SBA SOP 51 00

On-Site Lender Reviews/Examinations

Office of Lender Oversight
U.S. Small Business Administration

SMALL BUSINESS ADMINISTRATION
STANDARD OPERATING PROCEDURE

SUBJECT:	S.O.P.		REV
	SECTION	NO.	
On-Site Lender Reviews/Examinations	51	00	

INTRODUCTION

1. Purpose. This SOP establishes procedures for on-site risk-based lender reviews and safety and soundness examinations. It contains separate guidance and procedures for 7(a) Lenders and CDCs.

2. Personnel Concerned. All SBA employees.

3. SOP Canceled. This SOP replaces the Loan Policy and Program Oversight Guide for Lender Reviews, SOP 50 50 4B, Appendix 30; oversight of PLP lenders found in SOP 50 10 (4)(E), Subpart D, Chapter 3, paragraphs 10 and 11, and oversight of CDCs found in SOP 50 10 (4), Subpart H, Chapter 24, paragraph 2.

4. Originator. Office of Lender Oversight.

AUTHORIZED BY:		EFFECTIVE DATE
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		PAGE

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Chapter 1

Introduction

1. Purpose of this Standard Operating Procedure

Lending functions related to loans made under SBA loan programs (SBA loans) are performed by financial institutions (lenders) and Certified Development Companies (CDCs) authorized to make SBA loans (collectively "SBA Lenders"). The majority of loans guaranteed annually by SBA are made by SBA Lenders under delegated authority. In delegated loan programs, an SBA Lender is authorized to make credit determinations without prior review by SBA. All such determinations must comply with SBA requirements and are subject to subsequent review by SBA. While delegating lending functions to SBA Lenders allows small businesses faster, more efficient access to capital, SBA must have adequate controls to ensure that SBA Lenders are prudently originating and managing their SBA loan portfolios and complying with all SBA requirements. The Office of Lender Oversight (OLO) was established to provide this control. OLO reviews, monitors and evaluates SBA's Lenders, and implements Corrective Actions, as necessary.

Under certain 7(a) loan programs - the Preferred Lending Program (PLP), SBA*Express* Program and Community*Express* Program - SBA delegates to the lender the authority to make loan approval decisions, including credit determinations, without prior review by SBA. The regular 7(a) loan program is SBA's non-delegated 7(a) loan program. Under regular 7(a), SBA makes the loan approval decision, including the credit determination. SBA Lenders making loans under any of the 7(a) programs must assert that they would not make the loan without an SBA guaranty.

Most 7(a) SBA Lenders are depository institutions with a Federal Financial Institution Regulator. While these lenders are overseen and examined for safety and soundness by their respective Federal Financial Institution Regulator, SBA conducts risk-based and compliance reviews of their SBA lending operations.

In addition to the depository institutions, SBA authorizes other types of lenders to make SBA-guaranteed loans. These lenders include Small Business Lending Companies (SBLCs) and Non-Federally Regulated Lenders (NFRLs). SBLCs consist of a small number of 7(a) Lenders. SBLCs are generally not subject to oversight and examination by a Federal Financial Institution Regulator. SBLCs are non-depository lenders who enter into agreements with the SBA to provide 7(a) and micro-loans to qualified small businesses. By statute, SBA is the primary Federal regulator for SBLCs and conducts safety and soundness examinations of SBLCs.

NFRLs are state licensed non-depository financial service companies authorized as 7(a) Lenders. SBA has statutory authority to oversee NFRLs. SBA may perform safety and soundness examinations on NFRLs. SBLCs and NFRL are referred to collectively as SBA Supervised Lenders.

The 504 loan program is delivered through Certified Development Companies (CDC) that SBA has authorized to participate in the program. CDCs are generally (but not exclusively) non-profit organizations and may or may not engage in additional economic development activities. CDCs are also not depository institutions, and therefore are not subject to periodic examinations by a Federal or state regulatory authority.

CDCs can participate in a number of lender programs with SBA. Under the Accredited Lender Program (ALP), CDCs have been delegated additional authority to evaluate loan applications in return for expedited SBA processing. Under the Premier Certified Lender Program (PCLP), CDCs have delegated authority to make credit determinations. In all other 504 loans, SBA is responsible for making credit determinations. As part of the PCLP authority, a PCLP CDC is required to maintain a loan loss reserve account for those loans approved under its PCLP authority. All CDCs are subject to risk-based and compliance reviews of their SBA lending operations.

This Standard Operating Procedure (SOP) contains on-site review procedures for all types of SBA Lenders participating in SBA's 7(a) and 504 loan programs. It defines the on-site risk-based review conducted of 7(a) Lenders and CDCs, depending upon their level of lending activity. It also defines the more comprehensive safety and soundness examination conducted of those 7(a) Lenders that are SBA Supervised Lenders, which is also dependent upon the level of lender activity as well as other regulatory control.

2. Notice of Implementation

This SOP establishes procedures for on-site risk-based lender reviews and safety and soundness examinations. It contains separate guidance and procedures for 7(a) Lenders and CDCs. This SOP replaces the *Loan Policy and Program Oversight Guide for Lender Reviews*, SOP 50 50 4B, Appendix 30; oversight of PLP lenders found in SOP 50 10 (4)(E), Subpart D, Chapter 3, paragraphs 10 and 11, and oversight of CDCs found in SOP 50 10 (4), Subpart H, Chapter 24, paragraph 2.

3. Authority

The following statutory and regulatory citations provide authority for SBA's on-site review and examination activities: 15 USC § 650; 15 USC § 634 note, citing, Public Law 104-208, Division D, Title I, §103(h); 15 USC § 634(b)(14); 15 USC § 634(b)(7); 15 USC § 636(a)(31); 15 USC § 687(f); 15 USC § 696(3)(A); 15 USC § 697(a)(2); 15 USC § 697e(c)(8); 15 USC § 634(b)(6); 13 CFR § 120.470; 13 CFR § 120.454; 13 CFR § 120.410; 13 CFR § 120.414; 13 CFR § 120.451; 13 CFR § 120.472; 13 CFR § 120.853; 13 CFR § 120.845; and 13 CFR § 120.841.

4. Applicability

On-site reviews are generally conducted on: (1) all 7(a) Lenders with outstanding balances on the SBA-guaranteed portions of its loan portfolio amounting to $10 million or more and (2) all CDCs with outstanding balances on its SBA-guaranteed debentures totaling $30 million or more. Though less frequent, SBA may conduct on-site reviews of any SBA Lenders, as it considers necessary. SBA's calculation of the outstanding balances of 7(a) Lender loan portfolios and CDC debenture portfolios will be based on a 12 to 24 month cycle, determined depending upon the risk characteristics of the lender. SBLCs and selected NFRLs receive more extensive on-site examinations on a 12 to 24 months cycle, also determined based upon the risk characteristics of the lender. On-site reviews and examinations are supplemented by regular off-site reviews and monitoring.

Chapter 2

Risk-Based Lender Reviews and Examinations

1. Overview

This SOP governs the on-site lender review and examination process to be conducted as part of a comprehensive program of lender oversight. This process applies to all SBA Lenders, with adjustments made as necessary to recognize unique program and sub-program requirements. This chapter of the SOP describes the general approach and process applicable to both SBA Lender and SBA Supervised Lender risk-based reviews and examinations. Subsequent chapters of this SOP address specific requirements for 7(a) Lender reviews, SBLC and NFRL examinations, and CDC reviews, respectively.

The risk-based review/examination process allocates on-site review resources to those SBA Lenders with higher risk characteristics in terms of credit risk, portfolio performance, SBA exposure and/or compliance. The risk-based review assesses an SBA Lender's SBA lending operations, taking into consideration: (i) portfolio performance; (ii) SBA management and operations; (iii) credit administration practices for both performing and non-performing loans; and (iv) compliance with SBA requirements. Safety and soundness examinations assess an SBLC's and a NFRL's: (i) capital adequacy (as allowed by statute); (ii) asset quality; (iii) management; (iv) earnings; (v); liquidity; and (vi) compliance with SBA requirements. Depending upon an SBA Lender's performance in the identified components, a review/examination may concentrate more heavily in those specific components where more potential risk is identified.
All SBA Lenders must employ prudent lending policies, procedures and practices, and comply with SBA rules, SBA Loan Program Requirements, policies and procedures. The established goal of the review/examination process is to make an informed assessment of the SBA Lender's SBA lending operations and processes, including whether the SBA Lender exhibits prudent risk management. Review/examination results may have an impact on a lender's SBA lending authority. When weaknesses are identified in a lender's SBA lending operations, Corrective Actions to address deficiencies may be requested. Depending upon the severity of the situation, additional supervisory and enforcement actions may be considered.

2. Definitions for Risk-Based Lender Reviews and Examinations

a. For the purposes of this SOP and for all risk-based review and examination activity, the following definitions apply.

7(a) Lender. An institution that has executed a participation agreement with SBA under the guaranteed loan program. (13 CFR §120.10.)

Active Purchase. A 7(a) loan that has been purchased by SBA (SBA has paid its share of the guaranty upon request by the 7(a) Lender) but has an outstanding balance.

Catch-up Status. For 504 loan only, any loan where the monthly installment has been temporarily modified by agreement with CDC, as reflected in SBA's 504LAMP database.

Certified Development Company (CDC). An entity authorized by SBA to deliver 504 financing to small businesses.

Current Loan Status. Any loan where the installment payment due date has not been missed by more than 29 days, as reflected in SBA's loan accounting system database (SBA's Management Information System (MIS) status).

Corrective Action. A requirement placed upon an SBA Lender by SBA to implement, modify, alter, change or cease a component of its SBA lending activity.

Deferred Loan Status. Any loan where the monthly installments have been temporarily suspended by active agreement or action by the SBA Lender, as reflected in SBA's loan accounting system database (MIS status).

Delinquent Loan Status. Any loan where the installment payment due date has been missed by 60 or more days, as reflected in SBA's loan accounting system database (MIS status).

Federal Financial Institution Regulator. The primary regulator of a Lender. This term includes the Federal Deposit Insurance Corporation, the Federal Reserve Board, Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration and the Farm Credit Administration.

Finding. Any issue or characteristic identified for which SBA will require the SBA Lender to implement, modify, alter, change or cease conducting a defined action.

Liquidation Loan Status. Any loan that has been determined by SBA Lender with concurrence of SBA, to require enforced collection measures, as reflected in the SBA's loan accounting database (MIS status).

Management Official. An officer, director, general partner, manager, employee, agent or other participant in the management of an SBA Supervised Lender.

Material Deficiency. A loan file characteristic which calls into question the validity of part or the entire guaranty, if guaranty purchase is requested on the loan (e.g., missing collateral required by loan authorization), or which demonstrates increased financial risk to SBA in the handling of the loan e.g., failure by SBA Lender to monitor continued creditworthiness). (See SOP 50 51 2B, Chapter 13 for further guidance on materiality in guaranty purchase situations).

Non-Federally Regulated Lender (NFRL). A business concern that is authorized by the Administrator to make loans under section 7(a) and is subject to regulation by a state but whose lending operations are not subject to regulation by a Federal regulatory agency (i.e., a Federal Financial Institution Regulator).

Other Lender. All SBA Lenders except SBA Supervised Lenders.

Past Due Loan Status. Any loan where the installment payment due date has not been missed by more than 30-59 days, as reflected in SBA's loan accounting system database (MIS status).

Purchase Pending Status. For 504 loan only, any loan that has been determined by CDC to require enforced collection measures and that SBA purchase the debenture, as reported in SBALAMP database.

Risk-Based Review (Review). On-site lender assessment conducted by OLO covering (i) portfolio performance, (ii) SBA management and operations, (iii) credit administration and (iv) compliance components, and further described in Chapters 2, 3 and 5 of this SOP.

Risk-Based Examination (Examination). On-site lender assessment conducted by OLO covering (i) capital, (ii) asset quality, (iii) management, (iv) earnings, (v) liquidation and (vi) compliance components, and which is further described in Chapters 2 and 4 of this SOP. Risk-based examinations are conducted on SBLCs and selected NFRLs.

SBA Lender. A financial institution that participates in the 7(a) program or is a Certified Development Company that participates in the 504 program. This term includes SBA Supervised Lenders.

SBA Loan Program Requirements: Requirements imposed upon Lenders or CDCs by statute, SBA Loan Program Requirements, any agreement the Lender or CDC has executed with SBA, SBA SOPs, official SBA notices and forms applicable to the 7(a) and 504 loan programs, and loan authorizations, as such requirements are issued and revised by SBA from time to time. For CDCs, this term also includes requirements imposed by Debentures, as that term is defined in §120.802.

SBA Supervised Lender. Any 7(a) Lender that is either (1) an SBLC or (2) a NFRL.

Small Business Lending Company (SBLC). A non-depository lending institution that is licensed and authorized by SBA to only make loans pursuant to section 7(a) of the Small Business Act and loans to Intermediaries in SBA's Microloan Program. SBA has imposed a moratorium on licensing new SBLC's since January 1982.

b. Performance Rates

SBA has developed a set of performance statistics and rates upon which each SBA Lender's performance can be assessed. These statistics and rates are subject to change periodically, at SBA's discretion, but SBA expects to continue to focus on statistics and rates in the same areas.

The existing performance rates and definitions for SBA Lender performance analysis are listed below. All rates are based upon performance in the numbers, dollars and/or MIS loan status of individual SBA loans or, as applicable, in the SBA Lender's entire SBA portfolio (as reported in SBA's MIS records).

Currency Rate. Calculated using a numerator of total gross dollars in Current status and a denominator of total gross dollars outstanding.

Past Due Rate. Calculated using a numerator of total gross dollars in Past due and Deferred status and a denominator of total gross dollars outstanding.

Delinquency Rate. Calculated using a numerator of total gross dollars in Delinquent status and a denominator of total gross dollars outstanding.

Liquidation Rate. Calculated using a numerator of total gross dollars in Liquidation status and a denominator of total gross dollars outstanding.

The above Performance Rates do <u>not</u> include Active Purchases.

Problem Loan Rate for 7(a) Lender. Calculated using a numerator of total gross dollars of loans 90 days or more delinquent plus gross dollars in Liquidation and a denominator of total gross dollars outstanding. This rate does not include Active Purchases.

Problem Loan Rate for CDC. Calculated using a numerator of total gross dollars of loans 90 days or more delinquent plus gross dollars in Liquidation and a denominator of total gross dollars outstanding plus all total gross dollars in Liquidation and Purchase Pending (MIS status).

12-month Purchase Rate. Calculated using a numerator of total gross dollars purchased during the past 12 months and a denominator of total gross dollars outstanding plus gross dollars purchased during the past 12 months.

Cumulative Purchase Rate. Calculated using a numerator of total gross dollars purchased during the past five full fiscal years plus the current fiscal year-to-date and a denominator of gross dollars disbursed on loans approved during the past five full fiscal years plus the current fiscal year-to-date.

12-month Charge-Off Rate. Calculated using a numerator of total gross dollars charged-off during the past 12 months and a denominator of total gross dollars outstanding plus gross dollars charged-off during the past 12 months.

Cumulative Charge-Off Rate. Calculated using a numerator of total gross dollars charged off during the past five full fiscal years plus the current fiscal year-to-date and a denominator of gross dollars disbursed on loans approved during the past five full fiscal years plus the current fiscal year-to-date.

c. Credit Quality Rates

The existing credit quality rates and definitions for 7(a) lender credit quality analysis are listed below. All rates are based upon the Small Business Predictive Score (SBPS) of each loan, as provided by SBA's Loan and Lender Monitoring System (L/LMS).

Mean SBPS. Calculated using as a numerator the sum of the SBA share of each loan's outstanding dollars multiplied by the loan's SBPS. The denominator is the 7(a) Lender's total SBA share of outstanding dollars (i.e. weighted average SBPS).

Projected Purchase Rate. Calculated using a numerator of the sum of the SBA share dollars outstanding of each individual loan multiplied by the probability of its purchase (as determined by the SBPS of the individual loan). The denominator is total SBA share dollars outstanding.

The probability of a loan being purchased is based on the predictive credit scoring (SBPS) of the loan. Annually the SBPS credit scores are validated against SBA's entire loan portfolio and a probability of purchase is calculated for each score possible based on the validation.

For 7(a) Lenders only: *3-month change in SBPS.* The percentage change in the SBA share dollar weighted average of the SBPS from the previous quarter to the current quarter.

For CDCs only: *SBPS Score Average.* The weighted by SBA share dollars) average SBPS score for a CDC's portfolio for the current quarter.

All of the above Credit Quality Rates do not include Active Purchases.

7(a) Lender Score Ranges

Lower Risk SBPS Score Breakdown. Percentage of the number of loans with SBPS of 180 or higher.

Moderate Risk SBPS Score Breakdown. Percentage of the number of loans with SBPS of 140 through 179.

Higher Risk SBPS Score Breakdown. Percentage of the number of loans with SBPS of 139 or lower.

CDC Score Ranges

Lower Risk SBPS Score Breakdown. Percentage of the number of loans with SBPS of 170 or higher.

Moderate Risk SBPS Score Breakdown. Percentage of the number of loans with SBPS of 130 through 169.

Higher Risk SBPS Score Breakdown. Percentage of the number of loans with SBPS of 129 or lower.

All of the above Score ranges do not include Active Purchases, and apply only to the SBA Lender's SBA portfolio. These ranges are subject to change at the discretion of SBA, based upon current validation studies.

d. Active Purchase Rates

OLO evaluates loans that have been purchased from a 7(a) Lender that still have an outstanding balance separately from loans that have not been purchased. Purchased loans with an outstanding balance are referred to as Active Purchases. By separating the two types of loans, SBA is better able to understand the performance metrics of the performing portfolio without the characteristics being distorted by purchased loans being worked out or liquidated. At the same time, purchased loans need to be monitored and actively managed. The following rates are used to evaluate loans in this category.

Active Purchases Rate Percentage (in Numbers). Calculated using a numerator of the number of loans in Active Purchase Status. The denominator is the number of loans in Active Purchase Status plus the number of non-purchased loans outstanding.

Active Purchase Rate Percentage (in Dollars). Calculated using a numerator of the gross dollars outstanding in Active Purchase status. The denominator is the gross dollars outstanding in Active Purchase status plus gross dollars outstanding in non-purchased loans.

e. Peer Groups

Analysis of Lender performance compared to peer group performance is important. For peer group standards, SBA portfolios are defined as the SBA share of a Lender's portfolio of SBA-guaranteed loans outstanding.

The current 7(a) Lender peer groups are:

Group B: Lenders with SBA portfolios of $10.0 million to $99,999,999;
Group C: Lenders with SBA portfolios of $4.0 million to $9,999,999;
Group D: Lenders with SBA portfolios of $1 million to $3,999,999;
Group E: Lenders with SBA portfolios of $0 to $999,999 (lenders that disbursed at least one SBA loan in past 12 months). Any such lender is considered "Active"; and
Group F: Lenders with SBA portfolios of $0 to $999,999 (lenders that did not disburse at least one SBA loan in past 12 months). Any such lender is considered "Inactive".

The current CDC peer groups are:

Group A: Lenders with SBA portfolios of $100 million or more;
Group A: Lenders with SBA portfolios of $100 million or more;
Group B: Lenders with SBA portfolios of $30.0 million to $99,999,999;
Group C: Lenders with SBA portfolios of $10.0 million to $29,999,999;
Group D: Lenders with SBA portfolios of $5 million to $9,999,999;
Group E: Lenders with SBA portfolios of $0 to $4,999,999

3. Objectives for Risk-Based Lender Reviews and Examinations

SBA has three primary objectives for the on-site reviews/examinations it conducts on SBA Lenders: (i) To enhance SBA's ability to gauge the overall quality of the SBA Lender's 7(a) or 504 portfolio; (ii) To identify weaknesses in an SBA Lender's SBA operations before serious problems develop that expose SBA to losses that exceed those inherent in a reasonable and prudent SBA loan portfolio, as periodically defined by statute, SBA Loan Program Requirement and/or Notice; and (iii) To ensure that prompt and effective Corrective Actions are taken, as appropriate.

Further, the on-site review/examination approach is designed to incorporate the following four management objectives:

Materiality: The on-site review process is designed to evaluate issues that represent program risk and material loan file guaranty risk to SBA. By way of example, such risks include but are not limited to the risks associated with an SBA Lender's credit administration program for SBA lending and the determination of borrower eligibility;

Objectiveness: The on-site review process should be viewed as fair, objective and reasonable to all parties. There should be a determinable logic to the review components and the manner in which risks are evaluated;

Efficiency: The on-site review process is designed to minimize regulatory burdens on SBA Lenders and on SBA offices. On-site reviews are generally only conducted on SBA's largest lenders ($10 million or more in SBA dollars outstanding) and at a frequency that corresponds with the risk characteristics of an individual lender (utilizing 12-24 month review cycles); and

Usefulness: The review should provide useful information for both SBA and SBA Lenders.

4. Approach to Risk-Based Lender Reviews and Examinations

SBA should oversee and monitor the financial performance, SBA loan operations, and regulatory compliance of SBA lenders to ensure the soundness of SBA's business loan programs. Reviews and examinations foster effective, sound and reliable delivery of SBA loan programs. Each review involves three primary functional steps: (i) assessment, (ii) evaluation, and (iii) reporting.

Assessment – The review and analysis of pertinent data, documentation, and information on the SBA portfolio generated and serviced by the SBA Lender.

Evaluation – The determination as to the quality and management of an SBA Lender's SBA loan operations.

Reporting – The submission of written results and oral presentation of findings and conclusions.

Risk-based principles provide the framework for review/examination policies. Application of these principles may result in considerable differences in the scope and depth of review/examination activity among individual SBA Lenders. SBA achieves efficient use of reviewer resources by limiting work in areas of minimal risk, and expanding resource commitments in areas expected to have substantial risk or potential additional risk. Review/examination activities are specifically tailored for each SBA Lender.

The scope of the review/examination is determined prior to commencing on-site activities, utilizing information and data from various sources, including previous Review Reports (RR) or Reports of Examination (ROE) (collectively "Reports"), portfolio performance data, and information provided by the SBA Lender. The on-site review/examination focuses on issues specific to an individual SBA Lender. These issues may vary from SBA Lender to SBA Lender depending upon an SBA Lender's specific risk characteristics.

5. Relationship to Lender Oversight Program

The lender on-site review/examination process is part of a comprehensive program of lender oversight. Lender oversight activities are comprised of off-site monitoring/reviews, selective on-site reviews/examinations conducted in accordance with this SOP, and a series of graduated supervisory and enforcement actions used as appropriate and necessary.

At the heart of SBA's lender oversight activities is the Agency's L/LMS. L/LMS includes use of predictive small business credit scoring. All SBA small business loans with an outstanding balance and businesses with 504 debenture guaranties that have an outstanding balance are credit-scored quarterly. This data is aggregated, analyzed and evaluated to assess the credit quality of each individual SBA lender's portfolio of SBA loans. It allows SBA to monitor and conduct off-site reviews of all SBA Lenders. It serves as the primary means of reviewing less active SBA Lenders (generally SBA Lenders with less than $10.0 million in SBA dollars outstanding) although SBA may determine at its discretion to conduct on-site reviews of these SBA Lenders depending upon their level of SBA lending activities and their performance. For SBA's largest lenders, L/LMS provides performance data, both historical and projected: (i) for use in planning and conducting on-site reviews or examinations; (ii) to assist in prioritizing on-site reviews/examinations; and (iii) as a system to monitor SBA Lenders between on-site reviews/examinations.

6. On-Site Lender Review/Examination Program

OLO is responsible for selecting lenders to be reviewed or examined. Priorities for on-site reviews/examinations, though discretionary, are generally established based on an SBA Lender's risk characteristics including portfolio performance (metrics and trends), credit risk as measured by credit scores, and/or occurrence and results of last lender review/examination. Other factors may also play a part in determining review priorities including referrals or requests from other SBA offices.

The review cycle includes the following activities: (i) Pre-review activities; (ii) on-site activities; (iii) Reporting of Findings; and (iv) Resolution of issues.

On-site lender review/examinations results may be used in determining an SBA Lender's risk rating, establish recommendations for improvement in an SBA Lender's SBA loan portfolio, and to assist in the evaluation of applications for, expansion of and/or renewal of delegated or other program authority. OLO is responsible for the on-site review and examination process including managing the on-site review and examination schedules, conducting on-site reviews and examinations, assessing performance, preparing the written Report, and following up with the SBA Lender to address weaknesses or deficiencies identified during the review or examination.

7. Risk-Based Review Components

On-site risk-based lender reviews for most 7(a) lenders and CDCs assess the SBA Lender's SBA lending operations in terms of (i) portfolio performance, (ii) SBA management and operations, (iii) credit administration practices and (iv) compliance with laws, rules, the SOPs and SBA Loan Program Requirements. Additional details regarding risk-based review components for 7(a) lenders and CDCs are found in Chapters 3 and 5, respectively, of this SOP.

These chapters detail the risk-based review objectives, criteria and procedures governing each component. The objectives discussion outlines the basic goals and expected outcomes of the review component. The risk-based review criteria outline the applicable requirements, standards and other measures relevant to the review component. The risk-based review procedures provide specific procedures to guide a reviewer's effort. The procedures are not mandated rules to be rigidly followed by the reviewers. The lending business is a dynamic one, requiring reviewers to use their judgment to tailor review practices to individual situations. Reviewers can add, delete and/or modify procedures as appropriate, with the written approval of the Associate Administrator for Lender Oversight (AA/OLO) or designee, when an SBA Lender's particular circumstances and risk characteristics warrant.

