reduces the State's allocation of guarantee authority by the amount committed.

Prior to making Conditional Commitments, State office loan committees review the borrower and lender applications and the staff prepared project and loan analyses. A State Loan Committee is made up of appropriate State staff, generally the State Director and head of the business programs and at least one other person. Loan committee determinations become part of the loan file.

Once a State's allocation for loans is used up, (generally in the last quarter of the fiscal year) the State can apply for and compete for funding for in-State applicants out of the national office pool of unused funds.

In FY 97, the national office reviewed and made recommendations concerning 45 applications totaling \$187.5 million. In FY 98, 69 applications totaling \$305.8 million were reviewed and, in FY 99, 39 applications totaling \$277.3 million were reviewed by the national office.

Regulations are promulgated by RBS in accordance with the Administrative Procedures Act. Once these regulations are final, RBS must abide by them. Regulations address nearly every aspect of the B&I loan eligibility process and establish basic financial requirements for credit worthiness, security, cash flow, and repayment ability. In addition, loans can be made only to borrowers who will establish, expand, or continue businesses in a rural area that will save or create additional rural jobs. The overall business plan must be feasible, as the B&I loan program is not intended for substandard loans.

Regulations allow the Administrator, RBS, to "waive" or make exceptions to regulatory provisions when two requirements are met. First, the waiver must not be inconsistent with any applicable law. That is, the Administrator has no authority to waive a requirement that is grounded in statutory law. For example, the Consolidated Farm and Rural Development Act provides that "No loan may be made, insured, or guaranteed under this subsection that exceeds \$25,000,000 in principal amount." Thus, the Administrator does not have authority to "waive" the \$25,000,000 loan limitation because it is grounded in statute.

If the waiver is not inconsistent with any applicable law, an Administrator can waive a regulatory requirement, if and only if, enforcement of the requirement would harm the U.S. Department of Agriculture (USDA). In other words, the Administrator does not have authority to waive a regulation solely because regulation would adversely affect the borrower, the community, or even the Government, in general. In order for the Administrator to legally waive a regulatory requirement, he must show that there would be an adverse effect upon USDA if the requirement were enforced as written. This standard is

difficult to meet. We were told that prior Administrators had never exercised the waiver authority.

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## **OBJECTIVES**

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Our objective was to evaluate RBS national office internal controls over processing B&I loans. Specific objectives included determining whether controls were adequate to ensure that (1) the Administrator's waiver authority was exercised in accordance with applicable laws and regulation and (2) national office processing actions were performed in accordance with applicable laws and regulations.

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## **SCOPE**

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We performed audit fieldwork at the national office in Washington D.C., and the Annapolis, Maryland offices of a loan applicant. Because RBS did not keep systematic records of Administrator's waivers, we were unable to independently confirm whether our review identified all applicable waivers. Additionally, because the Administrator generally did not make formal written findings as to which regulations were being waived and the underlying rationale, we could not fully evaluate the wisdom of certain transactions. We attempted to review all loan applications reviewed by the national office processing division during FY's 1997 through 1999 and all Administrator's waivers granted during that period. The absence of complete documentation served as a scope limitation on the audit.

Due to the manner in which national office records were kept, we were unable to determine whether all applicable loans and waivers were presented for our review. This presented an additional scope limitation on our audit.

We reviewed 27 loan applications for over \$80 million, which comprised all loan applications identified by the national office as either (1) receiving Administrator's waivers; or (2) being denied an Administrator's waiver after a request from the State director. As part of our review, we also assessed national office actions relating to twelve loans on which the Office of Inspector General (OIG) had received hotline complaints during the course of our audit. There was overlap between the two groups. One borrower's request for a loan above the normal loan limit was appropriately recommended by the State, reviewed by national office staff, referred to the NOEL Committee and had the concurrence of the Under Secretary.

Our audit fieldwork was performed from September 1999 to July 2000 and was conducted in accordance with generally accepted Government auditing standards.

