

EVALUATION REPORT

EVALUATION OF SBA 7(A) LOANS MADE TO POULTRY FARMERS





EXECUTIVE SUMMARY

EVALUATION OF SBA 7(a) LOANS MADE TO POULTRY FARMERS

Report No.
18-13

March 6,
2018

What OIG Reviewed

This report presents the results of our evaluation of the Small Business Administration's (SBA's) 7(a) loans made to poultry farmers. The 7(a) Loan Program is SBA's primary program for helping startup and existing small businesses, offering financing guarantees for loan amounts up to \$5 million to fund startup costs, expand existing businesses, purchase equipment, repair existing capital, and other uses. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules and regulations. Some 7(a) loans are made by lenders using delegated authority, which undergo limited review by SBA prior to loan disbursement. Other 7(a) loans are subject to more extensive underwriting and eligibility review and approval by SBA before the loan is disbursed.

Our evaluation objective was to determine whether 7(a) loans made to poultry farmers (growers) met statutory, regulatory, and SBA requirements for eligibility.

What OIG Found

We found that 7(a) loans made to growers did not meet regulatory and SBA requirements for eligibility. The large chicken companies (integrators) in our sample exercised such comprehensive control over the growers that the SBA Office of Inspector General believes the concerns appear affiliative under SBA regulations. Therefore, SBA and lenders approved 7(a) loans that were apparently ineligible under SBA size standard regulations and requirements. Specifically, in our review of a sample of 11 7(a) loans made to growers, as well as review of defaulted 7(a) loans to growers, we found integrator control exercised through a series of contractual restrictions, management agreements, oversight inspections, and market controls. This control overcame practically all of a grower's ability to operate their business independent of integrator mandates.

This control was enforced through close integrator oversight, management agreements, and grower-integrator communication. A grower's failure to comply with these requirements could result in a significant decrease in integrator payments, a reduction in flock placements, or a can-

cellation of the contract. A grower's economic viability was based upon a performing production contract with an integrator and is the true basis for grower income and facility value. As a result, from FY 2012 to FY 2016, SBA guaranteed approximately \$1.8 billion in loans that may be ineligible.

OIG Recommendations

To improve SBA's oversight of the 7(a) Loan Program, we recommended the Associate Administrator for the Office of Capital Access (1) review the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination given the apparent affiliation based upon comprehensive contractual, oversight, and market control, and take the appropriate corrective action(s), and (2) review the arrangements between integrators and growers under the revised regulations, and establish and implement controls, such as supplemental guidance, to ensure SBA loan specialists and lenders make appropriate affiliation determinations.

Agency Response

SBA management agreed with both recommendations. Regarding Recommendation 1, SBA will perform a review of the loans cited in the evaluation to determine whether SBA loan specialists and lenders made proper size determinations. For Recommendation 2, SBA will review the arrangements between integrators and growers in light of the current affiliation rules and regulations. If needed, SBA will establish additional controls to ensure SBA loan specialists and lenders make the appropriate affiliation determinations.

In its final response, SBA noted the report inaccurately stated loans made by the delegated lenders undergo a limited review by SBA prior to disbursement. SBA further suggested we change the statement for accuracy. However, the information stated in the report is an accurate depiction from SBA's SOP 50 10 5, which states that such loans receive a brief eligibility review. In subsequent correspondence, SBA clarified the limited reviews cited in their policy are automated via SBA's electronic loan intake system.



**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416**

Final Report Transmittal
Report Number: 18-13

DATE: March 6, 2018

TO: Linda E. McMahon
Administrator

FROM: Hannibal "Mike" Ware
Acting Inspector General

A handwritten signature in black ink, appearing to be "H. Ware", written over the printed name of the Acting Inspector General.

SUBJECT: *Evaluation of SBA 7(a) Loans Made to Poultry Farmers*

This report presents the results of our evaluation of the Small Business Administration's (SBA's) 7(a) loans made to poultry farmers. Our objective was to determine whether 7(a) loans made to poultry farmers (growers) met the statutory, regulatory, and SBA requirements for eligibility.

We considered management comments when preparing this final report. Management agreed with both recommendations.

We appreciate the courtesies and cooperation extended to us during this evaluation. If you have any questions, please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616.

cc: Althea Coetzee Leslie, Deputy Administrator
Pradeep Belur, Chief of Staff
William M. Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Christopher Pilkerton, General Counsel
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Timothy E. Gribben, Chief Financial Officer and Associate Administrator for
Performance Management
LaNae Twite, Director, Office of Internal Controls