SBA evaluates the following components for on-site risk-based lender reviews:

a. Portfolio Performance

For the portfolio performance component, SBA reviews the size, composition, performance and credit quality of an SBA Lender's SBA portfolio. Risk, volume and status related data and information, including trends in the SBA Lender's portfolio performance, and whether requirements contained in SBA Loan Program Requirements or SOPs, are met are evaluated. This data is also considered in terms of industry and geographic concentrations, in comparison to peer groups, and along with explanations and observations related to performance trends. The portfolio performance review is instrumental towards SBA's determination that the SBA Lender has the continuing ability to make and manage its SBA loan portfolio in accordance with 13 CFR §§120.410(a), 120.451(b) and 120.845.

Portfolio performance data is instrumental in shaping the focus of a review. Performance discussions with the SBA Lender focus on identification of performance risk factors and identification of review strategies that are designed to assess these factors.

b. SBA Management and Operations

For this review component, SBA assesses an SBA Lender's overall management of its SBA loan program. Here, SBA reviews the SBA Lender's policy and procedural guidance, management and oversight of the SBA loan function. These procedures also assist SBA in determining whether the SBA Lender continues to meet SBA lending standards in 13 CFR §§120.410(a), 120.452, 120.453, 120.500-120.540, 120.848, 120.854 and 120.970. The following criteria are considered:

Effectiveness of SBA Lender's internal policy and procedural guidance given to the SBA lending function;
Demonstrated competence, leadership and administrative ability of SBA Lender management and staff whom have responsibility for the SBA loan portfolio; Adequacy of internal controls including internal loan review;
Ability to plan strategically and operationally, and to respond to changing circumstances; Poor portfolio performance attributable to policy or actions of SBA Lender's management; and Compliance with laws and SBA Loan Program Requirements.

c. Credit Administration

For the credit administration component, SBA assesses the SBA lending operation policies, processes and controls for origination, servicing and liquidation of SBA loans for prudent lending practices, in accordance with 13 CFR §§120.410(a), 120.452, 120.453, 120.500-120.540, 120.848, 120.854 and 120.970 and SBA's SOPs 50-10, 50 50 and 50 51. The adequacy of lending policies and procedures governing the full range of SBA lending activities is determined based upon review of the SBA Lender's SBA policies and procedures, and, when applicable, the SBA Lender's non-guaranteed commercial lending policies relevant to its SBA operations. Lending practices, reports and activities are identified and assessed for reasonableness and consistency with prudent lending practices. An SBA Lender's underwriting, and regular servicing of loans is evaluated. Loan servicing and monitoring practices including collection practices, and loan review and risk rating systems are assessed. Workout and liquidation practices are reviewed to determine whether timely actions are taken on a prudent basis.

d. Compliance

Lender's compliance with SBA-specific requirements, including eligibility and reporting to SBA is also a review component. The compliance review component considers those SBA Loan Program Requirements as generally found in the applicable sections of 13 CFR

§120 and SOP 50-10(4), other than those associated with prudent lending practices as evaluated in the credit administration review category. The criteria included in the compliance review component include but are not limited to the following:

Eligibility of the borrower to qualify for SBA financial assistance in accordance with 13 CFR §§120.100-120.105, 120.110, 120.120 and 120.130, and SOP 50 10(4); Accurate and timely reporting to SBA to facilitate the accurate assessment of the performance of an SBA Lender's SBA loan portfolio in accordance with 13 CFR §120.472 and SOP 50 50(4); Accurate and timely payment of guaranty fees, prepayment fees and other fees, payments or recoveries due to SBA in accordance with 13 CFR §§120.220-120.223, SOP 50 10(4), 50 50(4) and 50 51(2); Maintenance of PCLP reserve requirements in accordance with 13 CFR §120.847 and Findings from the Bureau of PCLP Oversight; and Compliance with other applicable SBA Loan Program Requirements.

8. Risk-Based Examination Components

SBA Supervised Lenders have a more comprehensive set of examination components that include capital (as applicable by statute), asset quality, management, earnings, liquidity and compliance with SBA requirements. These components are summarized here, and more extensively defined in Chapter 4 of this SOP.

For SBA Supervised Lender examinations, the following components are evaluated:

a. Capital

SBA's required capital structure for SBLCs is specified in 13 CFR §120.470(b). State statutes specify minimum capital requirements for NFRLs. The evaluation of capital focuses on the SBA Supervised Lender's ability to provide for growth and to absorb loan and operating losses. Criteria to consider when determining an assessment for capital include, but are not limited to: Compliance with the regulatory minimums; The level, composition or quality of capital;
The SBA Supervised Lender's asset growth rate compared to its capital growth rate; The threat posed by asset quality if allowance for loan losses is inadequate; The impact on capital from earnings, dividends, or other distributions; Any concerns raised by interest rate risk, off-balance-sheet exposure, concentrations of credit, or any near-term commitments of capital; and The adequacy of capital in relation to all pertinent ratios.

b. Asset Quality

Loans are generally the principal risk assets. Accordingly, the analysis of loans will provide an asset quality conclusion that will impact the assessment of the SBA Supervised Lender, under 13 CFR §120.410 for

7(a) lenders and under13 CFR §120.470(b) for SBLCs. Matters to be considered include, but are not limited to: The level and severity of criticized and classified loans, and delinquency, workout, and non-accruals trends; Adequacy of loan portfolio management, including strategic planning, policy and procedure, internal loan review, stress testing, and compliance; The adequacy of the loss allowance and capital in relation to classified and criticized loans;
Concentrations in industries or geographic regions that are suffering some economic distress; and History or track record of i) meeting underwriting standards, ii) quality of credit administration, iii) adequacy of internal loan review, and iv) the timeliness of charge-offs.

c. Management

The assessment of management must consider every operational area in addition to the policies and standards adopted. This category will assess the performance of both the Board of Directors (BOD) and executive management, in accordance with 13 CFR §120.410 for all 7(a) Lenders and also 13 CFR §120.470(b)(12) for SBLCs, based on factors such as: Effectiveness of policies, standards, and procedures; Adequacy of internal controls, including internal loan review; Ability to plan strategically and operationally, and to respond to changing circumstances; The overall condition of the SBA Supervised Lender, to the extent it can be attributed to policy or ineffective response to poor performance; Pending litigation; Compliance with law and SBA Loan Program Requirements; and Demonstrated competence, leadership, and administrative ability.

d. Earnings

Earnings are evaluated based on their quantity and quality, and the SBA Supervised Lender's ability to sustain both. In accordance with 13 CFR §120.410 for all 7(a) lenders and 13 CFR §120.470(b) for SBLCs, the following factors are among those considered in assessing the SBA Supervised Lender's earnings: The level of earnings compared to the SBA Supervised Lender's established goal; Dividend expectations; Composition (quality) of net income; Sustainability of earnings as indicated by interest rate risk and the volume and trend of non-accrual loans; The relationship between the level of earnings and capital growth needs; and Adequacy of the allowance for loan losses.

e. Liquidity

An SBA Supervised Lender's liquidity is evaluated on its capacity to promptly meet the demand for payment from its obligations and to readily meet the credit needs of borrowers in its territory, in accordance with 13 CFR §120.410 for all 7(a) lenders and also 13 CFR §120.470(b)(12) for

SBLCs, The following factors are among those considered when assessing liquidity: The existence of a parent company committed to providing the necessary liquidity to its subsidiary; The availability and cost of funding which is usually dictated by the overall condition of the SBA Supervised Lender; Any loans available for pooling and available for sale; Loan demand; The stability of the principal source of funding; and Any near term capital expenditures, cash dividend, or unexpected liquidity demands.

f. Compliance

The SBA Supervised Lender's compliance with SBA-specific requirements including eligibility and reporting to SBA, as found in the applicable sections of 13 CFR §120 and SOP 50-10(4), is also an examination component. The criteria included in the compliance review component include, but not limited to, the following: Eligibility of the borrower to qualify for the financial assistance in accordance with 13 CFR §§120.100-120.105, 120.120 and 120.130, and SOP 50 10(4); Accurate and timely reporting to SBA, to facilitate the accurate assessment of the performance of the SBA Supervised Lender's SBA loan portfolio in accordance with 13 CFR §120.220-223 and SOP 50 50(4); Accurate and timely payment of guaranty fees, prepayment fees and other fees, payments or recoveries due to SBA in accordance with 13 CFR §§120.220-120.223, SOP 50 10(4), 50 50(4) and 50 51(2); and Compliance with other applicable SBA Loan Program Requirements.

9. Lender Review/Examination Assessment Categories

Using judgment in evaluating the results of the review/examination and assessing the acceptability of risk an individual lender represents to SBA, the Examiner-in-Charge (EIC) for a review/examination recommends an assessment category; individual review/examination components are not rated. Rather, the EIC, in recommending an assessment, evaluates each individual review/examination component, any actual or anticipated financial risk to SBA, management's planned or proposed actions to address identified issues, and any relevant external factors and/or subsequent events (e.g., policies, procedures and/or internal controls partially implemented).

Determining the appropriate assessment category to recommend requires a thorough understanding of an SBA Lender's operation, knowledge of prudent lending practices, application of SBA requirements and judgment. The basis for the recommended assessment category must be clearly identified and substantiated in the written Report. The SBA Lender assessment will fall into one of three categories: (i) Acceptable, (ii) Acceptable with Corrective Actions Required, or (iii) Less than Acceptable with Corrective Actions Required. SBA Lenders within the assessment category of "Acceptable" are managing a satisfactory SBA loan program utilizing prudent lending practices and representing limited financial risk to SBA. SBA Lenders in the "Acceptable with Corrective Actions Required" category may have Findings but it is reasonably expected that the SBA Lender can address the Findings during the normal course of operations. Lastly, SBA Lenders in the assessment category of "Less than Acceptable with Corrective Actions Required" are operating an SBA lending program with serious deficiencies and/or represent significant financial risk to SBA. More detailed descriptions, including factors considered for each SBA Lender assessment category are presented below. While not all characteristics listed must be present for a particular assessment to be assigned, the descriptions provide the overall characteristics of each category that must largely represent the SBA Lender's operation.

a. Acceptable Category

SBA Lenders in this category are considered to be managing an SBA loan program that generally meets or exceeds SBA's expectations and requirements. Weaknesses, if present, are modest and can be easily addressed; no significant patterns or practice of deficiencies are noted; and SBA Lender represents limited financial risk to SBA. The following characteristics are reflective of SBA Lenders in the Acceptable assessment category:

- SBA lending operations, credit administration, and portfolio management practices demonstrate minimal or no problems;
- SBA portfolio performance indicators are comparable to or better than the SBA portfolio and peer group performance, defined by SBA;
- SBA lending program demonstrates the ability to withstand adverse business conditions, if experienced;
- Policy, procedure and internal controls are complete, well documented, and implemented;
- SBA Lender is able to manage SBA program expansion and/or delegated authority;
- SBA Lender utilizes risk management processes that are satisfactory relative to its size, the territory it serves, and the complexity of its operations;
- SBA Lender has an effective risk rating system for SBA loan assets;
- SBA Lender has a program of regular internal loan review that includes SBA loan assets;
- Reports and payments to SBA are accurate, complete and made on a timely basis;
- Knowledge of and compliance with SBA eligibility requirements is strong;
- No violations of law or SBA Loan Program Requirement are identified;
- SBA Lender is not operating with any supervisory restrictions or agreements that involve its lending practices with its Federal Financial Institution Regulator, if applicable;

For SBLCs and NFRLs (as applicable), the following additional characteristics are reflective of SBA Supervised Lenders in the Acceptable assessment category:

- SBA Supervised Lender has sufficient quality and/or quantity of capital to meet business operations and regulatory requirements;
- There is a low level of criticized and/or classified assets;
- There is an adequate allowance for loan losses, and good portfolio management practices;
- SBA Supervised Lender monitors external events that could impact its condition or performance;
- SBA Supervised Lender exhibits the ability to react to changing circumstances and addresses risk that may arise from changes in business conditions;
- SBA Supervised Lender has sufficient income to meet goals, augment capital after any necessary provisions to the loan loss allowance, and support any anticipated growth;
- SBA Supervised Lender has sufficient liquid funds available to meet obligations with management of cash flows; and/or
- The stability of the principal source(s) of liquid funds is sufficient.

SBA Lenders in this category are generally reviewed on-site on a 24-month cycle depending upon available resources. The written Report may contain recommendations. However, generally no follow-up or Corrective Actions to address Findings are required. Regular off-site monitoring of all SBA Lenders in this group occurs between on-site reviews, and if performance trends decline, may cause a change in the cycle of reviews.

b. Acceptable with Corrective Actions Required Category

SBA Lenders in this category are considered to be managing an SBA loan program that generally meets SBA's expectations and requirements, but have one or more weaknesses in its operation or a limited number of significant patterns or practice of deficiencies that, if not corrected, could negatively impact the SBA Lender's SBA lending and expose SBA to an unacceptable level of financial risk

The following characteristics are reflective of lenders in the Acceptable with Corrective Actions Required Category:

- SBA lending operations, credit administration, and portfolio management practices demonstrate correctable problems and

SBA Lender demonstrates the ability and willingness to correct the problems;

- SBA portfolio performance indicators are below SBA portfolio and peer group performance, as defined by SBA;
- SBA lending program demonstrates some vulnerability to the onset of adverse business conditions, if experienced;
- Policy, procedure and/or internal controls are incomplete, not well documented, and/or not effectively implemented;
- SBA Lender utilizes risk management processes that have some deficiencies relative to its size, the territory it serves, and the complexity of its operations;
- SBA Lender does not have a comprehensive and/or fully implemented risk rating system for SBA loan assets;
- SBA Lender does not have a fully implemented program of regular internal loan review that is applied to SBA loan assets;
- Reports and payments to SBA are not always accurate, complete and/or made on a timely basis;
- Knowledge of and compliance with SBA eligibility requirements demonstrates some weakness;
- Violations of law or SBA Loan Program Requirement are identified;
- SBA Lender is operating with no supervisory restrictions, but with one or more agreements that involve their lending practices with its Federal Financial Institution or State Regulator.

For SBLCs and NFRLs (as applicable), the following additional characteristics are reflective of SBA Supervised Lenders in the Acceptable with Corrective Actions Required assessment category:

- SBA Supervised Lender has marginally sufficient quality and/or quantity of capital to meet business operations and regulatory requirements;
- There is a high level of criticized and/or classified assets;
- There are unresolved questions regarding the adequacy of allowance for loan losses and good portfolio management practices;
- SBA Supervised Lender does not consistently monitor external events that could impact its condition or performance;
- SBA Supervised Lender exhibits lack of ability to react to changing circumstances and/or lack of ability to address risk that may arise from changes in business conditions;
- SBA Supervised Lender has insufficient income to meet goals, augment capital after any necessary provisions to the loan loss allowance, and support any anticipated growth;

- SBA Supervised Lender has less than sufficient liquid funds available to meet obligations with management of cash flows; and/or
- The stability of the principal source(s) of liquid funds is questionable.

SBA Lenders in this category are generally reviewed on an 18-24 month cycle depending upon available resources. Findings will require action on the part of the SBA Lender to address weaknesses including a response to SBA on planned actions in the form of a Corrective Action work plan and regular progress reports. Regular off-site monitoring of all SBA Lenders in this group occurs between on-site reviews, and if performance trends decline, may cause a change the cycle of reviews.

c. Less than Acceptable with Corrective Actions Required Category

SBA Lenders in this category have a SBA loan program that is considered unacceptable to SBA in one or more aspects. This assessment is a judgment that an SBA Lender's SBA loan program has weaknesses of such magnitude, or multiple and/or significant patterns of deficiencies noted, that its operation is negatively impacted. SBA Lender's SBA lending operations expose SBA to an unacceptable level of financial risk.

For SBLCs and NFRLs with a Less than Acceptable with Corrective Actions Required assessment are considered to be operating in an unsafe and unsound manner. The following characteristics are reflective of lenders in the Less than Acceptable with Corrective Actions Required assessment category:

- SBA lending operations, credit administration, and portfolio management practices demonstrate significant weaknesses, and SBA Lender demonstrates lack of ability and/or willingness to correct;
- SBA portfolio performance indicators are significantly below SBA portfolio and/or peer group performance, as defined by SBA;
- SBA lending program demonstrates significant vulnerability to the onset of adverse business conditions, if experienced;
- Multiple instances and/or a pattern where SBA Lender's policies, procedures and/or internal controls are incomplete, not well-documented, and/or not effectively implemented;
- SBA Lender demonstrates insufficient risk management processes relative to its size, the territory it serves, and the complexity of its operations;
- SBA Lender does not have a comprehensive risk rating system for SBA loan assets;

- SBA Lender does not have a program of regular internal loan review that is applied to SBA loan assets;
- Reports and payments to SBA are seldom accurate, complete and/or timely;
- Knowledge of and compliance with SBA eligibility requirements demonstrates critical weakness;
- Multiple violations of law or SBA Loan Program Requirement are identified;
- SBA Lender is operating under supervisory restrictions and/or agreements that involve their lending practices with its Federal Financial Institution or State Regulator, if applicable;

For SBLCs and NFRLs (as applicable), the following additional characteristics are reflective of lenders in the Less than Acceptable with Corrective Actions Required assessment category:

- SBA Supervised Lender has serious deficiency in quality and/or quantity of capital to meet business operations and regulatory requirements, and it may fail without an external injection of capital;
- There is a very high level of criticized and/or classified assets of such nature that they pose a threat to the lender's viability;
- There is inadequate allowance for loan losses, and/or lack of good portfolio management practices;
- SBA Supervised Lender does not monitor and/or react to external events that could impact its condition or performance;
- SBA Supervised Lender has inconsistent earnings or has experienced losses which are eroding the capital base and calling into question continued solvency;
- SBA Supervised Lender has serious threat to its liquidity with the potential for critical shortage of liquid funds to meet all obligations; and/or
- The stability of the principal source(s) of liquid funds is not sufficient.

SBA Lenders in this group are generally reviewed on a 12 month cycle, depending upon available resources. Immediate Corrective Action by the SBA Lender will be required to address identified deficiencies. SBA will consider appropriate enforcement actions to address the situation including suspension and/or removal from the SBA loan program. Communication with the SBA Lender is frequent with the SBA Lender receiving close monitoring by SBA until the situation is resolved to SBA's satisfaction.

10. Disclosure of Assessment Category

Assessments are disclosed to the SBA Lender in the Report, which will include the assessment category assigned and its basis. SBA Lenders are reminded that assessment ratings are summaries generated primarily for SBA's internal use. The condition, effect and Corrective Actions necessary are described in the Report. Disclosure of Report assessments or the Report to any other entities and/or individuals is strictly prohibited and the lender must comply with SBA Loan Program Requirements and agreements concerning the confidentiality of the assessments and the Report.

11. Use of Review/Examination Results

The Report and the assessment category assigned are used by SBA, in conjunction with SBA's L/LMS quarterly calculated risk ratings, to assist SBA in making determinations regarding an SBA Lender's participation in SBA programs. The assessment category may be a factor in the final risk rating assigned by SBA to an SBA Lender.

12. On-Site Lender Review/Examination Process

In conducting on-site risk-based reviews/examinations, SBA assesses existing SBA loan program policies, procedures, management reports and other information provided by the SBA Lender; holds discussions with management and other personnel involved in the SBA loan program; reviews a sample of loan files to assess an SBA Lender's adherence to its own and SBA's lending requirements, including application of a prudent lending standard. While reviews/examinations generally cover all of the components described in the applicable chapters of this SOP, the scope can vary from SBA Lender to SBA Lender, depending upon the nature and performance of an SBA Lender's SBA lending operation. Review/examination planning allows the EIC and reviewers to emphasize those areas where more risk to SBA appears possible.

a. Review/Examination Team

On-site reviews/examinations are conducted by the Office of Lender Oversight utilizing SBA staff and/or contract resources. OLO is responsible for the overall management of the review/examination process. Each on-site review/examination is managed by an SBA Senior Examiner (SBA employee) and led by the EIC assigned to the specific review/examination. The EIC is accompanied by a team of reviewers. The EIC plans the review, manages the on-site activities and prepares the Report.

b. Review/Examination Scheduling and SBA Lender Notification

The SBA review and examination schedules are generally outlined for an annual period and scheduled for three to six months in advance based upon the review/examination cycle and the risk characteristics of individual SBA Lenders. Managing the review/examination process efficiently requires careful preparation by the EIC and review team, as well as the SBA Lender. SBA generally provides a lender with 30-60 days advance notice, in writing, of an upcoming on-site review/examination. This approach allows for adequate planning, while providing SBA with the flexibility needed to make scheduling adjustments due to changed SBA Lender circumstances that may necessitate accelerating the need for a review/examination. Whenever practical, SBA, within its discretion, will make reasonable efforts to accommodate the needs of the SBA Lender when scheduling conflicts arise.

The notification letter is generally preceded by a telephone call to the SBA Lender's point-of-contact for the purpose of discussing the proposed on-site date and logistics, and to resolve any conflicts.

SBA generally will include in the written notice information regarding the scope and commencement date of the review/examination. This permits assembly of the necessary documentation and files by the SBA Lender. Specifically, the notification letter to the lender will contain the following information:

The Planned on-site start date;
Anticipated timing of the entrance conference;
A request for information to be provided to the EIC prior to the start of the review/examination for planning purposes;
Deadline for requested information to be submitted to the EIC;
Date by which the SBA Lender will receive the list of individual loan files selected for review/examination during the on-site visit;
Date by which the SBA Lender will receive a list of additional information and materials that must be available at the start of the review/examination;
On-site logistical information, e.g., on-site location, number of examiners, space required, telephone, internet needs; and
SBA Senior Examiner.

c. Scope of the Review/Examination

The scope of an on-site review/examination includes analysis of the identified components and any follow-up on actions taken by the SBA Lender to correct any weaknesses noted in previous reviews/examinations. SBA reserves the right to conduct targeted or limited scope reviews/examinations, including ad hoc reviews, additional monitoring activities, special performance assessments or reviews/examinations as deemed necessary by the AA/OLO or designee. In the case of a targeted or modified on-site review/examination, the scope is defined by the specific objective of the review/examination, and limited to evaluation of those areas needed to achieve it. These activities will be governed by identified objectives, needs or situations that SBA determines necessary and required to fully assess and understand a lender's risk characteristics.

The scope of the review/examination for each component is determined on the basis of information available at the time of development of the formal Review Plan (RP) or Examination Plan (EP), collectively referred to as "the Plan" in this SOP, and consistent with SBA guidance. The EIC is responsible for determining the scope of the review/examination and for making changes in the field, as necessary, to accommodate information and conditions that were not apparent at the time the Plan was developed. Any substantive changes to the Plan, must have the written approval of the AA/OLO or designee.

d. Review/Examination Planning

The AA/OLO shall designate an SBA Senior Examiner as the primary SBA point of contact for each review/examination. This Senior Examiner analyst shall be responsible for:

Notification to SBA Lender of a scheduled review/examination;
Communications with the team that will conduct all review/examination activities;
Compilation of all internal SBA data and information for use by the team;
Providing technical guidance on SBA policy and procedure issues to all team members; and
Any dispute resolution between SBA Lender and review/examination team.

Each review/examination is managed pursuant to a formal Plan. The primary purpose of the Plan is to develop the scope of the review/examination, including identifying significant review/examination components, risk characteristics and other issues to be assessed and evaluated during the course of the review/examination. The Plan serves as a basis for identifying the pre-site analysis and data collection activities that must be completed, resource and timing requirements, guides the review/examination team regarding the scope of the review/examination, and SBA Lender access that will be required by the review/examination team to complete the review/examination in a timely manner. The Plan also guides the on-site review/examination activities.

Planning for the on-site review/examination activity is an important step in identifying areas of potential risk. Through careful planning of the scope and approach for each individual review/examination, the EIC will be able to focus the team on those components most critical to the overall assessment of an SBA Lender's SBA lending operation. The Plan identifies the resources needed to conduct the review/examination, provides direction to the review/examination activity and makes the on-site portion of the review/examination more efficient.

Reviews generally will be planned and staffed with the expectation that the on-site portion of the review will be completed within one work-week. Examinations are typically more extensive, and may take additional work-weeks. The SBA will consult with the SBA Lender regarding the location of the review/examination site; however, the SBA will have final jurisdiction regarding the location of the site. In selecting the site, the SBA and the SBA Lender must remain cognizant of the fact that SBA will require immediate access to senior management officials and a wide variety of corporate and SBA loan program data and information, including corporate governance and complete loan file documentation.

The effective use of SBA Lender and SBA resources requires that the requested material be delivered to the review/examination site. This will permit ready access to the requested materials, operating personnel and management officials charged with responsibilities related to the SBA Lender's SBA program and management of the portfolio.

The Plan is organized pursuant to the established review/examination components and criteria, and lists the material and analysis necessary to identify the known conditions and issues for review/examination. The following list outlines key elements of the Plan:

Pre-Review Lender Analysis: A summary of the performance of the SBA Lender considering portfolio performance trends, prior on-site reviews, contacts with the SBA Lender since the prior review, the SBA Lender's response to prior review recommendations, input from other SBA offices, and other pertinent performance data and information about the SBA Lender.

Scope of Review: The proposed scope of the review consisting of a brief discussion of each of the review components, the lender-specific characteristics for each review component, and the extent of activities and analysis needed to evaluate each review component. Specific objectives for each review component are contained in subsequent chapters of this SOP by SBA Lender type.