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## **METHODOLOGY**

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To accomplish our objectives, we reviewed: (1) Rural Development regulations, instructions, policies, and procedures related to the B&I Guaranteed Loan Program; (2) B&I national office records of loans with waivers, to include loan files submitted by State offices when an application was forwarded for national office review; (3) applicants' financial and business records related to seven judgmentally selected loan applications; and (4) opinions issued by the OGC. We also interviewed staff at the national office and State levels, held discussions with selected lenders and one borrower, and talked to staff of other Government agencies knowledgeable about banking and guaranteed loans. We interviewed six judgmentally selected State Directors to obtain their perspective about national office loan processing activities. We reviewed hotline complaints relating to twelve loans and attempted to assess their validity.

We also assessed Rural Development's management control review of the B&I loan program, the functioning of the RBS NOEL Committee, and RBS national office staff reviews of waiver requests. We reviewed all waivers and waiver requests (subject to the scope limitation described in the Scope section, above) during FY 1997, 1998, and 1999.

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# FINDINGS AND RECOMMENDATIONS

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<b>CHAPTER 1</b>	<b>THE ADMINISTRATOR'S ACTIONS DAMAGED THE B&amp;I LOAN PROGRAM</b>
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The Business and Industry (B&I) loan program was weakened due to noncompliance with established internal controls at the national office level. Although the system of internal controls, as designed, was generally adequate to protect the integrity of the program, deviations, exceptions, and non-standard treatment of specific loans increased the likelihood that the program would not achieve its objective of promoting the health of rural America's business economy. Indeed, some of the actions taken at the national office level harmed the economy and residents of rural America.

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**FINDING NO. 1**  
**Administrator's Waivers**  
**Made Without Legal Authority**

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In 59 instances, for loans totaling over \$80 million<sup>3</sup>, regulations intended to protect the Government's interest were bypassed through application of the Administrator's Exception Authority. This occurred even though the Administrator did not actually have the regulatory authority for the type of waivers he

granted. Important provisions relating to credit quality and basic eligibility were waived, generally without formal written findings made by the Administrator and often in direct opposition to the advice of experienced underwriting staff. Further, the factual basis of many waivers was unclear. In some instances waivers were granted based in incorrect or unsupported data. As a result, the Government's risk of default and loss was increased. This practice also exposed the Department to charges of favoritism or unfair treatment.

**Collateral** In ten instances for loans totaling \$32.3 million, the Administrator waived the requirement that the borrowers have adequate collateral to protect the Government in the event of a default. This regulatory requirement is important, because sufficient collateral minimizes the risk of loss to the

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<sup>3</sup> Twenty-three applications for loans of \$80 million received a total of 59 Administrator's waivers. Some loan applications received multiple waivers of regulations.

Government in the event that a loan cannot be repaid. Regulations require that collateral be of such nature that repayment of the loan is reasonably assured.

For example, the Administrator waived the requirement for adequate collateral relating to a \$2 million loan for a chicken slaughter and processing plant. The Community and Business staff of the State office recommended that the loan not be guaranteed for ten well-documented reasons, to include insufficient collateral. The adjusted collateral analysis completed by the national office program analyst showed collateral of less than 65 percent of the loan value. Further, the Rural Development reviewers noted that the collateral valuations presented by the borrower were not based on independent data. The appraisal was performed by a division of the same firm that proposed to sell the equipment and machinery to the borrower. State office concerns were well documented and the State Director, the Director of Community and Business Programs, the Director of Rural Housing, and the Rural Development Coordinator each certified "Do Not Concur" with respect to the loan. The national office reviewer also recommended against issuance of the guarantee.

We agreed with the State office employees and the national office analyst that the loan should not be guaranteed. Further, we found that information submitted by the lender supporting the value of the collateral was sketchy and contained obvious inaccuracies. For example, the lender's analysis of the business states that the plant will be "the only plant that slaughters and cooks poultry east of the Mississippi." We confirmed with the Food Safety and Inspection Service that there are many plants that both slaughter and cook poultry east of the Mississippi. At least four such plants are located in the same State as the borrower.

Notwithstanding the recommendation of the State office staff and the obvious inaccuracies in the lender's application package, the Administrator waived the requirement for adequate collateral. His written explanation stated "The loan is highly leveraged and not well collateralized.... Based on this information, the Administrator has decided that this is a high priority project because the business is a minority owned business which will meet the objectives of USDA and RBS to make more guaranteed loans to minority-operated businesses. This is consistent with recommendations of the Civil Rights Action Team Report recently submitted to the Secretary of Agriculture."