Table of Contents

Introduction.....	1
Commercial Chicken Farming	1
Figure 1: Relationship of Integrators and Growers Within the Broiler Industry.....	1
SBA's 7(a) Loan Program	2
Significant Changes in the Characteristics of SBA's 7(a) Poultry Loan Portfolio	2
<i>Delivery Method</i>	3
Figure 2: Change in Delivery Method for 7(a) Poultry Loans, FY 2012–2016	3
<i>7(a) Loan Terms</i>	3
Figure 3: Change in 7(a) Poultry Loan Terms, FY 2012–2016.....	3
<i>7(a) Agricultural Loans</i>	4
Figure 4: Proportion of Poultry Loans of All 7(a) Agricultural Loans, by Value, FY 2012–2016.	4
Figure 5: Annual Value of 7(a) Poultry Loans to Other 7(a) Agricultural Loans, FY 2012–2016	4
<i>7(a) Poultry Loan Size and Lenders</i>	5
Figure 6: Growth in Annual Average 7(a) Poultry Loan Size, FY 2012–2016	5
Figure 7: Top Three 7(a) Poultry Lenders by Annual Value, Overlaid With the Annual Value of 7(a) Poultry Loans Reported as Sold on the Secondary Market, FY 2012–2016	5
Objective.....	6
Finding: SBA 7(a) Loans Made to Growers Did Not Meet SBA Eligibility Requirements	7
Integrators and Growers Were Affiliated	7
Economic Viability and Value of a Grower's Facility Depended Upon a Performing Production Contract With an Integrator.....	8
Table 1: Percentage Loss in Grower Facility Value Without an Integrator Contract.....	8
Multiple Factors Prevented SBA From Recognizing Affiliative Control.....	9
<i>SBA Relied on a 1993 Poultry Contract Review for Its Assumption of Eligibility</i>	9
<i>SBA Loan Specialists Did Not Have a Sufficient Knowledge Base of the Poultry Industry</i>	9
Conclusion	9
Recommendations.....	10
Analysis of Agency Response.....	10
Summary of Actions Necessary to Close the Recommendations.....	10
Appendix I: Objective, Scope, and Methodology	11
Use of Computer-Processed Data.....	11
Appendix II: Agency Comments	12

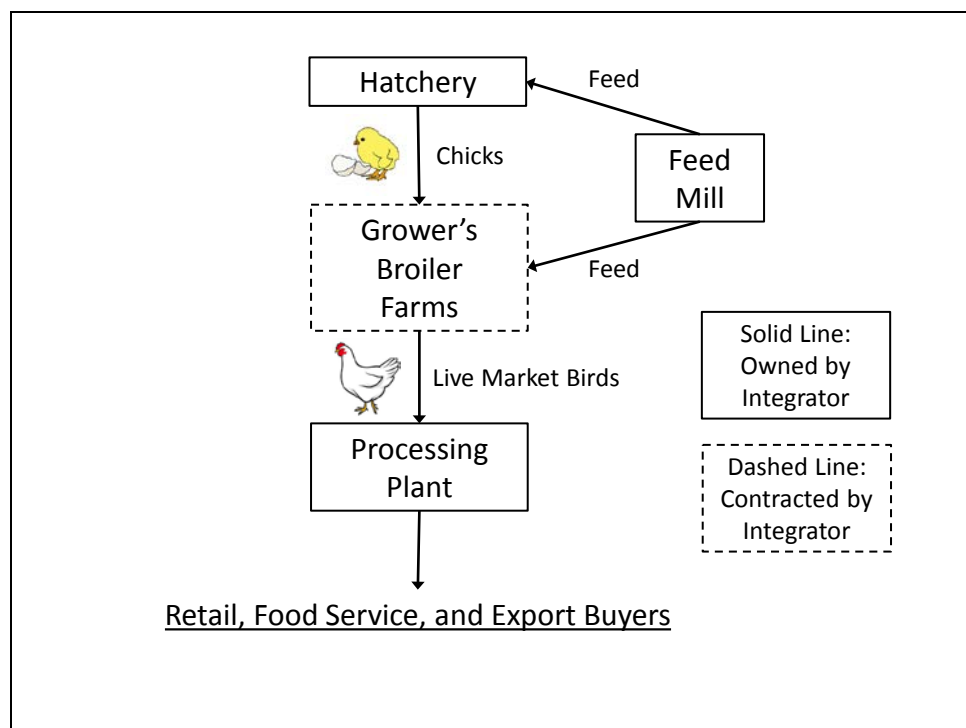
Introduction

Commercial Chicken Farming

The majority of chickens raised commercially in the United States are broilers: young chickens bred for meat production. With a 2016 market value of \$25.9 billion, broilers are raised almost entirely by poultry farmers (growers) that operate under exclusive contracts with large chicken companies (integrators).¹

The broiler industry's structure is vertically integrated, and production and processing is tightly controlled by the integrators. In this structure, integrators own and operate the hatcheries and deliver flocks of chicks to contract growers, which own the broiler housing and provide the utilities and labor to raise the flocks to market weights. The integrators pay contract fees to the growers and supply feed, veterinary services, technical supervision, and flock transportation. After 5–9 weeks, depending on bird size, live market birds are shipped from grower farms to the integrator's processing plant for slaughter and marketing. The following figure, adapted from a June 2014 United States Department of Agriculture (USDA) Economic Research Service report, illustrates the relationship between the integrators and growers within the broiler industry.²

Figure 1: Relationship of Integrators and Growers Within the Broiler Industry



Source: Office of Inspector General (OIG) adaptation of the June 2014 USDA Economic Research Service report.

