



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

Rural Development
Business and Industry Direct
Loan Program - Arkansas



Report No.
34601-14-Te
September 2002



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Southwest Region

101 South Main Street, Suite 309

Temple, Texas 76501

TEL: 254-743-6500 FAX: 254-298-1358



DATE: September 27, 2002

REPLY TO

ATTN OF: 34601-14-Te

SUBJECT: Business and Industry Direct Loan Program - Arkansas

TO: John Allen, State Director
USDA Rural Development
USDA Service Center
Federal Building, Room 3416
700 Capitol Avenue
Little Rock, AR 72201

ATTN: Shirley Tucker
Program Director

This report presents the results of the subject review. Your written response to the official draft report is included in its entirety as exhibit B with excerpts and the Office of Inspector General's position incorporated into the Findings and Recommendations section of the report. Your written response contained sufficient justification to reach management decision on Recommendations Nos. 1, 2, 4, 5, 7, 8, 9, 10, and 11. Please follow Departmental and your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

Based on the responses, management decision has not been reached on Recommendations Nos. 3 and 6. The information needed to reach management decision is set forth in our position section after each recommendation. In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days showing the actual or planned timeframes for implementing each audit recommendation. Please note that the regulation requires management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance, and final action to be taken within 1 year of each management decision.

/s/ Ralph P. Childs for
ROBERT E. GRAY
Regional Inspector General
for Audit

EXECUTIVE SUMMARY

BUSINESS AND INDUSTRY DIRECT LOAN PROGRAM - ARKANSAS AUDIT REPORT NO. 34601-14-Te

RESULTS IN BRIEF

This report presents the results of our audit of the Rural Development's Business and Industry (B&I) Direct Loan Program, as administered by the State of Arkansas. We performed this review as part of a nationwide audit of the B&I Direct Loan Program. The results of this audit may be included in a report to the Rural Development National Office (NO). The objective of our audit was to evaluate the State office's (SO) oversight of B&I direct loans. Specifically, we were to determine: (1) if the B&I direct loans were properly made and serviced (i.e., if collateral was monitored and required documentation was submitted to the NO in a timely manner), and (2) if the loan proceeds were used as specified in the applications.

Under the B&I Direct Loan Program, Rural Development makes and services loans issued directly to borrowers. The loans are intended to improve private business and employment in rural communities.

From October 1, 1996, to April 14, 2001, the Arkansas Rural Development SO funded 10 loans totaling \$9,447,000. We reviewed five loans totaling \$5,362,000 of the SO's loan portfolio.

Our review disclosed problems with all five loans. For example, the SO failed to secure first lien positions on collateral securing the B&I loans provided to borrowers B and C. This occurred because the SO relied on the borrowers' attorneys to ensure that the required closing documents were filed. Loans that are not adequately collateralized can result in losses to the Government should liquidation occur. The SO has initiated foreclosure actions against borrower B, and a total loss of the loan amount is anticipated.

We also found that the SO needed specific training in the making and servicing of B&I direct loans. We found that in addition to the exceptions noted above, all five B&I loans reviewed had loan making and/or loan servicing problems. For example, contrary to program requirements, the SO refinanced outstanding debts of borrowers A, B, and C without knowing the payment history of these debts to determine if these funds were used to refinance unsound loans. The SO also did not conduct the

required collateral inspections for borrowers B and D, did not completely document the use of loan funds by borrowers A and C, and had incomplete collateral listings for borrowers B, C, D, and E.

During our review of the five loans, we found no improper use of loan proceeds. While we identified problems with B&I direct loan making, we are not recommending corrective action because the program funding was terminated in fiscal year 2002.

KEY RECOMMENDATIONS

We recommended certification of existing subordination agreements and that the SO correct loan servicing exceptions noted in this report.

AGENCY RESPONSE

In a letter dated August 26, 2002, the SO generally agreed with the findings and recommendations. (See exhibit B.)

OIG POSITION

We agreed with the management decision for Recommendations Nos. 1, 2, 4, 5, 7, 8, 9, 10, and 11. However, we need additional information to reach management decision for Recommendations Nos. 3 and 6. The conditions needed to reach management decision are set forth in the findings and recommendations section of the report.

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INTRODUCTION

BACKGROUND

The Rural Business-Cooperative Service, an agency within the United States Department of Agriculture (USDA) Rural Development mission area, operates loan programs that are intended to assist in the business development of the Nation's rural areas and the employment of rural residents. To achieve this mission, the agency guarantees Business and Industry (B&I) loans to private lenders and issues loans directly to borrowers if the borrowers cannot obtain credit elsewhere.

The B&I Direct Loan Program is not intended for marginal or substandard loans. These loans are made primarily to finance sound business projects that create or retain jobs for businesses located in rural areas with populations less than 50,000. The maximum direct loan amount to any one borrower is currently \$10 million with maturities of 7, 15, or 30 years, depending on the collateral. Direct loan interest rates are based on a rate determined by the Secretary of Agriculture, but not less than rates determined by the Secretary of the Treasury on obligations of similar maturity plus an increment to cover losses and administrative costs.

The B&I Direct Loan Program is administered in accordance with the Code of Federal Regulations, Title 7, part 1980, subpart E, for loan making and loan servicing. While the B&I Direct Loan Program was not funded for fiscal years (FY) 2002 or 2003, existing loans continue to be administered under the applicable regulations.

The responsibilities of the State office (SO) staff include collecting payments, obtaining compliance with covenants and provisions of the loan documents, obtaining and analyzing financial statements (FS), verifying payment of taxes and insurance premiums, obtaining and maintaining liens on collateral, and ensuring sufficient collateral is pledged to secure the entire debt to the Government.

OBJECTIVE

Our overall objective was to evaluate the SO's oversight of B&I direct loans. Specifically, we were to determine: (1) if the B&I direct loans were properly made and serviced (i.e., if collateral was monitored and required documentation was submitted to the National Office (NO) in a timely manner), and (2) if the loan proceeds were used as specified in the application.

