AUDIT REPORT
PLP OVERSIGHT PROCESS

AUDIT REPORT NUMBER 1-19

September 27, 2001

The findings in this report are the conclusion of the OIG's Auditing Division based on testing of SBA operations. The findings and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or

another agency without permission of the Office of Inspector General.

U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
ISSUE DATE: SEPTEMBER 27, 2001
REPORT NUMBER: 1-19

TO: Janet Tasker, Associate Administrator, Office of Lender Oversight
Jane P. Butler, Associate Administrator, Office of Financial Assistance

FROM: Robert G. Seabrooks
Assistant Inspector General for Auditing

SUBJECT: Audit of the PLP Oversight Process

Attached is a copy of the subject audit report. The report contains five findings and ten recommendations. You agreed with four recommendations, partially agreed with three, and disagreed with three. We accepted one of the partial agreements. The remaining two partial agreements and the three disagreements will be resolved during the audit resolution process. Your comments have been synopsized in the report and included as an attachment.

The findings in this report are the conclusions of the Office of Inspector General's Auditing Division. The findings and recommendations are subject to review and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide your management response to the recommendations within 30 days from the date of this report on the attached SBA Forms 1824, Recommendation Action Sheet. The SBA Form 1824 should be sent to:

Audit Manager
SBA OIG / Atlanta Field Office, Suite 1803
233 Peachtree Street, NE
Atlanta, Georgia 30303

Any questions you may have regarding this report may be directed to Garry Duncan, Director, Credit Programs Group, at 202-205-7732.

Attachment

cc: ADA/Capital Access

AUDIT REPORT
PLP OVERSIGHT PROCESS

Table of Contents

SUMMARY

Under the Preferred Lender Program (PLP or program), the Small Business Administration (SBA) authorizes designated lenders to approve Federally guaranteed loans without prior SBA credit approval. In 1996, Congress passed Public Law 104-208 requiring SBA to conduct an annual assessment of preferred lender participation in the program to include lender loans, defaults, and recoveries. To comply with the law, SBA implemented the preferred lender compliance review process in fiscal year 1998. An Office of Lender Oversight was then established in August 1999 to ensure that the oversight system, among other things, provided a more effective means of identifying risk to the Federal government.

The audit objective was to determine if SBA's oversight of the preferred lender process ensures lenders are properly selected for participation in the PLP program and identifies lenders not processing, servicing, and liquidating loans in accordance with SBA policies and procedures.

We determined that program oversight needs improvement to ensure lenders are properly selected for participation and to identify those not in compliance with SBA guidelines. Specifically, the audit disclosed:

- All PLP lenders were not selected for review and their past due, delinquent, and liquidation status loans were not adequately evaluated.
- Lender participation in the program could be better assessed if the annual PLP review process considered financial and lender-based risk factors.
- PLP Lender Evaluation Worksheets allowed (1) lenders who did not meet performance benchmarks to obtain passing scores and (2) district offices to provide unwarranted scores.
- Annual lender reviews were not coordinated with the PLP renewal process.
- There was no documentation that safety and soundness examination results for non-bank lenders were considered during the renewal process.

We recommend that the Associate Administrator for Lender Oversight, in coordination with the Associate Administrator for Financial Assistance, make improvements in the areas of:

- selecting lenders and loans for review,
- emphasizing performance benchmarks and credit quality in the annual review process,
- scoring annual reviews and lender evaluation worksheets,
- coordinating annual PLP reviews and lender renewal dates, and
- informing district offices of safety and soundness examination results for non-bank lenders and documenting the results in the annual renewal process.

The associate administrators agreed with the recommendations concerning selecting lenders for review, scoring annual reviews, coordinating annual PLP reviews and lender renewal dates, and documenting safety and soundness examination results in the annual renewal process.

They partially agreed with the recommendations concerning emphasizing performance benchmarks in the annual review scoring process and informing district offices of safety and soundness examination results for non-bank lenders. They disagreed with recommendations concerning selecting loans for review and scoring lender evaluation worksheets.

INTRODUCTION

A. Background

SBA's Preferred Lender Program authorizes designated lenders to approve Federally guaranteed loans without prior SBA credit approval. The program has expanded significantly in recent years and now includes more than 500 lenders who account for a substantial portion of the Agency's business loan volume. In 1996, Congress passed Public Law 104-208 requiring SBA to conduct an annual PLP program review. As a part of its 5-year strategic plan, SBA re-engineered its oversight system with the intent of implementing an effective oversight function of internal and external operations and to provide a more effective means of identifying and reducing risk to the Federal government.

Two components of SBA's framework for oversight are the Risk Management Committee (RMC) and the Office of Lender Oversight (OLO). The RMC established a loan performance benchmarking system to flag deviations from normal performance of individual lenders. The benchmarks are based directly on financial risk. Their key value is to identify historically marginal lenders requiring detailed analysis and corrective action plans.

The OLO, a component of the Office of Capital Access, is responsible for the lender oversight program. The oversight program is defined as a "framework through which the SBA reviews and anticipates both financial and lender-based risks to the portfolio." In order to effectively identify and reduce risk, SBA first had to define the term. Risk, per SBA, is the difference between the amount that an investment (loan) promises to return and the expected value of the cash flows from the investment. SBA further states that the guaranteed portion of the loan portfolio is the actual value at risk. SBA divides risk in to two types--financial and lender-based.