¹ USDA National Agricultural Statistics Service, *Poultry – Production and Value 2016 Summary*, ISSN: 1949-1573, April 2017.

² USDA Economic Research Service, *Technology, Organization, and Financial Performance in U.S. Broiler Production*, EIB-126, June 2014.

Growers make substantial and long-lived investments to construct, operate, maintain, and periodically upgrade their broiler houses. These houses are special-purpose properties that have little value without a performing production contract with an integrator. Therefore, the integrator contract is the true economic value of a grower's facility.

The broiler industry relies almost exclusively on production contracts. Further, according to a 2016 report prepared for the National Chicken Council, the majority of broiler production contracts were for less than 1 year. Specifically, 42 percent of growers were contracted on a "flock-to-flock" basis, where the integrator made no specific commitment to provide chicks beyond the current flock's placement; an additional 11 percent of growers were on contracts of less than 1 year.³

In addition, the local market for growers is highly concentrated. According to the June 2014 USDA Economic Research Service report, 21.7 percent of growers reported that there was only a single integrator in their area, and another 30.2 percent reported two integrators in their area. Together, the growers in these markets accounted for approximately 57 percent of broiler production in the United States.

The growers' facilities are usually financed through borrowing from commercial banks or the Farm Credit System. Growers used Federal guarantees for poultry loans obtained through the U.S. Small Business Administration (SBA) 7(a) Loan Program, and the USDA Farm Service Agency.

SBA's 7(a) Loan Program

The SBA is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of Government-guaranteed loans. The 7(a) Loan Program is SBA's primary program for helping startup and existing small businesses, offering financing guarantees for loan amounts up to \$5 million to fund startup costs, expand existing businesses, purchase equipment, repair existing capital, and other uses. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules and regulations. Some 7(a) loans are made by lenders using delegated authority; these loans undergo limited review by SBA prior to loan disbursement. Other 7(a) loans are subject to more extensive underwriting and eligibility review and approval by SBA before the loan is disbursed.

SBA requirements state that the small business applicant must be small under SBA size standards. The applicant combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant or the primary industry of the applicant and its affiliates, whichever is higher.

Significant Changes in the Characteristics of SBA's 7(a) Poultry Loan Portfolio

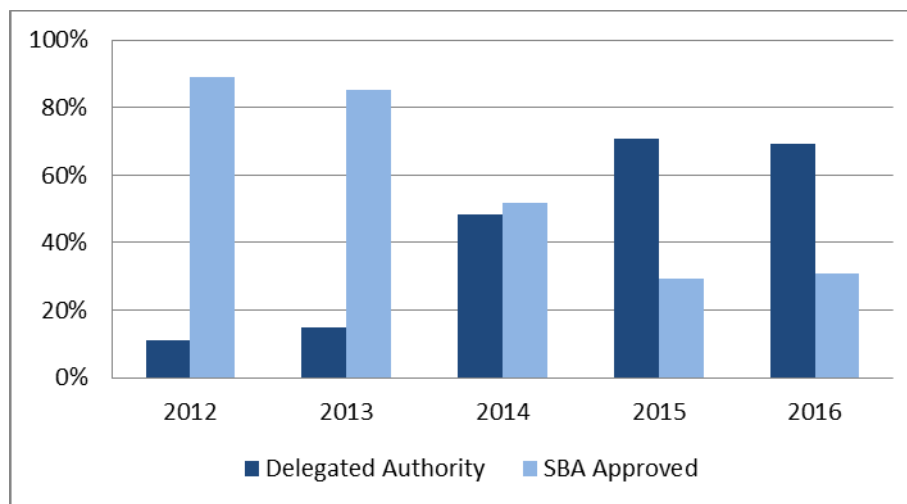
From fiscal year (FY) 2012 to FY 2016, SBA guaranteed 1,535 7(a) loans, totaling approximately \$1.8 billion, that were approved and disbursed to businesses operating within the poultry grower industry. Over this time and as described below, the characteristics of SBA's poultry loan portfolio changed significantly. The population for this analysis is defined in Appendix I.

³ FarmEcon LLC, *Live Chicken Production Trends*, April 26, 2016.

Delivery Method

The share of 7(a) poultry loans approved by lenders under delegated authority grew sharply. In FY 2012, SBA approved 89 percent of 7(a) poultry loans, with the remaining 11 percent made by lenders under their delegated authority. By FY 2016, however, SBA directly approved 31 percent, with the clear majority of loans—69 percent—being made by lenders under their delegated authority (see Figure 2).