SCOPE

We performed this audit as part of a nationwide review of the B&I Direct Loan Program. Arkansas was selected for review because of the size of its loan portfolio. We also revisited Arkansas to develop the issues previously identified during the survey phase of this audit.

The universe included all B&I direct loans funded from October 1, 1996 (FY 1997), through April 14, 2001. During this period, Rural Development funded 192 direct B&I loans totaling \$77.8 million nationwide of which 61 loans were delinquent or liquidated (31.77 percent). Of the 192 loans, the Arkansas SO funded 10 loans totaling \$9,447,000 (about 12 percent of the total nationwide).

We reviewed five loans totaling \$5,362,000, or 57 percent (\$5,362,000/\$9,447,000) of the SO's loan portfolio. The judgmentally selected loans consisted of two delinquent loans and three current loans. Our fieldwork was conducted from May 2001 through November 2001.

We performed the audit in accordance with Government Auditing Standards issued by the Comptroller General of the United States. Accordingly, the audit included such tests of program and accounting records necessary to meet the audit objectives.

METHODOLOGY

We relied on documentary, testimonial, and analytical evidence. To accomplish the audit objectives, we: (1) interviewed the Arkansas SO personnel to obtain an understanding of the SO's responsibilities for making and servicing the direct loans, and (2) reviewed the sample borrower case files to determine if loans were made and serviced in accordance with program rules and regulations, and loan proceeds were used as specified.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	SO FUNDED LOANS HAD INADEQUATE COLLATERAL
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Loans were made to borrowers B and C without assurance that adequate collateral was obtained. This occurred because the SO relied on borrowers' attorneys to close the B&I loans. As a result, the potential loss to the Government is increased should liquidation occur.

FINDING NO. 1

LOAN SECURED BY INADEQUATE COLLATERAL FOR BORROWER B

The SO failed to obtain a first lien position on the real estate securing borrower B's loan because the SO did not obtain the subordination of the first lien holder prior to funding the loan. This occurred because the SO relied on the borrower's attorney to ensure that required closing documents were filed.

The SO has initiated foreclosure proceedings because no payments have been received since March 11, 1998. Based on the liquidation appraisal of the real estate, the SO anticipates that the loan will be a total loss to the Government after liquidation expenses and debt payment to the first lien holder.

Regulations state that the lender is responsible for seeing that adequate collateral is obtained and of record to protect the interest of the lender.¹ They further state that the SO will ascertain that no claims or liens are pending or will adversely affect the collateral when the security instruments are filed.²

Regulations further state that when performing a credit analysis to determine collateral value for real estate, a maximum of 80 percent of current market value will be used.³

On October 20, 1997, borrower B received a \$700,000 B&I loan. The loan funds were used to pay \$580,769.96 of existing debt as well as provide \$119,230.04 of working capital. The loan was secured with real estate, equipment, and inventory.

¹ 7 CFR, subpart E, part 1980, section 443 (a), dated January 1, 1988.

² 7 CFR, subpart E, part 1980, section 443 (c) (1), dated January 1, 1988.

³ 7 CFR, subpart E, part 1980, section 443, administrative A (2), dated January 1, 1988.

Using the percentage stated in the regulations to calculate collateral value, the SO determined that the collateral value of all pledged assets was \$765,542. Of these assets, the major collateral was real estate that had an appraised value of \$670,000 and a collateral value of \$536,000 ($\$670,000 \times .8$). Our review disclosed that the SO failed to obtain a first lien position on the real estate which collateral value constituted 70 percent of the total collateral value for the loan ($\$536,000/\$765,542 = .7$).

The real estate that secured the B&I loan also secured two previous loans that the borrower had with the Arkansas Industrial Development Corporation (AIDC). When the SO officials received the title policy commitment on the real estate, they discovered that AIDC had a first lien on the real estate. The SO instructed the borrower that the AIDC debts had to be subordinated to the B&I debt before the \$700,000 B&I loan could be made.

The borrower's attorney processed the B&I loan-closing documents and certified that Rural Development had a first lien on the real estate. Several months later, when the SO received the title policy, it was disclosed that the AIDC debts still had first lien on the real estate. Because of pending legal action, we did not contact the borrower's attorney to determine why he had not obtained a first lien on the real estate.

At the exit conference, the SO officials stated that the lawsuit against the borrower's attorney had been dismissed because the SO had not obtained a statement from the attorney acknowledging his representation of the borrower and the Government as required by Arkansas law. The SO officials further stated that the document would be obtained for all future loan closings.

If the SO officials had communicated directly with AIDC, they would have detected this problem with the lien on the real estate, and they would have also known that the borrower was delinquent on the AIDC loans. On October 20, 1997, when the B&I loan was closed, the AIDC loans were approximately 8 months delinquent.

As stated, the SO calculated that there was a total collateral value of \$765,542. The collateral value, however, should have been reduced by the \$152,500 owed to AIDC so that the actual collateral value would have been \$613,042. Thus, the B&I loan was undercollateralized \$86,958 ($\$700,000 - (\$765,542 - \$152,500)$).

RECOMMENDATION NO. 1

Ensure that all loans in the existing loan portfolio have documented subordination agreements, as applicable.

Rural Development Response

Rural Development stated that it disbursed funds to the escrow account of borrower B's attorney with instructions not to close without a first lien position. It further stated that this is the accepted manner of closing loans in all program areas and regulations must be changed in order to modify existing procedures. Because borrower B is in foreclosure, the subordination cannot be obtained. The only other loan in the portfolio that required subordination was borrower C and that documentation was provided at the exit conference.

OIG Position

We accept the SO's management decision. For final action, the agency needs to provide the Office of the Chief Financial Officer (OCFO) with copies of documentation to support the foreclosure for borrower B and the subordination for borrower C.