The business failed and the Government has lost over \$2.5 million to date on this failed business. Equipment initially valued at \$734,000 was appraised at between \$65,000 and \$100,000 after the loan default. Based on a recent

walkthrough by the auctioneer, the estimated net collateral value is now a ~~negative~~ \$101,000, taking into account the liquidation expenses incurred to date and estimated liquidation expenses to dispose of the property.

Unfortunately, USDA was not the only party injured when the loan went bad. The local minority community suffered when the chicken processing business failed. Payroll checks bounced and workers did not benefit from the hours they had labored in the plant. Local utilities were also hard hit when the borrower failed to pay for electricity and sewer services. The borrower was also charged with cruelty to animals, for his treatment of live chickens left in the plant when operations were discontinued. Finally, the State incurred environmental cleanup costs totaling in excess of \$300,000 for remediation of layers of maggots and liquefied chicken parts from 100,000 pounds of fowl left to rot in the summer heat.

**Jobs Created or Saved.** In 8 instances for loans totaling \$35.5 million, the Administrator waived the requirement that jobs should be created or saved when a B&I guaranteed loan is used to refinance existing debt. This requirement is important to ensure that loan funds benefit the rural economy. Without this provision, refinancing a lender's troubled debt would benefit only the lender and not necessarily rural America.

Notwithstanding the recommendation of the State office staff and the obvious inconsistencies in the lender's application package, the Administrator waived the requirement that jobs be created or saved for a \$7.85 million loan for a hydroelectric plant.<sup>4</sup> A well documented project summary and analysis was completed by the State office Business and Cooperative specialist, who did not recommend approval, "...the project does not appear to save or create jobs..." The reviewer's concerns were echoed by others. The State Director, the Business and Cooperative Programs Director, the Rural Housing Programs Director and the acting Rural Utilities Program Director each certified, "We are unable to render a favorable recommendation."

Our analysis of lender supplied information disclosed obvious inconsistencies with respect to job creation. For example, regarding the dam, a positive employment impact was anticipated because "... the community's electricity was much less expensive." However, other loan files note that sales of power from this dam are generally at rates well above market. In this State, the current deregulated power price was about .03 per kwh, while the hydroelectric facility had a contract with guaranteed priced increasing from .0847 per kwh in 1999 to .1114 in 2010. Since the facility

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<sup>4</sup> OIG issued a management alert detailing problems with this loan as well as six related loans. As a result, the loan was never closed.



claims to sell its power for more than 2 and ½ times the current rate, it is unlikely that the community's power is "much less expensive" due to the generator or that less expensive power provided by the generator would increase rural employment.

Another obvious inconsistency regarding job creation involved the future of the firm. In one part of the application, job creation results because "The borrower plans to use the additional cash flow to expand its present operations through acquiring and renovating at least one other rural hydropower plant in the next 2 years." However, an April 28, 1999, letter from the president of the lender states, "The projects do not involve any construction or modifications to the facilities."

Nevertheless, the Administrator waived the job creation requirement. The waiver justification did not show how USDA would be harmed if the regulation was not waived. Waiver documentation stated, in part, "The applicant has no employees. It is an absentee landlord whose corporate parent provides contract labor to run the hydroelectric plant. In the event of default of the lease, the [conservation district] would regain control of the dam and the same contactors would presumably continue to operate the hydroelectric plant.... no jobs are created or saved. An exception to this requirement is granted...".

The Administrator waived 41 other regulatory provisions, to include tangible balance sheet equity, cash flow, hazard insurance, limits on distribution to owner, guarantee percentages, rural area, and loan guarantee limits. We were not always able to assess the quality of the waiver decisions, because the Administrator did not always document his rationale and apparently relied on information that was not retained in official loan files or docket.

The Administrator explained his use of waivers as follows:

With regards to the excessive use of the Administrator's exception provision in the regulations, I do agree that it should be used judiciously, however, I do not agree that its use should be limited. The use of the Administrator's exception authority should be used as often as necessary to have a profound effect on the economic opportunities made available for rural Americans. ... As the Administrator for Rural Business Cooperative Service (RBS), it has been my policy that exception authority should be used as often as necessary on a case-by-case basis, in order to meet the access to capital needs of businesses in rural America.