- Financial risk is the composite risk posed by loans and guarantees actually booked to SBA's portfolio and how they perform over time.
- Lender-based risk involves potential financial injury due to the lender's failure to perform its role properly and prudently. For oversight purposes this risk has three components:

  - the actual financial risk associated with the loans that the individual lender has <u>already booked</u> to the SBA portfolio,
  - the potential financial risk associated with the loans that the lender <u>is booking</u> and <u>will book</u>, and
  - the public policy risk associated with lenders that do not comply with SBA regulations, policies, and procedures.

One aspect of the oversight program is the PLP annual review process. Annual reviews either are conducted at the lender's location using contract personnel supervised by an SBA employee serving as "examiner-in-charge" or at the contractor's office as desk reviews. Desk reviews may be done when the lender has approved 12 or fewer loans in the prior fiscal year.

The first cycle of reviews was completed in March 1999. The second and third cycles began in April 1999 and April 2000, respectively, with completion dates in March of the subsequent year.

SBA evaluates lender performance by using a six-section checklist composed of application forms, eligibility, credit quality, loan authorization and closing, servicing and liquidation actions, and oversight. Questions in each section require a yes, no, or not applicable answer. The sections vary in the number of questions and the points assigned. Based on the scoring results, lenders are assigned one of the following levels of compliance: "substantially in compliance," "generally in compliance," "minimally in compliance," or "not in compliance." The following table shows the number of annual reviews completed and the average compliance ratings for each review cycle:

"Lender Reviews and Lenders' Final Scores"

COMPLIANCE	First Cycle		Second Cycle		Third Cycle*	
RATING	#	%	#	%	#	%
Substantially	**84**	**30.3**	**100**	**33.0**	**136**	**67.7**
Generally	**144**	**52.0**	**147**	**48.5**	**42**	**20.9**
Minimally	**34**	**12.3**	**37**	**12.2**	**15**	**7.5**
Non-Compliance	**15**	**5.4**	**19**	**6.3**	**8**	**4.0**

Legend:
- (green) = Substantially or Generally in Compliance
- (yellow) = Minimally in Compliance
- (red) = Not in Compliance

* As of November 2000, electronically scored.

Another process used to evaluate lenders is the Lender Evaluation Worksheet (worksheet). Effective September 2000, SBA established the worksheet for use by district offices to make recommendations regarding a lender's nomination, renewal, extension, or expansion in the program. The worksheet was designed to standardize the analysis of lender's performance, provide an early warning system that could be used in lender oversight, and reinforce the relationship of district offices with PLP lenders.

B. Audit Objective

The objective of the audit was to determine if SBA's oversight of the preferred lender process:

- ensures lenders are properly selected for participation in the program, and
- identifies lenders not processing, servicing, and liquidating loans in accordance with SBA's policies and procedures.

C. Scope and Methodology

We conducted audit fieldwork at the Kansas City Review Branch (Review Branch), the Sacramento Loan Processing Center (PLP Center), at four PLP lenders, and at SBA headquarters. The audit included reviews of loans approved during the periods October 1, 1998, to September 30, 1999; PLP Agreements expired during August 1, 1999, to October 31, 2000; and Lenders' Evaluation Worksheets processed on or after September 7, 2000.

To answer the audit objectives, we conducted comparative analyses of data at the Review Branch and the PLP Center, tested judgmentally selected lender reviews, made site visits to lenders and SBA offices and interviewed SBA officials and lenders' representatives. Also, we reviewed the results of management assessment processes conducted at the PLP Center and the Review Branch for internal control evaluation purposes. Fieldwork was performed from June 2000 through February 2001. The audit was performed in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

FINDING 1 The Process for Lender and Loan Selection Needs Improvement

The annual review process needs improvement to ensure that all lenders and loans subject to review are included. Standard operating procedures (SOP) require that lenders are selected for review based on their method of processing and servicing loans and that loans are selected based on status categories. The SOP requirements were not met because:

- there was no system in place to identify which lenders process and service loans centrally,
- past-due and delinquent loans were excluded from the definition of servicing.

Additionally, the size of the review sample for some lenders was not sufficient to assess fully the lender's performance. As a result, SBA could not assure that all lenders participating in the program were processing, servicing, and liquidating loans in compliance with established policies and procedures.

Lender and loan review process

The review guide for Loan Policy and Program Oversight (SOP 50 50 4B) states that lenders with a centralized processing and servicing center in one location would have a single annual review. The determination as to whether a lender has centralized processing and servicing is made based on data from the prior examination or from other information supplied by the lender. Once this determination is made, the loans for the lender and all its locations (branches and affiliates) are grouped together for one review if centralized processing exists. For the third round of PLP reviews, approximately 60 of 331 were to be accomplished at centralized processing centers.

The SOP further states that the number of loans to be reviewed will equal 20 percent of the lender's loan approval volume for the previous fiscal year (up to a maximum of 50) and that 75 percent of the review sample must be approvals from the previous fiscal year; 20 percent must be in liquidation status; and, 5 percent must be in active servicing. Lastly, the SOP requires that the review sample include at least one loan approval, one loan in liquidation status, and one loan in servicing status unless there is not a loan in one of these categories.

Lenders subject to review not selected

To determine if lenders were appropriately categorized as having centralized processing and servicing, we judgmentally selected seven centralized reviews performed during the third round. We contacted the seven primary lenders and were told that five did not have centralized processing and servicing. The following table shows the results of our telephone contacts.