RECOMMENDATION NO. 2

Provide documentation that all existing loans have certifications from borrowers' attorneys acknowledging representation of the borrower and the Government.

Rural Development Response

Rural Development stated that it has closed 11 loans to date. Of the 11 loans, the statute of limitations has run or will expire before calendar year end for five loans, borrowers have been paid in full for two loans, and there are letters on file for the remaining four loans. In addition, debarment proceedings are being processed on the attorney that closed borrower C's loan.

OIG Position

We accept the SO's management decision. The SO provided us with justification for the SO's decision not to obtain a certification for borrower C. The SO provided us with documentation from borrower's attorneys acknowledging representation of the borrower and the Government for four loans. For final action, the agency needs to provide OCFO with a copy of this documentation.

FINDING NO. 2

UNDERCOLLATERIALIZED LOAN FOR BORROWER C

At the time of the audit, the SO had not properly secured the loan to borrower C. This occurred because the SO relied on the borrower's attorney to process the loan documents. Based on the incomplete documentation provided during our audit, the

loan was undercollateralized by \$385,244.

Regulations require that proper and adequate collateral will be obtained and maintained in existence to protect the interest of the lender. Collateral must be of such a nature that repayment of the loan is reasonably assured when considered with the integrity and ability of project management, soundness of the project, and the applicant's prospective earnings.⁴ Regulations further state that when performing a credit analysis to determine collateral value, the following percentages should be used: real estate – a maximum of 80 percent of current market value; accounts receivable (less than 90 days delinquent) – 60 percent; and inventory – a maximum of 60 percent. Whereas, the collateral value assigned to machinery, equipment, furniture and fixtures will be based on its marketability, mobility, useful life, and alternative uses, if any.⁵

Borrower C had sold and serviced trucks, tractors and trailers since 1997 in Brinkley, Arkansas. The SO loaned \$1,215,000 to borrower C on October 17, 2000. The funds were to refinance \$1,020,000 of debt, purchase \$50,000 of equipment and provide \$145,000 of working capital. The SO secured the loan with real estate, equipment, parts, accounts receivable, furniture, and fixtures. The SO discounted the appraisals and book values of the assets pledged using the regulation-specified percentages for a collateral value of \$1,241,009.

⁴ 7 CFR, subpart E, part 1980, section 443, (a) (1 and 2), dated January 1, 1988.

⁵ 7 CFR, subpart E, part 1980, section 443, administrative A (a), (3, 4, 5), dated January 1, 1988.

The following schedule shows the collateral values that we were able to determine based on documentation at the SO.

COLLATERAL	VALUE	PRIOR LIENS	DISCOUNT VALUE PER OIG	DISCOUNT VALUE PER RURAL DEVELOPMENT	DIFFERENCE
Real Estate (Commercial)	\$750,000	\$ 0	\$489,320	\$600,000	\$110,680
Equipment & Towing Equipment	251,650	0	150,990	150,990	0
Titled Vehicles	399,875	0	0	239,925	239,925
Parts Inventory	35,000	0	17,500	17,500	0
Accounts Receivable	21,295	0	0	10,648	10,648
Furniture/Fixtures	31,136	0	15,568	15,568	0
Residence	165,000	63,278	81,378	81,378	0
Liquor Store Real Estate	70,000	143,000	0	0	0
Purchased Equipment	50,000	0	0	50,000	50,000
Purchased Inventory/ Parts	75,000	0	75,000	75,000	0
TOTALS			\$829,756	\$1,241,009	\$411,253

This schedule indicates that we could not fully account for \$411,253 worth of collateral. Since the B&I loan was for \$1,215,000, we calculated that the effect of this condition was unaccounted-for collateral of \$385,244 (loan amount of \$1,215,000 less discounted value of collateral per the Office of Inspector General (OIG) of \$829,756). The following paragraphs provide an explanation of the differences between the OIG and the Rural Development collateral values.

As of January 31, 2000, the commercial real estate was appraised for \$750,000 and the SO discounted the appraised value 80 percent for a collateral value of \$600,000 ($\$750,000 \times .8$). The valuation was based on the SO having a first lien position on the property. The SO was aware that Monroe County had a superior lien as shown on the title commitment, and correspondence with Monroe County stated that they would subordinate their lien position to the SO. Although the SO officials stated that they had instructed the borrower's attorney to obtain the subordination, as of May 2001 the SO had not received documentation that the subordination had been executed.

The October 1, 2000, balance sheet stated that the borrower owed Monroe County \$138,350, but there was no verification of the balance in the file. We used the unverified balance to determine that the collateral was understated by \$110,680 ($\$138,350 \times .8$) at the time the loan was made. On December 7, 2001, the SO provided us with a copy of the subordination that they had recently received from borrower C's attorney.

The October 17, 2000, security agreements listed 14 vehicles with an appraised value of \$399,875. As of our review in May 2001, the SO did not have the vehicle titles showing Rural Development as the lien holder. When we requested the titles, the SO officials stated that after repeated requests they have yet to receive the titles from the borrower's attorney. They further stated that as part of the loan closing they expected the borrower's attorney to pay off the creditor, obtain a release of the lien, and subsequently perfect the SO's lien status on the vehicles by having the SO recorded as the lien holder with the State of Arkansas. Using a 60 percent margin value, we concluded that the loan was undercollateralized \$239,925 ($\$399,875 \times .6$) due to the unperfected lien status. During the June 1999 loan review performed by the NO, the SO was cited for the same issue and instructed to perfect their lien status on the vehicle titles.

In the loan documents for borrower C, the SO showed that the borrower would purchase \$50,000 of equipment with loan proceeds. The SO did not discount the purchases for the collateral value calculation. Our review disclosed that the borrower had not provided the SO with receipts to substantiate that the assets had been purchased. Because the borrower lacked documentation to support the purchased assets, we did not include the \$50,000 collateral value in our calculation.