The Administrator does not have the legal authority to use the exception authority in the way he describes. His stated policy, to use waivers to meet the access to capital needs of businesses in rural America, conflicts with the clear language of regulatory waiver authority.<sup>5</sup> The Administrator can legally waive regulatory requirements only when the requirement is not based on statute and when application of the requirement would adversely affect USDA's interests. For 59 waivers and loans totaling \$80 million, the Administrator waived regulations but did not explain how USDA would be harmed if the borrower was required to comply with the regulation. In nearly every case, USDA's interests were harmed by the waiver. Further, the waivers had the effect of allowing substandard loans to be approved when other loans that met regulatory standards went unapproved.

Although RBS staff had completed a Management Control Review of the B&I program in September 1999, the scope of the review did not include a review of the Administrator's actions and did not evaluate the Administrator's exception authority.

In response to a hotline complaint about seven inter-related B&I loan applications, we issued a Management Alert on October 22, 1999, stating that the Department risked financial loss and forfeiture of program integrity if the loan guarantee commitments were issued as proposed by the lender, in accordance with multiple waivers issued by the Administrator. On October 28, 1999, the Undersecretary for Rural Development advised the Administrator that the requested loan guarantees should be denied, based on OIG's Management Alert and a memorandum from the Office of General Counsel. As a result, RBS was prevented from issuing \$32.4 million in loan guarantees that did not adequately protect the government's interests and would have had only minimal effects, if any, on employment and economic growth in rural America. (See Exhibit A.)

We noted three loan applications totaling \$12.9 million where the Administrator had waived regulatory requirements, but the loans had not been closed as of October 6, 2000. In the response to the discussion draft of this report, agency staff explained that one of these applications, for \$3 million, was the first loan obligated in conjunction with the Cooperative Stock Purchase Program and 19 of 21 constituent loans had already been closed. According to agency staff, the Department would be harmed if the remaining loans were not

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<sup>5</sup> The Administrator may, in individual cases, grant an exception to any requirement or provision of this subpart which is not inconsistent with any applicable law provided, the Administrator determines that application of the requirement or provision would adversely affect USDA's interest.

obligated. We have accepted this explanation and reduced the Monetary Results shown on Exhibit A accordingly.

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**RECOMMENDATION NO. 1**

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Require the Administrator, RBS, to make formal written findings each time the Administrator's exception authority is exercised. Copies of the decision, and an explanation of any underlying

rationale, should be provided to the Office of the Under Secretary and to OGC. If the decision contradicts the recommendations of State Directors or national office staff, the Administrator should include his reasons for reaching a different conclusion and his plan for resolving any conflicts of fact that may be contained in the loan docket.

**Agency Response**

All general exceptions being considered by the Administrator will be reviewed by the National Office Executive Loan (NOEL) Committee to determine consistency with applicable regulations, and the reasons will be documented prior to the granting of a general exception by the Administrator. An Informational Memorandum outlining the reasons for the general exceptions; recommendation of the State Director and the NOEL Committee; and reasons for granting the general exception, if inconsistent with recommendations of the State Director and NOEL Committee, will be provided to the Under Secretary and to the Office of General Counsel. The Administrator will address any concerns raised by either the Under Secretary or General Counsel prior to issuing the exception. If no response is received within 48 hours, the Administrator may issue the exception.

**OIG Position**

OIG accepts RBS' management decision for this recommendation.

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**RECOMMENDATION NO. 2**

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For the three loans where the Administrator has made waivers but the loan has not yet been closed, ensure that the loans meet all regulatory and statutory requirements prior to closure.

Rescind Administrator's waivers unless the waivers meet all relevant criteria.

**Agency Response**

Only one of the three projects identified in this recommendation was obligated and will soon close. Another loan has been rejected and a completed loan application has never been received for the third loan.

## **OIG Position**

OIG accepts management decision for this recommendation, based on the agency's oral explanation that failure to guarantee the final Cooperative Stock Purchase loans would damage the Department, given that 19 of the 21 constituent loans have already been obligated. For the remaining two loans, we agree that formal rescission of the Administrator's waivers will not be needed, based on the rejection of one loan and the absence of a completed application for the other. Our agreement with the management decision is conditioned on assurances that the waivers will be formally rescinded, in the event that either applicant reapplies and attempts reliance on the Administrator's waivers.