Figure 2: Change in Delivery Method for 7(a) Poultry Loans, FY 2012–2016

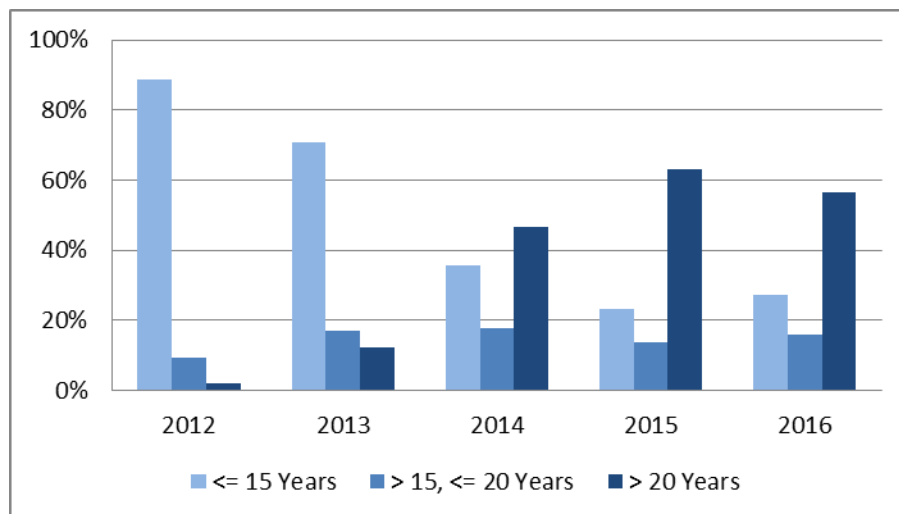


Source: OIG analysis of SBA data.

7(a) Loan Terms

Moreover, as delegated authority became more common, the maturity terms of the poultry loan portfolio also changed substantially. In FY 2012, 89 percent of the approved loan value matured in 15 years or less, while only 2 percent had maturities greater than 20 years. In FY 2016, however, 57 percent of the approved loan dollars had maturities greater than 20 years (see Figure 3).

Figure 3: Change in 7(a) Poultry Loan Terms, FY 2012–2016

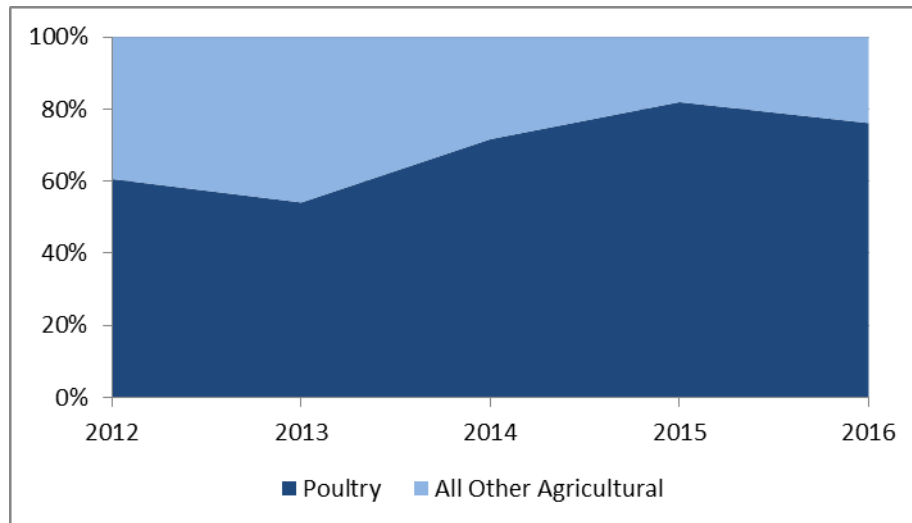


Source: OIG analysis of SBA data.

7(a) Agricultural Loans

Although poultry loans have accounted for the largest portion of 7(a) agricultural loans, poultry's share has grown over time. Poultry's portion increased from 61 percent of all 7(a) agricultural loans in FY 2012 to 76 percent in FY 2016 (see Figure 4).

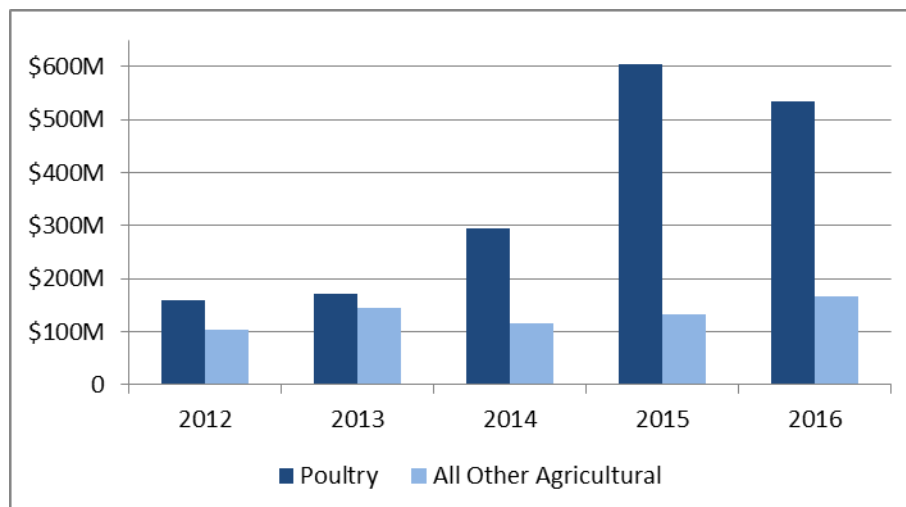
Figure 4: Proportion of Poultry Loans of All 7(a) Agricultural Loans, by Value, FY 2012–2016



Source: OIG analysis of SBA data.