Using the October 1, 2000, balance sheet figure for accounts receivable, the SO calculated a collateral value of \$10,648 ($\$21,295 \times .5$) after discounting the account receivable 50 percent. The SO failed to obtain the required account receivable aging that would show any ineligible receivables that were over 90 days old. Since no aging of receivables was in the loan file, we could not determine how much of the receivables were ineligible; thus, we excluded the \$10,648 in our collateral valuation.

As previously stated, we calculated total collateral value of \$829,756, which resulted in the loan being undercollateralized \$385,244 ($\$1,215,000 - \$829,756$).

RECOMMENDATION NO. 3

Work with borrower C to make sure that the B&I direct loan is adequately collateralized.

Rural Development Response

Rural Development continues to work with the borrower and the borrower's attorney to obtain all documentation that was required at loan closing. Titles from vehicles, trailers, and other equipment that were paid off with loan proceeds are still in the registration process.

OIG Position

To reach a management decision, the SO needs to provide us with documentation showing that USDA is the lien holder on all titled collateral for borrower C.

FINDING NO. 3

We found that the SO needed specific training in the making and servicing of B&I direct loans. As shown in the following schedule, we found that in addition to the exceptions detailed in Chapter 1 of this report, all five

B&I loans reviewed had loan making and/or loan servicing problems (see chart below). We believe that this indicates that the SO needs specific training in these areas. The lack of training was confirmed by SO personnel. As a result, the risk of loss is increased should liquidations occur.

In October 1996, the NO began funding the B&I Direct Loan Program, but the first training that they provided was not until July 1998. The NO has provided annual program training since then; however, training for all 10 programs that are administered by Rural Development is covered during these training conferences.

Our review of the conference agendas and training material showed that the NO provided approximately 25 hours of training directly for the B&I loan program that included material for both guaranteed and direct lending during the four annual conferences (1998 – 2001). We found that the major topic discussed during the 1998 conference was a review of the draft regulations that still have not been approved. Whereas, the major topics for the 2001 training conference were credit analysis and loan liquidation. The loan making and servicing training provided in 1999 and 2000 comprised only 12 hours. The SO personnel confirmed that this training was not sufficient.

We are not recommending corrective action in the loan making portion of the B&I Direct Loan Program because program funding was terminated in fiscal year 2002. However, we are making recommendations to address training in the servicing of B&I direct loans, to service existing direct loans, and to correct the deficiencies we identified in the direct loans we reviewed.

	BORROWER A	BORROWER B	BORROWER C	BORROWER D	BORROWER E
LOAN MAKING EXCEPTIONS					
Payment Status with Creditors Unknown	X	X	X	N/A	N/A
Assignment of Life Insurance Policies	X	X	X	X	X
Incomplete List of Collateral on Security Agreements		X	X	X	X
Missing Documentation for Loan Fund Disbursements	X				
LOAN SERVICING EXCEPTIONS					
Fiscal year financial statements	X	X	X	X	X
Interim financial statements	X	X	X	X	X
Hazard Insurance	X	X	X		X
Collateral Inspections (Annual)	N/A	X	N/A	X	N/A

A. Payment Status With Creditors Unknown

The SO refinanced debts for borrowers A, B, and C without knowing their payment status. The SO had not obtained the borrowers' payment histories from the creditors prior to funding the loans.

Regulations state that the intent of the program is not to make marginal or substandard loans or to "bail out" lenders having such loans.⁶ Thus, when a borrower requests a debt refinancing, regulations require that a complete review be made to determine if the restructuring will allow the borrower to continue operating successfully rather than refinancing an unsound loan.⁷ The SO review should include a debt schedule showing the debts to be refinanced, including the name of creditor, original amount and balance of loan, date of loan, interest rate, maturity date, payment schedule, payment status, and collateral.⁸

As part of the loan approval process, the SO obtains business credit reports for all of their loan applicants from Dunn and Bradstreet. The SO officials stated that the Dunn and Bradstreet credit report is the only source of information used to review the credit histories of the B&I applicants. We found, however, that the Dunn and Bradstreet reports were not a complete source of information to determine the status of the loans being refinanced. Borrower A used \$211,261 in loan funds to refinance debts that were not shown on its credit report; borrower B used \$577,394 in loan funds to refinance debts that were not shown on its credit report; and borrower C used \$994,907 in loan funds to refinance debts that were not shown on its credit report. In total, the SO had refinanced approximately \$1.8 million in debts

⁶ 7 CFR, subpart E, part 1980, section 401 (b), dated January 1, 1997.

⁷ 7 CFR, subpart E, part 1980, section 451 administrative, C, 1, dated January 1, 1992.

⁸ 7 CFR, subpart E, part 1980, section 451 (i)(7), dated January 1, 1997.

outstanding to these three borrowers without knowing if the debts were current or delinquent.

Regulations state that the program is not intended to “bail out” lenders, and to ensure that does not happen, the SO should determine the borrowers’ payment histories and current status before advancing loan funds.

B. Questionable Life Insurance Policies

During our review, we were unable to determine if the required life insurance coverage was obtained. The determination could not be made because either the available documents did not show the amount of insurance coverage that was obtained, or the SO had not obtained the acknowledgement from the insurance companies stating that the policies had been assigned to the SO. The acknowledgement of the assignment by the insurance company is the final step in securing the collateral. The SO officials agreed that the documentation was necessary. They further stated that they have and will continue to request the necessary information from the borrowers, the borrowers’ attorneys, and the borrowers’ insurance agents.