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### **FINDING NO. 2**

#### **National Office Executive Loan Committee Unilaterally Disbanded**

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The National Office Executive Loan Committee (NOEL) was unilaterally dissolved by the Administrator in July 1999. This longstanding committee comprised of experienced loan analysts and senior managers had served since the mid 1970's as an advisory body to review the underwriting and analysis of applications processed in the national office. The NOEL Committee process functioned as an internal control to ensure that only quality B&I loans were approved and that regulations were applied equitably. However, the Administrator abolished the NOEL Committee, "in an effort to improve the efficiency in the decision making process." No compensating control was substituted.

The Administrator explained orally that his decision to dissolve the NOEL Committee was based on his personal belief that staff did not prepare adequate loan analyses and that staff raised trivial or unwarranted objections to proposed loans. However, we were unable to confirm his assertion that staff had not performed well. We noted that the cited employees had received recent outstanding performance appraisals. Further, the Administrator had not taken action to document problems, to provide additional training, to re-engineer business processes, or to do anything else aimed at improving the skill level or performance of his staff. Also, we noted that earlier in July of 1999, the NOEL Committee seemed to be properly functioning when the NOEL Committee concurred with a State Director's request for a guarantee of a loan above normal limits based on analysis by State and national office staff. Following regulatory directives, the analysis outlined how the Department would be harmed without the loan and the Under Secretary's concurrence was sought.

Our analysis of the examples of "poor performance" cited by the Administrator showed that most of the Administrator's concerns related to

proposed loans that did not comply with one or more regulatory requirements. In general, we concluded that the analyses performed by staff were complete, addressed substantive issues, and were based on a sound knowledge of B&I regulations.

When we attempted to validate the Administrator's assertions that poor staff performance lay behind his decision to eliminate the NOEL Committee, we found that the Administrator had not used sound analytical techniques to reach his conclusions about specific staff analyses.

For example, concerning an \$8.08 million loan, the national office reviewer had reached the conclusion that refinancing would not improve cash flow. "The loan will not significantly improve the borrower's cash flow. The borrower show (sic) a significantly greater cash flow in the months before closing than the cash flow would be after closing. ... The borrower's current month to month cash flow is substantially greater than cash flow will be after the loan." This conclusion was supported by a reasonable financial analysis performed in accordance with standard RBS practices. Section III "Projections" compares the new annual payment of \$748,000 to the prior annual payment of \$129,000. The interest rate also increased from 7.5% to 7.71%.

Concerning this staff analysis, the Administrator concluded, "While I have not run the numbers personally, it is inconceivable that the company could refinance its debt and be worst (sic) off then (sic) before refinancing occurred or that we would allow this to happen. I too read the analysis ... that indicated this would be the result, however, it is still inconceivable."

We confirmed that cash flow would not have been improved by making the loan. One of the reasons that cash flow would not have been improved was that the borrower's parent company had not made a payment on the loan to be refinanced for more than 4 years and was more than \$6.9 million in arrears. The borrower had posted net losses in each of the 3 prior years. Liquidity was negative, even before refinancing. Payment on the proposed RBS guaranteed loan would have exacerbated the company's problems, adding an additional drain on cash.

The Administrator's conclusions were not based on an objective analysis of cash flow and liquidity. He did not point out any problems with the cash flow analyses performed by his staff. Rather, he substituted his own unsubstantiated opinion that it was "inconceivable" that a firm's cash flow would not be improved through refinancing.

We concluded that the Administrator's abolition of the NOEL Committee did not increase efficiency and was not warranted based on poor staff performance. Instead, a potentially effective internal control was eliminated, without documented analysis. Said another way, the Administrator removed an internal control that could have served to check unwise decisions; no other controls were instituted to make up for the resulting weakness.

The NOEL Committee was subsequently reestablished in November 1999. Administrator's waivers totaling \$32.9 million were approved during the 4-month period that the program operated without a national office loan committee.

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**RECOMMENDATION NO. 3**

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Continue the reestablished NOEL Committee. Ensure that decisions are based on documented, objective analysis.

**Agency Response**

Applicable regulations will be amended, as part of the general rewrite of the regulations, to require that a NOEL Committee be permanently established to review and make recommendations on all B&I Guaranteed and Direct Loan Program loan making and servicing actions requiring national office review and concurrence. An objective analysis by a national office loan specialist will continue to be required and will be presented to the NOEL Committee along with a recommendation.