Lenders Without Centralization			
Lender Name	**Centralized**	**Structure**	**Locations not reviewed**
Wells Fargo Bank	**No**	**Four processing and servicing centers**	9
Firstar Bank, N. A.	**No**	**Two processing and servicing centers**	4
National City Bank of Pennsylvania	**No**	**Two processing and servicing centers**	3
Imperial Bank	**No**	**Five processing centers and one servicing center**	1
Zions First National Bank	**No**	**Utah– processing at branches and one servicing center. California – one processing and service center.**	1

As a result of the misclassification of five lenders as having centralized processing and servicing, 18 affiliated lenders were not reviewed. The reviews were not done because SBA did not have a reliable system for identifying lenders that use centralized processing and servicing. SBA personnel stated that lenders were grouped according to whether the primary lender and branches had the same primary contact person's name. Information regarding the name of the primary contact person was obtained from lenders' questionnaires and prior reviews.

Loans subject to review not selected

To determine if the required number and categories of loans were reviewed, we selected 10 reviews involving 531 loans evaluated during the third round of PLP reviews. Seven of the reviews were accomplished at lender locations and three were desk reviews. The results showed that loans classified as past due and delinquent were not included in the reviews. Past-due and delinquent loans are those for which the borrower has missed a scheduled payment by at least 30 days. Also, loans in liquidation status were not included in desk reviews, and some samples were too small to adequately assess lender performance.

Past-due and delinquent loans

None of the 10 reviews included past due or delinquent loans even though loans in this status were available. By not including this category of loans in reviews, the lender's ability to service loans could not be fully determined. Review Branch personnel stated that past-due and delinquent loans were not intentionally excluded from the selected samples.

Loans in liquidation status

The three desk reviews included only one or two loans. Our analysis of each lender's portfolio at the time the review was made showed that loans in liquidation status were available in two of the lender's portfolios. By not reviewing liquidated loans, a complete assessment of the lender's compliance level and program participation could not be made.

Review sample size

Of 331 third round reviews accomplished or scheduled, 92 (28 percent) included only 1 or 2 loans. We examined the portfolios of 30 of the 92 lenders and found 8 (27 percent) had past due or liquidated loans. By selecting only one or two loans for review, the examiners could not properly assess the lender's performance for each of the required loan categories (current, servicing, and liquidation). SBA personnel stated that their intent was to have 25 percent of the sample include loans in servicing or liquidation status, but limit the sample size of one or two loans to minimize the cost to the smaller lenders.

RECOMMENDATIONS

We recommend that the Associate Administrator for Lender Oversight in coordination with the Associate Administrator for Financial Assistance:

1A. Develop and implement a system for identifying lenders that use centralized processing and servicing.
1B. Define the term "servicing" to include past-due and delinquent loans.
1C. Require sample sizes to include at least one loan from recent approvals, one in liquidation status, and one in past-due or delinquent status, where applicable.

Management Comments

The associate administrators agreed with recommendation 1A and stated that the implementation of the Partner Information Management System will address the identification of lenders with centralized processing and servicing by providing more information about lenders, their links with subsidiaries, and their relationships with SBA.

The associate administrators disagreed with recommendation 1B because they believe the term servicing already includes any loans that are past due and delinquent. They added that the selection of loans for review is a random process and to specifically skew a sample to include past due and delinquent loans would not provide a fair and reasoned assessment of how a lender is performing.

The associate administrators partially agreed with recommendation 1C and stated that beginning with the fourth cycle of PLP reviews, the minimum sample size will be expanded to five loans. However, for the reasons previous stated, they do not believe it is necessary to require at least one loan in past due and one loan in delinquent status be included among the five loans selected.

Evaluation of management's comments

Management's response to recommendation 1A is acceptable. Concerning recommendation 1B, we agreed that SOP 50 50 4A provides a definition of the term servicing that considers loans in past due and delinquent status. For this reason we will partially accept their response. We disagree with their response to recommendation 1C and the portion of recommendation 1B that addresses the inclusion of past due and delinquent loans. It should be noted that the definition of servicing requires the monitoring of the borrower loan payment history, recognizing potential problems early, and determining solutions and taking appropriate actions. SBA cannot adequately evaluate lender compliance with these requirements without reviewing loans in past due and delinquent status. The selection of these loans will not skew the results, but will allow SBA to determine if lenders' actions meet procedural requirements to be prudent and commercially reasonable.

FINDING 2 The Annual Review Scoring Process Should Consider Lender Performance

Lender participation in the preferred lender program could be better assessed if the annual review scoring process included a complete assessment of financial and lender-based risks. Public Law 104-208 requires SBA to conduct an annual assessment of all PLP lenders. As a result, an oversight program was established with the intent of determining financial and lender-based risk. The annual review process, however, was only designed to assess lender compliance with SBA guidance. The absence of a full evaluation of financial and lender-based risk prevents a full assessment of the quality of each lender's participation in the program.

Lender compliance review

It is SBA's intention, through the oversight program, to review and anticipate both financial and lender-based risk to the portfolio. Financial risk is defined as composite risk posed by loans and guarantees actually booked to SBA's portfolio and how the loans have performed over time. Lender-based risk is defined as (i) loans that the lender has recently made and will be making, (ii) loans already booked to the SBA portfolio, and (iii) public policy risk associated with lender's noncompliance.