Review Component Criteria: A review requires development and assessment of data for an established set of criteria for each review component. The criteria guide the EIC's review planning activities. In addition to identifying the activities to be undertaken consistent with the review criteria, the review plan should identify those review criteria that are (i) waived as not applicable or not necessary, given an individual SBA

Lender's operation; and (ii) added to the review process based on the characteristics of an individual SBA Lender's SBA operation.

Logistics: The Plan also contains an estimate of the reviewer resources necessary to complete the review, and a schedule annotating the scheduled date for each significant activity, including selection and briefing of the review team, notification to the SBA Lender of the review date, timing of the request to the SBA Lender for advance material, data and information, start and completion dates of the on-site work and expected completion date of the draft Report.

e. Review/Examination Plan Responsibility and Preparation

The EIC is responsible for the preparation of the Plan. The process begins approximately 60 days prior to commencement of on-site activities with verbal and written communications with the SBA Lender and commencement of the development of the Plan by the EIC. The EIC should note any information regarding changes in SBA policy direction by the SBA Lender, key staff changes, and letters and memoranda regarding any actions the SBA Lender may have taken following the last review.

In analyzing the available information, the EIC is looking for indicators that suggest areas that should affect the scope and focus of the review/examination. Such indicators include trends (positive or negative) in loan quality statistics, changes in policy, significant increases in loan volume, addition of new programs, changes in markets served, changes in senior management, responses to prior reviews/examinations, late filings of required reports, errors in filed reports, adverse publicity, and violations of SBA Loan Program Requirements, policies and procedures.

The Plan addresses each review/examination component and gives sufficient guidance to ensure that the expansion or contraction of the scope is properly reflected in the respective lead sheet that directs review/examination activity for each review/examination component. The Plan should not contain an exhaustive analysis of the scope for each review component. It should identify areas related to the customary scope of a review that do not appear to pose a concern and areas of concern that go beyond the customary scope of a review. In this manner, the Plan serves as a guide to the reviewers who will be assisting in the review/examination as they complete the various components of the review/examination.

The final Plan must be completed prior to the commencement of the on-site activities, inclusive of the lead sheets that direct individual component review/examination activities. The Plan is then reviewed and approved by the AA/OLO or designee. Substantive changes to the Plan must be approved in advance by the AA/OLO or designee.

f. Sources of Information for Plan Development

The EIC should, as applicable to the SBA Lender's status, develop the following information to assist in the preparation of the Plan:

- The most recent portfolio performance data;
- Any prior SBA Lender review and SBA Lender's response to same, including any follow-up actions;
- Information provided by the SBA Lender;
- Guaranty Loan Status and Remittance Reports (SBA Form 1502) filed by the SBA Lender since the last review;
- Internal audits conducted on the SBA lending program;
- Regulatory examination reports, to the extent the SBA Lender is authorized to provide the information to SBA (or certification of SBA Lender that it is in good standing with Federal and state regulators and not subject to any agreements, Memorandums of Understanding (MOU) or any other type of supervisory or enforcement action);
- Results of all searches relative to regulatory actions;
- Results of the internet search for information available concerning SBA Lender announcements and publicized activities relevant to the review components;
- Data and information resulting from off-site reviews/monitoring;
- Any internal SBA reports or tracking;
- SBA reports and analysis developed in response to field contact with the SBA Lender; and
- Letters and memoranda documenting communications with the SBA Lender since the previous review.

g. Loan Sample Composition and Selection

A critical part of the risk-based review is a review of individual loan files. The number and type of files to be reviewed is also a key element in determining the review team number and composition. Files to be selected are based on a random sample of the Lender's SBA loan portfolio and a judgmental sample of loan files selected based on unique characteristics of the individual Lender. The random sample is composed of a statistically determined sample size based upon the Lender's portfolio of outstanding SBA loans.

The judgmental sample for a Lender should be comprised of loans from those areas identified in the Plan that require additional investigation. For example, if a Lender is embarking upon a new marketing initiative, introducing credit scoring, using loan agents, or reporting high levels of deferred, delinquent, liquidated and/or purchased loans, loans that could provide information on these practices would be judgmentally selected to further evaluate the respective practice(s).

h. Plan Format

The Plan developed during the initial scheduling of the review/examination guides the information collection phase including information to be requested of the SBA Lender. The SBA Lender will be provided a reasonable time (approximately 2-3 weeks) to provide requested information to the EIC for review.

Upon receipt of the requested information from the SBA Lender, combined with SBA data and information, the final Plan is developed. The final Plan contains the following information:

- SBA Lender's official name and SBA identifiers, generally the FIRS numbers;
- SBA Lender's location;
- SBA Lender's point of contact (POC), telephone number and email, if available;
- Name of the EIC;
- Requirement for assisting reviewers;
- Dates scheduled for on-site activities;
- SBA Lender's active Supplemental Guaranty Agreements;
- SBA Lender's organizational structure and affiliations; and
- Most recent review/examination results and brief synopsis of the results of any required responses, as applicable.

i Review/Examination Team Composition

General. The review/examination team shall be comprised of staff knowledgeable of SBA's lending programs. Generally, on-site reviews/examinations have multiple reviewers/examiners. One member of the team is designated as the EIC. The SBA Senior Examiner will coordinate all Agency interaction with the EIC and team, and provide guidance for the review/examination, as necessary.

The EIC. The EIC is the manager of the on-site review/examination, including coordination among the review/examination staff assigned. The EIC is responsible for:

- Reviewing all pertinent SBA Lender information for planning purposes;
- In conjunction with the Senior Examiner, informing the SBA Lender of the upcoming review/examination;
- Contacting the SBA field office(s) for input, as applicable;

- Developing the Plan;
- Making arrangements with the SBA Lender to ensure that the facilities, equipment and supplies required by the team while on-site will be available when required;
- Briefing the team on the scope of the review/examination;
- Assignment of areas to be reviewed to each member of the team;
- Ensuring that the team members have access to material and documentation necessary to complete their assignments;
- Serving as the primary contact with the SBA Lender's point of contact during the course of the review/examination;
- Conducting the entrance and exit conferences;
- Ensuring that a complete set of workpapers is properly prepared during the review/examination;
- Following up with the members of the team to ensure the timely completion of their portions of the review/examination, including proposed written comments for the Report;
- Preparing the Report in a complete, well-organized and comprehensive manner;
- Ensuring that the Report is filed in a timely manner; and
- Ensuring that the documentation developed in support of the Report Findings and work papers is properly indexed and filed.

The EIC is expected to brief the review/examination team during which the EIC will provide:

- Specific assignments;
- A copy of the Plan;
- Discussion of those areas of review/examination that have been modified to include more or less review/examination activity than is defined in the customary lead sheet for a given component;
- Copies of internally developed materials that may assist the examiners in completing their assignments; and
- Copies of the materials provided by the SBA Lender that may assist the examiners in completing their assignments.

Review Team. The review/examination team reports to the designated EIC for that specific review/examination. Each member of the team is assigned to review or examine one or more of the components consistent with the Plan and procedures found in this SOP. Review/examination components can affect or be affected by other components and substantial discussion between members of the team is expected. Team members must catalogue all documentation, complete all required workpapers, prepare a finished draft of the Findings and conclusions and forward these materials to the EIC within the time-frame established by the EIC. At the discretion of the EIC, team members may be asked to attend meetings and to make presentations concerning the components they reviewed.

j. Conducting the On-Site Review/Examination

The on-site activities begin with an entrance conference conducted by the EIC. At the entrance conference, the team is introduced, the on-site schedule and process is presented, and logistical details resolved.

During the on-site portion of the review/examination, written policies, transaction journals, strategic and operational planning documents, and anything else that would facilitate an evaluation of the components outlined in the Plan are reviewed and evaluated.

The on-site activities end with an exit conference conducted by the EIC. At the exit conference, the SBA Lender is advised of preliminary Findings and any unresolved issues. The seriousness of the review/examination Findings must be clearly communicated to the SBA Lender. The EIC also should clearly offer an opportunity for the SBA Lender to provide, within a specified timeframe, additional information and data in response to the preliminary Findings or to address outstanding issues. A more detailed discussion of the on-site review activities follows.

Entrance Conference

The entrance conference serves as the introduction of the review/examination team to the management and staff of the SBA Lender and an opportunity to discuss the review/examination process. The conference should be held as soon after the team arrives on-site as is practical and should include:

- Introduction of the EIC and review team members;
- Introduction of the SBA Lender's management and staff involved in the review/examination;
- Discussion of the scope of the review/examination, activities planned and schedule;
- Discussion of significant changes in SBA Lender's personnel, policies, procedures, and SBA loan programs since the last review/examination;
- Discussion of the status of recommendations contained in the previous Report;
- Logistical details; and
- Question and answer session.

Assessment of Review Components

The team carries out the Plan for each of the review/examination components. On-site activities include a review of the lender's written policies and procedures, transaction journals, operational documents, loan files, and additional data, material and information deemed necessary to facilitate a complete assessment pursuant to the scope of the review. The scope of the review/examination may be modified during the course of the review/examination when it becomes apparent that issues or concerns appear to be of more or less significance than originally anticipated. Substantive changes to the Plan must have the approval of the AA/OLO or designee. The EIC is responsible for contacting the AA/OLO or designee to explain the nature of proposed substantive changes and reach a consensus regarding the change request. (Electronic mail is an acceptable means of contacting the AA/OLO or designee.) The AA/OLO or designee shall prepare an informal record of the change approved, for inclusion in the Review File.

During the course of the review/examination work on-site, discussions will be held with SBA Lender's officials in an attempt to reconcile any differences between the preliminary Findings and the perspective of the company officials.

During the on-site review/examination, the team will evaluate and form a conclusion regarding the quality of the SBA Lender's operation for each of the applicable components (four for reviews and six for examinations). After the conclusions are formed, an overall risk assessment will be assigned to the lender's SBA operations.

All team members will be responsible for providing observations, workpapers and component assessments regarding specific review/examination components to the EIC managing the review/examination. At the conclusion of the review/examination, the EIC will prepare a summary of the Findings to be discussed with the lender, including issues requiring management's attention.

File Review

Individual files are reviewed for delegated authority and requirements applicable to the SBA delivery method under which the Lender originated the loan. Loan files included in the random sample are reviewed for both credit administration and compliance purposes. Judgmental sample loans may be more comprehensively reviewed for both credit administration and compliance purposes or may have a targeted assessment for specific purposes identified in the Plan (e.g., failure to remit collateral recovery payment to SBA within required time limit).

Communications and Issue Resolution

Document Requests. The EIC has the authority to request and receive all documents and files deemed necessary to accomplish the objectives of the review. A list of required documentation and loan files for on-site reviews/examinations will be provided to the SBA Lender approximately 2-3 weeks prior to the start of on-site activities, with the stated understanding that the SBA Lender may be required to provide additional documentation and files during the course of the review/examination activities.

Communication Among Reviewers: Communication among reviewers is essential to achieve accurate Findings and overall conclusions. The EIC must ensure that communication among all reviewers exists so that areas of potential risk are adequately investigated and possible interrelationships are sufficiently analyzed.

Communicating Issue Discussions with SBA Lender. During the course of the review/examination, reviewers should discuss all issues with management as they are identified to give the SBA Lender time to respond. Discussions during the review/examination are exploratory and informational to ensure a complete understanding and assessment of the component. All issues should be familiar to management at the exit conference. Preliminary Findings are to be explicitly presented to management at the exit conference to ensure that there is an adequate understanding of SBA's concerns and their implications. In presenting the preliminary Findings, SBA should specifically inform management that preliminary Findings are subject to change upon completion of the analysis and Report.

The EIC is responsible for on-site communications with the SBA Lender and resolving data collection and other issues necessary to conduct the review. When discussing the preliminary Findings with the SBA Lender, the EIC and reviewers should be very clear in regard to the nature, implications and seriousness of the preliminary Findings. To the degree a lender responds to the preliminary Findings with specific actions to address any deficiencies identified, the EIC or team member may describe such plans in the Report (noting that they are not implemented) and, as appropriate, comment on the degree to which, if properly implemented, they may address the issue. Final evaluation of any action proposed by an SBA Lender will be made only after implementation.

Documenting Issue Discussions with SBA Lender. Workpapers should document the SBA Lender's response to the review/examination Findings, particularly Findings related to weaknesses. If the SBA Lender agrees with a Finding and proposed Corrective Action, this should be carefully documented in the workpapers. If the SBA Lender disagrees with a Finding, reviewers should document the disagreement and SBA Lender's explanation in the workpapers. All unresolved issues must be discussed with the SBA Lender and documented in the Report. Although the EIC may delegate to the reviewer(s) responsible for contact with the lender on various matters, the EIC is ultimately responsible for ensuring that each relevant discussion is documented in the workpapers with the time, date, and name of the individual responding on behalf of the SBA Lender.

Exit Conference

The EIC is responsible for conducting a formal exit conference with SBA Lender officials at an agreed upon time at the conclusion of the on-site portion of the review/examination. All preliminary Findings and planned recommendations proposed by reviewers to be included in the Report should be brought to the SBA Lender's attention at the exit conference, as well as a discussion of all preliminary Corrective Actions proposed by the SBA Lender. Although all of the observations and preliminary Findings are to have been discussed with the SBA Lender as the review/examination progressed, the exit conference provides an opportunity for the EIC to summarize the meaningful observations and Findings into one presentation. The purpose of the exit conference is to review Findings and issues, identify any unresolved issues and agree to a plan to address them. While conclusions made prior to the issuance of the Report are considered preliminary and subject to change based on further analysis of review Findings or data received subsequent to the conclusion of the on-site portion of the review/examination, identified concerns with an SBA Lender's SBA loan program will be fully presented and the implications (e.g., SBA's next action – potential enforcement action) discussed with the SBA Lender. To the degree necessary, the seriousness of the Findings must be clearly communicated to the SBA Lender.

The exit conference is also designed to give the SBA Lender another opportunity to respond with additional information that could affect the review/examination conclusions prior to the results being encapsulated into the Report. The EIC should clearly state a specified timeframe for the SBA Lender to provide additional information and data in response to the preliminary Findings or outstanding issues.

While a final SBA Lender risk assessment will not be assigned until all information is received and analysis concluded, the EIC will indicate if the review/examination Findings at the time of the exit conference are so significant that Corrective Actions are likely to be required of the SBA Lender. In circumstances where an assessment of "Less than Acceptable with Corrective Actions Required" is anticipated, or significant Findings are present, the AA/OLO or designee will be advised prior to the exit conference and may choose to participate in the exit conference.

k. Work Schedules

The team is expected to maintain the same duty hours as those observed by the SBA Lender. Under no circumstances will team members remain on the lender's premises after the SBA Lender's staff has departed at the close of the business day. Although the team must obtain all of the information needed to complete the scope of the review/examination, the team should make reasonable efforts to avoid unnecessary disruption to the SBA Lender's business operation.

l. Conduct

Team members are expected to conduct themselves in a professional and courteous manner at all times. If offered, reviewers may accept coffee, tea, water and soft drinks. However, reviewers may not accept gifts of any type, including lunches or dinners. Any offer of a gift by an SBA Lender or its employees should be discussed with the EIC.

13. Development of Findings

Findings and conclusions must be supported in the Report. The component evaluations in the Report, which discuss condition, criteria, cause, and effect, will facilitate development of the review/examination Findings and should provide the necessary support. The Findings portion of the Report should conclude with a discussion of management's response, SBA Lender's plan for Corrective Action, and EIC concurrence with management's response or, when management's response is considered inadequate, EIC recommendations.

Each Finding should be developed using an analytical approach to review the components. The analytical approach employed in the review/examination process generally fall into one of two classifications: Condition or Criteria. Findings may be further evaluated on the basis of cause and effect to determine the impact of the Finding.

Condition – Condition is the evidence supporting a Finding reached. It is often expressed as a percentage, e.g. the percentage growth in a particular SBA program or the percent of loans in default.

Criteria – Criteria are the specific standards or requirements, e.g. laws, SBA Loan Program Requirements, SBA policies and procedures, prudent lending practices, a lender's documented policies and procedures, and Generally Accepted Accounting Principals (GAAP).

Cause – Cause is a concise statement of the situations or events that led to a specific Finding. Causes may include ineffective or inadequate internal controls, lack of sound policy direction, lack of staff experience, or some other breakdown in operations. A complete identification and understanding of a cause is necessary in order to achieve desired changes.

Effect – Effect or potential effect is the impact the condition has or may have on an SBA Lender. The effect should be quantified to the extent possible. Effect should include an assessment on how conditions may impact the SBA's guarantee of loans.

Upon completion of each component of the review/examination, the reviewer must develop conclusions and, if applicable, Findings of weakness. In developing such conclusions, the reviewer should consider the degree to which an SBA Lender's SBA individual component performance compares to its performance in all other components. In making this evaluation, the reviewer should also consider mitigating circumstances such as lending that, while being riskier, may further SBA's mission, or the degree to which mergers have impacted performance. All conclusions should be presented to management at the exit conference along with an evaluation of the seriousness of the Findings relative to the SBA Lender's SBA activities.

Management's expected plan of action should be included with each Finding. The Report should indicate the action needed, but not recommend a specific method of Corrective Action. All conditions of review/examination Findings and all necessary Corrective Action(s), must be clearly stated. As a result, an SBA Lender will be sufficiently knowledgeable of the issues to be addressed.

14. Development of Component Assessments

The individual component sections of the Report will be prepared by the reviewer responsible for each component, and will contain a critical narrative assessment that summarizes the component and states the issues, if any, identified related to those lender portfolio performance measurements that require acknowledgement and/or attention. The component section should:

Clearly define all weaknesses and/or Findings;
Identify the factors contributing to the weakness and/or Finding;
Identify any connection between an individual component and SBA's evaluation of the remaining review/examination components;
Discuss mitigating factors;
Formulate preliminary conclusions;
State management's response to preliminary Findings;
State SBA Lender's proposed actions, if applicable;
Discuss SBA's response to SBA Lender's proposed actions; and
Provide SBA's recommendations, if any, for this review component.

Any statistical analysis contained in the narrative should be presented in a graphical or tabular format. The method of presentation should be selected on the basis of the format that most readily facilitates an understanding of the analysis and depiction of the variances or deficiencies that are to be brought to the attention of the reader in the

narrative analysis. Not all review/examination criteria will be presented in the Report. The reviewer will present those that are important to clearly summarize the SBA Lender's portfolio performance, any changing trends and/or risk characteristics.
The component assessments must support the overall SBA Lender assessment (e.g., Acceptable, Acceptable with Corrective Actions Required or Less than Acceptable with Corrective Actions Required).

15. Report

Each Report must contain the following language on the first page.

THIS REPORT IS STRICTLY CONFIDENTIAL
This copy of the Report is the property of the U.S. Small Business Administration, Office of Lender Oversight, and is furnished for the confidential use of the examined entity. Under no circumstances shall any recipient of this Report or its parent company, or any of their directors, officers, employees, attorneys or auditors disclose or make public this Report or any portion thereof. Unauthorized disclosure of any of the contents of this Report is subject to the penalties in 18 USC 641. The Office of Lender Oversight must be notified immediately if the examined entity receives a subpoena or other legal process calling for the production of this Report.

After completing analysis of the data and information generated as a result of the on-site review and any additional information that may have been provided by the SBA Lender in a timely manner subsequent to the exit conference, the EIC prepares the Report. The Report provides a clear, concise, objective evaluation of the SBA Lender's SBA program and portfolio as of a certain date. The EIC in drafting a Report should follow the same general guidelines as set forth below. The Report states the assessment category assigned and addresses each of the review components describing: 1) summary conclusions; 2) all weaknesses identified; 3) any additional weaknesses the EIC determines to be appropriate; and 4) recommendations for improvement and/or Corrective Action, as appropriate to the assessment assigned. A properly prepared Report discloses the current condition of an SBA Lender and identifies causes and effects. The Report details the substantive Findings supporting the SBA Lender assessment and the recommendations for Corrective Action or other resolution. All Report Findings are supported by factual material contained in the review workpapers. Measures of the quality of a Report include accuracy, timeliness, persuasiveness, balance, focus, and readability. An accurate, succinct, and timely Report is essential to the accurate portrayal of the status and condition of an SBA Lender's SBA program and portfolio.

16. Report Preparation and Format

The EIC is responsible for the preparation of the Report. The Report must include sufficient detail to present and support all significant Findings and recommendations and to present the Findings and recommendations in an objective manner.

The Report format identifies the SBA Lender, provides an executive summary of the Findings and recommendations and includes a comprehensive discussion of the Findings

supported by tables and exhibits (when necessary to add clarity to the Findings and recommendations). The Report contains the following:
Cover Page - A cover page will be the first page of the Report. It identifies the name of the SBA Lender, the SBA Lender's address, the "as of date" of the examination, the period during which the on-site portion of the review was conducted, and the date of the exit conference.

Executive Summary - Each Report will start with a brief overall summary of the present and the expected condition of the SBA Lender and the assessment category assigned. The summary should not provide the extensive detail that follows in each subsequent section. Rather, it should contain a description of the overall condition of the lender and the causes and effects of said condition. It should also summarize the Findings for each review/examination component.

Components Narrative - The Report narrative should discuss the Findings and conclusions of each review/examination component.

For 7(a) lenders and CDC review Reports, the review components to be addressed are i) portfolio performance, ii) SBA management and operations, iii) credit administration and iv) compliance. For SBA Supervised Lenders, the review components to be addressed are i) capital, ii) asset quality, iii) management, iv) earnings, v) liquidity and vi) compliance. Further descriptive information on each review component can be found in subsequent Chapters in this SOP.

The discussion of each review/examination component should describe the scope of review/examination undertaken, the Findings, recommendations, management's response and/or plans to address Findings, and the EIC's assessment of management's plans. Selected charts and graphs may support significant issues. Considerable judgment needs to be exercised when deciding what other matters beyond the specific review/examination components need to be addressed.
Appendices - Appendices provide details that lend further support to Findings and conclusions cited in the Report narrative. All appendices must be numbered and have titles/headings. The appendices are dictated by the Findings of the review/examination. Regardless of the nature of the appendices, they must be easy to understand. If the purpose is not immediately recognizable, the Report should include an explanatory paragraph. Examples of appendices that may be included in a Report include:

Summary of Findings, recommendations, and prior SBA Lender responses;
Summary of SBA Lender actions taken since last review/examination, if applicable;
List of loan files subjected to loan file review/examination, including loan number, borrower names, SBA loan program, performance status and any additional data considered appropriate; and
Listing of compliance and/or credit administration exceptions identified in the review/examination including any material exceptions identified that may affect SBA's guaranty.

For SBA Supervised Lenders, three appendices are required, at a minimum -- a balance sheet, an income statement and key statistical data. Additional appendices other than those discussed above may include, but are not limited to, summaries of classified loan lists; credit administration deficiencies; trend comparisons; and details supporting allowance for loan losses recommendations.

Report Findings **-** The Report formally documents SBA's evaluation and explains the conclusions that are drawn from the weaving together of the conditions or criteria, the cause and effect analysis, and the risk exposure that each Finding poses to the Agency. It also documents what action is necessary on the part of the SBA Lender to ensure that the risk is managed at a level acceptable to the SBA. The conclusions contained in the Report must be concise and supportable.

The Report prepared by the EIC will identify i) the assessment category assigned the SBA Lender, supported in the Report by a detailed description and evaluation of all Findings, ii) recommendations for improvement, iii) any Corrective Actions required, and iv) management's response including planned actions. Individual components of the review are not rated, but rather summarized as strengths and weaknesses individually.

It is important to remember that the Report is not an exception report. It is not intended that the Report be a listing of the problems. The Report must have proper balance. Areas where the conditions are satisfactory may merit only a sentence, but should still be addressed. It is preferable that language explaining necessary Corrective Action be persuasive rather than directive.

The Report will be submitted to the AA/OLO or designee for review, concurrence and issuance. Final authority for the assessment category assigned rests with the AA/OLO.

17. Workpapers

A thoroughly completed and documented set of workpapers is required to demonstrate that the review analyses have been completed, and that the Findings have been substantiated. The examiners should analyze and summarize in the workpapers all pertinent data gathered during the review. The review/examination file must contain all required documentation, including the Plan, criteria and related workpapers, observation and interview notes and all other documentation developed during the review/examination necessary to support the Findings and recommendations contained in the Report.

All workpapers required to meet the scope of the review/examination must be completed and, if relevant to the Findings, supported by documentation developed during the course of the review/examination. Special effort must be made to ensure that all issues that may be discussed in the Report or may be cited in support of a Report recommendation are documented in the workpapers to the extent necessary to withstand challenge on the basis of the material contained in the review/examination file.

The preparation of the workpapers is guided by the scope of the review/examination and the criteria for the review/examination components. The form and nature of the workpaper varies with the nature of the review/examination criteria. In most instances where the element is qualitative in nature the workpaper will be narrative in form, whereas in cases where the review/examination criteria are quantitative in nature the workpaper will generally take the form of a "spreadsheet," table or graph. (See discussion below on workpapers form.) The Plan and criteria usually provide sufficient guidance to complete the workpaper requirement.

Instances will arise, however, where the reviewer will have to rely on a general statement of the work. This condition will usually arise when the scope of the review/examination is expanded in the field as a result of on-site Findings. Instances may also arise where the source documentation may be so voluminous or otherwise not amenable to inclusion in the workpapers. In these instances, the Findings must be written in the field and verified by the EIC or a reviewer designated by the EIC.

Workpapers are the primary resource for data supporting the Findings of the review/examination, including written, copied, or electronically stored information prepared or obtained during a review/examination. The functions of workpapers include:

- Evidence of work performed;
- Basis for determining that review/examination objectives are achieved;
- Source and support data for the Report Findings and recommendations;
- Basis upon which to respond to challenges to the Report;
- Basis upon which to judge the quality of the work performed by the team; and
- Facilitation of the planning for future reviews/examinations.

