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Review of Lender with Business and Industry Guaranteed Loan in Virginia

Audit Report 34099-10-Te
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REPLY TO
ATTN OF: 34099-10-Te

TO: Judith A. Canales
Administrator
Rural Business-Cooperative Service

THROUGH: John Purcell
Director
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FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Review of Lender with Business and Industry Guaranteed Loan in Virginia

Summary

The Rural Business-Cooperative Service (RBS) is an agency within the Department of Agriculture's Rural Development mission area. RBS guarantees loans made by private lenders to borrowers in the nation's rural areas. Loans guaranteed by the Business and Industry (B&I) Guaranteed Loan Program are intended to improve the economic and environmental climate in rural communities by supporting businesses.

In a letter dated March 6, 2007, the RBS National Office asked the Office of Inspector General (OIG) to review the loan portfolio of one of its lenders because of the elevated default rates of its loans. This report presents the results of our review of 1 of 4 loans from the lender's portfolio of 34 loans.[1] The borrower for this loan is a textile company based in Pulaski County, Virginia. On December 7, 2000, the lender obtained a loan note guarantee of 90 percent on a $5 million loan. The loan funds were to be used for refinancing prior debts on equipment and real estate, and for paying closing costs.

Although this loan should have been classified as substandard and thus not eligible for a B&I guarantee, the lender did not misrepresent or conceal significant deficiencies in the borrower's financial position and the decreasing value of the borrower's assets. Knowing this information, the Virginia State Rural Development Office (State office), with the RBS national office's concurrence, granted the lender a 90-percent B&I guarantee.[2] We are not making any recommendations; however, we strongly suggest that RBS reconsider approving future loans with problems of this size and scope.

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[1] As of March 31, 2007, the lender had 34 B&I guaranteed loans for about $92.6 million, of which 15 were either in default or liquidation, with a potential loss to the Government of about $30.9 million. OIG received information concerning the March 31, 2007, portfolio from the Farm Credit Administration.

[2] Title 7, *Code of Federal Regulations* (CFR), section 4279.119(b), dated January 1, 2000, states that, at the Administrator's discretion, 90-percent guarantees can be approved for loans of $10 million or less under certain circumstances.

Background

RBS operates loan programs intended to assist in the business development of the nation's rural areas and promote the employment of rural residents. The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities. These loans are not intended for borrowers in substandard financial circumstances.

To accomplish its mission, RBS, through the B&I Guaranteed Loan Program administered by the various Rural Development State offices, guarantees loans made by private lenders. A lender provides the loan to the borrower, and Rural Development guarantees repayment of a percentage of the loan if the borrower defaults. The guarantee allows the lender to have additional capital available for other loans.

Regulations require lenders to be responsible for the loan origination, servicing the loan, and taking servicing actions of a prudent lender. Regulations also state that a guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation of which a lender or holder has actual knowledge at the time it becomes such a lender or holder or which a lender or holder participates in or condones.[3]

As of March 31, 2007, the lender had 34 B&I guaranteed loans for approximately $92.6 million—15 of the 34 loans were either in default or in liquidation, with a potential loss to the Federal Government of approximately $30.9 million.

Objective

The objective of our review was to determine if the lender complied with program regulations.

Scope and Methodology

This review concentrated on the lender RBS requested that we review and one of its B&I guaranteed loans to a borrower operating in Virginia. To accomplish the objective, we reviewed regulations, policies, and procedures that provide guidance for the making, servicing, and liquidating of B&I guaranteed loans. We reviewed supporting documentation to verify the accuracy of the lender's applications, certifications, disbursement of funds, and other loan activities, and conducted interviews with State officials. Additionally, we reviewed documentation provided by RBS, and the Safe and Soundness review[4] conducted on the lender by the Farm Credit Administration. We selected this loan for review because the lender required a 90-percent guarantee before it would make the loan to the borrower.

Fieldwork was performed from August 2007 to June 2009.

We conducted this performance review in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the review to obtain

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[3] 7 CFR 4279.72(a), dated January 1, 2000

[4] The review primarily focused on the lender's asset quality, portfolio management, capital adequacy, earnings (relative to capital accretion), and liquidity. It also included a review of management areas such as planning, internal controls, and information systems as they related to the lending function.

sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Finding 1: Substandard Loan Approved Under Community Adjustment and Investment Program

While this should have been considered a substandard loan and not eligible for a B&I guarantee, we found that the lender disclosed the borrower's problems to the State office prior to loan closing. Over the 2 months prior to loan closing, the lender sent RBS letters requesting a 90-percent guarantee. The letters stated that the lender would need a 90-percent guarantee on this loan for three reasons. First, the type of industry in which the borrower was involved. Specifically, the borrower was in the textile industry, which had been hit extremely hard over the past several years, as evidenced by the large number of plant closings in the State of Virginia. Second, a majority of the collateral involved with this project was textile-related equipment. The lender had substantial concerns that the present value of the collateral would not be available in a liquidation scenario. Lastly, the lender requested that, since the county where the borrower conducted business had been designated eligible for the Community Adjustment and Investment Program (CAIP), the loan be made as part of that program. The CAIP is intended to help ameliorate unemployment as a result of North American Free Trade Agreement (NAFTA)-related plant closings and layoffs.[5]

Additionally, RBS National Office officials stated that the loan was coded for funding under CAIP in the Guaranteed Loan System and that Pulaski County, Virginia, was severely adversely impacted by NAFTA—over 7,000 textile, apparel, and furniture jobs lost in a town with a population of 9,473. The RBS National Office further stated that it concurred with the 90-percent guarantee to potentially save the existing jobs and create new ones if the borrower's Business Plan was successful.

Based on the letters sent to RBS, the lender did not misrepresent relevant information concerning the risky nature of this loan. Regulations[6] state that these guarantees are not intended for borrowers in substandard financial circumstances. However, the guarantee was approved at the RBS National Office with a 90-percent guarantee.[7] While the borrower had been making interest-only payments from October 2007 to October 2008, it defaulted on the loan on October 1, 2008.

Given the problems that have occurred due to guaranteeing this substandard loan, we strongly suggest that RBS reconsider approving future loans with problems of this size and scope.

[5] Eligibility for CAIP is based on an analysis of NAFTA-related job losses within the context of local unemployment rates. To be eligible, local unemployment must exceed the national average.
[6] 7 CFR 4279.101(b), dated January 1, 2000
[7] 7 CFR 4279.119(b), dated January 1, 2000, states that, at the Administrator's discretion, 90-percent guarantees can be approved for loans of $10 million or less under certain circumstances.