The annual review process is a compliance review designed to assess only the first and third elements of lender-based risk. Financial risk and the second element of lender-based risk (loans already booked) are not assessed because performance benchmarks were not considered and loans in servicing categories were not included in the review. Desk reviews did not always include loans in liquidation status. Additionally, scoring weights do not sufficiently emphasize financial or public policy risk.

Lender performance benchmarks not considered

Scoring for the annual review process does not include lender performance benchmark results. Performance benchmarks were established by SBA's Risk Management Committee to assess lender performance. We observed that ratings resulting from the annual reviews frequently did not reflect the lender's failure to achieve what SBA has established as parameters for satisfactory performance. As the benchmarks are based directly on financial risk, their exclusion from the annual review scoring process prevents it from assessing the financial and lender-based risk for each lender.

A comparison of the third round annual review results and lender benchmark performance disclosed 17 lenders who obtained ratings of "substantially or generally in compliance" but who missed at least one of the five benchmarks. The following table shows some examples.

Lenders Rated "Substantially in Compliance"

Lender	Benchmark type	%	Benchmark type	%	Lender Percentages (%)	
FOIA EX. 4.	Currency Rate	70.0	Liquidation Rate	7.0	66.3	8.5
FOIA EX. 4.	Currency Rate	70.0	Liquidation Rate	7.0	54.5	19.2
FOIA EX. 4.	Default (Purchase) Rate	9.0	Liquidation Rate	7.0	13.6	9.3

Lender Rated "Generally in Compliance"

Lender	Benchmark type	%	Benchmark type	%	Lender Percentages (%)	
FOIA EX. 4.	Default (Purchase) Rate	9.0	Liquidation Rate	7.0	11.5	8.3
FOIA EX. 4.	Default (Purchase) Rate	9.0	Charge-Off (Loss) Rate	6.0	9.4	9.5
FOIA EX. 4.	Default (Purchase) Rate	9.0	Liquidation Rate	7.0	11.0	15.3

Limited review of loans

The annual review process does not fully consider the lender-based risk associated with loans in servicing or liquidation status. We re-examined three loan files in liquidation status that were originally reviewed in round three. For each of these loans, we noted that four of the six sections of the checklist were not completed. When we completed the four sections, two instances of lender noncompliance in the area of credit quality were identified.

The Chief of the Kansas City Review Branch stated that these were liquidation cases and credit elements were not reviewed. We noted that SOP 50 50 4B does not require examiners to complete the Eligibility, Credit Quality, Loan Authorization, and Closing sections of the checklist when reviewing loans in servicing or liquidation status. By not reviewing all sections of the checklist, management could not identify the reduced credit quality for these loans and the potential risk they posed.

Scoring weights

The assignment of points to certain eligibility, credit quality, closing, and servicing questions may not result in a score that truly reflects the lender's level of compliance or SBA's risk. SBA management stated that questions were weighted (highest to lowest) according to the following structure: statute, regulation and SOP.

We concluded that this basis does not appropriately consider risk to the Federal government. For example, in the eligibility section of the checklist, points assigned to a question concerning a "business of a sexually prurient nature" were as much as 4 times greater than points assigned to each of 19 other eligibility questions. Management stated that this question was public policy and should be weighted more than other eligibility questions. We found no analysis that showed a business of a sexually prurient nature created a greater financial or public policy risk than other ineligible businesses.

In the credit quality section, we found points assigned to a question about the availability of working capital had only half the value of each of six other questions concerning items such as capitalization, management ability and collateral. The point disparity does not reflect the risk associated with a business with inadequate working capital. SBA SOP 50 11 states that working capital is essential for a company to meet continuous operational needs and its adequacy influences the firm's ability to remain financially viable.

RECOMMENDATIONS

We recommend that the Associate Administrator for Lender Oversight in coordination with the Associate Administrator for Financial Assistance take the following actions:

2A. Require that all applicable sections of the annual review checklist be completed for each loan reviewed.

2B. Revise the annual review process scoring system to include an assessment of lender performance benchmarks.

2C. Revise the scoring for the annual review process to ensure that the volume and weighting of point values of other questions does not offset low scores for eligibility and credit quality.

Management Comments

The associate administrators disagree with recommendation 2A and stated that the Office of Lender Oversight believes that all applicable sections of the annual review checklist are completed for each loan reviewed.

The associate administrators stated that they partially agreed with recommendation 2B. The Office of Lender Oversight stated that it is currently reviewing the annual review process to determine how best to assess lender effectiveness and expects to obtain contractor assistance to assist in this evaluation process. The Office of Financial Assistance (OFA) stated that performance benchmarks are considered when making determinations about lender participation in the preferred lender program, but OFA does not believe that the benchmarks should be included in the compliance review scoring because it believes an effective evaluation requires both knowledge of lender compliance and lender portfolio performance. OFA stated that if this information were combined in a single score, a valuable assessment tool would be lost.

The associate administrators agreed with recommendation 2C and stated that contract services will be obtained to assist in the evaluation and enhancement of the existing PLP compliance review process and that the scoring model and its weights will be one aspect of the work to be done.

Evaluation of Management Comments

Concerning recommendation 2A, we disagree with management's statement that all applicable sections of the annual review checklist are completed for each loan reviewed. Audit tests of three PLP loans selected for liquidation compliance during the annual review revealed that the contract reviewers only completed the liquidation sections of the annual review checklists. We believe the sample results are representative of all loans included in the annual review process. Also, Appendix 30, SOP 50 50 4B required that for loans selected as "Servicing" or "Liquidation" loans the reviewer need not complete all of the other sections (credit quality) of the loan review. We believe that by not completing all sections of the PLP annual review checklist, management cannot identify the reduced credit quality for these loans and the potential risk they posed to the SBA.