**OIG Position**

We agree with the action planned. Management decision can be reached when a target date is provided for the proposed action.

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**FINDING NO. 3**  
**Decisions Made Without Competent Support**

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For at least 10 loan applications, important decisions were reached without competent supporting analysis. This occurred because the Administrator sometimes required national office staff to develop the rationale or support for a position after a decision had already been made by the Administrator; in other cases no support was ever developed. This "post decision" justification gave the appearance that waivers, loan approvals, and other administrative actions were not the result of a reasoned process. In some cases, the Administrator did state his opinion that the loan or other action supported a specific departmental initiative. Nevertheless, the haphazard

nature of post-decision justification or the complete absence of competent support resulted in inconsistent decisions that could expose the Department to charges of favoritism or discrimination.

One example of a decision reached without competent supporting analysis involved a \$2 million loan. In February 1997, the State Director denied a request for a guarantee because:

- "1. Collateral is insufficient for the proposed loans. ...
- "2. Insufficient current financials. ...
- "3. Projections not feasible. ...
- "4. Lack of a feasibility study. ...
- "5. Equity insufficient. ...
- "6. The credit report reveals that [loan applicant's] credit history is unacceptable.
- "7. Equipment appraisal never completed by a qualified appraiser who would have no interest in the sale.
- "8. There has never been a executed sales agreement for the real estate.
- "9. No architectural/engineering technical report ...
- "10. The Phase I Environmental Assessment ... has not been updated to this time."

Less than a month after the application was rejected, the Administrator wrote to the loan applicant that the loan was approved. In the letter to the applicant, the Administrator stated that the State Director would receive official notification of his decision the following day. Although he did not provide documentation to support his decision, the Administrator advised the State Director that he waived requirements for tangible balance sheet equity, loan guarantee limits, and collateral.

Later, when it became evident that the borrower would not be able to operate without additional funding, the Administrator determined to provide additional direct loans. In a Note to the File, the Administrator explained "The Administrator has given the Processing Division instructions to prepare a memorandum of concurrence approving the \$675,000 equipment loan and \$250,000 working capital direct loans, even though the State Office or Processing Division did not recommend the proposal because of the business lacking equity, repayment ability, collateral, and working capital not being a (sic) authorized loan purchase (sic) [purpose?] under FmHA Instruction 1980-E."

At the Administrator's instructions, loan servicing for this guaranteed loan, as well as the two subsequent direct loans to the same borrower, was transferred from the State office to the national office, an unprecedented action. In a letter responding to questions about this decision, the

Administrator stated “When I make decisions as an Administrator, they may or may not adversely impact Rural Business programs operations. ... The decision was made in the best interest of the Government because I became privy (sic) to information which suggested that the staff in [State office] were not operating in the best interest of our customer, the borrower, in this case.” We noted that the files do not include details of the information referred to by the Administrator.

Within a year from loan closing, the borrower defaulted on the \$2 million loan, as well as two related direct RBS loans totaling \$925,000. Although a final loss claim had not been filed as of July 7, 2000, the estimate of loss is somewhat greater than \$2.5 million because of the negative value of collateral and potential joint liability for cleanup.

Based on our interviews with national office staff and with selected State Directors, the practice of unilateral decision making without analytical support was endemic to this particular Administrator. In most cases, State Directors had already documented different conclusions, sometimes rejecting loans outright for noncompliance with regulatory and legal requirements. The Administrator’s practice of making unsupported decisions, without documentation of his reasoning, damaged the integrity of the B&I loan program, particularly when decisions were not consistent with regulations or were based on incomplete or incorrect information. The Administrator resigned from USDA as of July 3, 2000.

State and national office staff expressed concern to the Administrator and to staff in the Under Secretary’s office about the manner in which their analyses were disregarded. We noted that RBS does not have a formal process for documenting disagreements or for resolving legitimate professional differences. The B&I program would be strengthened if the agency developed a mechanism to air differences in analytical technique and to determine the proper methodology for difficult or new underwriting issues. However, in general, the decisions that were overridden by the Administrator did not involve overly complex or unique situations.

The Management Control Review completed in September 1999 did not identify the lack of objective analytical data for the Administrator’s decisions. This occurred, in part, because the reviews did not attempt to address high risk or unusual transactions and did not evaluate the use of the Administrator’s exception authority.