Regulations require life insurance be carried on the principals and key employees of the borrowers.⁹

Borrower A was required to obtain \$1,700,000 of life insurance coverage for the key employee. We were able to find a quotation summary for that amount in the loan file, but this document stated that it was a proposal, not a contract, and there was no documentation that showed the policy had been purchased or that it had been assigned to the SO. After the exit conference held on January 8, 2002, the SO provided us with proof that the borrower had purchased the \$1,700,000 life insurance coverage and that the insurance acknowledged that the policy was assigned to USDA, Little Rock, Arkansas.

Borrower B was required to obtain \$700,000 of life insurance coverage for a key employee. The borrower executed a collateral assignment of the life insurance policy on October 6, 1997, but the SO failed to obtain the acknowledgment of assignment from the insurance company. The SO officials agreed that they needed the acknowledgement of assignment from the insurance company to ensure that any benefit disbursements are paid to the SO.

Borrower C was required to have \$500,000 of life insurance for its key employee. Documentation in the file showed that the key employee

⁹ 7 CFR, subpart E, part 1980, section 443 (c)(3), dated January 1, 1988.

had two insurance policies, but neither stated an amount of insurance coverage. One policy showed a change of beneficiary in favor of the SO, but the insurance company had not acknowledged the change. There was also no acknowledgment by the second insurance company that the policy was assigned to the SO.

Borrower D was required to obtain \$247,000 of key employee life insurance coverage. There was an application for \$250,000 of coverage for the key employee with the SO listed as the beneficiary, but no proof that the insurance was obtained. In response to our review, the SO requested on June 7, 2001, that the borrower provide them with proof of insurance. At the January 2002 exit conference, the SO officials stated that they were still trying to obtain the information from the borrower and/or the insurance agent.

The letter of conditions for borrower E stated that the SO would accept a junior lien position on the \$1,500,000 life insurance policy obtained for a previously funded \$2,500,000 guaranteed loan. There was no evidence of the policy or its joint assignment to the bank and the SO in the loan file.

C. Incomplete Lists of Collateral on Security Agreements

We found that the security agreements executed with borrowers B, C, D, and E were incomplete. Each security agreement had an extensive collateral listing attached, but numerous pieces of equipment listed were not identified by model and/or serial number. This condition would make it very difficult for the SO to adequately account for the collateral security for the B&I loans.

The Uniform Commercial Code states that one of the requirements for the lender to establish a security interest in pledged collateral is to execute a security agreement that contains a description of the collateral, and the debtor must sign the security agreement.¹⁰

A creditor needs the model and/or serial numbers to specifically identify the collateral during collateral inspections. If the equipment is not completely identified, more valuable pieces of equipment could be replaced and the SO would be unaware. If the SO suspected that equipment had been replaced, it would need the model and/or serial numbers to support its case. Also, disputes between the SO and other creditors regarding rights to equipment would be quickly resolved if the SO had complete identification of the equipment on the security agreements. The SO officials agreed that the model and/or serial numbers, if available, should be listed on the security agreements.

¹⁰ UCC, article 9, part 2, section 9-103.

D. Missing Documentation for Loan Fund Disbursements

We found that the SO did not obtain sufficient documentation for the disbursements of loan funds to borrower A. One of seven-loan fund advances to borrower A was not requested in writing and was not supported by the required invoice.

Regulations state that when a loan is funded in multiple advances the borrower will request the advances in writing. The contractor submits Form FmHA 440-11, Estimate of Funds Needed for 30-Day Period Commencing _____, and an invoice supporting the request for funds. Form FmHA 440-11 is a cumulative record of all project costs as of the date on the form. Also, the contractor shows on the form that all prior advances have been paid.

When the SO made the loan to borrower A on August 25, 2000, the settlement sheet showed that the building contractor received a first advance of \$199,946 of the loan funds totaling \$1,700,000. This first advance was not documented with a written request from the contractor. On November 1, 2000, the contractor submitted a second request for an advance but did not show that the previous advance had already been received. However, this was not the case with the third through the seventh requests that showed the receipt of previous advances. During our audit the SO contacted the borrower and requested the first invoice. On January 8, 2002, the SO gave us the requested documentation that the borrower had only recently submitted to them.

E. Financial Statement (FS) and Hazard Insurance Not Documented

We found that none of the loans reviewed had current fiscal year (FY) end or interim FS on file, although the SO had sent letters to the borrowers requesting them. In addition, we found four of the five loans did not have current insurance coverage on file.

Following is a schedule that shows the delinquent status of the FS.

	Date Loan Funded	Date of Last FY FS	Next Due FY FS	Number of Years Delinquent ^{1/}
Borrower A	10/17/00	12/31/99	12/31/00	1
Borrower B	10/20/97	12/31/98	12/31/99	2
Borrower C	08/25/00	12/31/99	12/31/00	1
Borrower D	11/19/99	05/31/99	05/31/00	1
Borrower E ^{2/}	12/11/98	10/31/98	10/31/99	1

^{1/} As of May 2001 review.

^{2/} Liquidation completed; charge-off in process.

Regulations state that borrowers must submit FS at whatever frequency is determined necessary to monitor the loan. The SO required that the five borrowers reviewed submit FY-end FS within 120 days of yearend per their loan agreements. As part of the general servicing actions, regulations require that the SO monitor insurance coverage to ensure that adequate insurance is continuously maintained. The hazard insurance should have a standard mortgage clause naming the lender as the beneficiary.¹¹

As of May 2001, four of the five borrowers had not submitted FY FS after the loans were closed. Without this information, the SO would not be aware of developing financial weaknesses until the borrower failed to make the payments.

Of the five loans reviewed, only borrower D had current hazard insurance, borrowers A and B had expired insurance policies and borrowers C and E had no proof of insurance on file. The SO was listed as the loss payee on the expired policies; thus the insurance companies should have notified the SO if the policies were renewed.

We asked the SO officials if they had a system for tracking when FS and proof of hazard insurance were required. The SO officials stated that they used the Rural Communities Facilities Tracking System to post receipt of FS and hazard insurance. Additionally, the system provides the SO with a tickler system to determine when FS are due or hazard insurance has expired. The SO officials stated that they send letters to the borrowers requesting the necessary information when the report shows that it is due.