The extent of the workpaper documentation will vary with the scope of the review/examination. The experience level of the reviewers can also be a factor, with the possibility that reviewers being trained may be required to produce an increased amount of documentation to more fully demonstrate and document the thoroughness of a review/examination procedure. At a minimum, workpapers should conform to the scope of the review/examination and demonstrate support for the results of the review/examination.

Materials provided by the SBA Lender that are of particular importance to the completion of the workpapers should be filed in the Workpaper File. All retained documents in-file should relate to review components or Findings.

Workpapers should be clear and accurate, thus providing an easily understood representation of the reviewer's analysis, Findings, and conclusions regarding condition, cause and effect. The workpapers should be legible and neatly stored. Whenever possible, workpapers should be prepared on only one side of standard 8½ x 11" paper.

a. Work Paper Forms

The team will document all Findings in the workpapers with particular attention being given to major Findings that may become subject to Report comment. Major Findings become the basis for recommendations. The EIC is responsible for assuring that the documentation in the workpapers is sufficient to support the team's Findings.

In addition to providing support for the review/examination Findings, the workpapers must document the SBA Lender's response to the Findings wherever applicable. The documentation should detail whether management agrees with the Finding or, if there is disagreement, the reason(s) for the disagreement. Documentation should also detail management's explanation for the cause of the problem and any planned Corrective Action. The source(s) of this information should be detailed. It should also be noted that much information is learned during the discussions held with senior officials. Reviewers should document these discussions in writing for retention when they provide information for other reviewers or for future reviews/examinations.

The reviewer assigned to each component of the review/examination will be responsible for developing documentation in support of Findings, including development and organization of all relevant workpapers.

Workpapers generally take one of several forms:

Narrative Summary - A narrative description of a condition, reviewer's actions, management's response(s) and/or reviewer's conclusions and recommendations. Narrative summary workpapers should be initialed and dated by the author, at a minimum. Narrative workpapers of a critical nature should also be initialed by the EIC.

Loan File Review Workpaper - A summary of information from an individual loan file review. Any such summary should also be initialed and dated by the author.

SBA Lender Provided Documentation – Where the SBA Lender provides documentation for the review, the reviewer will create a workpaper that lists the documents collected, outlines the specific areas reviewed within the documents and attaches the documents, if possible.

Statistical Analysis - In cases where the data to be gathered is statistical in nature (e.g. loan production analysis, demographic analysis, currency and delinquency analysis), the workpaper may consist of a grid and an attachment defining the objective of the analysis and the data source, or other tables or graphs, as applicable.

Checklists - Those situations which lend themselves to a checklist format where all of the elements are listed with a “Yes” or “No” response and space to make brief comments.

Spreadsheets - Any statistical analysis or tabular material suitable for spreadsheet and/or electronic analysis.

Compilation(s) of Exception - An automated compilation may be employed in file reviews to produce a compilation listing of the SBA Lender’s SBA SOP compliance issues.

b. Organizing Work Papers

The EIC is responsible for assuring that the workpaper file is properly organized, and contains all relevant material. Workpapers should be logically organized, numbered, and bound at the conclusion of each review/examination to facilitate quality assurance and future review/examination activities. Care should be taken to include only those documents relevant to the work performed. The goal of all review/examination filing is to maintain complete and easily-accessed information for any discussion or subsequent actions determined appropriate by review/examination Findings.

Workpapers are to be sorted and organized so that reviewers can quickly find pertinent documents. If a workpaper file contains extensive information, the EIC may want to include an index for sections. The name of the SBA Lender should appear clearly on the outside of each workpaper package along with date of the review/examination. The documentation and workpapers are to be sorted into the following subject sections filed as follows:

- Correspondence and communication with the SBA Lender, including administrative materials;
- Workpapers for each review component;
- All the materials relating to the finalization of the Report (e.g. Exit Conference notes, draft Report sections); and
- Any ancillary material (e.g., Internet search documents, supplemental schedules of data, etc.).

Review/examination criteria for the individual review components are listed on a lead sheet which is to be signed and dated by the reviewer preparing the sheet and reviewed and initialed by the EIC. The workpapers for each review component are to be bound together with the lead sheet attached to the top.

18. SBA Lender Files Related to Reviews/Examinations

Generally, there are at least three types of files associated with SBA lender reviews/examinations. They are (i) a review/examination file for each individual review/examination of the SBA Lender (hereinafter referred to as the "Review File"), (ii) an active (temporary) review/examination file for any review/examination in active process (hereinafter referred to as the "Active Review File"), and (iii) a permanent file for the SBA Lender. The Review File contains the workpapers generated for each individual SBA Lender review or examination. The Active Review File contains all information for any active review/examination in process. The permanent SBA Lender file contains material and information to assist in the planning of subsequent reviews/examinations. The permanent file also contains information concerning corporate information and the SBA Lender's relationships with SBA.

There will be occasions where a limited amount of documentation may be stored in multiple files. Often, documents outlining the scope of a review/examination and the final Report will fall into this category. This will allow the future reviews/examinations planning to access why the last review/examination was conducted to the depth that it was without going into the individual review/examination file that contains the workpaper files.

a. Review/Examination File

The Review/Examination File is composed of copies of workpapers and documentation developed that documents all Findings. The file will usually contain:

- Correspondence with the SBA Lender regarding review/examination scheduling;
- Review/examination plan;
- Documentation prepared by the EIC detailing on-site adjustments to the scope of the review;
- Copies of correspondence or other material that would be significant to the planning of future reviews;
- All workpapers relevant to the review/examination;
- Copy of the final Report; and
- Any response from SBA Lender to the Report.

b. Active Review/Examination File

The active review/examination file is maintained by the EIC and is intended to be updated annually. The EIC purges material that will not be relevant to the next review. The purged documents should be returned to the original workpapers compilation for the specific review for which they were generated, rather than destroyed. The EIC for the review being planned will be responsible for maintaining and up-dating the active review/examination file. The file will usually contain:

- Copy of the most recent final Report;
- Current review/examination plan;
- Documentation prepared by the EIC detailing on-site adjustments to the scope of the review;
- Copies of correspondence or other material that may be significant to the planning of future reviews; and
- Any response from SBA Lender to review/examination Findings, as applicable.

c. Permanent File

The permanent file serves as a centralized source of background chronological information about the SBA Lender. The following information will be maintained in this file:

- General correspondence;
- Review scheduling letters;
- Prior Reports and appropriate workpapers;
- Documents relating to the corporate and management structure;
- Formal responses by management to Findings of weakness; and/or
- Copies of approvals and adverse actions.

d. Retention Schedule

All permanent files will be warehoused in the SBA at an office designated by the AA/OLO, with both electronic and paper storage media utilized. Copies of any document should be immediately available to the AA/OLO and other OLO staff, as well as any other SBA internal officials as deemed appropriate by the AA/OLO.

The retention schedule of workpapers will be in accordance with SBA SOP 00 41 2 requirements. Under unique circumstances, as defined by the AA/OLO, or designee, the retention period of workpapers may be lengthened. The responsible party designating the extension will so note in writing the additional time and reason for the extension and file copies of the decision to extend the retention in the Workpaper File and Permanent File.

e. Loan Files with Material Deficiencies and/or Suspected Fraud

SBA has established grounds for denial or repair of loan guaranty purchase requests (See 13 CFR §120.524 and SOP 50 51, Loan Liquidation and Acquired Property, Chapter 13). During file review, SBA may identify various regulatory, SOP or other policy or procedural requirements that, if not met, may result in a denial or repair when that particular SBA loan is submitted for guaranty purchase. When such a Material Deficiency is identified in an SBA loan file being reviewed, it must be identified and flagged as such in the Agency's Centralized Loan Chron System (CLCS). The data (needed for) entry will be taken from the SBA loans listed in the Report appendices. The SBA Senior Examiner assigned to the review is responsible for ensuring that SBA loans with Material Deficiencies are flagged in the Agency's Centralized Loan Chron System (CLCS) database.

During the course of the review, instances of suspected fraud by a borrower, loan agent or lender may be identified. All such loans or situations must be referred to the Assistant Inspector General for Investigations (AIGI) in the Office of Inspector General (OIG). The EIC is responsible for preparing the referral to OIG. In the event that lender fraud is suspected, the lender must not be notified of this finding without the written consent of the AIGI.

19. Distribution of Report

The Report will be distributed to the SBA Lender by the AA/OLO, with instruction to respond to identified Findings. The AA/OLO is also responsible for distributing the Report to the appropriate SBA offices. The SBA Lender generally will receive the Report within 60 days after completion of all on-site activities. Distribution of the Report is strictly prohibited, in accordance with paragraph 15 of this Chapter. SBA employees and contractors must be mindful of the fact that the information contained in Reports will generally be considered by the lender and borrowers that are identified in the Reports to be confidential and proprietary. Therefore, Reports must not be made available to members of the public unless disclosed in response to a Freedom of Information Act request where it has been determined that the information in the Report is not exempt from disclosure under that Act.

20. SBA Lender Response and Corrective Actions

SBA usually will not request an SBA Lender, whose operations are assessed as "Acceptable" to respond to the Report or to submit periodic reports.

Any SBA Lender that receives an assessment rating of "Acceptable with Corrective Actions Required" or "Less than Acceptable with Corrective Actions Required" will be required to submit a response to SBA addressing the exceptions, Findings, conclusions and recommendations contained in the Report. Depending upon the nature of the Findings and the Corrective Actions, the SBA Lender may be required to provide monthly or quarterly status reports until issues(s) are resolved to SBA's satisfaction. SBA will continue to communicate with the SBA Lender to ensure that the basis of the Findings and recommendations are understood, and the proposed resolution is satisfactory. SBA should consult with the SBA Lender if a proposed course of action is determined to be non-responsive or if the SBA Lender's problems are extreme. SBA action and/or SBA Lender resolution of issues are to be documented in SBA files so that reviewers will be aware of the situation when planning subsequent reviews. OLO staff will consult with the AA/OLO, or designee, to determine a course of action if SBA Lender management is non-responsive or if the SBA Lender's problems are extreme. Supervisory and/or enforcement actions may be considered. Communication related to problem resolution, both internal and external, must be documented in the SBA Lender's review file.

21. Appeal of Assessment

In the event that the SBA Lender identifies a specific mistake in the Findings of any review or examination which, in the opinion of the SBA Lender, renders the assessment to be inappropriate, the SBA Lender may request an appeal of the final assessment. The appeal of any assessment must be in writing, prepared by the SBA Lender's SBA program management official, be directed to the AA/OLO, and be received by SBA within 30 working days of the receipt of the Report and transmittal letter. The appeal must state the specific fact(s) which are challenged, and provide supporting information, along with a request for appeal of the final assessment. The AA/OLO or designee make a determination and respond within 60 calendar days. Any such appeal of facts does not alter the deadline for receipt of any SBA Lender Corrective Actions. However, a Finding in favor of the SBA Lender may alter the nature or scope of the response requested.

22. Quality Control

A quality assurance program is critical to ensure the integrity of the review process and the issuance of a quality Report. An effective quality assurance program consists of a number of processes, including cross-referencing workpapers and Report review. Prior to forwarding the Report to SBA Headquarters for review, the EIC must ensure that each Report Finding is supported by the review workpapers and documentation and that the recommendations flow logically from the Findings. The AA/OLO, or designee, will direct an internal review of a sampling of all Reports and related workpapers. This internal review confirms that Report Findings are supported by workpapers, statements including numerical presentations are accurate, and the narrative portion of the Report is clearly presented and grammatically correct. Additionally, selected Reports may be subject to additional review for quality control purposes by OLO staff. This additional review may take place before or after the Report is issued.

23. Cost of Reviews

In accordance with Section 5(b)(14) of the Small Business Act, 15 U.S.C. §634(b)(14), SBA may charge a fee to 7(a) lenders to cover the costs of the review or examination. SBA will provide notice to 7(a) lenders of the fee amount and other related information. SBA is currently promulgating regulations covering review and examination fees for all 7(a) lenders (i.e. 7(a), SBLC, NFRL). This SOP will be revised to incorporate such guidance when the regulations become effective.

Chapter 3

7(a) Risk-Based Lender Reviews

1. Introduction

This chapter addresses the on-site risk-based lender review process for all 7(a) Lenders other than SBLCs and certain NFRLs. (Chapter 4 describes the examination process for those 7(a) Lenders.) The risk-based review process focuses on performance and operational factors that allow SBA to assess the quality of a Lender's 7(a) lending operations. SBA determines the nature and scope of the review for each lender individually depending upon its SBA lending activity and actual or expected performance as an individual Lender. Subsequent sections of this chapter describe the review objectives and criteria for each of the review components that will be used in reviews of 7(a) Lenders. The review components for 7(a) Lenders are (i) portfolio performance, (ii) SBA management and operations, and, (iii) credit administration, and (iv) compliance.

2. Portfolio Performance Review Component

a. Introduction

The analysis of portfolio performance focuses on an evaluation of a Lender's SBA loan portfolio to assess historical, current and projected performance and to identify various risk characteristics of the portfolio. This analysis considers a Lender's performance compared to the SBA portfolio, to SBA-defined peers, and to itself, over time (trends). While the criteria and procedures identified are not an exhaustive list and may be modified during review planning or on-site activities, they provide a reasonably complete list of the processes used to evaluate this component. The procedures are not mandated rules to be rigidly followed by the reviewers. The lending business is a dynamic one, requiring reviewers to use their judgment to tailor review practices to individual situations. Reviewers can add, delete and/or modify procedures as appropriate, with the written approval of the AA/OLO or designee, when a Lender's particular circumstances and risk characteristics warrant. (Electronic mail is an acceptable means of obtaining the written approval of the AA/OLO or designee.) Any criteria or procedure that is added, deleted or modified in a particular review should be so identified in the Report, along with the reason for the change.

b. Review Criteria

13 CFR §120.410 requires that all participating Lenders have a continuing ability to evaluate, process, close, disburse, service and liquidate small business loans. SBA assesses this ability, in part, through review criteria regarding portfolio performance, as described below. The criteria are not all inclusive and during the course of the review, additional criteria may

be identified as well as certain criteria may be determined not to apply. SBA would add or delete criteria where such would provide a better measure of risk for that Lender's activities.

The purpose of the portfolio performance review is also to establish a picture of the Lender's SBA portfolio risk characteristics using predictive credit scoring as the measure of credit risk. This allows SBA to predict purchases over a 12-24 month period. SBA aggregates the Lender's loan scores, analyzes the Lender's SBA loan performance and compares it to SBA's portfolio and peer group performance.

The portfolio performance criteria are:

- Key performance statistics;
- Loan production activity;
- Comparative performance analysis;
- Credit quality; and
- Any other risk characteristic(s) identified in the Plan.

c. Review Objectives

The objective of the Portfolio Performance review is to assess the performance of a Lender's SBA 7(a) loan portfolio and the demographics of the portfolio, and to determine whether Lender is failing to meet any portfolio performance requirements set forth in statute, SBA Loan Program Requirement or Notice.

d. Review Procedures

Procedures are provided as guidance in conducting each component of the review. The procedures are not an exhaustive list. They will be expanded, contracted or adapted as warranted, in SBA's sole discretion, based on (i) the circumstances of the individual Lender, particularly if there are program and operational changes, (ii) changes in economic conditions, or (iii) Agency policy changes.

The Portfolio Performance Review procedures are designed to analyze portfolio characteristics such as growth rates, performance, industry and geographical concentrations; determine that Lender is meeting any portfolio performance requirements of Agency SBA Loan Program Requirements or SOP; and assess portfolio credit quality (as measured through credit scores). The review procedures include analysis and comparison of SBA and lender data.

Summary of Key Performance Statistics

Identify the Lender’s outstanding SBA portfolio and program composition.
Analyze the Lender’s portfolio composition, portfolio performance rates, and delivery method performance characteristics.
Identify any significant variations, fluctuations or performance trends in the individual delegated loan programs for further assessment.
Analyze Lender’s Active Purchases to establish a basic picture of the outstanding loans which have been purchased but are still within the purview of the Lender’s control.
Identify any significant characteristics of the Active Purchases, or trends of increasing numbers, for further assessment.

Loan Production Activity.

Analyze the annual production (numbers and dollars), delivery method break-down, average loan size, and discuss any trends or significant period-to-period fluctuations.

Comparative Performance Analysis.

Compare the Lender’s SBA loan portfolio performance to overall SBA portfolio and peer group, and past trends of lender itself at least over two prior years.
Identify and analyze outstanding portfolio performance (in numbers and dollars) by loan payment status (e.g. current, delinquent, default, etc.) and delivery method, and in comparison to portfolio, program and peer group performance rates, as available.
Identify and analyze any deviation of performance in Lender’s portfolio or in any particular program as compared to the available standards (SBA portfolio and peer).

Active Purchases

Identify and analyze the lender’s outstanding Active Purchases (in numbers and dollars) and trends over two fiscal years, as available.

Industry Concentration

Identify and analyze industry concentration(s) within the lender’s portfolio, and risk implications; i.e. significant percentage of dollars in one or more industries.
Compile a table of industry concentrations for loan portfolio (numbers and dollars).
Compare to SBA portfolio and peer averages, if available.
Analyze concentrations of 20% or more identifying the risk implications of such concentrations.

Geographic Concentrations

Identify and analyze any geographical concentrations and risk impact; i.e. any current economic issues of the geography with positive or negative impact on the portfolio.
Compile a table of geographic industry concentrations for loan portfolio (numbers, dollars and any available performance metrics.
Compare to SBA portfolio and peer averages, as available.
Analyze concentrations of 20% or more identifying the risk implications of such concentration.

Early Default Trends

Identify early defaults and analyze risk implications (early default defined as default reported within 18 months of disbursement); i.e. sporadic versus trend evidence, etc.

Guaranty Purchases

Identify any trends in Lender's guaranty purchases. Consult available Agency data regarding Lender's purchase activity for both the past-one year and five-year periods, inclusive of any denial of purchase activity, as available.

Other Segmentation

Identify and analyze any other segmentation of the portfolio with risk implications, and compare to SBA portfolio and/or peer averages, as available.
Compile any other tables or presentation of data, as appropriate during the review investigation, and as available, compare to any available applicable standards.

Credit Quality

Compare Lender's SBPS data to SBA's portfolio and peer averages, and discuss risk implications; i.e. significant deviation from the SBA portfolio average, positive or negative trends, quarter-to-quarter and/or year-to-year fluctuations, etc.
Analyze stratification of Lender's portfolio by credit score ranges and discuss proportions of predicted at-risk loans, both low and high, and risk implications; i.e. percentage of portfolio at high risk, trend over time, etc.
Analyze Projected Purchase Rate (PPR), and compare to SBA portfolio and peer averages.

Other Risk Characteristics

Identify and analyze any other risk characteristics as noted in the Review Plan through any other evaluations or other research.

Conclusion

Discuss all portfolio performance preliminary Findings with management. Conclude on the portfolio performance of the Lender.

3. SBA Management and Operations Review Component

a. Introduction

The SBA management and operations review component provides an overall assessment of a Lender's SBA lending operations. It assesses the adequacy of the Lender's corporate organization relative to the SBA lending operation including defined lending and decision making authorities; lending policies and procedures; management oversight and internal controls; ability to plan operationally and respond to changing circumstances; managerial expertise, leadership and administrative ability; and overall compliance with laws and SBA Loan Program Requirements, for the 7(a) loan program.

Lender should have defined SBA lending delegations of authority and oversight responsibilities. Lender's SBA program should also provide guidance to Lender's SBA program management on the identification of and response to changes in external factors affecting the viability of Lender's existing programs and services, including anticipated changes in economic conditions, markets, and competition.

The Lender should have SBA portfolio-related functional and operating guidance as evidenced by the development and implementation of program policy and procedure, operating goals and budgets, growth planned, business development and marketing plans and clear delegations of management and loan approval authority.

b. Review Criteria

- SBA Corporate Organization and SBA Management;
- Delegations of Authority;
- Operating Plan and Performance;
- Internal Oversight;
- External Oversight; and
- Any other Risk Characteristic(s) Identified in the Plan.

c. Review Objectives

The objective of the SBA Management and Operations component is to assess the completeness and effectiveness of the Lender's management of its SBA loan program, as evidenced by, for example, the adequacy of its lending policies, procedures, operations and internal controls. It is also to assess the management leadership and expertise in SBA lending.

The review objectives for SBA Management and Operations include:

- Determine completeness of corporate guidance, including policies, procedures and other operational direction applicable to the Lender's SBA loan program;
- Assess implementation of policies, and procedures;
- Identify demonstrated competence, leadership, and administrative ability by Lender's SBA management;
- Identify completeness and implementation of delegated lending and exception approval authority throughout the SBA department;
- Determine sufficiency of knowledgeable SBA loan personnel;
- Determine whether training is adequate to maintain well-informed SBA loan personnel;
- Determine the adequacy of the SBA organizational structure;
- Identify if normal geographic lending area for SBA is well-defined;
- Identify authority for consideration of exceptions to policy.
- Assess SBA management's performance in maintaining up-to-date and reliable operating policy, procedure, SBA budgets and performance reports;
- Determine adequacy of internal controls over the SBA loan program, including internal loan review function and SBA compliance review activities;
- Determine whether lender is in good standing with its Federal Financial Institution Regulator; and
- Determine adequacy and effectiveness of independent oversight of the SBA operation.

A Lender's portfolio performance, credit administration practices for both performing and problem loans, and compliance is largely affected by the result of decisions made by management. Findings and conclusions in these other components, made during the course of the review of these components, will strongly influence SBA's evaluation of management. However, an "acceptable" assessment in one does not necessitate an acceptable assessment for SBA Management and Operations. Judgment in evaluating this component is essential. For example, in positive economic conditions, a Lender's portfolio performance can be strong even though policies, procedures and controls may be inadequate.

d. Review Procedures

This assessment is conducted through review and analysis of (i) the Lender's corporate governance documents, (ii) structure of SBA program governance, (iii) operational and management policies and procedures, (iv) underwriting and loan monitoring policies and procedures, and (v) exception to policy processes. This assessment is then tested through observations and interviews with Lender's SBA program management.

SBA Corporate Organization and SBA Management

- Review organizational chart and identify the chain of command from the Board of Directors (BOD) to senior management of the Lender's SBA program.
- How does BOD/senior management maintain awareness of and direction over SBA operations through this chain of command process?
- Identify what meetings, reports or other methods of communication are conducted to accomplish direction of SBA operations, and obtain documentation or records of these meetings, reports, and methods.
- Are there any policy or procedural weaknesses which must be corrected by lender in the direction of the SBA portfolio?
- Determine whether any long-range planning demonstrates a significant change to the lender's approach to its SBA program. Describe the proposed change(s) and management's intent. Is it prudent?
- Determine whether Lender's SBA management is knowledgeable of SBA lending requirements.

Delegations of Authority

Determine whether delegations related to the SBA program for loan approval and servicing authority have been approved by the BOD or senior management, and that documentation related to the delegations confirms this.
Determine whether management communicated its delegations to the SBA portfolio staff to meet the goals and objectives of senior direction.
What internal controls exist to ensure that exceptions to delegations are properly handled?

Operating Plan and Performance

Describe Lender's business plan for SBA lending, including SBA loan program goals.

Determine whether Lender's SBA business plan is realistic in terms of lender's capacity, expertise and lending infrastructure.
Describe and analyze materials and methods employed to periodically communicate the SBA financial results, production data, portfolio performance, liquidation and charge-off information to senior lender management. Obtain reports (or copies) which demonstrate this reporting.
Determine what the Lender does to train and maintain proficiency in lending for its SBA personnel.

Internal Controls and Oversight

Determine the nature and frequency of the internal activities that provide oversight data and information to the SBA management. Identify the types of independent review being used to oversee the SBA lending program (e.g., internal and external audits). (This is *not* reporting, but *review independent* of the loan program management). Review any internal audit reports or compliance examinations of the SBA lending operation and review Findings and recommendations for deficiencies. Determine what actions have been taken by Lender to address any identified deficiencies.

External Oversight

- To what extent is the SBA program and/or the SBA loan portfolio subjected to third party/independent examination, review or audit over past three years or since the most recent SBA review?
- Obtain and review copies of available independent reports, examinations, reviews or audits on Lender's SBA loans or SBA portfolio.
- Review report Findings and recommendations for deficiencies.
- Determine what actions has been taken by Lender to address deficiencies and the results achieved.
- If Lender cannot provide copies of examination reports from its Federal Financial Institution Regulator, obtain confirmation from Lender that it is in good standing with its Federal Financial Institution Regulator.
- Obtain any copies of available supervisory agreements, memorandums of understanding, cease and desist orders or any other relevant documents. Review documents provided and determine any impact on SBA lending program. Determine what actions has been taken by the Lender to address deficiencies.

Other Risk Characteristics

Identify and analyze any other risk characteristics as noted in the Plan, related to any evaluations or other research conducted.

Conclusion

Discuss all preliminary SBA management and operations Findings with Lender management.
Conclude on adequacy of SBA management and operations.