In addition to these changes, key measures for loan values of SBA's portfolio of 7(a) poultry loans also has changed significantly. For example, the value of 7(a) poultry loans originated in a fiscal year increased 235 percent, from \$159 million in FY 2012 to \$534 million in FY 2016. For comparison, the value of all other 7(a) agricultural loans increased 62 percent (see Figure 5).

Figure 5: Annual Value of 7(a) Poultry Loans to Other 7(a) Agricultural Loans, FY 2012–2016

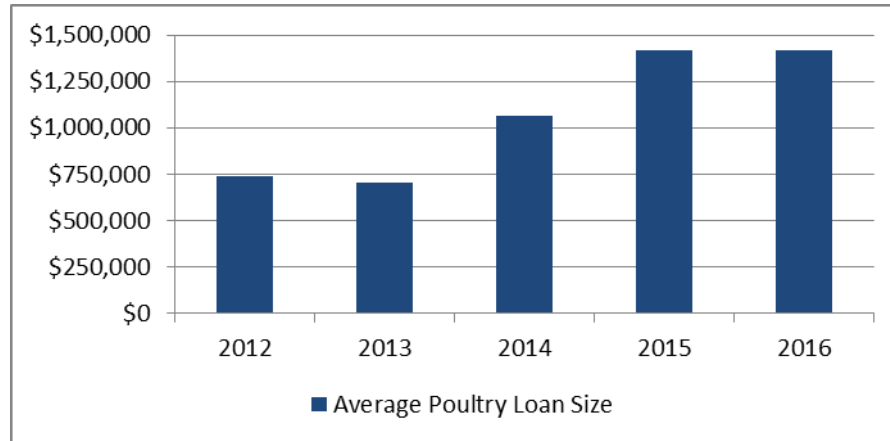


Source: OIG analysis of SBA data.

7(a) Poultry Loan Size and Lenders

Additionally, the average size of 7(a) poultry loans originated in a fiscal year increased 91 percent, from \$741 thousand in FY 2012 to \$1.4 million in FY 2016 (see Figure 6).

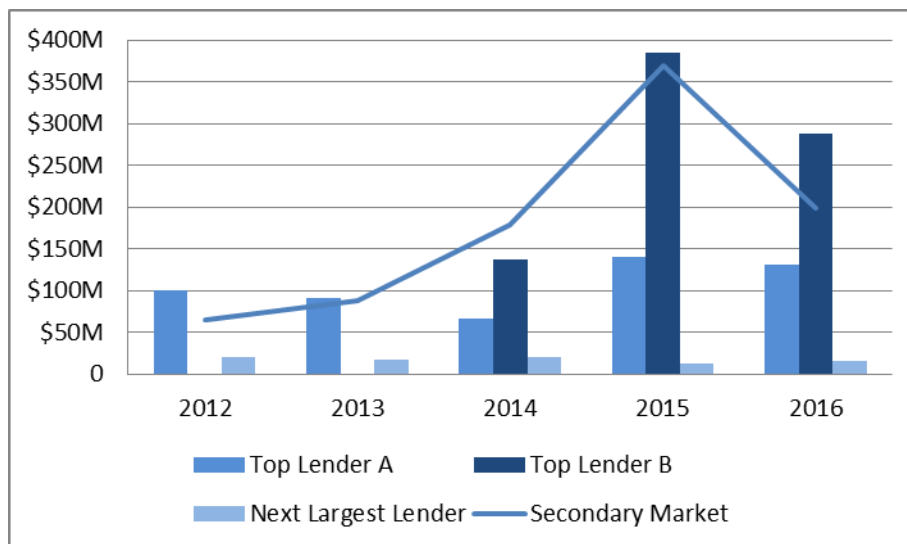
Figure 6: Growth in Annual Average 7(a) Poultry Loan Size, FY 2012–2016



Source: OIG analysis of SBA data.

Finally, as seen in the following figure, during this period, two lenders accounted for a clear majority of the approved 7(a) poultry loan value, with the next largest lender in any year accounting for a significantly smaller amount. Additionally, the value of 7(a) poultry loans approved in a given fiscal year, and then reported as sold on the secondary market, increased as much as 469 percent from \$65 million in FY 2012 to \$369 million in FY 2015. Although these numbers decreased in FY 2016 to \$199 million, the overall increase in loans sold on the secondary market over this period was significant (see Figure 7).

Figure 7: Top Three 7(a) Poultry Lenders by Annual Value, Overlaid With the Annual Value of 7(a) Poultry Loans Reported as Sold on the Secondary Market, FY 2012–2016



Source: OIG analysis of SBA data.