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**RECOMMENDATION NO. 4**

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Base decisions about loan making and servicing on objective analysis. If justification must be developed “after the fact,” decisions should be considered provisional, until fully supported. A forum should be developed for the resolution of legitimate professional differences.

**Agency Response**

All B&I Guaranteed and Direct Loan Program loan making and servicing actions requiring national office concurrence will be reviewed by the NOEL Committee. An objective analysis is conducted by a loan specialist and the results of the objective analysis along with the loan specialist’s recommendation are presented to the NOEL Committee. In cases where legitimate professional differences cannot be resolved between the loan specialist and the NOEL Committee, the Administrator will make the decisions. In cases where legitimate professional differences cannot be resolved between program staff and the Administrator, a memorandum to the Deputy Under Secretary for Rural Development will be prepared, outlining the differences. The Deputy Under Secretary will be responsible for resolving the differences.

**OIG Position**

We agree with the action planned. Management decision can be reached when a target date is provided for the proposed action.

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**RECOMMENDATION NO. 5**

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Ensure that future Management Control Reviews incorporate steps to assess the impact of unusual or high-risk transactions. The evaluation should include a determination of the adequacy of documentation for Administrator’s waivers and any deficiencies should be brought to the attention of the Under Secretary for appropriate action.

**Agency Response**

The Management Control Review scheduled for 2001 of the RBS Rural Business Enterprise Grant Program control objectives and techniques (COTs), will be revised to allow the reviewer mechanisms to assess the impact of any unusual high-risk transactions at the national office level. The COTs will include a determination of the adequacy of documentation for the Administrator’s waivers. Any deficiencies noted will be brought to the attention of the Senior Management Council. The Senior Management Council will be responsible for advising the Under Secretary.

**OIG Position**

We agree with the actions planned. Management decision can be reached when a target date is provided for the 2001 Management Control Review.

**EXHIBIT A – MONETARY RESULTS**

<b>Recommendation</b>	<b>Description</b>	<b>Amount</b>	<b>Category</b>
1	Administrator's Waivers Rescinded As a Result of OIG Management Alert	\$32.4 million	FTBPTU
2	Outstanding Waivers to Be Rescinded	\$ 9.9 million	FTBPTU

# EXHIBIT B – AUDITEE RESPONSE TO DRAFT



United States  
Department of  
Agriculture

Rural Business-  
Cooperative Service

Washington, DC  
20250

NOV 30 2000

SUBJECT: Rural Business-Cooperative Service  
National Office Processing of Business and Industry Loans  
Audit No. 34001-003-HQ - DISCUSSION DRAFT

TO: James R. Ebbitt  
Assistant Inspector General for Audit  
Office of Inspector General

THROUGH: Leroy Jones *L. Jones*  
Acting Director  
Financial Management Division  
Rural Development

NOV 30 2000

This is in response to the recommendations outlined in the discussion draft of Audit No. 34001-003-HQ, dated October 8, 2000. Our responses to the recommendations are as follows:

#### RECOMMENDATION NO. 1:

Require the Administrator, RBS, to make formal written findings each time the Administrator's exception authority is exercised. Copies of the decision, and an explanation of any underlying rationale, should be provided to the Office of the Under Secretary and to the Office of the General Counsel. If the decision contradicts the recommendations of State Directors or National Office staff, the Administrator should include his reasons for reaching a different conclusion and his plan for resolving any conflicts of fact that may be contained in the loan docket.

#### Agency Response:

All general exceptions being considered by the Administrator will be reviewed by the National Office Executive Loan (NOEL) Committee to determine consistency with applicable regulations, and the reasons will be documented prior to the granting of a general exception by the Administrator. An Informational Memorandum outlining the reasons for the general exception; recommendations of the State Director and the NOEL Committee; and reasons for granting the general exception, if inconsistent with recommendations of the State

The Rural Business - Cooperative Service replaces the Rural Development  
Administration. RBS is an Equal Opportunity Lender. Comments of discrimination  
should be sent to: Secretary of Agriculture, Washington, D.C. 20250



Director and NOEL Committee, will be provided to the Under Secretary and the Office of the General Counsel. The Administrator will address any concerns raised by either the Under Secretary or General Counsel prior to issuing the exception. If no response is received within 48 hours, the Administrator may issue the exception.