4. Credit Administration Review Component

a. Introduction

Credit Administration evaluates a Lender's SBA program from the perspective of the lending operation. This component of the review assesses how loans are originated, closed, serviced, and problem loans managed either through workouts and restructuring and/or liquidation.

b. Review Criteria

In accordance with 13 CFR §120.410, each Lender's credit administration practices must demonstrate the Lender's continuing ability to evaluate, process, close, disburse, service and liquidate small business loans. The SBA's small business lending criteria is further outlined in 13 CFR §§120.101, 120.102, 120.120, 120.150, 120.151, 120.160, 120.191, 120.201, 120.211-120.214, 120.313, 120.524, 120.540 and other related SBA Loan Program Requirements and SOP provisions, as amended by SBA from time to time. The criteria upon which the assessment of the Lender's credit administration practices is performed is listed below. The criteria are not all inclusive and during the course of the review, additional criteria may be identified as well as certain criteria may be determined not to apply. The credit administration criteria include:

- Creditworthiness;
- Collateral;
- Closing and Disbursement;
- Regular Servicing and Assessment of Continued Creditworthiness;
- Collection Practices and Intensive Servicing and Liquidation;
- Active Purchases Management;
- Other Portfolio Management Items (i.e., Consistency with SBA Policy, Risk Rating Systems, etc.), and
- Other Risk Characteristics (i.e., Effectiveness of Internal Controls, Use of Loan Agents, Loan Sales/Participations, etc.).

c. Review Objectives

The objective of the review of a Lender's credit administration practices is to assess the Lender's ability to evaluate, process, close, disburse, service and liquidate its SBA portfolio. This assessment includes an analysis of Lender's credit policies, procedures, practices and internal controls, as well as an analysis of a sample of performing loans and intensive servicing of non-performing assets, in accordance with paragraph 12 of Chapter 2. This also includes analysis of acquired collateral to identify systemic features of the loan portfolio that pose an unnecessary risk of loss to the Agency, and to assess effectiveness of the management and staff in managing these risks related to the Lender's SBA program. The review procedures are designed to determine if loan origination, loan monitoring and collection activities (i) are in accordance with Lender's policy and SBA policy, and (ii) demonstrate prudent small business lending practices and adequate internal controls.

This component also considers other credit administration factors that may not apply to all Lenders. For example, for those Lenders involved in SBA loan participation sales, the ability of the Lender to manage a program of asset securitization and/or loan sales will be evaluated. Management practices will be evaluated for those Lenders utilizing loan agents or other third parties to originate loans to ensure that the Lender is adequately managing this aspect of the SBA loan portfolio. Practices of Lenders with performance statistics that compare unfavorably with the SBA portfolio and Lender's peer group performance will be analyzed to identify policies and procedures which may contribute to such performance.

The Credit Administration review will evaluate:

- Lender's organizational structure within which it performs credit administration and portfolio management functions including origination, servicing and liquidations of the SBA loan portfolio;
- Lender's ability to (i) exercise approval authority, including exception approval authority, (ii) document approvals, and (iii) review for the proper level of approval authority;
- Lender's ability to determine the creditworthiness of each applicant, in accordance with SBA policy, through consideration of (i) repayment ability, (ii) capitalization sufficiency, (iii) sufficiency of working capital, (iv) management ability of principals, (v) credit history of applicant and/or principals, (vi) sufficiency of collateral assessment, and (vii) requirement of all necessary collateral;
- Lender's ability to use its commercial policies for credit determinations, to the extent possible, to determine that the SBA guaranteed loan is approved in a manner consistent with lender's requirements for non-guaranteed commercial loans of similar size and type, e.g. for SBA*Express* loans;
- Use of any credit scoring appropriate to the SBA program in a manner that is consistent with its use in Lender's non-guaranteed commercial lending program;

- Lender’s maintenance of effective systems for on-going monitoring of performing loans to assess continued creditworthiness;
- Lender’s maintenance of effective tickler systems for Uniform Commercial Code (UCC) continuations, annual review of borrower financial statements or other prescribed routines for review of the account relationship, and insurance renewals;
- Whether Lender’s servicing actions result in an apparent increase in risk, including but not limited to actions that result in a substitution of, lowering of lien priority or release of collateral, are taken appropriately;
- Lender’s SBA program management requirements to report delinquent SBA loans to senior management and the BOD;
- Lender’s documentation of policies and procedures based upon a prudent lending standard for the following:
- Servicing resources to properly perform workout and liquidation activities throughout geographic area served by the lender;
- Legal resources to properly perform intensive servicing, workout and/or liquidation activities throughout geographic area served by the lender;
- Periodic review by management of SBA loans in workout and liquidation status;
- Reasonableness of workout actions taken by lender that resulted in an apparent increase in risk;
- Basis for and documentation required to transfer a loan into liquidation status, other than when required pursuant to an SBA “adverse event” (as defined in SOP 50 51 2);
- Adherence to SBA requirements for mandatory transfer to liquidation status;
- Degree to which liquidation practices for SBA loans conform to practices accorded lender’s non-guaranteed commercial loans;
- Response to notices of bankruptcy and other legal actions that might hamper workout or liquidation activities;
- Actions to be taken to remedy deficiencies, inadequacies, or to seek rectification of legal and regulatory violations by the borrower;
- Documentation related to efforts to be made to resolve liquidation cases prior to commencing efforts to take possession of the collateral or seek performance by the guarantors;
- Documentation of efforts to be made to control collateral in a timely manner;
- Prudence of the process to be employed to determine net realizable value of collateral;
- Prudence of delegated authority to release or abandon collateral;
- Prudence of delegated authority to compromise with, or agree to release of guarantors;

- Documentation of procedures to be employed to dispose of acquired collateral; and
- Consistency of lender's policy and procedure for disposal of collateral on non-SBA guaranteed commercial loans with actions taken on SBA-guaranteed loans;
- Lender's SBA program management requirements to report loans that are in "workout" or "liquidation" status to senior management and the BOD;
- Determination whether: Any aspect of Lender's credit administration policy is in direct conflict with SBA policy, and if so, how does lender propose resolution;
- Lender's delegations of authority are adequate to ensure appropriate credit administration of the SBA portfolio;
- Lender's risk rating system is adequate;
- Lender's use of loan agents and what risk factors are apparent; and
- Overall effectiveness of Lender's internal controls.

d. Review Procedures

The following procedures are provided as guidance in conducting the credit administration component of the review. The procedures are not an exhaustive list. They will be expanded, contracted and adapted, as warranted, within SBA's sole discretion based on (i) the circumstances of the individual Lender, particularly if there are program and operational changes, (ii) changes in economic conditions, or (iii) Agency policy changes.

The adequacy of a Lender's credit administration practices are assessed and evaluated through a review of written lending policies and procedures and discussions with management and Lender staff. A review of individual loan files is also performed to ascertain the degree to which lending policies and procedures are followed. The adequacy of a Lender's credit administration practices will be evaluated based upon prudent lending practices for commercial lending.

Creditworthiness

Determine whether Lender's SBA loan policy establishes requirements for creditworthiness that, at a minimum, include reasonable expectation of repayment, sufficient cash flow to fund operations, adequate management ability, adequate capitalization and satisfactory credit history consistent with 13 CFR §120.150 and SOP 50-10(4), Subpart A, Chapter 4. Determine whether Lender's policies and practices adhere to SBA's credit elsewhere requirement set forth in 13 CFR §120.101 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 3. Identify any separate credit standards for SBA delivery methods (e.g., SBA*Express*, Community*Express*),

industry type, business type, or any other portfolio segmentation, and whether these separate standards establish sufficient creditworthiness for these delivery methods consistent with 13 CFR §120.150, SOP 50-10(4), Subpart A, Chapter 4 and Subpart D, Chapter 3, Paragraph 7, SBA*Express* Program Guide, Paragraph 5 and Community*Express* Program Guide, Paragraph 9. Determine whether Lender's SBA credit policy demonstrates the continuing ability to evaluate and process SBA loans in accordance with 13 CFR §120.410. Review any scorecard model used and related policies and procedures, the process for developing the scorecard, and methodology for validating the scoring model on a periodic basis. Describe Lender's application of credit scoring on individual SBA loan decisions and practices for overriding credit score determinations. Describe the circumstances under which the credit score model is used on SBA loan decisions as compared to non-SBA loan decisions.
Describe any exceptions to the credit scoring policy or ability to override credit score policy, and/or practice. Review a sample of loans to determine whether Lender is adhering to all loan policies and all SBA loan policy requirements, and identify and provide examples of any Material Deficiencies or patterns of deficiency.

Collateral

Determine if Lender's SBA loan policy establishes requirements for collateral that, at a minimum, obtains all available collateral and meets all SBA collateral requirements contained in 13 CFR §120.160 and SOP 50-10(4), Subpart A, Chapter 4, Paragraph 1.h.. Review Lender's commercial loan collateral requirements, by program segments if applicable (i.e., new business, industry type, etc.). Identify if Lender's collateral valuation policy for non-guaranteed commercial loans is inconsistent with its SBA collateral valuation policy. If so, is Lender's SBA collateral policy consistent with Lender's non-guaranteed commercial collateral valuation (loan-to-value) in determining whether the loan is fully secured? Review sample of loans to determine if Lender is adhering to its loan policy and all SBA requirements regarding collateral, and identify and provide examples of any Material Deficiencies or patterns of deficiencies.

Closing and Disbursement

Determine whether Lender's SBA loan policy establishes requirements for closing and disbursement which include, at a minimum, execution of the loan authorization, obtaining all required executed loan documents, meeting all loan authorization conditions, verification of equity injection, verification of use of proceeds, verification of financial information, perfection of lien and guaranty requirements, obtaining all required insurance policies, including any applicable assignments and/or acknowledgments; and all other SBA-specific closing and disbursement requirements. Determine whether Lender's SBA closing policy demonstrates the ability to close and disburse SBA loans in accordance with 13 CFR §120.410. Determine whether Lender fully completes and follows requirements of SBA Form 1050, Settlement Sheet, for each disbursement, when applicable. Review any special Lender standards and practices (i.e. post-closing lien searches in lieu of pre-closing, Ownership and Encumbrance (O&E) Reports versus title insurance, appraisal, environmental or insurance standards, etc.) to determine the effect upon SBA loan closing and/or disbursements. Review sample of loans to determine whether Lender is adhering to its loan policy and all SBA requirements regarding loan closing and disbursement, and identify and provide examples of any Material Deficiencies or patterns of deficiencies.

Regular Servicing & Assessment of Continued Creditworthiness

Describe Lender practices for evaluating continued creditworthiness (e.g., annual financial statement analysis, credit modeling for portfolio management purposes, etc.).

Determine whether Lender's SBA policy for continued monitoring of the SBA portfolio is, at a minimum, consistent with its policy for non-guaranteed commercial loans, and is in accordance with all loan authorization requirements. Determine whether Lender's policy for SBA loan servicing is consistent with 13 CFR §120.513 and SOP 50 50 4, Loan Servicing.

Determine whether Lender's SBA servicing policy demonstrates the continuing ability to service SBA loans in accordance with 13 CFR §120.410.

Determine whether adequate controls exist to ensure required insurance coverage is in place, including any applicable assignments and/or acknowledgments are obtained, and all required insurance policies are renewed as necessary.

Determine whether "umbrella" insurance is in place to protect lender and SBA in the event insurance policies are not properly renewed. Determine that any such insurance is proportionately applied to Lender's and SBA's exposure. Identify examples of application of any umbrella insurance.

Determine whether adequate controls exist to ensure required lien positions are obtained and renewed, as necessary.

Describe and determine procedures for processing borrower servicing requests.

Review sample of loans to determine whether Lender is adhering to loan policies and all SBA requirements , including those contained in 13 CFR §120.513 and SOP 50 50(4), regarding regular servicing and portfolio management, and identify and provide examples of any Material Deficiencies or patterns of deficiencies.

Collections/Intensive Servicing/Liquidation

Determine whether the Lender's policies and procedures include collection procedures for past due and delinquent loans, procedures for deferring loans, and processes for referring loans from regular collections to intensive servicing and/or liquidation, and demonstrate Lender's continuing ability to liquidate in accordance with 13 CFR §120.410.
Determine whether Lender's policy for collections and deferrals of the SBA loan portfolio is complete in procedure and followed.
Determine whether Lender's policies and procedures establish a basis upon which a loan will be subjected to intensive servicing or liquidation action, including workouts, site visits, liquidation plans, inventory of, control, possession and/or protection of collateral; and access to counsel, and is consistent with 13 CFR §120.540 and SOP 50 51 2.
Review sample of loans to determine whether Lender is adhering to its loan policy and all SBA requirements, as set forth in 13 CFR §120.540 and SOP 50 51 2, regarding management of collections, intensive servicing and liquidation of accounts, and identify and provide examples of any Material Deficiencies or patterns of deficiencies.

Management of Active Purchases

Determine whether Lender's policies and processes to manage Active Purchases are consistent with those for its non-purchased SBA loans up to Final Wrap-up Report submission. Review a selection of purchased loans to determine whether Lender has well-defined and clear action plan events, with timelines and responsibilities for intensive attention. Confirm that the unguaranteed portions of purchased loans and/or loans in liquidation status are consistently managed.

Other Portfolio Management Items
Consistency/Conflict with SBA Policy

Identify if any stated Lender policy is in conflict with SBA Loan Program Requirements, policies and/or procedures. If so identified, what actions, if any, must be taken to address the conflicts. Reviewer must be mindful of this while conducting analysis of all Lender policies and procedures related to the SBA loan portfolio and its individual SBA loans and their administration.

Risk Rating System

Evaluate policies for internal grading, risk rating and/or classification of loans, and practices for rating loans at regular intervals through life of loan (at least annually).

Determine how these rating systems affect Lender's SBA portfolio management. Identify who is responsible for maintaining accurate risk ratings. Review management reports containing risk ratings or classifications of all SBA loans.

Effectiveness of Internal Controls

Review any checklists or other practices which assist in ensuring that all files are managed consistently and correctly, and in accordance with Lender and SBA policies. Describe any serious gaps in internal controls which indicate a weakness in following any policies and procedures.

Use of Loan Agents

- Does the Lender routinely or on an ad hoc basis use loan agents in originating its SBA loans?
- Determine whether Lender's policies and procedures establish a basis for routine or ad hoc use of loan agents (packagers, referral agents, brokers, etc.) in originating SBA loans.
- Determine whether loan agent-originated loans are fully meeting SBA standards, including those on creditworthiness.
- For Lenders with active loan agent relationships, obtain list of loans referred by loan agents, and analyze a sample of loans referred by loan agents to determine whether performance trends and/or credit quality is comparable to book of business originated directly by Lender.
- Determine whether SBA Form 159, "Fee Disclosure Form and Compensation Agreement" has been completed, as applicable, for each loan in which a loan agent has participated.
- Determine whether additional file review is appropriate to fully assess loan agent activity. If so, review a small selection of loan files for loans originated by loan agents to determine whether each decision was reached in accordance with Lender's and SBA's policies and to better evaluate Lender's use of loan agents.

Loan Sales, Participations, Pledges and/or Securitizations

Determine whether Lender sells loans in the secondary market, buys or sells participations, pledges any portion of any of its SBA loans, and/or securitizes the unguaranteed portion of any of its SBA loans. If so, review policies governing such SBA loan sales, participations, pledges, and securitization to determine whether Lender has provided for written consent of SBA prior to sale, pledge, or securitization of any SBA loan or pool of SBA loans consistent with 13 CFR §§120.430-435.

Evaluate Lender practices to determine that Lender has followed applicable polices and procedures for any such sales, participations, pledges or securitizations.

Conclusion

Discuss all credit administration preliminary Findings with management. Conclude on the effectiveness of Lender's credit administration policies and practices. In making these conclusions, the reviewer should identify mitigating circumstances such as lending that, while being more risky, may further SBA's mission in a positive manner. However, additional risk in the SBA loan portfolio must be accompanied by more rigorous credit administration practices in servicing and oversight. The conclusions shall be presented to management at the exit conference along with an assessment of the seriousness of the preliminary Findings relative to the lender's SBA activities.

5. Compliance Review Component

a. Introduction

The compliance review component of the risk-based review is focused on those areas of SBA lending that are uniquely SBA requirements. These areas are not associated with credit and portfolio management activities but with eligibility and other Agency and/or program specific requirements (e.g. borrower eligibility, reporting, and others, as stipulated).

b. Review Criteria

Each Lender must demonstrate that it is in compliance with SBA lending requirements, in accordance with 13 CFR §§120.100-397, §120.452-453, §120.500-554 and SOP 50-10(4). The criteria upon which the assessment of the Lender's compliance is performed is listed below. The criteria listed are not all inclusive and during the course of the review, additional criteria may be identified, as well as certain criteria may be determined not to apply. The criteria are as follows:

- Borrower Eligibility;
- Reporting to SBA; and
- Any other Compliance matters identified.

c. Review Objectives

Making loans guaranteed by SBA imposes unique loan origination, servicing, liquidation, and reporting requirements on the Lender. The objective of the compliance component of the review is to determine whether the Lender is knowledgeable of these unique SBA requirements and maintains a lending program that meets these requirements so that only loans eligible for an SBA guaranty are made. An additional objective of the compliance component is to assess whether the Lender meets SBA program and reporting requirements.

The review objectives of the Compliance component include:

Determination as to:

- Knowledge and application of eligibility requirements set forth in 13 CFR §§120.100, 120.103, 120.110, 120.111, 120.120, 120.130, 120.131 and SOP 50-10(4), Subpart A, Chapter 2;
- Accuracy of "Guaranty Loan Status & Lender Remittance Form", SBA Form 1502 reporting;
- Timeliness of SBA Form 1502 reporting and accuracy of remittances (including all fees);
- Resolution of issues on SBA Form 1502 exception reports;
- Accurate and timely reporting and remittance of any required daily SBA Form 1502 reports for sold loans;
- Accurate and timely reporting and remittance of any unscheduled transactions;
- Remittance of guaranty and all other fees accurately; and
- Remittance of guaranty and all other fees in a timely manner.

d. Review Procedures

The following procedures are provided as guidance in conducting the compliance component of the review. The procedures are not an exhaustive list. They will be expanded, contracted and adapted, as warranted within SBA's sole discretion based on (i) the circumstances of the individual lender, particularly if there are program and operational changes, (ii) changes in economic conditions, and (iii) Agency policy changes.

The compliance review is conducted and compliance assessed, on the basis of (1) a review of a sample of loan files, selected in accordance with Chapter 2, Paragraph 12 of this SOP, for compliance with SBA eligibility requirements; and (2) review and analysis of the lender's 1502 reporting to SBA.

Borrower Eligibility

Review each loan based upon applicant (borrower), project and lender file management. Review issues include eligibility requirements, as applicable, to the type, delivery method, size, and any other parameters

defined by SBA. Compile individual incidences of deficiency, and analyze to determine whether any patterns of deficiency exist, as follows:
Identify all compliance deficiencies in each sample file reviewed, and determine whether there are patterns of deficiencies among all files, reviewing for the following:

- Determine whether all principal owners of the business are eligible and of good character as demonstrated on "Statement of Personal History", SBA Form 912 (13 CFR §§120.100 and 120.150(a) and SOP 50-10(4), Subpart A, Chapter 2);
- Determine whether the Lender obtained SBA Form 912, Statement of Personal History, on all persons required (SOP 50-10(4), Subpart A, Chapter 6, Paragraph 4.d.);
- Identify that the applicant business is small by SBA size standards (13 CFR §120.100(d) and Part 121 and SOP 50-10(4), Chapter 3);
- Determine whether credit is not otherwise available on reasonable terms from non-Federal sources without guaranty provided by the SBA (13 CFR §120.101 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 3);
- Determine whether desired funds are available from the personal resources of any owner of 20% or more of the equity of the applicant, including limits on outstanding personal liquid assets, and if available are injected (13 CFR §120.102 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 4);
- Determine whether the business is for profit, domestic operation, and otherwise eligible in accordance with SBA SOP (13 CFR §120.100(a) and (b) and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 2);
- Determine whether the applicant has ever caused prior loss to the Government from prior federal financial assistance (13 CFR §120.110(q) and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 8.q.);
- Identify all use of proceeds of the loan as eligible, including funds used to purchase any portion of rental real estate, pay debts or change ownership of the applicant business (13 CFR §§120.120, 120.130, 120.131, 120.160(d), 120.201 and 120.202 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 10);
- Identify that any franchise financing is eligible (SOP 50-10(4), Subpart A, Chapter 3, Paragraph 3.e.);
- Determine whether all principal owners of the business are U.S. citizens or eligible resident aliens (SOP 50-10(4), Subpart A, Chapter 2, Paragraph 15.h.);
- Identify any actual or apparent conflicts of interest or preferences (13 CFR §§120.110(o), 120.140, 120.453(a) and SOP 50-10(4), Subpart A, Chapters 2 and 3, and Subpart D, Chapter 3, Paragraph 7.a.(4)(j));

- Determine whether all SBA delegated program-specific eligibility issues (e.g. PLP, SBA*Express*) are met (13 CFR §§120.450-455; SOP 50-10(4), Subpart D, Chapter 3, Paragraph 7.a. and SBA*Express* Program Guide, Paragraph 5.A.);
- Determine whether all Community*Express* loan applicants are eligible and have received pre-and post-closing technical and management assistance arranged and, if necessary, paid for by Lender (Community*Express* Program Guide, Paragraphs 6, 7 and 9.A.); and
- Identify any other SBA statutory, regulatory or SOP violations of eligibility.
- Compile a list of all eligibility deficiencies by issue type and by errors per file, and identify any trends of deficiencies which warrant lender attention.
- Compile a list of material eligibility deficiencies by loan file number and reason for deficiency. (Material Deficiency is defined in Chapter 2 of this SOP).

Reporting and Payments to SBA

Compare the SBA Form 1502 Report submissions for the most recent three months to the loan transcripts for the loans in the review sample to determine accuracy of Lender's reporting, including accuracy of loan: status; outstanding guaranteed loan balance; and paid-to-date information. Summarize any risk implications of errors in reporting; i.e. inaccurate reporting to SBA, etc.

- Determine whether Lender is providing SBA accurate loan payment information.
- Review Lender's transmittal records for SBA Form 1502 reports for the most recent three months to determine timeliness of reporting to SBA's Fiscal and Transfer Agency (FTA). (The month-end SBA Form 1502 Report is due on the third business day following the end of the month with a two-day grace period).
- Review the Lender's Automated Clearing House (ACH) or manual payments records for the past three months to determine that remittances have been paid accurately and in a timely manner to the FTA. The remittance of scheduled receipts must be made by the third business day following the end of the month with a late fee being assessed on the second day following the due date.
- Determine whether all transmittals include all required payments and fees, including secondary market fees, basis points fees, late fees and/or prepayment fees.
- Review exception reports received by the Lender during the most recent three-month period to determine timeliness of necessary Corrective Action taken by the Lender.

- Determine whether Lender responds to error/exception reporting to successfully resolve any such errors.
- Identify any steps Lender management has taken to resolve any patterns or trends, and any additional steps required to meet SBA standards.
- Review loan transcript for each loan in the review sample to identify any unscheduled "daily remittance transactions" (on sold loans) due, and compare to the appropriate "daily" SBA Form 1502 Report to assess accuracy and timeliness of remittances. Unscheduled transactions on sold loans include such items as payoffs, late payments, and interest only payments.
- Review ACH records to identify any unscheduled transactions remitted to determine if they were made in a timely manner. Reporting and remittance of unscheduled receipts must be made by the second business day following the receipt of good funds. The reviewer must determine if the funds were "good" at the time of receipt, i.e. cash, wired or on deposit with the Lender, in which case they must be remitted by the second business day following receipt. Regarding "paper" funds drawn on another institution, for review purposes, remittances made by the fifth business day following of the receipt would be considered timely.

Conclusion

Conclude whether Lender is providing SBA accurate information on unscheduled transactions.

Other Compliance Characteristics

Determine whether the guaranty fee was paid in accordance with 13 CFR §120.220 and SOP 50-10(4), Subpart B, Chapter 1, Paragraph 15.
Determine whether all SBA requirements regarding collateral have been met and determinations regarding sufficiency of collateral have been made (13 CFR §120.150(h) and SOP 50-10(4), Subpart A, Chapter 4, Paragraph 1.h.).
Determine whether Lender has verified any required borrower injection prior to disbursement (13 CFR §120.150(f) and SOP 50-10(4), Subpart A, Chapter 4, Paragraph 1.f.).
Determine whether Lender has obtained any required personal guaranties, appraisals, environmental assessments, flood insurance, or other required insurance, prior to disbursement (13 CFR §§120.160(a), (b) & (c), §120.170 and SOP 50-10(4), Subpart A, Chapter 5).
Determine whether Lender required, obtained and reconciled IRS tax transcripts for any applicant when required by SOP (13 CFR §120.191 and SOP 50 10(4), Subpart A, Chapter 6, Paragraph 4.f.).

Determine whether Lender followed SBA requirement for site visit or other intensive servicing activity when loan is 60-days or more past due, or there are other reasons for concern (SOP 50 51 2, Chapter 8, Paragraph 8.B.).

Determine whether Lender has followed all SOP requirements regarding management of liquidation cases, including preparation of a liquidation plan, timely site visits, use of current appraisals, consideration of environmental issues, and preparation of a wrap-up report at conclusion of liquidation (SOP 50 51 2, Chapter 8, paragraph 11).

Identify whether Lender has forwarded all recoveries on repurchased loans within 15 days of receipt (SOP 50 51 2, Chapter 8, paragraph 25.).

Conclusion

Conclude on the Lender's compliance with SBA's requirements for (i) eligibility; (ii) payment reporting processes, procedures and implementation, and (iii) other listed compliance requirements.

Chapter 4

Small Business Lending Company and Non-Federally Regulated Lender Examinations

1. Introduction

The majority of the lenders that participate in SBA's 7(a) program are banks which take deposits from customers, extend loans to the general public and are regulated by a Federal Financial Institution Regulator.