Objective

This evaluation was initiated independently in response to an indication from congressional staff that large businesses were, in effect, subsidized by SBA's lending program. The concern expressed was with regard to the contracts between the growers and integrators and whether they are so controlling that affiliation exists.

Our evaluation objective was to determine whether 7(a) loans made to poultry farmers (growers) met the statutory, regulatory, and SBA requirements for eligibility. See Appendix I for information on our scope and methodology.

Finding: SBA 7(a) Loans Made to Growers Did Not Meet SBA Eligibility Requirements

We found that 7(a) loans made to growers did not meet regulatory and SBA requirements for eligibility. Integrators were ineligible to participate in the SBA 7(a) Loan Program due to their size; however, integrators exercised such comprehensive control over the growers that the SBA OIG believes the concerns were affiliated. Therefore, SBA and lenders approved 7(a) loans to growers that appear ineligible under SBA size standard regulations and requirements.

SBA did not recognize this affiliative control because it relied on a 1993 Agency decision based on a review of a grower–integrator contract. The review found that the contract, standing alone, did not bring about affiliation. In addition, SBA deferred to delegated lenders to effectively underwrite 7(a) poultry lending. We believe the level of control integrators had over the growers was sufficient evidence to find that from FY 2012 to FY 2016, SBA guaranteed approximately \$1.8 billion in loans that may be ineligible. As a result, SBA was guarantying loans to affiliative enterprises inconsistent with its stated mission to assist small business concerns.

Integrators and Growers Were Affiliated

It is our opinion that the relationship between the growers and the integrators was affiliative. SBA regulations in effect at the time of loan approval stated that “entities are affiliates of each other when one controls or has the power to control the other. It does not matter whether control is exercised, so long as the power to control exists. SBA considers factors such as management and contractual relationships, in determining whether affiliation exists.” Further, current SBA regulations find that affiliation “arises where a single individual, concern, or entity controls the management of the applicant concern through a management agreement.” Regulations and SBA standard operating procedures (SOPs) also stated that the applicant must be small under SBA size requirements and the applicant business combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is greater.

During our review of a sample of 11 7(a) loans made to growers, as well as a review of defaulted 7(a) loans, we found that integrators exercised comprehensive control over the growers through a series of contractual mandates and restrictions, management agreements, operating procedures, oversight, inspections, and market controls that overcame practically all of the grower’s ability to operate their businesses independent of integrator mandates. Our observation of such control was further supported by research, studies, and reports from governmental, academic, and trade publications, as well as interviews with various lenders, growers, and staff of Federal agencies and academic institutions.

Integrator control included instructions to growers on how to inspect flocks and broiler houses, prescribing where and how to walk through the houses, the frequency and timing of inspections, and how to record the results. Integrators directed and closely oversaw grower operations in other attributes as well, including broiler house lighting, heating, ventilation, and cooling, flock feeding, watering, and the culling of birds. In addition, integrators also exercised significant control over grower facilities, providing detailed construction specifications for the grower’s broiler houses, site grading, equipment, signage, and other attributes, and exercised oversight throughout the construction to ensure compliance. Following the construction of the grower’s facility, integrators exercised regular and detailed oversight through inspections of broiler houses, equipment, and

facility grounds. The results of the inspections were recorded in reports that detailed deficiencies, and required the grower’s remediation by a specific date and time.

Moreover, we observed that integrators made unilateral and mandatory changes to the management agreements and other operating practices that governed the grower’s operations. Grower facilities were subjected to similar requirements, with integrators mandating significant capital upgrades to broiler houses and equipment. These integrator-driven changes to operating practices, and requirements for additional capital upgrades, resulted in the need for the growers to seek additional funding through the SBA 7(a) Loan Program.

Economic Viability and Value of a Grower’s Facility Depended Upon a Performing Production Contract With an Integrator

We found that a grower’s production contract with an integrator was the true basis for grower income and facility value. Moreover, these contracts must be performing; that is, the grower must have a steady and predictable supply of flocks from the integrator in order to remain economically viable. Our review demonstrated that a grower’s failure to comply with integrator requirements, as described above could—and did—result in a significant decrease in integrator payments, a reduction of flock placements, a withholding of flocks, or the cancellation of the contract. The delays in flock placements, and their effect on the grower’s cash flow, resulted in the need for the growers to seek modifications to existing loans. Further, we found that integrator refusals of further flocks, or contract terminations, resulted in the failure of grower businesses.

In addition, SBA, USDA, lenders, and appraisers recognize that broiler houses and their associated equipment are special-purpose buildings, which have little value without a production contract with an integrator. According to an executive at one lender, “without an integrator contract, the houses themselves are worthless.”

To better understand the value of a production contract, we performed a review of several poultry loans that recently defaulted following the loss of an integrator contract. The review clearly demonstrated the substantial loss in the value of a grower’s facility without the integrator contract (see Table 1).