The response to recommendation 2B appears to be a disagreement as opposed to a partial agreement. Both offices appear to support the use of performance benchmarks as an assessment tool; however, neither agreed to include performance benchmarks in the annual review scoring process. The concerns of the OFA about combining compliance and performance benchmarks into a single score and therefore losing an assessment tool can be overcome by scoring the compliance component and the performance benchmarks component separately. The scores could subsequently be combined into one score for the overall annual review result. Our concern with the associate administrators' comments is that they appear to place performance benchmarks as a supplement to compliance and, therefore, do not ensure that the annual review process will be a true measure of risk.

Concerning recommendation 2C, the response is acceptable but a date when the revision of the scoring process will be completed and implemented should be provided.

FINDING 3 Lender Evaluation Worksheet Scoring Should Reflect Risk

Scoring for the Lender Evaluation Worksheet (worksheet) needs to be modified to better reflect risk. The oversight program is a framework for anticipating and reviewing financial and lender-based risk to the portfolio. The worksheet, a component of the oversight program, does not assist in this objective because it allows lenders who do not meet performance benchmarks (financial risk and lender-based risk parameters) to obtain a passing score and allows district offices to award points that are not warranted. This occurs because the worksheet's design does not emphasize performance benchmarks. If the worksheet placed greater emphasis on financial and lender-based risk, it would allow OLO to more effectively assess each lender's participation in the program and provide better information on which to gauge expected risk to better review and anticipate risk.

Worksheet preparation

The worksheet is divided into six sections: compliance, lending, credit, early warning and trend analysis, marketing, and economic development, with a total of 20 elements divided among the sections. Of the 20 elements, 15 have points awarded automatically based on information supplied by the PLP Center and formulas built into the worksheet. For the remaining five elements, points are awarded at the discretion of the district office based on its assessment of the lender. A lender must score 75 or more of a possible 100 points for a positive recommendation (65 points for nominations during FY 2001 and for the lender's first renewal before September 1, 2002).

Performance benchmark scoring

Worksheet scores do not emphasize financial and lender-based risk. The performance benchmarks are part of the credit quality section and have a maximum score value of 20 points. This represents only one-fifth of the maximum point total for the worksheet. Theoretically, a lender could receive zero points for its performance benchmarks and still obtain a passing score.

Our analysis of 31 worksheets completed between September 2000 and February 2001 (for nominations and renewals), applicable to 17 lenders, showed that 4 lenders obtained passing scores even though they did not receive the maximum points awarded for performance benchmarks. Specifically:

- A lender received a score of 74 points even though it only scored nine points for the three performance benchmark elements,
- A lender received a score of 80 points even though it only scored six points for the three performance benchmark element,
- A lender received a score of 78 points even though it only scored 13 points for the three performance benchmarks,
- A lender received a score of 72 points even though it only scored 16 points for the three performance benchmarks.

Discretionary scoring

In three of the four aforementioned examples, the lender's passing score included the maximum or near maximum scores in the elements based on district office discretion. There are discretionary elements in three of the six sections of the worksheet with a maximum score of 28 points. A lender who receives the maximum points from discretionary elements only needs 47 points (65 percent of the remaining points) from the other elements (including performance benchmarks) to receive a passing score.

We were informed of one lender who passed because the district office provided unearned discretionary points. The district director stated that initially the lender scored less than 65 points, so additional points were added to allow the lender to obtain a passing score.

RECOMMENDATION

We recommend that the Associate Administrator for Lender Oversight in coordination with the Associate Administrator for Financial Assistance take the following action:

3A. Revise the Lender Evaluation Worksheet scoring to ensure that lenders who score less than 75 percent of the points available for performance benchmarks cannot achieve a passing score to provide for a full assessment of lender performance.

Management Comments

The associate administrators disagreed with the recommendation and stated that reviews, as opposed to worksheets, are better suited for addressing lender-based risk. They stated that the worksheets were developed to assist the program by providing a uniform method for communicating field office assessments of lender PLP activity. They also commented that lender performance data has no greater bearing on determining participation than any other evaluation component, and that the report does not present any empirical evidence supporting a 75 percent threshold for performance data. Lastly, they replied that worksheets have failsafe triggers that are tied to lender compliance and loan volume.

Evaluation of Management's Comments

We disagree with the administrators' positions that annual reviews are better suited to address lender-based risk. As stated in finding 2, the annual reviews currently do not include performance benchmarks in the scoring process and, therefore, do not adequately address lender-based risk. The SBA Procedural Notice states that the worksheets can be used as a part of the oversight process. As stated in the finding, the oversight process is a framework for anticipating and reviewing risk and, therefore, the worksheets should address risk to SBA. Performance benchmarks were developed specifically to address risk. Items such as lender compliance and loan volume do not address risk. Lenders with low performance benchmarks and, therefore high risk, should not be able to achieve a passing score for nomination, renewal, or expansion due to field office assessments of the lender's local activity. As discussed in the finding, these assessments can be biased. The 75 percent score for the performance benchmarks section of the worksheet is presented as one possible criterion. An alternative percentage may be acceptable if it reflects an acceptable level of risk.