SBLCs are non-depository financial institutions that are licensed by SBA and may only make loans under the SBA 7(a) program and loans to intermediaries participating in the Microloan program. SBA supervises, examines, regulates and enforces laws against SBLCs. An SBLC is subject to all applicable SBA Loan Program Requirements, including those governing Lenders. With nearly 20% of the entire SBA outstanding 7(a) loan portfolio currently comprised of loans originated by SBLCs, these lenders play a major role in the SBA's delivery of financial assistance to small businesses. SBA will conduct examinations on all SBLCs, in accordance with 13 CFR §120.470 and the provision of this Chapter 4.

There are also non-depository institutions that specialize in lending to small businesses that are eligible to participate in 7(a) lending program. These non-SBLC/non-depository lenders are typically licensed by state authority. These non-depository institutions which participate in the 7(a) program are referred to as "Non-Federally Regulated Lenders" (NFRLs). The level of supervision provided by state authority varies widely from state to state. Capitalization sources for these lenders also vary widely. For NFRLs, SBA has the authority to supplement state supervision with its own oversight to ensure that the interest and concerns of the SBA are properly addressed.

2. Lenders Who Will Receive Examinations

"SBA Supervised Lender" is a term that SBA applies collectively to both SBLCs and NFRLs. The provisions of this chapter apply to examinations of SBA Supervised Lenders. However, depending upon the level of lending activity and the extent and nature of regulation by other Federal or State financial regulatory agencies, SBA will not conduct an examination on every SBA Supervised Lender. For NFRLs, the AA/OLO or designee will determine, in their sole discretion, whether to conduct a risk-based review (in accordance with Chapter 3 of this SOP) or an examination (in accordance with this chapter). Factors upon which this determination will be made include the level of 7(a) lending activity of the NFRL, the NFRL's risk characteristics, and availability of resources.

The examination outlined in this chapter is applicable to SBLCs licensed by SBA (except for those SBLCs that are subject to regulation by another Federal or State financial regulatory agency as determined by SBA pursuant to regulation), and to those NFRLs which have been determined to be a candidate for the more extensive examination process. This determination will be accomplished through OLO's off-site monitoring, and will be based upon each individual NFRL's level of risk to the Agency (e.g. outstanding SBA exposure and performance rates relative to program or peer standards). SBLC-licensing standards which are not applicable to NFRLs (e.g. minimum capital requirements) will be excluded from the examination process for NFRLs.

SBLCs operate differently from banks in that SBLCs are non-depository lending institutions whose operations are limited to originating and servicing SBA 7(a) loans. In addition to comparing SBLC performance to its 7(a) peer group, SBA performs a comparative analysis of an SBLC's performance to the overall SBLC peer group. For this reason, SBA compiles portfolio performance statistics for the SBLC lenders on a quarterly basis and uses these statistics in assessing an SBLC's performance.

3. Examination Components

Examinations of SBA Supervised Lenders cover six major components – capital, asset quality, management, earnings, liquidity and SBA compliance. Some of the evaluation criteria are reiterated under one or more of the other components to reinforce the interrelationship between components. The procedures are not mandated rules to be rigidly followed by the reviewers. The lending business is a dynamic one, requiring examiners to use their judgment to tailor review practices to individual situations. Examiners can add, delete and/or modify procedures as appropriate, with the written approval of the AA/OLO or designee when an SBA Supervised Lender's particular circumstances and risk characteristics warrant. (Electronic mail is an acceptable means of obtaining the written approval of the AA/OLO or designee.) Any procedure that is added, deleted or modified should be so identified in the Report, along with the reason for the change. The listing of evaluation criteria for each component is in no particular order of importance.

Capital

SBA's required capital structure for SBLCs is specified in 13 CFR §120.470(b). State statutes specify minimum capital requirements for NFRLs. The evaluation of capital focuses on the SBA Supervised Lender's ability to provide for growth and to absorb loan and operating losses. Criteria to consider when determining an assessment for capital include, but are not limited to:

- Compliance with the regulatory minimums;
- The level, composition or quality of capital;
- The SBA Supervised Lender's asset growth rate compared to its capital growth rate;
- The threat posed by asset quality if allowance for loan losses is inadequate;
- The impact on capital from earnings, dividends, or other distributions;
- Any concerns raised by interest rate risk, off-balance-sheet exposure, concentrations of credit, or any near-term commitments of capital; and

- The adequacy of capital in relation to all pertinent ratios.

Asset Quality

Loans are generally the principal risk assets. Accordingly, the analysis of loans will provide an asset quality conclusion that will impact the assessment of the SBA Supervised Lender, under 13 CFR §120.410 for 7(a) lenders and under13 CFR §120.470(b) for SBLCs. Matters to be considered include, but are not limited to:

- The level and severity of criticized and classified loans, and delinquency, workout, and non-accruals trends;
- Adequacy of loan portfolio management, including strategic planning, policy and procedure, internal loan review, stress testing, and compliance;
- The adequacy of the loss allowance and capital in relation to classified and criticized loans;
- Concentrations in industries or geographic regions that are suffering some economic distress; and
- History or track record of i) meeting underwriting standards, ii) quality of credit administration, iii) adequacy of internal loan review, and iv) the timeliness of charge-offs.

Management

The assessment of management must consider every operational area in addition to the policies and standards adopted. This category will assess the performance of both the BOD and executive management, in accordance with 13 CFR §120.410 for all 7(a) Lenders and also 13 CFR §120.470(b)(12) for SBLCs, based on factors such as:

- Effectiveness of policies, standards, and procedures;
- Adequacy of internal controls, including internal loan review;
- Ability to plan strategically and operationally, and to respond to changing circumstances;
- The overall condition of the company, to the extent it can be attributed to policy or ineffective response to poor performance;
- Pending litigation;
- Compliance with law and regulations; and
- Demonstrated competence, leadership, and administrative ability.

Earnings

Earnings are evaluated based on their quantity and quality, and the SBA Supervised Lender's ability to sustain both. In accordance with 13 CFR §120.410 for all 7(a) lenders and 13 CFR §120.470(b) for SBLCs, the following factors are among those considered in assessing the SBA Supervised Lender's earnings:

- The level of earnings compared to the company's established goal;

- Dividend expectations;
- Composition (quality) of net income;
- Sustainability of earnings as indicated by interest rate risk and the volume and trend of non-accrual loans;
- The relationship between the level of earnings and capital growth needs; and
- Adequacy of the allowance for loan losses.

Liquidity

An SBA Supervised Lender's liquidity is evaluated on its capacity to promptly meet the demand for payment from its obligations and to readily meet the credit needs of borrowers in its territory, in accordance with 13 CFR §120.410 for all 7(a) lenders and also 13 CFR §120.470(b)(12) for SBLCs. The following factors are among those considered when assessing liquidity:

- The existence of a parent company committed to providing the necessary liquidity to its subsidiary;
- The availability and cost of funding which is usually dictated by the overall condition of the company;
- Any loans available for pooling and available for sale;
- Loan demand;
- The stability of the principal source of funding; and
- Any near term capital expenditures, cash dividend, or unexpected liquidity demands.

Compliance

The SBA Supervised Lender's compliance with SBA-specific requirements including eligibility and reporting to SBA, as found in the applicable sections of 13 CFR §120 and SOP 50-10(4), is also an examination component. The criteria included in the compliance review component include, but not limited to, the following:

- Eligibility of the borrower to qualify for the financial assistance in accordance with 13 CFR §§120.100-120.105, 120.120 and 120.130, and SOP 50 10(4);
- Accurate and timely reporting to SBA, to facilitate the accurate assessment of the performance of the SBA Supervised Lender's SBA loan portfolio in accordance with 13 CFR §120.472 and SOP 50 50(4); and
- Accurate and timely payment of guaranty fees, prepayment fees and other fees, payments or recoveries due to SBA in accordance with 13 CFR §§1202110, 120.223, SOP 50 10(4), 50 50(4) and 50 51(2).

4. Capital Examination Component

a. Introduction

The purest and most stable forms of capital an SBA Supervised Lender may hold include: the common shareholders' equity (common stock, surplus, and retained earnings); non-cumulative perpetual preferred stock; and the minority interests in the equity accounts of consolidated subsidiaries. It is the equity of an SBA Supervised Lender that will comfort investors and borrowers. An acceptable level of these forms of capital:

- Assure customer and shareholder confidence in the SBA Supervised Lender's stability;
- Support volume growth in the SBA Supervised Lender's primary business;
- Absorb any unexpected loan or operating losses;
- Permit the SBA Supervised Lender to continue to meet the credit demands within its territory; and
- Evidence owner/management investment.

There are other forms of capital that exist in the financial institution community, although quite rare and which have limited value. A discussion of these follows. Limited-life preferred stock is not as strong a form of capital because it has a maturity date, and in certain circumstances, does not retire as a class. Subordinated debt, when issued by an SBA Supervised Lender, may also be of limited value. Careful consideration is warranted. A subordinated debt issue can take different forms, including an interim repayment schedule prior to maturity. Examiners must recognize that this form of capital is not available to absorb loan losses. Such debt instruments should be investigated to determine their impact on the SBA Supervised Lender's long and near term capital position.

The allowance for loan losses is not a form of capital. It is a valuation account set aside for potential loan losses. Nevertheless, examiners must consider the adequacy of the allowance when attempting to evaluate capital adequacy. For example, it is not prudent to say capital is inadequate solely due to a very high gross classified asset-to-capital ratio if the allowance is adequate to absorb potential loss. On the other hand, capital is the next alternative if the allowance is inadequate. Thus, an inadequate loss allowance may impact an SBA Supervised Lender's capital evaluation. Thus, the examiners assigned to Capital and to the Capital (Loan Loss) Allowance should co-ordinate their conclusions.

b. Examination Criteria

13 CFR §120.470(b)(3) requires that each SBLC have "unencumbered paid-in capital and paid-in surplus of at least $1,000,000 or ten percent of the aggregate of its share of all outstanding loans, whichever is more. However, these are <u>minimum</u> requirements, and as such may not prove to be adequate capital for an SBLC. Furthermore, 13 CFR §120.470(b)(4) states that each SBLC "must avoid capital impairment at all times." The regulations further provide that "impairment exists if the retained earnings deficit of an SBLC exceeds 50 percent of combined paid-in capital and paid-in surplus, excluding treasury stock." The same regulation requires any impaired SBLC to give SBA written notice within 30 days of the first month end report that reflects said condition. Finally, the regulation provides that an SBLC may not present any loans to SBA for guarantee until the impairment is cured. The requirements of these regulations demonstrate the importance that SBA places on capital held by an SBLC.

For NFRL capital adequacy will be determined based on regulatory requirements of the Lender's state licensing authority.

Other regulations applicable to evaluating capital are:

- 13 CFR §120.470(b)(6) "Voluntary capital reduction." Without SBA prior written approval, an SBLC must not reduce its capital, or purchase and hold more than two (2) percent of any class or combination of classes of its stock;
- 13 CFR §120.470(b)(13) "Borrowed funds." SBLCs must not be capitalized with borrowed funds without SBA's prior written approval;
- 13 CFR §120.472(d)(3) "Reports to SBA." SBLCs must report any changes to its capitalization;
- 13 CFR §120.472(d)(5) "Reports to SBA." A notice of pledge of stock as collateral for indebtedness must be submitted to SBA if more than ten (10) percent of the stock is pledged; and
- 13 CFR §120.473 "Change of Ownership or Control." Any change in ownership or control without SBA's prior written approval is prohibited.

The following provide SBA guidance regarding calculation of capital adequacy:

- Both 13 CFR §120.425(a) and 13 CFR §120.470(b)(3) provide guidance on the minimum capital structure for an SBLC. Which regulation applies to an individual SBLC depends on whether or not the individual SBLC has securitized any of the unguaranteed portions of its 7(a) loans after April 12, 1999; and

- 13 CFR §120.470(b)(4) is applicable to all SBLCs, regardless of whether or not they have securitized the unguaranteed portion. However, this regulation would only be triggered if the SBLC had a retained earnings deficit.

Regulations Summary

Regulations		
13 CFR §120.425(a)	13 CFR §120.470(b)(3)	13 CFR §120.470(b)(4)
Capital Requirements – All securitizers must be considered to be "well capitalized" by their regulator. SBA sill consider a depository institution to be in compliance with this section if it meets the definition of "Well capitalized" used by its bank regulator. SBA's capital requirement does not change the requirements that banks already meet. For nondepository institutions, SBA, as the regulator, will consider a non-depository institution to be "well capitalized" if it maintains a minimum unencumbered paid in capital and paid in surplus equal to at least 10 percent of its assets, excluding the guaranteed portion of 79a) loans. The capital charge applies to the remaining balance outstanding on the unguaranteed portion of the securitizer's 7(a) loans in its portfolio and in any securitization pools. Each nondepository institution must submit annual audited financial statements demonstrating that it has met SBA's capital requirement.	In addition to complying with §§120.400 through 12.0413, an SBLC must meet the following requirements:… Capital structure. It must have unencumbered paid-in capital and paid-in surplus of at least $1,000,000, or ten percent of the aggregate of its share of all outstanding loans, whichever is more.	In addition to complying with §§120.400 through 12.0413, an SBLC must meet the following requirements:… Capital impairment. It must avoid capital impairment at all times. Impairment exists if the retained earnings deficit of an SBLC exceeds 50 percent of combined paid-in capital and paid-in-surplus, excluding treasury stock. An SBLC must give SBA prompt written notice of any capital impairment within 30 calendar days of the month-end financial report that first reflects the impairment. Until the impairment is cured, an SBLC may not present any loans to SBA for guarantee.
The institution has securitized any portion of its unguaranteed 7(a) loans after April 12, 1999.	The institution <u>has not</u> securitized any portion of its unguaranteed 7(a) loans since April 12, 1999.	There is a retained earnings deficit.
Total paid-in-capital and surplus (reduced by negative retained earnings, if any) May include subordinated debt and preferred stock <u>but only as specifically approved</u> by SBA and, is reduced by formula as it nears maturity. <u>Maturity Date</u> <u>%</u> <u>Counted Towards Capital</u> 4 to <5 years 80% 3 to <4 years 60% 2 to <3 years 40% 1 to < 2 years 20% Less than 1 year 0%	Total paid-in-capital and surplus (reduced by negative retained earnings, if any) May include subordinated debt and preferred stock <u>but only as specifically approved</u> by SBA and, is reduced by formula as it nears maturity. <u>Maturity Date</u> <u>%</u> <u>Counted Towards Capital</u> 4 to <5 years 80% 3 to <4 years 60% 2 to <3 years 40% 1 to < 2 years 20% Less than 1 year 0% [this is the same as 425(a)]	Retained earnings deficit
Total assets (per balance sheet) minus the guaranteed principal balance of loans to the extent they are included in total assets, minus the B-traunch of a securitization that is on the SBLC's balance sheet, plus the unguaranteed principal of loans either securitized or participated (unless sold entirely and	Total unguaranteed principal balances of loans owned plus the principal balance of loans participated plus servicing rights assets, IO strips and other residual assets resulting from the guaranteed and unguaranteed portions of loans sold.	Total paid-in-capital and surplus (not reduced by negative retained earnings, if any) May include subordinated debt and preferred stock <u>but only as specifically approved</u> by SBA and, is reduced by formula as it

Regulations		
13 CFR §120.425(a)	13 CFR §120.470(b)(3)	13 CFR §120.470(b)(4)
servicing was transferred with SBA approval).	Include participated loans unless sold entirely and servicing was transferred with SBA approval. -Include OREO (net of charge offs)	nears maturity. [this is the same as numerator for 425(a) and 470(b)(3), <u>except this is not</u> reduced by negative retained earnings]
Goodwill is not deducted from either assets or capital. No need to adjust the numerator or denominator for either accrued interest or the allowance for losses. No need to include Accumulated Other Comprehensive Income or Losses in numerator.	Goodwill is not deducted from either assets or capital.	Goodwill is not deducted from either assets or capital.

While SBA's regulations and summary provide a basis to assess capital adequacy, the final judgment involves evaluation of other critical variables that could impact an SBA Supervised Lender's financial condition. The adequacy of the allowance for loan losses, management capability, loan demands, and the quantity and quality of earnings represent a partial list of these variables. Therefore, an examiner evaluating capital must maintain a routine dialogue with other examiners participating in the Examination who are evaluating the SBA Supervised Lender's operation to obtain information on the other variables. It is very important that the examiner evaluating the allowance for loan losses be queried early. An examiner cannot conclude the adequacy of capital until it is determined that the allowance is adequate.

Dividends are distributions of earnings to owners. To declare a dividend, the BOD must take formal action, declaring the amount, the medium, the date of record for stockholder qualification, and the date of payment. Dividends are usually declared and paid in cash or stock. On the rare occasion, dividends come in the form of real or personal property. These are referred to as "dividends-in-kind." When examiners encounter dividends-in-kind, GAAP should provide guidance as to the impact of said dividends on the SBLC's capital structure. Stockholder distribution may impact capital adequacy, as dispersions of cash or stock will lower retained earnings.

Stock dividends are distributions of additional shares to stockholders in proportion to the number of shares they own. If a stock dividend is declared, a transfer from retained earnings to common stock must be made. As a consequence, any decision to declare a stock dividend must consider the SBA Supervised Lender's earnings performance. The SBA's regulatory definition of impairment provides a minimum level of paid in capital, so examiners should not expect to see stock dividends declared that result in a near impairment.

No matter what the structure, paid in capital and retained earnings must be able to comfortably absorb any distributions. Examiners must be aware of who owns the SBA Supervised Lender when evaluating capital. Some SBA Supervised Lenders are subsidiaries of larger parents. A parent with an interest in a subsidiary may require distributions. If an SBA Supervised Lender is closely held and the owners have financial needs, the pressure for dividends may become acute. The SBA Supervised Lender should be in strong financial shape before it distributes any dividends.

As mentioned above, there are qualitative factors that also affect capital. Some of the more important qualitative factors that must be reviewed are:

Quality of Management

The quality, experience, depth, and sophistication of bank management are extremely significant in determining capital adequacy. A sound management implements and monitors policy, practices, procedures, internal controls, and reviews processes. No amount of capital is sufficient if management is inept or dishonest.

Asset Quality

Poor asset quality increases the risk of loan losses. Eventually, capital will be impacted if it must be written off or allocated into the allowance for loan losses.

Earnings, Their Quality, and Their Retention

Current and historical earnings performance is another key element in the evaluation of capital adequacy. Solid earnings performance enables an SBA Supervised Lender to expand, serve its territory, and build capital and confidence. Earnings allow an SBA Supervised Lender to (1) build its loss allowance, (2) satisfy shareholder demands for distributions, (3) fund operational projects, and (4) build a buffer to its paid-in capital structure.

Ownership

The financial status and objectives of an SBA Supervised Lender's owners are important to the evaluation of capital. Financially depressed or self-serving owners will erode capital over a period of time.

Loan Demand

SBA Supervised Lenders located in territories where loan demand is strong must focus on building capital in order to meet this demand.

Funds Management/Interest Rate Sensitivity

Funds management and interest rate sensitivity may impact SBA Supervised Lender earnings. The problems that could result from interest rate maturity mismatches, off balance sheet transactions, and the absence of liquidity could render the SBA Supervised Lender non-competitive.

In connection with the qualitative factors discussed above, it is imperative that the examiner understands growth trends, plans, and prospects. If new growth is anticipated, it must be capitalized. If the capital cannot be raised internally, it will have to be raised externally. If an examiner encounters this situation, the examiner needs to assess the prospects of the SBA Supervised Lender selling additional stock or raising capital otherwise.

c. Examination Objectives

The objectives of the Capital component section are to:

Determine whether the SBA Supervised Lender is in compliance with all regulations dealing with capital;
Determine whether capital is adequate in relation to the risks presented;
Assure that the SBA Supervised Lender's owners are not exercising undue influence on the financial affairs of the SBA Supervised Lender (e.g. exerting pressure to distribute dividends which are inappropriate as to timing and amount);
Determine whether the policies, practices, procedures, and controls regarding capital accounts are adequate; and
Determine if financial statements related to capital are fairly stated.

d. Examination Procedures

The following is a model examination procedure for evaluating capital. It is consistent with risk-based examination principles and can be added to, deleted, or modified as the situation dictates.

- Review the SBA Supervised Lender's most recent disclosure to determine if there have been any changes to the capital base compared to previous disclosures or examinations.
- Ascertain whether the previous examination or the external auditor identified any deficiencies regarding the capital accounts, and whether appropriate Corrective Actions were taken.
- Review the financial forecasts prepared by the SBA Supervised Lender to learn whether a capital plan was developed in conjunction with the forecast. If asset growth is planned, determine how the supporting capital will be generated.

- Review the individual capital accounts on the most recent financial statement and determine if there have been any changes or unusual fluctuations in the accounts. If changes have occurred, determine why.
- Determine whether the dealings of the major shareholders with the SBA Supervised Lender are appropriate.
- If dividends were paid since the last examination or during the most recent disclosure, verify that the distribution came from earnings and assess the impact on capital.
- Determine what impact future dividends would have on the capital base.
- Review board meeting minutes or other documentation to determine whether a public or private offering of bank stock or subordination of notes or debentures is planned. If so, determine whether the board or management has evaluated the market for the stock or debt issues. Also, determine whether they have considered the underwriting expenses, dilution of shareholders' equity, aspirations of any known purchasers, and any other impacts the examiner deems warranted.
- If there is a pending change in control, ensure the SBLC has sought SBA approval.
- Determine whether the SBLC is operating in compliance with the minimum capital level prescribed by SBA and with all other SBA Loan Program Requirements on capital. Obtain and review the SBLC capital calculations for adherence to the guidance set forth in the latest Capital Letter issued by SBA to all SBLCs.
- Team members must coordinate with the examiners evaluating the allowance for loan losses to determine if they have reached any tentative conclusions that would impact capital.
- Evaluate current earnings and the impact to capital by reviewing the following issues:
    - Is current income sufficient to cover expenses and any necessary provisions to the allowance for loan losses, and still provide net income;
    - Does income performance meet business plan targets; and
    - Address any dividends, distributions to the parent, or payments to subordinate debt holders that may be due.
- Discuss Findings with management.
- Draw conclusion on capital adequacy.

5. Asset Quality Examination Component

a. Introduction - Loan Portfolio Management Subcomponent

Loan portfolio management involves the strategic direction given by the board and executive management to the staff and management involved in the lending function in some capacity. All SBA Supervised Lenders should have leadership that directs portfolio objectives, risk tolerance limits, systems, and controls.

Loan portfolio management is a leadership task. The examiner evaluating loan portfolio management must address the highest levels of the organization and assess their performance. As examiners assigned to other components assess their assigned area, they will also address the results of management's effort to plan, strategize, and control.

All SBA Supervised Lenders should have basic loan portfolio management principles in place. However, the size of the SBA Supervised Lender, the number of lending offices, the complexity of the portfolio, and the management information systems in place will dictate how sophisticated the process needs to be to implement the principles. Smaller SBA Supervised Lenders should be able to implement these principles in a less formal, less structured, and less resource intensive manner than larger SBA Supervised Lenders. However, all SBA Supervised Lenders, large and small, should have an effective loan portfolio management process.

Examiners must use their judgment to determine the depth of investigation to pursue in this subcomponent. For example, a large SBA Supervised Lender with a number of loan production offices might require an in-depth evaluation of loan portfolio management using all of the model procedures. A smaller SBA Supervised Lender with one office might only require an interview. In any case, because loan portfolio management is such an important element in the examination, the evaluation of the SBA Supervised Lender's primary supervisory activity is paramount.

As will be discussed more fully below, SBA Supervised Lenders may have sold many loans for which they retain the servicing responsibility. Thus, the quality of servicing is among the most important control issues to be evaluated during an examination.

b. Examination Criteria - Loan Portfolio Management Subcomponent

In recent years, losses stemming from the banking and thrift crises have indicated that historic efforts to monitor and underwrite loans have been insufficient. Loans were approved without the requisite planning and analysis of how it fits into the organization's overall strategy. In some cases, concentrations in an industry or geography resulted. In others, loan officers were unfamiliar with the borrower's industry. Monitoring practices relied too heavily on trailing indicators of credit quality such as delinquency, charge-off, and internal grading trends. Lenders have found that these trailing indicators do not give them sufficient lead-time to initiate Corrective Action. As a result, excessive losses overcame the banks' and thrifts' loan loss allowance and therefore capital.

Now, many SBA Supervised Lenders are viewing risk management in terms of the entire portfolio. They set portfolio objectives in terms of the different loan segments that they will approve and the risk tolerance levels they will accept. The goal is to diversify the portfolio, to set maximum exposure and to fix minimum quality levels. They also stress test the portfolio, evaluating what would happen if the yield curve changed or if a certain industry saw prices drop by a certain percentage, etc. Even the smaller SBA Supervised Lenders need to do some degree of stress testing. However, they must have an adequate management information systems infrastructure to perform such analysis. Information systems are required to monitor credit risk as well. Monitoring credit risk is important to SBA Supervised Lenders which actively sell loans in the secondary market. An SBA Supervised Lender's success at managing the loan portfolio determines the satisfaction level of the buyers. Thus, they maintain some loan risk and they take some reputation risk.

The larger SBA Supervised Lenders should also have a mechanism for monitoring loan policy and underwriting exceptions. Sound portfolio management techniques include monitoring underwriting exceptions in the aggregate. This monitoring aids in the assessment of adherence to existing standards by different loan offices or individuals. From a leadership perspective, monitoring these exceptions may indicate demand for a new segment of lending. Perhaps, the policies or the underwriting standards need to be modified. Also, the exceptions may be the product of one loan officer or one production office. Finally, an analysis of the exceptions in the aggregate might reveal a correlation between certain exceptions and internal risk ratings.