Table 1: Percentage Loss in Grower Facility Value Without an Integrator Contract

Original 7(a) Loan Size	Appraised Market Value at Origination (Production Contract Assumed)	Sale Price in Final Liquidation (Without Production Contract)	Percentage Loss in Appraised Value v. Sale Price
\$2,100,000	\$1,950,000	\$135,000	-94%
\$1,975,000	\$1,888,000	\$720,000	-62%
\$834,000	\$900,000	\$275,000	-69%
\$594,800	\$835,000	\$90,000	-89%

Source: OIG Analysis of SBA Data and Loan Files.

As observed in our review, a reduction of flock placements, the withholding of flocks, or the outright cancellation of the contract directly affected the viability of the grower’s business. Therefore, the integrator requirements appeared to have overcome the ability of the growers to operate as independent businesses.

Multiple Factors Prevented SBA From Recognizing Affiliative Control

SBA Relied on a 1993 Poultry Contract Review for Its Assumption of Eligibility

Although SBA loan specialists and other staff had expressed concerns that the grower–integrator relationship may be affiliative, and SBA officials and staff had stated that the growers were highly controlled by the integrators, SBA continued to rely on a 1993 Agency decision to allow for these loans.

The 1993 decision stated that in order to regard the grower–integrator relationship as affiliative, the grower’s very existence as a viable business must depend upon it, as such a level of control would rob the grower of its independence.⁴ SBA’s decision found that the contract terms, standing alone, did not affect the viability of the grower. SBA’s decision, however, did not consider the full universe of controls in place over the grower. SBA officials stated that aside from this decision, there have been no further determinations on affiliation. Moreover, SBA officials stated that a June 2016 regulatory change, which amended several tests for affiliation, made this decision immaterial.⁵

SBA Loan Specialists Did Not Have a Sufficient Knowledge Base of the Poultry Industry

SBA officials also noted that poultry loans are a very small part of the 7(a) portfolio, and as such, the Agency did not have a familiarity with poultry industry. SBA loan specialists affirmed this unfamiliarity, stating that they were not structured or resourced to develop a knowledge base on the poultry industry. Further, SBA relied on the knowledge of lenders to properly underwrite the loans for delegated lending decisions.

Conclusion

A key component of SBA’s mission is to maintain and strengthen the Nation’s economy by enabling the establishment and vitality of small businesses. One of SBA’s goals is to grow businesses and create jobs by expanding access to capital and fuel high-growth small businesses and startups to drive innovation. As previously noted, the 7(a) Loan Program is SBA’s primary program for helping startup and existing small businesses. Growers used this program to finance their facilities and meet contractual obligations of large businesses, that is, the integrators.

We found that integrators exercised significant control over the growers’ operations, broiler houses, equipment, and grounds. In addition, we found that the growers’ economic viability and facility value depended on a performing contract with the integrator. As such, affiliation was evident. We believe this level of control was sufficient evidence to find that from FY 2012 to FY 2016 SBA guaranteed approximately \$1.8 billion in loans that may be ineligible under contemporaneous and current regulations.

⁴ It is important to note that SBA was not able to locate the grower–integrator contract that was the basis of this decision, and as such, the actual terms of the contract are no longer known.

⁵ 13 CFR 121.301(f)(4).

Recommendations

We recommend that the Associate Administrator for the Office of Capital Access:

1. Review the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination given the apparent affiliation based upon comprehensive contractual, oversight, and market control, and take the appropriate corrective action(s).
2. Review the arrangements between integrators and growers under the revised regulations, and establish and implement controls, such as supplemental guidance, to ensure SBA loan specialists and lenders make appropriate affiliation determinations.

Analysis of Agency Response

SBA management agreed with both recommendations. They plan to implement the corrective actions by August 31, 2018.

In its final response, SBA noted the report inaccurately stated loans made by the delegated lenders undergo a limited review by SBA prior to disbursement. SBA further suggested we change the statement for accuracy. However, the information stated in the report is an accurate depiction from SBA's SOP 50 10 5, which states that such loans receive a brief eligibility review. In subsequent correspondence, SBA clarified that the reviews cited in their policy are automated via SBA's electronic intake system, which includes automated rules and controls, with lender self-certification.

The Agency's response is included in its entirety in Appendix II.

Summary of Actions Necessary to Close the Recommendations

This section provides the status of recommendations and the actions necessary to close them.

1. **Resolved.** SBA management concurred with our recommendation and will perform a review of the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made proper size determinations under applicable policies and requirements. SBA will document their findings and follow up with OIG upon completion of their review. This recommendation can be closed when SBA management provides evidence that they completed the review, which includes review findings, and any appropriate actions taken.
2. **Resolved.** SBA management concurred with our recommendation and will review the arrangements between integrators and growers in light of the current affiliation rules and regulations. If needed, SBA will establish and implement controls or supplemental guidance to ensure that SBA loan specialists and lenders make appropriate affiliation determinations. This recommendation can be closed when SBA management provides evidence that the review was completed, including their findings and any applicable controls or guidance established as a result of the review.