**RECOMMENDATION NO. 2:**

For the three loans where the Administrator has made waivers but the loan has not yet been closed, ensure that the loans meet all regulatory and statutory requirements prior to closure. Rescind Administrator's waivers unless the waivers meet all relevant criteria.

**Agency Response:**

Only one of the three projects identified in this recommendation was obligated and will soon close. One of the three loans was rejected at the application stage, while the other proposed project never materialized into a complete application.

The loan that was obligated, in the amount of \$3 million, and scheduled to close in the near future was the first loan obligated in conjunction with the Cooperative Stock Purchase Program authorized in the Fiscal Year 1996 Farm Bill. In conjunction with this loan, there were 21 separate obligations, totaling \$1,004,500, to individual guaranteed loans for financing purchases of stock in start-up value-added cooperatives. Nineteen of the 21 loans have closed.

Blanket exceptions were granted to allow cooperative guaranteed loans to individual producers to be approved with a 1 percent guarantee fee, in lieu of 2 percent guarantee fee, and a 90 percent guarantee to be made available to all cooperative stock loans. These exceptions were granted because it was determined that the application of an 80 percent guarantee with a 2 percent guarantee fee would adversely affect the interest of the U.S. Department of Agriculture for the following reasons:

1. the administrative burden to review and approve each individual exception in accordance with applicable regulations,
2. this supported the Administration's initiative to enhance rural cooperative development,
3. it provided a partial solution for the need for more hog slaughtering facilities to offset the large number of hogs being produced that cannot be slaughtered due to lack of slaughtering facilities, and
4. it provides additional revenue to cooperative members through value-added processing of the hogs they produce by a cooperative which they own and in which they share profits.

**RECOMMENDATION NO. 3:**

Continue the reestablished NOEL Committee. Ensure that decisions are based on documented, objective analysis.

**Agency Response:**

Applicable regulations will be amended, as part of the general rewrite of the regulations, to require that a NOEL Committee be permanently established to review and make recommendations on all B&I Guaranteed and Direct Loan Program loanmaking and servicing actions requiring National Office review and concurrence. An objective analysis by a National Office loan specialist will continue to be required and will be presented to the NOEL Committee along with a recommendation.

**RECOMMENDATION NO. 4:**

Base decisions about loanmaking and servicing on objective analysis. If justification must be developed "after the fact," decisions should be considered provisional, until fully supported. A forum should be developed for the resolution of legitimate professional differences.

**Agency Response:**

All B&I Guaranteed and Direct Loan Program loanmaking and servicing actions requiring National Office concurrence will be reviewed by the NOEL Committee. An objective analysis is conducted by a loan specialist and the results of the objective analysis along with the loan specialist's recommendation is presented to the NOEL Committee. In cases where legitimate professional differences cannot be resolved between the loan specialist and the NOEL Committee, the Administrator will make the decision. In cases where legitimate professional differences cannot be resolved between program staff and the Administrator, a memorandum to the Deputy Under Secretary for Rural Development will be prepared, outlining the differences. The Deputy Under Secretary will be responsible for resolving the differences.

**RECOMMENDATION NO. 5:**

Ensure that future Management Control Reviews incorporate steps to assess the impact of unusual or high risk transactions. The evaluation should include a determination of the adequacy of documentation for Administrator's waivers, and any deficiencies should be brought to the attention of the Under Secretary for appropriate action.

**Agency Response:**

The Management Control Review scheduled for 2001 of the RBS Rural Business Enterprise Grant Program control objectives and techniques (COTs) will be revised to allow the reviewer mechanisms to assess the impact of any unusual high risk transactions at the National Office level. The COTs will include a determination of the adequacy of documentation for the Administrator's waivers. Any deficiencies noted will be brought to

the attention of the Senior Management Council. The Senior Management Council will be responsible for advising the Under Secretary.

This concern will be raised at the next RBS Management Control Advisory Group (MCAG), which will meet in April 2001 to decide whether or not to elevate the issue to the Senior Management Council for recommendation that all future Management Control Reviews of RBS programs COTs will provide review mechanisms to assess the impact of unusual or high risk transactions.



HILL LONG THOMPSON  
Under Secretary  
Rural Development

cc: Jim Newby, Deputy Under Secretary