Loan policy is one of the first pieces of information an examiner evaluating loan portfolio management will review. This is the primary means by which the board and executive management guide lending activities. For this policy to be an effective risk management tool, it must clearly establish the responsibilities of those involved in the lending function. For example, who is authorized to approve loan policy or underwriting exceptions? If two internal parties differ on a credit grading, who makes the final decision? Who comes up with the conditions for stress testing? The policy should also be reviewed periodically and revised to accommodate changes in the company's strategic direction, its risk tolerance, or external conditions. For example, loan policy guiding the operations of a $2 billion company would not be appropriate for a $10 Million company. Thus, as the company grows, its loan policy must be adjusted. In addition, as SBA changes or adopts new SBA Loan Program

Requirements, the SBA Supervised Lender may need to revise this and other policies accordingly.

While the form and content of loan policy may differ, there are some topics that should be addressed by all. They include:

- Loan authorities;
- Underwriting criteria;
- Financial information, including the SBA's requirements, and analysis requirements;
- Pricing guidelines;
- Industry limits;
- Desirable types of loans;
- Collateral and structure requirements;
- Territory limits;
- Provisions to the allowance, charge-offs, and accounting treatments;
- Internal grading or classification system; and
- Other documentation standards particular to the type of lending.

Pricing guidelines change frequently as interest rates and competition change. In addition, more specific guidelines in certain categories such as underwriting and analysis requirements may exist. These guidelines may be treated as a supplement to the policy.

It is important for examiners to remember that proper loan portfolio management becomes more difficult when the SBA Supervised Lender's territory is spread over a large area through a number of loan production offices. Loan production offices solicit and originate business outside the territory of their main offices. In this case, how are loans approved? If they are approved at remote sites, how can the company be sure the loans fit into the segments the boards have approved? Will these loans fit into the overall plans so that the SBA Supervised Lenders can stress test them, or will they resort to monitoring them solely through the familiar trailing indicators? Policies governing the lending function must clearly establish the authorities of the remote offices and the procedures they must follow.

Risk tolerance limits should be set by management based on their relationship to expected profits. "Industry limits" present one example of risk tolerance. Others could include capping the number of exceptions to standards over a certain period or limiting the loan size to less than the SBA ceiling. The limits should take into consideration the SBA Supervised Lender's historical loss experience, its ability to absorb further losses, as well as its desired level of return. Since SBA Supervised Lenders sell loans frequently, both on- and off-balance sheet exposures should be considered in the risk limit measurement system. Exceptions to established limits should require the board's approval.

Risk identification through asset classification is another important process impacting the lending function. The SBA uses five asset classifications during examinations: pass, substandard, doubtful, loss, and other assets especially mentioned. The SBA does not dictate that the SBA Supervised Lender use SBA's classification system. However, it does require SBA Supervised Lenders to have a grading system in place that is easy to understand and accurately portrays the risk in each credit. The larger SBA Supervised Lenders may have a separate department assigned to the task of internal credit review. The smallest SBA Supervised Lenders might accomplish their risk identification and categorization through a rotation of duties. The CEO or another staff member who is not involved in lending might perform the function. Perhaps, loan officer A classifies loan officer B's loans and vice versa in order to provide independent reviews. The smaller SBA Supervised Lenders may even contract out this service. Regardless of the method, a process should be in place to periodically update assessed grades and to correct any deficiencies noted.

In many cases, SBA Supervised Lenders operate as loan brokers: making loans, pooling the guaranteed portions and/or unguaranteed portions, and reinvesting the proceeds. If the SBA Supervised Lender is reinvesting those proceeds and retaining the servicing aspect of the loans, the high volume of assets being serviced may pose an additional risk. Servicing loans is a revenue generating activity. However, the SBA Supervised Lender must recognize the inherent risk of servicing more loans than it is capable. The examiner(s) analyzing loans will evaluate the adequacy of servicing. However, the examiner reviewing loan portfolio management should seek to confirm that management addresses an SBA Supervised Lender's capacity to service loans.

Another piece of information to be examined is the budget for loan portfolio goals. The budget should correlate with the strategic decisions made, and these decisions should be realistic in light of budgetary resources. Examiners should be alert to overly aggressive goals because they tend to require high growth and more risk-taking.

Examiners performing related functions will provide much information to the examiner evaluating loan portfolio management. The examiner(s) analyzing the loans will share information on the quality of the loans, the adequacy and accuracy of the internal grading system, and the profitability of the portfolio. The examiner evaluating the allowance for loan losses will advise on the adequacy of the process and of the amounts provided. The examiner evaluating management will provide an assessment of the strategic direction of the board and the executive management. Also, the examiner evaluating loan portfolio management must read all or much of the guidance provided by the board and the executive management to the loan officers and others involved in the lending function. Most importantly, all of these examiners should note evidence showing how these loan portfolio management guidelines are implemented and enforced.

c. Examination Objective - Loan Portfolio Management Subcomponent

The objectives of the Loan Portfolio Management Subcomponent are:

- Determining the adequacy of loan portfolio management including strategic portfolio planning, lending policy and procedure, internal loan review, stress testing, and portfolio risk identification and management;
- Concluding on the sufficiency of underwriting standards and track record of meeting these standards;
- Determining whether loans are extended, serviced (including those loans sold where servicing responsibility is retained), and collected in accordance with applicable SBA Loan Program Requirements, SOPs and other SBA guidance, the Supervised Lender's policies and procedures, and sound lending practices; and
- Evaluating whether credit administration practices, including servicing actions, adequately control risks to the loan portfolio.

d. Examination Procedures - Loan Portfolio Management Subcomponent

The following procedures are provided to facilitate the examination of Loan Portfolio Management. Consistent with risk-based examination concepts, examiners should add, delete, or modify the following procedures as needed.

- Evaluate actions to address the previous examination's Findings and recommendations on loan portfolio management.
- Review the most recent external audit report to determine the status of previously identified problems related to loan portfolio management.
- Review any updates to the SBA Supervised Lender's loan policy and procedures related to portfolio management that have been implemented since the previous examination or risk-based review.
- Determine whether the SBA Supervised Lender has a written statement of portfolio management policy.
- Determine whether the SBA Supervised Lender has a written commitment to make loans to all qualified applicants regardless of race, color, national origin, religion, sex, marital status, disability or age.

- Identify whether the SBA Supervised Lender support agency initiatives.
- Determine whether the SBA Supervised Lender’s written policy describes the fees that may be charged to the borrower.
- Determine whether the SBA Supervised Lender’s written policy outlines what collection actions may be taken against borrowers who do not make timely payments.
- Determine whether the SBA Supervised Lender’s written policy consistent with SBA policy.
- Verify that the SBA Supervised Lender documents its procedure for ensuring that only allowable fees are charged to the SBA borrower.
- Verify that the SBA Supervised Lender documents its training procedure for staff involved in SBA financing.
- Determine whether the board and management have adopted appropriate internal controls over the loan portfolio. Specifically, does the SBA Supervised Lender have an internal risk rating system that adequately identifies problematic segments of the portfolio? Also, does the SBA Supervised Lender have an internal credit review program (ICR)?
- Determine whether the SBA Supervised Lender has a written policy of lending authority delegations.
- Determine whether the SBA Supervised Lender has a written policy for its portfolio review process.
- Verify that the SBA Supervised Lender documents its procedure to ensure that loans are approved and authorizations signed by officers with the appropriate authority.
- Determine whether the SBA Supervised Lender documents its procedure to assure that required closing documents are obtained. (If the SBA Supervised Lender makes loans in more than one state, the procedure must include allowances for state variations in the required documents).
- Determine whether the SBA Supervised Lender documents its process for ensuring that items required after closing are collected.
- Verify that the SBA Supervised Lender documents its method of safeguarding collateral documents in the lender’s care.
- Determine whether the SBA Supervised Lender has a process for updating UCC filings, financial statements and insurance requirements. (tickler system, etc.)
- Determine whether the SBA Supervised Lender has access to counsel available for processing, closing and servicing advice. (If the SBA Supervised Lender lends in more than one state, it must have access to counsel in each state).
- Verify that the SBA Supervised Lender maintains its loan files in a consistent, orderly and accessible manner.

- Determine whether SBA Supervised Lender documents its procedures to ensure that required forms are with their SBA applications.
- Verify that the SBA Supervised Lender documents its procedure to ensure that SBA credit and eligibility requirements are complied with.
- Verify that the SBA Supervised Lender documents its process for ensuring timely filing of SBA Form 1502 reports and the correction of submission errors.
- Summarize the credit administration results from the individual loan review.
- Discuss with management whether there are any external factors that would impact the loan portfolio and inquire whether any stress testing has been conducted. Review the stress tests for adherence to industry norms. Are assumptions logical? Are all exposures tested? How frequent is the testing?
- Evaluate the management information systems used in loan portfolio management to determine their sufficiency. Are there periodic evaluations? Are the systems accurate? Are reports meaningful and meeting the needs of the BOD? Are the systems timely? Is the information generated secure?
- Evaluate the process for identifying portfolio concentrations. Are discussions held concerning the risk in new or pending concentrations? Are the concentrations stress tested?
- Determine whether the SBA Supervised Lender has a normal geographic lending area and under what circumstances it may provide lending outside this area.
- Determine whether the SBA Supervised Lender's the process for appraising collateral is documented and adequate. Also, evaluate the credentials of those who appraise collateral. Do they possess any certifications? Are appraisal reviews completed?
- Determine whether the loan officer or anyone else periodically visits the site of the business to discuss operations, and to verify and evaluate the condition of collateral. Are these visits documented?
- Does the SBA Supervised Lender maintain a schedule of any field visits required and document loan files when visits are completed?
- Did the SBA Supervised Lender document its process for ensuring routine portfolio reviews and borrower contact on SBA loans?
- Determine whether the SBA Supervised Lender is servicing its portfolio in compliance with the following SBA Loan Program Requirements:
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    - 13 CFR §120.511 Servicing guaranteed loans;
    - 13 CFR §120.453 Servicing and liquidation requirements of a PLP Lender;

    - 13 CFR §120.513 Servicing actions that require SBA prior consent;
    - 13 CFR §120.520 Honoring the SBA guarantee; and
    - 13 CFR §120.540 SBA's policies concerning liquidation of collateral.
- Determine whether the SBA Supervised Lender documents that it has the resources available for proper servicing and liquidation (if applicable) throughout the geographic area in which it makes loans?
- Determine whether the SBA Supervised Lender document its process to set up regular reviews of all delinquent loans.
- Verify whether the SBA Supervised Lender documents its process to ensure proper notification to SBA of servicing/liquidation actions taken.
- Determine whether the SBA Supervised Lender has sufficient ability to identify and manage its SBA loans for which guaranty purchase has been requested.
- Determine whether the SBA Supervised Lender satisfactorily monitor and manage its portfolio of loans for which SBA's guaranty has been honored.
- Verify if the field office approved any contracts the SBA Supervised Lender has with service providers.
- After reviewing findings from all items above, determine if there are any events that would cause the SBA to be released from liability on its guaranty.
- Where documentation is missing above, is there evidence to confirm that the SBA Supervised Lender met the criteria?

e. Introduction – Portfolio Performance Subcomponent

The analysis of portfolio performance focuses on an evaluation of a lender's SBA loan portfolio to assess historical, current and projected performance and to identify various risk characteristics of the portfolio. This analysis considers a lender's performance compared to the portfolio, to SBA-defined peers, and to itself, over time (trends). While the criteria and procedures identified are not an exhaustive list and may be modified during review planning or on-site activities, they provide a reasonably complete list of the processes used to evaluate this category. The procedures are not mandated rules to be rigidly followed by the examiners. The lending business is a dynamic one, requiring examiners to use their judgment to tailor examination practices to individual situations. Examiners can add, delete and/or modify procedures as appropriate, with written approval of the AA/OLO or designee, when a lender's particular circumstances and risk characteristics warrant. (Electronic mail is an acceptable means of obtaining the written approval of the AA/OLO or designee.) Any criteria not used in a particular review should be so identified in the Report, along with the reason for the change.

f. Examination Criteria – Portfolio Performance Subcomponent

13 CFR §120.410 requires that all participating lenders have a continuing ability to evaluate, process, close, disburse, service and liquidate small business loans. SBA assesses this ability, in part, through review criteria regarding portfolio performance, as described below. The criteria are not all inclusive and during the course of the review, additional criteria may be identified as well as certain criteria may be determined not to apply.

The purpose of the credit quality review is to establish a picture of the SBA Supervised Lender's SBA portfolio risk characteristics using predictive credit scoring as the measure of credit risk. This allows SBA to predict purchases over a 12-24 month period. SBA aggregates the lender's loan scores, analyzes the lender's SBA loan credit quality and compares it to SBA's portfolio and peer group performance.

The portfolio performance criteria are:

Loan production activity;
Key performance statistics and comparative performance analysis;

Credit quality; and
Any other risk characteristic(s) identified in the Plan.

g. Examination Objectives – Portfolio Performance Subcomponent

The objective of the Portfolio Performance review is to assess the performance of an SBA Supervised Lender's SBA 7(a) loan portfolio and the demographics of the portfolio, and to determine whether SBA Supervised Lender is failing to meet any portfolio performance requirements based upon statute, SBA Loan Program Requirement or Notice.

h. Examination Procedures – Portfolio Performance Subcomponent

Procedures are provided as guidance in conducting each component Examination. The procedures are not an exhaustive list. They will be expanded and contracted or adapted as warranted, in SBA's sole discretion, based on (i) the circumstances of the individual lender, particularly if there are program or operational changes, (ii) changes in economic conditions, or (iii) Agency policy changes.
The Portfolio Performance procedures are designed to analyze portfolio characteristics such as growth rates, performance, industry and

geographical concentrations; determine whether the SBA Supervised Lender is meeting any portfolio performance requirements of SBA Loan Program Requirements or SOP; and assess portfolio credit quality (as measured through credit scores). The examination procedures include analysis and comparison of SBA and SBA Supervised Lender data.

Summary of Key Performance Statistics

- Identify the lender's outstanding SBA portfolio and program composition.
- Analyze the lender's portfolio composition, portfolio performance rates, and delivery method performance characteristics.
- Identify any significant variations, fluctuations or performance trends in the individual delegated loan programs for further assessment.
- Analyze lender's Active Purchases to establish a basic picture of the outstanding loans which have been purchased but are still within the purview of the lender's control.
- Identify any significant characteristics of the Active Purchases, or trends of increasing numbers, for further assessment.

Loan Production Activity

Analyze the annual production (numbers and dollars), delivery method break-down, average loan size, and discuss any trends or significant period-to-period fluctuations.

Comparative Performance Analysis

- Compare the SBA Supervised Lender's SBA loan portfolio performance to overall SBA portfolio and peer group, and past trends of SBA Supervised Lender itself.
- Identify and analyze outstanding portfolio performance (in numbers and dollars) by loan payment status (e.g. current, delinquent, etc.) and delivery method, and in comparison to portfolio, program and peer group performance rates, as available.
- Identify and analyze any deviation of performance in SBA Supervised Lender's portfolio or in any particular program as compared to the available standards (SBA portfolio and peer).
- Compare to past trends within lender itself.

Active Purchases

Identify and analyze the SBA Supervised Lender's outstanding Active Purchases (in numbers and dollars) and trends over two fiscal years, as available.

Industry Concentration

- Identify and analyze industry concentration(s) within the SBA Supervised Lender's portfolio, and risk implications; i.e. significant percentage of dollars in one or more industries.
- Compile a table of industry concentrations for loan portfolio (numbers and dollars).
- Compare to SBA portfolio and peer averages, if available.
- Analyze concentrations of 20% or more identifying the risk implications of such concentrations.

Geographic Concentrations

- Identify and analyze any geographical concentrations and risk impact; i.e. any current economic issues of the geography with positive or negative impact on the portfolio.
- Compile a table of geographic industry concentrations for loan portfolio (numbers, dollars and any available performance metrics.
- Compare to SBA portfolio and peer averages, as available.
- Analyze concentrations of 20% or more identifying the risk implications of such concentration.

Early Defaults

Identify early defaults and analyze risk implications (early default defined as default reported within 18 months of disbursement); i.e. sporadic versus trend evidence, etc.

Guaranty Purchases

Identify any trends in SBA Supervised Lender's guaranty purchases. Consult available Agency data regarding SBA Supervised Lender's purchase activity for both the past-one year and five-year periods.

Other Segmentation

Identify and analyze any other segmentation of the portfolio with risk implications, and compare to SBA portfolio and/or peer averages, as available.
Compile any other tables or presentation of data, as appropriate during the review investigation, and as available, compare to any available applicable standards.

Credit Quality

- Compare SBA Supervised Lender's SBPS data to SBA's portfolio and peer averages, and discuss risk implications; i.e. significant deviation from the SBA portfolio average, positive or negative trends, quarter-to-quarter and/or year-to-year fluctuations, etc.
- Analyze stratification of SBA Supervised Lender's portfolio by credit score ranges and discuss proportions of predicted at-risk loans, both low and high, and risk implications; i.e. percentage of portfolio at high risk, trend over time, etc.
- Analyze Projected Purchase Rate (PPR), and compare to SBA portfolio and peer averages.

Other Risk Characteristics

Identify and analyze any other risk characteristics as noted in evaluations or other research.

Conclusion

Discuss all portfolio performance Findings with management. Conclude on the portfolio performance of the SBA Supervised Lender.

i. Introduction - Credit Administration Subcomponent

Credit administration practices are the processes an SBA Supervised Lender follows when originating, servicing, and collecting loans. An examiner reviewing an SBA Supervised Lender's credit administration practices must evaluate for those loans reviewed whether: (1) the loan officer obtained sufficient information about the borrower before extending credit; (2) the loan officer analyzed the information; and (3) the loan was structured with the income circumstances of the borrower in mind. The lending policies should specify the minimum data loan officers should obtain and review before a lending recommendation is forwarded to a manager or the loan committee. The amount of data required may depend on the purpose, size and type of loan requested and the borrower's credit history. For example, some SBA Supervised Lenders have adopted separate policies for small loans designed to speed the credit delivery process. Credit scoring is one process commonly found in credit administration policies for small loans. However, for all loans, SBA Supervised Lenders should document all lending processes to ensure consistency and accordance with the policies of the BOD.

SBA Supervised Lender who extends credit guaranteed by the SBA must obtain specific information and perform certain minimum procedures. Thorough analysis of loan data must be performed to ensure the loan is structured in a manner that will allow the borrower to pay as agreed and that the borrower has not absorbed more debt than can be serviced. Then, the loan officer should periodically monitor the borrower's progress. The loan officer should not just monitor payment performance, but also the progress of the business. If a borrower needs to have the structure of his or her loan altered, it should be altered prior to significant problems occurring. It has often been said that poor credit administration practices are the forerunner of asset quality problems.

j. Examination Criteria - Credit Administration Subcomponent

Credit administration is most effectively examined using a systems analysis approach that compares how the process is to work, how it actually operates, and what, if anything, has gone wrong. This approach will allow the examiner to identify any deficiencies and formulate a corrective strategy. Any written process for proper credit administration, as mentioned before, must describe the documentation that is required for loan consideration and to properly monitor the borrower's operations during the life of the loan.

Many SBA Supervised Lenders participate in SBA's Preferred Lender Program (PLP). An SBA Supervised Lender can lose its preferred lender status if it fails to perform the administration of credit in a proper manner. More importantly, SBA can be released of its liability on its guaranty under certain circumstances as set forth in 13 CFR §120.524. This should be sufficient incentive to carry out proper procedures. Again, poor credit administration practices are the forerunners of asset quality problems.

In the PLP, creditworthiness is a determination to be made by the lender. Thus, examiners need to ensure the SBA Supervised Lender is employing prudent practices. This means the SBA Supervised Lender needs documentation to reflect how proceeds will be used and repayment will be effected. Subsequent monitoring should reveal from where, in fact, repayment is coming. Repayment from a source other than the originally identified source often indicates operational problems. If a sample reveals a number of credit administration deficiencies, additional testing may be warranted.

It is vital that credit administration policy also provides guidance on loans that fail to perform. Guidance should include the preferred manner of dealing with a troubled borrower, restructuring alternatives, foreclosure proceedings, and other options as determined by the Board. In addition, the policy should advise SBA Supervised Lender staff of the requirements of 13 CFR §120.453 which, at present, requires a PLP lender to submit its liquidation plan to the SBA before taking any such action. PLP SBA Supervised Lenders should not accept a compromise of debt settlement without the SBA's written approval.

The credit administration criteria include:

- Creditworthiness;
- Collateral;
- Closing and Disbursement;
- Regular Servicing and Assessment of Continued Creditworthiness;
- Collection Practices and Intensive Servicing and Liquidation;
- Active Purchases Management;
- Other Portfolio Management Items (i.e., Consistency with SBA Policy, Risk Rating Systems, etc.); and
- Other Risk Characteristics (i.e., Effectiveness of Internal controls, Use of Loan Agents, Loan Sales/Participations, etc.).

k. Examination Objectives - Credit Administration Subcomponent

The objectives of the Credit Administration Subcomponent are:

- Determine whether loans are originated, serviced (including those loans sold where servicing responsibility is retained), and collected in accordance with the SBA Supervised Lender's policies and procedures and prudent lending practices;
- Evaluate the SBA Supervised Lender's ability to (i) exercise approval authority, including exception approval authority, (ii) document approvals, and (iii) review for the proper level of approval authority;
- Lender's ability to use its commercial policies for credit determinations, when applicable, e.g. for SBA*Express*, to make a determination that the SBA guaranteed loan is approved upon a basis comparable to lender's requirements for non-guaranteed commercial loans of similar size and type;
- Evaluate the SBA Supervised Lender's use of any credit scoring appropriate to the SBA program in a manner that is consistent with its use in its non-guaranteed commercial lending program (when applicable);
- Lender's oversight of loan agents;
- Determine whether credit administration practices are in compliance with applicable SBA Loan Program Requirements;
- Does the lender have policy in direct conflict with SBA policy, and if so, how does the lender propose resolution?
- Lender's ability to determine the creditworthiness of each applicant, in accordance with SBA policy, through consideration of (i) repayment ability, (ii) capitalization sufficiency, (iii) sufficiency of working capital; (iv) management ability of principals; (v) credit history of applicant and/or principals; (vi) sufficiency of collateral assessment; and (vii) requirement of all necessary collateral.

- Evaluate whether credit administration practices, including servicing actions, adequately control risks to the loan portfolio;
- Lender's ability to manage its delegation of authority to ensure appropriate credit administration;
- Evaluate the adequacy of SBA Supervised Lender's Risk Rating System;
- Lender's maintenance of effective systems for on-going monitoring of performing loans to assess continued creditworthiness;
- Lender maintenance of effective tickler systems for Uniform Commercial Code (UCC) continuations, annual review of borrower financial statements or other prescribed routines for review of the account relationship, and insurance renewals;
- Evaluate SBA Supervised Lender's use of loan agents;
- Determine SBA Supervised Lender's overall effectiveness of internal controls; and
- Ensure Corrective Action is taken to remedy any deficiencies.

l. Examination Procedures - Credit Administration Subcomponent

The examination procedures in this section are not intended to serve as a compliance guide. Rather, the following procedures address the safety and soundness issues for credit administration practices and procedures. Consistent with risk-based examination principles and the particular circumstances of the company, examiners should add, delete, or modify the following model examination procedures as appropriate.

In coordination with the examiner evaluating loan portfolio management, review the SBA Supervised Lender's lending policies and procedures to ensure they include proper credit administration standards and requirements which address the following areas:

- The uses of proceeds prescribed in 13 CFR §§120.120, 130, 131, 201, and 202;
- The contents of a business application as required by 13 CFR §120.191;
- The SBA's lending criteria as required by 13 CFR § §120.101, 102, 103 and 150;
- The statutory limit for total loans to a borrower as articulated in 13 CFR §120.151;
- Loan conditions required by 13CFR§120.160; and
- Eligibility requirements as prescribed in several SBA Loan Program Requirements depending on the type of loan.
- Determine whether the loan officer analyzed the credit request rather than simply retrieving the forms. Did the loan officer document the purpose and the terms of the loan? Did the terms seem logical given the nature of

operations of the small business? Was the source of repayment identified and was it a reliable source? Was there sufficient working capital? Did the loan officer not only review past performance, but did he or she also project future performance and repayment capacity? Did the loan officer accurately value collateral? Was it properly recorded? Were all notes, mortgages, and applicable insurance forms signed and safeguarded?

- Determine whether the loan officer documented the recommendation to lend in writing, citing the basis for the recommendation.
- Determine whether the loan officer or someone in the credit department documented discussions with the borrower after credit was extended.
- Determine whether the loan officer or anyone else visits the site of the business to discuss operations, and to verify and evaluate the condition of collateral. Are these visits documented? Were there any recommendations for modifications to the credit arrangements as a result of such a meeting?
- Evaluate whether the credit department notifies management when a loan becomes past due. How soon after the borrower missed payment will management be notified? Determine whether an agent of the SBA Supervised Lender follows up with the borrower when this situation occurs, in accordance with SBA SOP requirements.
- There are many servicing actions that require the SBA's prior written approval, such as releasing significant portions of collateral, accelerating the maturity, etc. (see 13 CFR §120.513). Determine whether the SBA Supervised Lender is complying with these SBA Loan Program Requirements.
- Conclude whether the SBA Supervised Lender is servicing loans properly in conformance with prudent lending standards. Ensure the same care is taken in servicing loans that have been sold and servicing rights retained.
- Evaluate whether the SBA Supervised Lender takes action to have the SBA's guaranty honored on those loans that become 60 days past due (13 CFR §120.520).
- Determine whether the SBA Supervised Lender reevaluates collateral when it becomes known that a loan has to be liquidated.
- Determine whether the SBA Supervised Lender continues to service and collect loans in accordance with SBA requirements after the SBA has honored its guaranty (13 CFR §120.512).