F. Collateral Inspections

¹¹ 7 CFR, subpart E, part 1951, section 220, (c), dated January 1, 1993; subpart E, part 1980, section 443 (c)(2), dated January 1, 1988.

Of the five loans reviewed, the SO should have performed site visits to inspect the collateral in year 2000 for borrowers B and D since their loans had been funded for more than 1 year. As of our review, the SO had not performed the required collateral inspections.

The regulations state that the State director should assure that annual site visits are performed. During the visit the collateral is to be observed.¹²

Borrower B received its loan in 1997, and borrower D received its loan in 1999. The SO program director stated that the site visits are normally conducted on an annual basis and begin 1 year after funding the loan. During the visit, the collateral is also inspected. The SO officials agreed that the visits were due for borrowers B and D.

RECOMMENDATION NO. 4

Contact the creditors that are to be refinanced and obtain the credit information that is required by regulations.

Rural Development Response

Rural Development stated that it contacted creditors for payoff figures on loans that were refinanced. It further stated that regulations require the agency to obtain a credit report and debt schedule from the borrower and that all files included the required data. The SO officials stated that it would continue to use an agency form to obtain a debt schedule on any loans that are processed and will verify balances prior to loan closing. The SO provided us with a copy of its form which includes a debt schedule correlated to the latest balance sheet and showing for each loan the creditor, loan purpose, original loan amount, loan balance, date of loan, interest rate, maturity date, payment schedule, whether the payment status is current or delinquent, and collateral.

OIG Position

We accept the SO's management decision. For final action, the agency needs to provide OCFO with a copy of its form.

RECOMMENDATION NO. 5

Obtain the required life insurance coverage documentation for borrowers B, C, D, and E.

Rural Development Response

¹² 7 CFR, subpart E, part 1980, section 469 administrative, C, 2, dated January 1, 1997.

Rural Development stated that it had obtained life insurance coverage for borrowers B and D, and that it continues to work with borrower C in obtaining the required documentation. The SO officials informed us that borrower E's loan has been liquidated.

OIG Position

We accept the SO's management decision. We acknowledge that borrower B had obtained the required life insurance coverage, but USDA's interest is not secure until an insurance company representative signs the collateral assignment. We understand that you have attempted to obtain documentation of insurance coverage for borrower D. Subsequent to its response, the SO provided the justification that because borrower B is in foreclosure, the executed assignment of life insurance cannot be obtained. In addition, the SO provided us with the required life insurance coverage documentation for borrower C and loan pay off documentation for borrower D.

For final action, the agency needs to provide OCFO with documentation to support that borrower B's loan is in foreclosure, borrower C has the required life insurance coverage, borrower D's loan has been paid in full, and borrower E's loan has been liquidated .

RECOMMENDATION NO. 6

Obtain amended security agreements to include complete listings of collateral for borrowers B, C, D, and E.

Rural Development Response

Rural Development stated that security agreements were as complete as possible at the time of loan closing. Some items were adequately described but did not have serial numbers. In addition, it stated that it does not have sufficient staff to verify the voluminous documents. The SO informed us that borrower B's loan is in foreclosure and explained that the fixtures and some of the equipment do not have serial numbers. The SO officials stated that it continues to work with borrower C in obtaining a new security agreement. The SO explained that borrower D's new security agreement has question marks on those items that do not have serial numbers. Items from the original security agreement that were left off the new security agreement were items that had been replaced and the new equipment was reflected on the new security agreement.

OIG Position

We cannot accept the SO's management decision. The SO provided us with a copy of the new security agreement for borrower D. We have reviewed borrower B's foreclosure file and borrower E's liquidation file. Therefore, you do not need to provide us with any other documentation for borrowers B and E. We can reach management decision when the SO: (1) amends the security agreement to include complete listing of collateral for borrower C, and (2) provides its proposed completion date for implementing its corrective action.

RECOMMENDATION NO. 7

Obtain the documentation to support the first loan advance to borrower A.

Rural Development Response

Rural Development has required loan advances to be requested in writing. The only exception was the first advance to borrower A. All subsequent requests were in writing with supporting documentation. The SO will assure that all advances have a written request with supporting documentation.

OIG Position

We accept the SO's management decision. The SO has provided us with documentation to support the first loan advance to borrower A. For final action, the agency needs to provide OCFO with a copy of this documentation.

RECOMMENDATION NO. 8

Take action to make sure that FS are received as required. This action may include acceleration of the loans.

Rural Development Response

Rural Development has written all borrowers concerning receipt of FS. The SO was not certain how effective acceleration of an account would be when it is difficult to obtain funds to provide servicing of the accounts that are in monetary default. Agency policy does not allow for acceleration of an account for technical default.

OIG Position

We accept the SO's management decision. The SO has utilized the Rural Communities Facilities Tracking System to determine when FS are due and has notified the borrowers, in writing, regarding the requirement for submission of FS. For final action, the agency needs to provide OCFO with a copy of its agency policy that does not allow for acceleration of an account for technical default.

RECOMMENDATION NO. 9

Obtain current insurance coverage documentation for borrowers A, B, C, and E.

Rural Development Response

Rural Development agreed to monitor insurance more closely in the future and provided us with copies of current insurance documentation for borrowers A, B, and C. The SO added that borrower B is in default and the first lien holder has provided coverage. The SO officials informed us that borrower E's loan has been liquidated.

OIG Position

We accept the SO's management decision. For final action, the agency needs to provide OCFO with copies of current insurance coverage for borrowers A, B, and C, and documentation that borrower E's loan has been liquidated.

RECOMMENDATION NO. 10

Perform required collateral inspections for borrowers B and D.