FINDING 4 Annual Reviews Should be Coordinated with Lender PLP Renewals

Lender annual reviews were not coordinated with lender renewal dates. The annual review includes a determination of a lender's compliance with applicable SBA regulations and policies. This determination is considered when the lender's PLP status is renewed. Because OLO did not coordinate the scheduling of the annual reviews with the renewal dates, renewal decisions were sometimes made without current information about the lender's compliance level, and renewal decisions did not always agree with the results of the annual reviews.

Title 13 of the Code of Federal Regulations states that lenders are certified to operate within the program for no more than 2 years. At the end of the 2-year period, the lender's PLP status is either renewed or denied based on, among other factors, its performance, PLP activity, and compliance level.

Lenders with PLP status are reviewed annually for a determination of their compliance level and are rated either substantially, generally, minimally, or not in compliance. Although SBA tries to schedule the annual reviews 12 months apart, the elapsed time between reviews may vary depending upon the availability of review staff and the lender's availability.

Our review of 113 renewal actions done between August 1, 1999, to October 31, 2000, showed that there was no coordination between the renewal dates and the annual reviews. The elapsed time between the annual reviews considered in the renewal decision and the renewal dates ranged from 16 to 504 days with most annual reviews occurring more than 181 elapsed days before the renewal date. Due to the elapsed time, the renewal decision for these lenders may not have been representative of the lender's compliance level. Details are shown in the following chart.

Elapsed Days	0 to 120	121 to 180	181 to 270	271 to 365	366 +
Annual Reviews	26	16	29	25	16

We also analyzed the elapsed time between the renewal date and the subsequent annual reviews (the next review done after the renewal date) to determine if these reviews were close to the renewal date. Six of the subsequent annual reviews were started before the renewal date and 32 within 120 days of the renewal date. This information shows that for at least 38 lenders the renewal decisions could have been based on current annual review results with some adjustments to either the annual review date or the renewal date.

The renewal decisions did not reflect the results of subsequent annual reviews for five lenders. Three of these lenders had already been renewed when the subsequent annual review, done less than 30 days after the renewal date, showed that their compliance levels had decreased to only minimally or not in compliance. Another lender, whose prior annual review was only minimal, was not renewed but received a subsequent review anyway. The lender was rated substantially in compliance based on the subsequent review. These five lenders are shown in the following table.

"Timing of Annual Reviews with Lender Renewal"

Lender's Name	Location	Round 1 Review Results	PLP Expiration Date	Round 2 Review Date	Round 2 Review Results
FOIA EX. 4		Minimal	09/29/99	10/18/99	Substantial
		General	09/01/99	09/06/99	Minimal
		General	09/18/99	10/08/99	Minimal
		N/A	08/18/99	08/30/99	Not
		General	10/19/99	03/27/00	Minimal

RECOMMENDATION

We recommend that the Associate Administrator for Lender Oversight in coordination with the Associate Administrator of Financial Assistance:

4A. Establish procedures to coordinate annual lender PLP reviews and PLP renewal dates to ensure those annual PLP results are available and considered before PLP status is renewed.

Management Comments

The associate administrators agreed with the recommendation.

Evaluation of Management's Comments

The response from management is acceptable.

FINDING 5 Safety and Soundness Examination Results Should be Provided to Field Offices

SBA district offices were not provided non-bank lender safety and soundness examination results for inclusion in their renewal recommendations. Further, alternative procedures for considering the examination results were not documented. Standard operating procedures require renewal recommendations to include comments that may impact the renewal decision. Management stated that examination results were not provided to field activities due to security concerns but were considered in the renewal process. If the examination results are not considered, improper renewal decisions may be made.

Standard Operating Procedure 50 10 (4) states that during the renewal process for PLP lenders, the PLP Center will obtain comments from all district offices where the lender has PLP status, will analyze the comments, and send the comments with a recommendation to the Office of Financial Assistance. Upon receipt of a recommendation package, the Office decides whether to renew or not to renew the lender. Among the comments to be made by the district offices should be the identification of any areas of concern.

An area of concern not included in the comments from the field offices was the results of the non-bank lender safety and soundness examinations. Each of these offices indicated that the examination results were not provided to them, so they were unaware of any concerns.

We identified one instance of a lender whose PLP status was renewed after receiving positive recommendations from the field offices but who had negative comments in the examination results. The examination report stated that the lender had weaknesses relating to capital permanence and earnings capacity and had significant internal control weakness. At least one person in a field office stated that its renewal recommendation would have been negative if the examination results had been known.

The AA/FA stated that the examination results were not provided to field offices due to concerns about unauthorized release of the information and that the examination results were considered when the renewal decision was made. However, documentation of this consideration was not available.

RECOMMENDATIONS

We recommend that the Associate Administrator for Lender Oversight in coordination with the Associate Administrator for Financial Assistance take the following actions:

5A. Provide the results of the non-bank lender safety and soundness examinations to the appropriate field offices.

5B. Require the consideration of the examination results to be documented in the recommendation packages submitted to the Office of Financial Assistance.

Management Comments

The associate administrators partially agreed with recommendation 5A and fully agreed recommendation 5B. For recommendation 5A, they stated that the Office of Lender Oversight is considering preparing a memorandum summarizing the material finding and recommendations in the report, and providing the summary to the appropriate field offices. They believe this approach would allow the sharing of information while maintaining confidentiality.