Appendix I: Objective, Scope, and Methodology

Our evaluation objective was to determine whether 7(a) loans made to poultry farmers (growers) met the statutory, regulatory, and SBA requirements for eligibility.

To accomplish our objective we reviewed Federal laws and regulations, SBA policies and procedures governing the 7(a) Loan Program, files of performing and defaulted loans, as well as grower–integrator contracts, agreements, and communications. We further reviewed USDA’s loan program guidance, industry-related economic and analytic publications, relevant publications from state university agricultural extensions, and publications from industry trade associations. We also reviewed SBA internal communications, guidance, and selected SBA Office of Credit Risk Management lender reviews.

We interviewed officials and staff from the SBA Office of Capital Access, SBA Office of General Counsel, USDA Economic Research Service, USDA National Agricultural Statistics Service, USDA Farm Service Agency, USDA Office of Rural Development, and the USDA Office of Inspector General. We also interviewed executives and loan officers at various lending institutions, certified assessors, integrators, and growers.

We analyzed the population of 7(a) loans made to agricultural enterprises, and to the agricultural subset of poultry farmers, to obtain an understanding of the SBA loan portfolio, and its characteristics, for FYs 2012 through 2016. This population was limited to approved regular 7(a), Certified Lender Program, and Preferred Lender Program loans. Further, for this analysis, we defined agricultural enterprises to include North American Industry Classification System (NAICS) codes 111110 through 114210. The subset of poultry farmers was defined with NAICS codes 112320 and 112390. From this population, we judgmentally selected a sample of 11 loans; this sample was populated by loans at either the median size or the largest size for its fiscal year. We used this sample to guide a review of loan files, grower contracts, and grower–integrator communications, and interview parties to these loans. Further, we reviewed a sample of defaulted poultry loans to understand the degree to which integrator contracts affect facility value.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency’s quality standards for inspection and evaluation. These standards require that we adequately plan inspections; present all factual data accurately, fairly, and objectively; and present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objective.

Use of Computer-Processed Data

We relied on information from SBA’s Mainframe Loan Accounting System to obtain multiple data sets on SBA 7(a) loans. Previous OIG engagements have verified that the information maintained in this system was reasonably reliable. Further, data elements associated to the reviewed 7(a) loans were verified against source documents. As a result, we believe the information was reliable for the purposes of this evaluation.

Appendix II: Agency Comments



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

MEMORANDUM
February 16, 2018

To: Hannibal “Mike” Ware
Acting Inspector General

From: William M. Manger
Associate Administrator, Office of Capital Access

Subject: Response to Draft Report on the Evaluation of SBA 7(a) Loans Made to Poultry Farmers, Project No. 17005

Thank you for the opportunity to review the draft audit report on the U.S. Small Business Administration (SBA) 7(a) Loans Made to Poultry Farmers. We appreciate the role that the Office of Inspector General (OIG) plays in assisting management in ensuring that these programs are effectively managed.

SBA’s Office of Capital Access (OCA) takes great effort to ensure compliance with statutory, regulatory, and SBA requirements regarding the eligibility of small business loans. SBA issued Standard Operating Procedure (SOP) 50 10 5(J) on January 1, 2018. This version of the SOP enhances and strengthens the guidance on underwriting loans to farm enterprises, including:

1. Clarifying the prohibition on the use of SBA-guaranteed loan proceeds to obtain excess land that is not used in the operation of the applicant business; and
2. Reducing the maximum maturities of loans to farm enterprises.

OCA notes that the section of the OIG draft report titled “SBA’s 7(a) Loan Program” indicates that 7(a) loans made by delegated Lenders “undergo a limited review by SBA prior to loan disbursement,” which is not accurate. SBA does not perform any level of review of loans approved by delegated Lenders using their delegated authority prior to loan disbursement, as per SBA regulations, 13 CFR § 120.452. That regulation requires that delegated 7(a) Lenders are responsible to independently make all loan decisions, including determining eligibility and creditworthiness; performing loan closings; and complying with all requirements of law and SBA rules and regulations. OCA recommends that OIG change that statement for accuracy.

Management's response to the recommendations in the draft report is noted as follows:

1. Review the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination given the apparent affiliation based upon comprehensive contractual, oversight, and market control, and take the appropriate corrective action(s).

OCA concurs with this recommendation and will perform a review of the 11 loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination under applicable policies and requirements with regard to the 11 loans reviewed. We will document our findings, and follow-up with you upon completion of our review.

2. Review the arrangements between integrators and growers under the revised regulations, and establish and implement controls, such as supplemental guidance, to ensure SBA loan specialists and lenders make appropriate affiliation determinations.

OCA concurs with this recommendation. We will review the arrangements between integrators and growers in light of the current affiliation rules and regulations. If needed, we will establish and implement controls or supplemental guidance to ensure that SBA loan specialists and Lenders make appropriate affiliation determinations.

Again, thank you for the opportunity to review the draft report. Please let us know if you need additional information or have any questions regarding our response.