Rural Development Response

Rural Development stated that both borrowers have had security inspections. It will assure that in the future the security inspections are done in a timelier manner and properly documented.

OIG Position

We accept the SO's management decision. The SO provided us with documentation of the inspections. For final action, the agency needs to provide OCFO with a copy of the documentation of the inspections.

RECOMMENDATION NO. 11

Seek specific training on servicing B&I direct loans, covering at a minimum the exceptions noted in this report.

Rural Development Response

The SO would be happy to participate in training that would perfect its loan making and loan servicing skills. The staff has participated in the Mid-

South School of Banking, other bank training, and agency sponsored training. The SO provided us with a copy of a letter to the NO requesting training on the specific areas that have been addressed.

OIG Position

We accept the SO's management decision. For final action, the agency needs to provide OCFO with a copy of its letter to the NO requesting training.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
1	1	Inadequate collateral for borrower B	\$ 86,958	Questioned loan. No recovery recommended.
2	3	Unsupported collateral values for borrower C	385,244	Questioned loan. No recovery recommended.
TOTAL			\$472,202	

EXHIBIT B – AUDITEE’S RESPONSE TO DRAFT REPORT



UNITED STATES
DEPARTMENT OF
AGRICULTURE

Rural
Development
August 26, 2002

USDA Service Center
Federal Building, Room 3416
700 West Capitol Avenue
Little Rock, AR 72201-3225

Subject: Business and Industry Direct Loan Program- Arkansas
34601-14-Te

TO: Frederick F. San Buenaventura
Acting Regional Inspector General
for Audit
USDA
Temple, TX

Reference is made to the revised draft report of subject audit that was conducted from May 8, 2001 through December 2001. The following five borrowers were reviewed during the audit period:

Borrower A.
Borrower B.
Borrower C
Borrower D
Borrower E

RBS in Arkansas has made eleven loans, to date, for a total of \$9,601,000. Of these loans, two have paid in full in the normal course of business. Two loans are delinquent and one has been liquidated. Of the delinquent loans, foreclosure is being initiated on one; the other loan is delinquent with potential for recovery if the farm economy and the economy as a whole realize some recovery in the upcoming year. The other loans are all performing.

We noted in your introductory paragraph that you have stated that the loan program is not intended for marginal or substandard loans. If the loans were not marginal or substandard why then were we required to have a test for credit? The test for credit required certification by the borrower and documentation by the agency that credit could not be obtained through commercial credit at reasonable rates and terms. The funding package restricted the use of funds except in under-served segments of the population and rural areas of the country suffering fundamental physical and economic stress.

The following information is provided in response to the draft of the audit.

USDA Rural Development is an Equal Opportunity Lender, Provider and Employer
Complaints of discrimination should be sent to: USDA, Director,
Office of Civil Rights, Washington, D.C. 20250-9410

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Finding Number 1.

Loan Secured by Inadequate Collateral for Borrower B

Recommendation Number 1: Ensure that all loans in the existing loan portfolio have documented subordination agreements, as applicable.

The debt to the AIDC was not disclosed to USDA until the preliminary title insurance binder was received by the Agency on October 20, 1997. OGC issued instruction requiring a first lien. Funds had not been allocated to pay off this debt since it was not reflected on the debt schedule or financial statements. After receipt of the preliminary binder, discussions occurred with the borrower concerning this debt. State Office staff was advised that this had been converted to equity. Borrower indicated that AIDC was going to subordinate or forgive this debt. USDA disbursed funds to the escrow account of the attorney with instructions not to close without a first lien position. This is the accepted manner of closing loans in all program areas. Regulations must be changed in order for staff to modify existing procedures. Borrower B is in foreclosure and the subordination cannot be obtained.

The only other loan in the portfolio that required a subordination was Borrower C and that documentation was provided at the exit conference.

Recommendation Number 2: Provide documentation that all existing loans have certifications from borrower's attorneys acknowledging representation of the borrower and the government.

Arkansas USDA Rural Development Office has closed 11 loans to date. The statute of limitations has run or will expire prior to calendar year end on the following loans:

[

]

Loans to following borrowers have been paid in full:

[

]

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The following borrowers have letters on file:

[]
[]
[] and the State Office does not feel that it would be beneficial to
the government. []

National Office guidance contained in RD AN No. 3343 dated June 23, 1997 stated that the underwriting criteria for the B & I Direct loan program was contained in RD Instruction 1980 E, and the application processing guidelines were contained in RD Instruction 1942 A. We have researched 1942 A concerning use of applicant attorney. Instruction 1942 (j) (4) references land acquisition. All references indicate that the applicant is responsible for certifying and providing a legal opinion relative to the title. In paragraph 1942.17 (j) (4) (B), it states those Title Opinions must be provided by the applicant's attorney. Paragraph 1942.17 (l) (1) Professional Services states that the applicant will be responsible for providing the services necessary to develop the project. This list includes the attorney and bond counsel.

The State Office has used the Office of General Counsel (OGC) to advise on methods to close loans and to protect the interest of the government. The OGC performs a post review of loan closing documents after the loan is closed. The staff followed regulations, policy, and the accepted method of loan closing for all programs. Regulations and National Office policy must be changed in order to close loans differently from the borrower selecting the attorney.

Finding Number 2. - Under collateralized Loan for Borrower C

Recommendation Number 3: Work with borrower C to make sure that the B & I direct loan is adequately collateralized.

The State continues to work with the borrower and borrower attorney in obtaining all documentation that was required at loan closing. The subordination that was required was signed on the date the loan was closed and the attorney has since provided the signed document to the State Office. Some titles from vehicles have gone through the registration process with USDA Rural Development listed as lien holder. Application has

been made for other replacement titles, which will be refiled to obtain a lien position for Rural Development when the titles are issued. The process of obtaining the titles and replacement titles is very slow. A list of equipment that was purchased with the \$50,000 escrowed funds has been received from the borrower and has been listed on the financing statement that has been filed. (UCC attached) While we did not discount the equipment being purchased, our discounted collateral value was greater than \$1 for \$1 after the discounts were taken. Every attempt is being made to adequately secure the government's interest.