Evaluation of Management's Comments

Management's comments for recommendation 5B are acceptable. Concerning recommendation 5A, management's response indicates that the summarization of the safety and soundness examination results is only under consideration. This approach would be acceptable if the OLO agreed to implement this method and provided an implementation milestone date.

OTHER MATTERS

The following matter was noted during our audit. It is not directly related to the audit objective and, therefore, was not included as a finding. We believe, however, that the condition is germane to the PLP Oversight process and should be considered by SBA management.

PLP review results did not reflect one lender's noncompliance with SBA's requirement to verify business financial information submitted in support of loan applications against tax returns submitted to the Internal Revenue Service (IRS) and to report discrepancies to SBA. During a PLP review conducted in January 2001, examiners reported they found one loan where the lender had not compared tax returns of a seller submitted financial information. The examiners claimed their comparison of the tax returns to the financial information disclosed substantial differences. Per the examiners, the numbers in the tax return were substantially less than the financials used to process the loan.

It was reported that during the review the lender stated that IRS verification might not have been obtained because the seller had not filed a return. However, because the seller was a regular customer, the lender was able subsequently to obtain the tax returns. During further discussion, the lender implied that it does not comply with the IRS verification requirement. The lender stated that in several cases the financial information provided by applicants was inadequate to establish repayment ability and that about 70 percent of their customers only report (*for tax purposes*) about half their actual income. To overcome this problem, the lender creates new financials based on receipts reviewed during visits to borrowers or sellers.

Our review of the scoring results showed that they did not reflect the noncompliance found for this loan and did not reflect the lender's general noncompliance with this requirement. The lender was given the highest rating possible, "in substantial compliance." By not including identified noncompliances, the intent of the PLP oversight process is undermined. SBA cannot appropriately assess lender participation in the PLP program unless all noncompliances are identified and scored and the level of noncompliance is considered in the overall lender rating.

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

DATE: September 21, 2001

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

Janet A. Tasker

FROM: Janet A. Tasker
Associate Administrator for Lender Oversight

Jane Palsgrove Butler

Jane Palsgrove Butler
Associate Administrator for Financial Assistance

SUBJECT: Management Response to the Draft Audit Report – Audit of the PLP Oversight Process

CC: Jeanne Sclater
Acting Associate Deputy Administrator for Capital Access

Attached please find Management's Response to the Draft Audit Report – Audit of the PLP Oversight Process

Please call either Janet Tasker at (202) 205-3049 or Jane Butler at (202) 205-6490 should you have any questions or need additional information.

Attachment

MANAGEMENT RESPONSE TO
DRAFT AUDIT REPORT – AUDIT OF THE PLP OVERSIGHT PROCESS

FINDING l: The Process for Lender and Loan Selection Needs Improvement

Recommendation lA: Develop and implement a system for identifying lenders that use centralized processing and servicing.

Program Response: Agree

The Office of Lender Oversight (OLO) expects that implementation of the Partner Information Management System (PIMS)-will largely address the issues identified in this regard. PIMS will provide more information about lenders and their links with subsidiaries that will allow for a more comprehensive understanding of a lender's relationships with SBA. In the interim, OLO will assess whether any additiona1 steps are appropriate to ensure that all lenders receive the required reviews.

Recommendation lB: Define the term servicing to include past due and delinquent loans.

Program Response: Disagree

The term servicing already includes any loans that are past due or delinquent. Loans selected for review for servicing purposes are randomly selected from the pool of loans post-closing to liquidation. No loans are specifically excluded by pay status. A sample may be selected that does-not have any past due or delinquent loans but that is not due to the fact that these types of loans were excluded but, rather, that the random sampling process did not select a past due or delinquent loan. To specifically skew a sample to these types of loans, would not provide a fair and reasoned assessment of how a lender is generally performing its servicing functions.

Recommendation 1C: Require the sample sizes to include at least one loan from recent approvals, one in liquidation status, and one in past due or delinquent status, where applicable.

Program Response: Partially Agree

With the fourth cycle of PLP compliance reviews begun in April 2001, the minimum sample size for all types of reviews was expanded to five loans. The distribution of loans to be reviewed is 60% new production; 20% servicing and 20% liquidation. However, there is no requirement that the loans reviewed for servicing must include one loan in a past due or delinquent status. The rationale for this position was discussed above in our response to Recommendation 1B.

FINDING 2: The Annual Review Scoring Process Should Consider Lender Performance

Recommendation 2A: Require that all applicable sections of the annual review checklist be completed for each loan reviewed.

Program Response: Disagree

The Office of Lender Oversight believes that all applicable sections of the annual review checklist are completed for each loan reviewed. For loans approved as PLP loans all sections of the annual review checklist are completed. For loans approved outside of PLP, the eligibility and credit determinations are made by the district office, not the lender. As this process results in a compliance assessment of SBA lender, it would not be appropriate to assess compliance with eligibility and credit decisions that the lender did not make.

Recommendation 2B: Revise the annual review process scoring system to include an assessment of lender performance benchmarks.

Program Response: Partially Agree

The Office of Lender Oversight is currently reviewing the annual PLP compliance review process to determine how to best assess a lender's effectiveness as an SBA lender. We expect that this process will include both performance and compliance as well as operational considerations. Lender Oversight has recently initiated a statement of work to obtain contract services to assist with this evaluation and enhancement of the existing PLP compliance review process.