CHAPTER 2 - Specific training needed in the B & I Direct Loan Program

Recommendation Number 4: Contact the creditors that are to be refinanced and obtain the credit information that is required by regulations.

Creditors were contacted for payoff figures on loans that were refinanced. Regulations require the RBS staff obtain a credit report and a debt schedule from the borrower. All files included the required data. Regulations require that when refinancing is a part of the loan package, the reason for refinancing must be documented and made a part of the file, and refinancing can be done when it is necessary to spread substantial debt over a longer period of time, improving the businesses cash flow, payment of short term debt that is customarily financed over long periods of time and when it is necessary to place a permanent loan subsequent to an interim loan. The only other requirement noted in regulations concerning refinancing is the need to obtain, as a minimum, the previously held collateral. We can find no reference for other information in the regulations. Form RD 449-1, Application for Loan and Guarantee, Item 17 Q requires a debt schedule correlated to the latest balance sheet reflecting the name of the creditors and suggest the use of RD 449-29, Attachment 1. The form will continue to be used on any loans that are processed. Verification of balances will be made prior to loan closing. Attached is a copy of the form and attachment.

Recommendation Number 5: Obtain the required life insurance coverage documentation for borrowers B,C,D, and E.

Our review of the files indicated that the executed assignment was received in the State Office on October 20, 1997 on \$1,500,000 and the loan was closed on October 27, 1997 for borrower B. The staff had received an assignment on one half the required coverage on Borrower D and a copy of the application in process with a note from the Agent confirming remaining coverage was in the file at the time of loan closing. Numerous contacts with the Agent have not generated a policy for our file even though he is adamant that we have the coverage. Regulations state that "ordinarily, life insurance is required for the principals and key employees." No dollar amount is required by regulations but generally an agreed upon amount is set out in the Letter of Conditions.

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We have obtained the required life insurance coverage on borrowers B and D. Borrower E also had a guaranteed loan and we could not obtain additional life insurance for the direct loan at a reasonable rate; therefore, we only required that the previously held coverage be maintained. This account has been liquidated.

All documentation was obtained prior to the end of the audit except for Borrower C. On Borrower C, we have obtained an assignment of a \$200,000 policy (copy attached) and have completed and mailed the request for assignment to the insurance company (copy attached).

Recommendation Number 6: Obtain amended security agreements to include complete listing of collateral for borrowers B, C, B, E.

Security agreements were as complete as possible at the time of loan closing. Some items were adequately described but do not have serial or model numbers. Staffing in the field and work load does not permit the hours necessary for the scrutiny that is provided by the auditor to cross check these voluminous documents.

Borrower D had question marks on those items that did not have serial numbers on the new security agreement. Items from the original security that were left off the new security agreement were items that had been replaced and the new equipment was reflected on the security agreement.

Borrower B is in foreclosure. The fixtures and some of the equipment do not have serial numbers.

We continue to work with Borrower C in obtaining a new security agreement.

Recommendation Number 7: Obtain the documentation to support the first loan advance to borrower A.

We have required loan advances to be requested in writing. The only exception of this was the first advance on Borrower A. This had been verbally agreed upon for the down payment on the building. Because it was the first advance at loan closing we overlooked the fact that it was not in writing. All subsequent requests were in writing with supporting documentation. You will note in the summary grid provided by the auditor only one borrower shows lack of documentation on advances.

The State Office will assure that all advances have a written request with supporting documentation.

Recommendation Number 8: Take action to make sure that FS are received as required. This action may include acceleration of the loans.

The RBS staff has written all borrowers concerning receipt of financial statements. We are not certain how effective acceleration of an account would be when it's difficult to obtain funds to provide servicing of the accounts that are in monetary default. National Office policy does not allow for acceleration of an account for a technical default. This is a verbal policy. Historically an account has never been foreclosed for non-monetary default. In review of the regulations all guidance refers to a period of time when payments have not been made. We recognize that the receipt of financial statements is a problem on a national basis. We will continue to monitor receipt of financial statements and continue to remind the borrowers to furnish statements on a timely basis.

Recommendation Number 9: Obtain current insurance coverage documentation for borrowers A, B, C, and E.

Insurance companies have been contacted in every case. USDA was listed as the mortgagee in all cases. We do not understand why renewal statements were not received. We will monitor insurance more closely in the future. Current policies are in file for Borrower A. Borrower B is in default and the first lien holder has provided coverage (copy attached). A copy of the coverage for Borrower C is attached.

Borrower E has been liquidated.

Recommendation Number 10: Perform required collateral inspections for borrowers B and D.


Both borrowers have had security inspections. Inspections were performed on C on July 24, 2001. The loan was closed in December 1999 and the funds were advanced in 2000. An inspection should have been made in the spring of 2000 after the equipment was installed and operational. This was an oversight on the part of the RBS staff and we will attempt to monitor security inspections more closely in the future. Site inspections were made on Borrower B by the Area Office staff, State Office staff and National Office staff on numerous occasions since the loan was closed but documentation was not completed for a security inspection. The state office staff will assure that in the future the security inspections are done on a more timely manner and properly documented.

Recommendation Number 11: Seek specific training and servicing of B & I direct loans, covering at a minimum, the exceptions noted in this report.


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The Arkansas RBS staff would be happy to participate in training that would perfect the loan making and loan servicing skills. The staff has participated in the Mid South School of Banking, other bank training, and agency sponsored training. We are attaching a copy of a letter to the National Office Servicing Branch requesting training on the specific areas that have been addressed.

If you have questions, please contact Shirley Tucker, RBS Program Director, at 501301-3290.



JOHN ALLEN
State Director



Enclosures