In the interim, however, it should be noted that a lender's benchmark performance is considered by the Office of Financial Assistance in making determinations about a lender's participation in the PLP program. Further, the Office of Financial Assistance does not believe that the benchmarks should be included in the compliance review scoring because it believes that effective evaluation of a lender requires specific knowledge of both how well a lender is complying with program requirements and how well a lender's loan portfolio is performing. If this information is combined in a single score, a yaluable assessment tool will be lost. Despite this, however, OFA does strongly agree that it is important to have accurate benchmark performance data for evaluation as part of the lender review and as part of PLP action consideration.

Recommendation 2C: Revise the scoring for the annual review process to ensure that the volume and weighting of point values of other questions does not offset low scores for eligibility and credit quality.

Program Response: Agree

As mentioned in recommendation 2B, the Office of Lender Oversight recently initiated a statement of work to obtain contract services to assist with the evaluation and enhancement of the existing PLP compliance review process. Review of the Scoring model and its weights is one aspect of the work to be done by the contractor.

FINDING 3: Lender Evaluation Worksheet Scoring Should Reflect Risk

Recommendation.3A: Revise the Lender Evaluation Worksheet scoring to ensure that lenders who score less than 75 percent of the points available for performance benchmarks cannot achieve a passing score to provide for a full assessment of the lender performance.

Program Response: Disagree

The basis for developing this worksheet tool had nothing to do with PL 104-208 and should not be drawn into this audit of SBA's compliance with the statute. Reviews, as opposed to worksheet evaluations, are better suited to addressing lender-based risk as defined in the statute. As described in its introductory memorandum presented in SBA Procedure Notice 5000-687, the PLP Lender Evaluation Worksheet assists the program by providing a uniform method for communicating field office assessments of a lender's local SBA loan activity as a PLP lender. The objective is to standardize the criteria for evaluating PLP lender participation.

The criteria for making a thorough evaluation of a lender includes, in part, performance data derived from local PLP loan activity. Lender performance data has no greater bearing on determining lender participation than any other component. Not only is there is no empirical evidence presented in the report that supports a threshold of attaining 75% of the possible points available from lender performance data, a 75% threshold has no regulatory support in the program's operating procedures, its regulations, or in the statutes pertaining to PLP. A static 75% threshold ignores the program's need to provide flexibility when local economic distress is occuring in a particular region. Discouraging lenders from participating in a "down" economic climate is counter productive to SBA's ability to deliver programs to those most in need. Finally, revised Lender Evaluation Worksheets already have failsafe triggers which are tied to unsatisfactory lender compliance and insufficient loan volume. These are bona fide criteria specified in § 120.455 of the SBA Regulations for continued lender participation in the program.

Also, please note that the Associate Administrator for Financial Assistance is currently the program official responsible for evaluating initial and continued lender participation in PLP.

FINDING 4: Annual Reviews Should be Coordinated with Lender PLP Renewals

Recommendation 4A: Establish procedures to coordinate annual lender PLP reviews and PLP renewal dates to ensure those annual PLP results are available and considered before PLP status is renewed.

Program. Response: Agree

The Office of Lender Oversight began implementing this recommendation with the commencement of the fourth cycle of PLP Compliance Reviews in April 2001.

FINDING 5: Safety and Soundness Examination Results should be Provided to Field Offices

Recommendation 5A: Provide the results of the non-bank lender safety and soundness examinations to the appropriate field offices.

Program Response: Partially Agree

In presenting this finding, it is our understanding that the non-bank lenders referred to in the audit report are 7(a) participants commonly identified as Small Business Lending Companies ("SBLCs"). We wish to distinguish these participants from other non-bank lenders such as credit unions, business-and-industrial development companies, Farm Credit system members, and other state-regulated finance companies.

The reports of examination are highly confidential documents and are protected from public disclosure under the Freedom of Information Act. The need for tight controls over their distribution is essential to ensure that this protection is preserved.

At the same time, we believe that it is important for field office staff to be knowledgeable of the results of safety and soundness reviews of SBLCs as the field is SBA's point of contact with individual lenders and makes recommendations regarding an SLBC's continued involvement in the Preferred Lender Program.

Currently, field office staff are offered the opportunity to attend both entrance and exit conferences involving safety and soundness examinations for each SBLC. The Office of Lender Oversight is considering whether or not to prepare a memorandum that summarizes the material findings and recommendations included in the report of examination. This summary would be provided to the appropriate field office staff having involvement with individual SBLCs. This approach would allow for the sharing of relevant and appropriate information on an SBLC's safety and soundness examination while still maintaining the integrity of the highly confidential nature of the reports of examination.

Recommendation 5B: Require the consideration of the examination results to be documented in the recommendation packages submitted to the Office of Financial Assistance.

Program Response: Agree

OFA has assigned program staff responsible for SBLC oversight to provide written comments and a recommendation on all PLP actions involving SBLCs. These comments include pertinent information presented in the SBLC's most recent safety and soundness examination, along with the status of any required actions arising from supervisory recommendations made by the program official.

Also, please note that the Associate Administrator for Financial Assistance is currently the-program official responsible for evaluating initial and continued lender participation in PLP.

APPENDIX B

Office of Inspector General
Audit Report Distribution

Recipient	Number of Copies
Administrator	1
Deputy Administrator	1
Associate Administrator for Lender Oversight	1
Associate Administrator for Field Operations	1
Associate Administrator for Financial Assistance	1
Financial Administrative Staff Attention: Jeff Brown	1
General Counsel	2
General Accounting Office	1