- If the prospect is that certain borrowers cannot pay within a reasonable period, and if the SBA Supervised Lender is liquidating the loan on the SBA's behalf, determine whether it moves promptly to liquidate collateral subject to prior creditors' lien(s) according to 13 CFR §120.540.
- Does the Lender routinely or on an ad hoc basis use loan agents in originating its SBA loans?
- Determine whether Lender's policies and procedures establish a basis for routine or ad hoc use of loan agents (packagers, referral agents, brokers, etc.) in originating SBA loans.
- Determine whether loan agent-originated loans are fully meeting SBA standards, including those on creditworthiness.
- For Lenders with active loan agent relationships, obtain list of loans referred by loan agents, and analyze a sample of loans referred by loan agents to determine whether performance trends and/or credit quality is comparable to book of business originated directly by Lender.
- Determine whether SBA Form 159, "Fee Disclosure Form and Compensation Agreement" has been completed, as applicable, for each loan in which a loan agent has participated.
- Determine whether additional file review is appropriate to fully assess loan agent activity. If so, review a small selection of loan files for loans originated by loan agents to determine whether each decision was reached in accordance with Lender's and SBA's policies and to better evaluate Lender's use of loan agents.
- Conclude on the adequacy of credit administration. Share Findings with the examiner(s) analyzing loans.

m. Introduction – Asset Classifications Subcomponent

To a very large extent, the primary assets of an SBA Supervised Lender are loans. However, it would not be unusual for an SBA Supervised Lender to have other assets such as fixed assets, foreclosed real estate and equipment, accounts receivable, and equipment used in the lending business. While the guidance in this section will largely focus on loans, it is important for the BOD of an SBA Supervised Lender to ensure that all of an SBA Supervised Lender's assets are managed in a prudent manner. An analytical review of assets should be conducted at each examination to determine whether the assets are being managed properly.

The interest generated from loans, revenues from the sale of loans, and servicing fees account for an SBA Supervised Lender's primary sources of income. Conversely, the inherent risk in loans requires a lender to establish an allowance for loan losses which is indicative of the risk of losses that lending poses. Accordingly, loans and other assets must be carefully analyzed to determine whether there are any trends or weaknesses that might cause harm to the SBA Supervised Lender's financial posture. Given that many SBA Supervised Lenders actively package and securitize loans, it is imperative that the examiners evaluate the initial credit decision process to ensure selections are made on a prudent basis. The classification of loans and other assets are discussed in the Asset Classification paragraphs of this Chapter. This section will discuss the factors to be considered in analyzing loans and other assets. Model procedures are provided to facilitate this analysis.

SBA Supervised Lenders may sell all or portions of their loans but must retain servicing responsibilities. So, examiners must ensure that servicing activities are evaluated as well. Normally, the examiner evaluating Loan Portfolio Management will conduct this activity. The evaluation of servicing is the same whether the loans are on the books or sold. The examiner analyzing loans may be asked to address the servicing of loans that have been sold.

The SBA uses asset quality classifications to identify and disclose, to the SBA Supervised Lender and Agency management, the risk residing on SBA Supervised Lender's loan portfolios. The SBA's classification system is patterned after the system successfully employed by bank regulators. The goal is to quantify risks and to focus SBA Supervised Lender management on problematic loans in its portfolio. While the SBA does not mandate that SBA Supervised Lenders use the asset quality classification system described herein, the SBA recommends that SBA Supervised Lenders employ this system, or a similar grading system, as part of their internal credit review practices. As mentioned elsewhere in this SOP, effective internal risk identification is essential to the safe and sound operation of SBA Supervised Lenders. This section of the SOP will define the individual classifications and some of the factors that would lead to a classification decision. Suggested examination procedures are also included.

n. Examination Criteria – Asset Classifications Subcomponent

The condition of earning assets can be evaluated by assessing (a) composition, (b) quality, (c) profitability, and (d) Other Assets. For purposes of this discussion, composition refers to the type and amount of assets held. Quality refers to the risk of deterioration or loss of the assets. Profitability is the ability of the assets to generate a sufficient return to cover expenses. Other Assets typically do not require extensive examination.

Composition

Since the great majority of assets held by SBA Supervised Lenders are loans, the first topic to be discussed is concentrations of credit. If an SBA Supervised Lender has several loans to small businesses in the same industry, it may incur losses if the industry suffers a decline. This is not an uncommon scenario for a financial institution with one industry dominating its territory. In some cases, SBA Supervised Lenders believe they know a particular industry better than others do. Thus, they make a number of loans to businesses in that industry. Whatever the reason, concentrations of credit increase the risk that losses will be substantial. Several borrowers may simultaneously experience problems if their industry suffers an economic decline. Thus, examiners analyzing loans need to assess the portfolio for concentrations and test the exposure against the company's allowance and capital.

Quality

Another important consideration when evaluating loans is how loan proceeds are used. It is very difficult for an SBA Supervised Lender to know where the source of repayment will come from if the purpose of the loan is not documented and the location of the proceeds are unknown. Furthermore, if the SBA Supervised Lender is unsure where the proceeds were directed, it runs the risk that moneys may have been used for illegal or imprudent purposes. SBA Loan Program Requirements list the certain types of business loans and/or use of loan proceeds that are prohibited. Accordingly, examiners evaluating loans should ensure the SBA Supervised Lender knows the purposes of the loans and the use of the loan proceeds.

Information systems should be available to assess asset quality. Does the SBA Supervised Lender know which loans are delinquent 30 days or more? 90 days? Are collection efforts increased as loans become increasingly delinquent? Some larger SBA Supervised Lenders may have another department or officer responsible for collection of delinquent accounts other than the loan officer. Are collection efforts proper given the status of the accounts? Does the SBA Supervised Lender cease accruing income on loans that reach a severely past due status? It is also necessary to test the accuracy of the systems in place. For instance, did the examiner find any past due loans that were not categorized properly in the SBA Supervised Lender's information systems?

The loan file will verify that the loan is a small business loan, it will disclose the borrower's industry, it should reveal the purpose of the loan, and it will detail the borrower's repayment capability and plans. All of this information is required by the SBA SBA Loan Program Requirement for loan applicants. A typical loan file will document contact and correspondence between the SBA Supervised Lender and borrower. The file should contain all of the borrower’s financial data collected by the SBA Supervised Lender, analyses the loan officer may have performed and a description of any collateral obtained. Regarding collateral, the file should contain evidence of the legal recordation of collateral. In addition, the file must provide evidence that the SBA Supervised Lender is servicing the loan properly or the SBA may initiate a transfer to an alternate servicer. It is in the loan file that an examiner will find most of what they will need to judge quality.

Profitability

A more difficult assessment for an examiner is the profitability of the loans under review. Loans are ordinarily priced according to the risk they pose. The pricing structure adopted by the SBA Supervised Lender should consider the cost of funds so that a profit will result. The loan files should establish the price and the basis. The SBA sets no rules regarding pricing beyond ceilings it has established for loans according to loan characteristics in tandem with SBA delivery method. Thus, pricing decisions must be logical to the examiner or further inquiry will be necessary. The examiner evaluating earnings will need the results of this profitability test.

The examiner will evaluate the financial information on file to determine a borrower’s capacity to repay according to the loan’s terms. The examiner will also evaluate the borrower’s previous borrowing relationships, if any, to determine the borrower’s character. Lastly, the examiner will evaluate any collateral under lien to ensure it is properly valued, recorded and safeguarded.

Loan officers should be consulted before a conclusion is reached regarding the loans under review. Very recent developments may have occurred that have not been documented in the loan file or on the status lists mentioned above. Depending on the size and sophistication of the SBA Supervised Lender under examination, there may be a separate credit department. If so, examiners may visit this department to see if additional information is obtainable there.

The examiner evaluating Loan Portfolio Management will need information from the examiners analyzing individual loans. If the examiners evaluating loans classify a number of loans for the first time, the examiner evaluating Loan Portfolio Management will want to know if there is a common basis of criticism. The same examiner will want to know if the loans are part of a concentration or if the loans are still earning interest. So, after reviewing individual loans and deciding on their credit and performance classifications, examiners analyzing the loans will need to look at the portfolio from a macro sense to determine whether there are any common themes to their decisions.

Other Assets

Generally, the remaining assets on an SBA Supervised Lender's books will not require extensive examination coverage. Examiners should ensure that SBA Supervised Lenders have submitted to the SBA a liquidation plan for all loans to be liquidated. This is important since the guaranteed portion of the loan is the largest exposure. Upon liquidation, portions of loans not guaranteed are those that examiners should ensure are treated properly from an accounting standpoint.

Fixed assets of the SBA Supervised Lender, such as premises and equipment, require no analysis. However, equipment will have to be depreciated properly. Please note investment in fixed assets should not exceed a reasonable portion of capital.

Cash on hand or held on deposit elsewhere should be reconciled each day by the SBA Supervised Lender. Examiners should review the reconciliations to test their accuracy. Furthermore, given that many SBA Supervised Lenders fund their operations primarily through borrowed funds, cash should not be held for extended periods.

Loans with no deficiencies will avoid classification. In effect, they pass the test during an examination. Depending on the severity of problems, loans and other assets can be classified Substandard, Doubtful, and Loss. In addition, the term Other Assets Especially Mentioned is used for loans that are not classified, but exhibit trends or balance sheet abnormalities that warrant mention in the Report of examination. Assets other than loans also can be classified according to the risk they present. For example, real estate obtained from foreclosure is often classified substandard due to the frequent difficulties SBA Supervised Lenders have selling such property and the prospect that the lender may not recoup all moneys owed. In fact, aged collateral that does not appear to generate any buyer interest may be assigned a more severe classification. Close attention must be paid to appraisals to ensure that the appraised value is not overstated, thereby overstating the liquidation value.

Other Assets Especially Mentioned

"Other Assets Especially Mentioned" (a/k/a Special Mention) are assets that are generally profitable but exhibit potential weaknesses. This weakness could result in deterioration if uncorrected. The problem could be as simple as the structure of a loan. The borrower may demonstrate that they can comfortably make payments at the present level. However, as the contract calls for increased payments, the borrower does not demonstrate the capacity to pay such amounts. The loan structure might need to be modified. Another example involves a borrower who has made all payments in a timely manner, but the borrower's earnings have trended downward with no indication of a reversal. In this case, the potential concern is that the borrower will continue to struggle and that repayment may be interrupted.

It is expected that SBA Supervised Lender management can eliminate the concerns rather quickly. Accordingly, it is unlikely that a loan will be a “Special Mention” category for two consecutive examinations. Management should be able to resolve the potential weaknesses in the normal course of business, in which case the loan will pass scrutiny at the next examination. If management's effort is unsuccessful, the potential weakness will likely become an actual weakness warranting a classification.

Substandard

Substandard assets typically have well defined weaknesses or weaknesses that could hinder normal collection of the debt. While by definition there is no loss potential identified in an individual substandard loan, the SBA does expect that some losses will result from the SBA Supervised Lender’s total volume of substandard loans.

The clearest description of a substandard loan is one where the expected repayment source has faltered badly and the SBA Supervised Lender is now looking at the secondary source of repayment: collateral. The collateral is appraised at a level that, upon successful liquidation, would extinguish the debt. Given that collateral is the secondary source of repayment and that a lender often has trouble selling collateral, a substandard classification is assigned. Real estate taken in foreclosure is generally considered substandard for similar reasons. However, subsequent lower appraisals, collateral deterioration, or sales of comparative assets at a lesser value, or any combination of these scenarios may warrant a more severe classification.

Doubtful

Assets classified “Doubtful” have a weakness or weaknesses similar to those of substandard loans but are so extreme that significant loss potential exists. There is an element of doubt as to the full collection of the loan. Examiners should expect that any loans classified doubtful will also result in sizable loan loss provisions to the allowance. An example of a doubtful loan is when a borrower has fallen into very difficult times, the continuation of the business as an on-going concern is in jeopardy and the borrower is attempting to sell the business but has no offers. The collateral under lien is fully protected as long as the borrower continues to operate. Should the borrower cease operations, the value of the collateral would decline significantly. Given the significant loss potential, the entire loan is classified doubtful. In a situation where part of the collateral is liquid and therefore assured, a split classification could be assigned. Split classifications will be discussed later in this section

Loss

SBA Supervised Lender management will be asked to charge-off any loans or other assets classified “Loss” by the SBA's examiners. Assets assigned this classification are considered uncollectible and no longer of any value. Thus, they should be eliminated from the balance sheet of an SBA Supervised Lender. As mentioned in the section on allowance for loan losses, when a loan or any part of a loan is classified Loss, it is done so with an understanding that there may be a partial recovery sometime in the future. However, there is no opportunity at present.

The SBA expects SBA Supervised Lender management to charge losses to the allowance for loan losses in the period in which they are identified. This is important to ensure proper disclosure, since the allowance may have to be restored after an unexpected or larger than expected charge-off. Examiners will expect SBA Supervised Lender management to record loan losses prior to the next disclosure during or after the examination. For example, if examiners identify a loss during an examination, the examination continues through a month end, and the SBA Supervised Lender has a disclosure due at month end, the charge-off will be taken almost immediately upon identification.

Split Classification

Examiners may consider split classifications. Each problem loan has individual circumstances that merit thorough review by both management and the SBA examiners. Because of the significant difference in definition, it is not appropriate to call part of a credit relationship Special Mention, while classifying the balance. However, it is a common practice to have part of a loan classified substandard, with the remainder doubtful or loss. An example of a substandard/doubtful combination would occur when a loan's source of repayment is now solely from the sale of collateral. A recent appraisal shows a value range. If the SBA Supervised Lender got 100% upon liquidation, the loan would be repaid. In this case, it would be appropriate to classify the lower end of the range substandard, while the difference between the lower and the higher would be doubtful. If, in the same example, the collateral did not provide 100% coverage, a dollar amount approximating the lower end of the range would be classified substandard, the difference would be doubtful, and the shortfall would be classified loss.

The goal of any asset quality grading system is to identify, and quantify to some extent, the risk in the loan portfolio and any other risk assets. Accordingly, the SBA encourages SBA Supervised Lenders to adopt an internal credit review system as part of their overall internal controls policy. The SBA's examiners will not insist that internal classifications be changed when the SBA classifies loans, except when loans classified as a loss need to be treated accordingly. Even if the SBA Supervised Lender adopts the SBA classification system, examiners will not force re-classification. Suppose a loan is classified substandard internally and the examiners classify the loan as doubtful. The examiners will be more interested in what management is doing about the problem than the correct classification. The examiners will also ensure that any provision to the Allowance specifically set aside to adjust for this loan is appropriate. The SBA will use the classification of its examiners to make a variety of decisions. SBA Supervised Lenders may adopt categories as they wish, but examiners will be critical of failure to take efforts to restore classified assets to good standing.

In that regard, the BOD of each SBA Supervised Lender must ensure it receives reliable information on the quality of the company's loan portfolio and other risk assets. Each SBA Supervised Lender should adopt an internal asset quality grading system that its Board understands. Asset quality problems can be serious. Each BOD has a fiduciary duty to remain aware of the financial condition of the institution it serves. An accurate, easily understood classification system is vital to this effort.

There is a secondary market for the guaranteed and the unguaranteed portions of loans. In many instances, loans will be sold. Of the portion (guaranteed or unguaranteed) of loans remaining on the books, some may be classified. Examiners should not ordinarily extend classifications to the guaranteed portion of the loans. This decision could change, however, if the examiner has reason to believe the guaranty is in jeopardy. If so, the examiner should consider a classification befitting this portion of the loan as if there were no guaranty. The examiner or the EIC should also report any compliance violations involving fraud, waste or abuse, to the Office of Inspector General (OIG).

o. Examination Objectives – Asset Classifications Subcomponent

The examination objectives for the asset classifications subcomponent and the analytical review of assets are:

- Determining the accuracy and reliability of the internal asset quality grading system;
- Assessing the risk in the loan portfolio and other risk assets, both on assets serviced and owned;
- Reviewing management's plan to remedy classified assets;
- Determining the composition and quality of assets and the profitability of the portfolio;
- Concluding on the threats from concentrations in industries or geographic regions that are suffering some economic distress;
- Determining the impact asset quality has on risk funds;
- Ensuring proper accounting treatment of troubled assets; and
- Concluding on portfolio risk from both the institution's and SBA's perspective.

p. Examination Procedures – Asset Classifications Subcomponent

The following procedures are provided to assist examiners in completing an assessment of risk in an SBA Supervised Lender's asset portfolio. Consistent with risk-based examination objectives, examiners should add, delete, or modify these procedures given the results of the pre-examination analysis of the circumstances existing at the time of the examination.

- Evaluate actions to address the applicable examination's Findings and recommendations cited in most recent return on earnings (ROE).
- Obtain and review any updates to the SBA Supervised Lender's policies governing the oversight of the loan portfolio to determine whether they provide a comprehensive guide to those responsible for classifying or grading the loans. Factors to be considered include:
  - Clarity of risk definitions in the grading system;
  - Frequency and scope of updates to be sure classifications are current and comprehensive;
  - Lines of responsibility and the independence of the credit review function (NOTE: smaller SBA Supervised Lenders may not need a staffed internal credit review department. An independent review by another loan officer or employee could suffice.)
  - History and current efforts to strengthen classified loans; and
  - Reporting to executive management.
- Select a random sample of the loan portfolio, in accordance with Chapter 2, Paragraph 12 of this SOP, along with a judgmental sample from the high risk and new loan portfolio segments.

- Determine the accuracy and reliability of the SBA Supervised Lender’s internal loan risk grading system by examining selected loans in the test sample.
- If any loans were placed on non-accrual during the examination, determine whether any recent interest earned should be reversed. Determine the remaining impacts on income earned and conclude on the profitability of the asset portfolio.
- Determine whether the SBA Supervised Lender has requested SBA to honor its guaranty for those loans scheduled for liquidation. If SBA has denied any such requests, thoroughly analyze the reason(s) for such denial, and also discuss the reasons with management officials. As necessary, contact the applicable SBA office for additional details.
- Using the workpaper, ensure a loan write up is completed on those loans reviewed.
- Evaluate asset quality trends and the direction they are going. Identify the underlying cause(s) of any identified deterioration in the 7(a) serviced portfolio that occurred subsequent to prior examinations.
- Develop an overall comparative analysis of the SBA Supervised Lender’s loan portfolio performance including an analysis of the SBA Supervised Lender’s loan performance to that of their Peer Group.
- Evaluate credit risk concentrations and other portfolio threats to risk funds.
- Analyze the changes in the composition of the portfolio including any off-balance-sheet exposure resulting from loan sales, any growth shifts in key industry segments, or any new concentrations. Coordinate with the examiner analyzing Valuation and Accounting for Servicing Rights Asset and Residual Interests to assess the company’s Financial Accounting Standards Board (FASB) 140 analyses for impairment of servicing rights assets. In addition, determine whether there are any contingent liabilities related to asset securitization and loan sales or purchases.
- Assess overall policy regarding use of outside loan packagers and loan agents and the adequacy of controls the company has in place to avoid the possibility of originating fraudulent applications. For example:
    - Does it re-underwrite loan applications it might accept from loan packagers?
    - Does it track the performance of originations which were referred by packagers or agents to assess the quality of such referrals?
    - Is loan packager or loan agent compensation based on the quality of previous referrals?

- What controls are in place to deter the acceptance of fraudulent applications or referrals?
- Conclude on the condition of assets.

q. Introduction – Allowance for Loan Losses Subcomponent

The allowance for loan losses (allowance) is a valuation reserve established and maintained by provisions made from the SBA Supervised Lender's operating income. 13 CFR §120.470(b)(7) requires the SBLCs to "maintain a reserve in the amount of anticipated losses on loans and receivables". As a valuation account, the allowance is established as an offset to, or reduction in, the gross value of loans on an SBA Supervised Lender's balance sheet. Failure to maintain the allowance at an adequate level is an unsafe and unsound practice. It could also lead to a misunderstanding of an SBA Supervised Lender's true financial condition by investors or other interested parties. Accordingly, examiners must ensure that each SBA Supervised Lender has adopted a policy to regularly review the adequacy of its allowance.

The SBA requires all SBA Supervised Lenders to maintain their allowances in accordance with Generally Accepted Accounting Principles (GAAP). The primary pronouncements under GAAP that address the establishment and maintenance of the allowance are Statement of Financial Accounting Standards (SFAS) No. 5, "Accounting for Contingencies" (SFAS 5), SFAS No. 114, "Accounting by Creditors for Impairment of a Loan", (SFAS 114) and SFAS No. 118, "Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosure" (SFAS 118). SFAS 118 amends certain provisions of SFAS 114. Guidance regarding when an SBA Supervised Lender should establish provisions for identified impaired loans is discussed in SFAS 114. Under provisions of SFAS 114, a loan is considered impaired when "based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." To a large extent, the factors involved in determining whether a loan is impaired are the same as those involved in determining whether a loan should be adversely classified. These factors include the borrower's character and repayment history, overall financial condition, disposition of proceeds, guarantor protection and resources, and collateral values.

r. Examination Criteria – Allowance for Loan Losses Subcomponent

When determining an adequate allowance, management of an SBA Supervised Lender should consider all outstanding loans (principal and interest) and any binding commitments to lend. This effort should be in accordance and in compliance with an established policy. In addition, SBA Supervised Lenders should make it a practice to grade the quality of each loan and use the grading system results to aid in determining their "anticipated" loss potential. Management should not be required to make provisions on the guaranteed portions of any loans, except under the extreme circumstance where management itself believes the guaranty may be voided due to non-compliance with SBA policy or for any other reason. Once management's review is complete, any necessary provisions to the allowance should be made in a timely manner. Since any provisions to the allowance come from current earnings, the provisions should be made in the disclosure period they are determined necessary.

As mentioned before, management must adopt a policy requiring that a systemic methodology be used in estimating the allowance. The methodology must be logical, appropriate given the SBA Supervised Lender's particular circumstances, and consistently applied. More specifically, the policy should indicate which amounts are deemed adequate and the criteria used to make such a determination. The policy should also specify the frequency of evaluations. Finally, the policy should discuss the SBA Supervised Lender's charge-off policy and the criteria that must be met before a reversal of any loan charge-off is justified.

Given the guidance provided in SFAS 114, SBA Supervised Lender management must determine and document estimated provisions to the allowance for any impaired loans. The SBA Supervised Lender may also have a pool of loans made to companies in a similar business. If the SBA Supervised Lender has such concentrations, management may decide to evaluate loss potential on a pool basis rather than on a loan by loan basis. This practice should be permitted by established policy including the criteria to be used.

It is also likely that management may further segment the portfolio in order to establish an allowance. For example, all adversely graded or classified loans may comprise a segment. Past due loans may comprise another. All smaller loans may be reviewed as a pool using primarily historical performance. Once the evaluation is complete, the allowance needed from each segment should be combined to arrive at the overall allowance. Any loan charged-off during a given period should have a provision in the allowance on its behalf. Regardless, all loans charged-off will be charged to the allowance. If there were no provision for a particular loan charged-off, the SBA Supervised Lender may need to replenish the account. SBA Supervised Lender's should not delay recognizing actual losses merely because they are already provided for in their allowance. Failing to charge-off losses may cause assets to be overstated on the SBA Supervised Lender's financial statement.

Adversely classified loans reflect examiner judgment that these loans bear more risk than the norm. As such, these loans should always be included among those being evaluated for potential loss. However, not all will necessarily warrant a provision to the allowance. Substandard loans, by their very definition, do not exhibit loss potential individually, although it is recognized that in a population of substandard loans there will likely be some losses experienced. Thus, it is reasonable to expect that some substandard loans may warrant provisions to the allowance. Doubtful loans, on the other hand, have a number of weaknesses that make full collection of principal and interest improbable. Loss potential exists, and by their definition, they are also impaired. An examiner should expect a provision to the allowance for every doubtful or equivalent SBA Supervised Lender graded loan.

The task for management and examiners becomes more complex if loans are determined to be impaired. The measurement of impairment is based on the present value of future cash flows discounted at the loan's effective rates. If the present value is less than the recorded investment (loan balance), the impairment is recognized by establishing an allowance for loss on the impaired loan with a corresponding charge to a provision for loss expense account. Subsequent changes in the level of impairment will affect both the allowance and the expense account. As an alternative, management may decide to simply charge-off the difference between the loan's value and the recorded balance. The SBA finds either method acceptable.

Estimating the present value of future cash flows on a problem loan will be a difficult task. Accordingly, SFAS 114 allows, "as a practical expedient" impairment to be determined based on the loan's observable market price, or the fair value of the collateral under lien if the loan is collateral dependent. Very few SBA Supervised Lender loans will have an "observable market value". However, when an SBA Supervised Lender decides that foreclosure is the sole alternative, for example, impairment must be determined by the fair value of collateral. SFAS 114 also recognizes that lenders may have impaired loans with common characteristics among them. If so, the lender can aggregate those loans and use historical statistics such as an average recovery period and the average amount recovered, using a composite interest rate as a means of determining the impairment of these loans. In any event, the amounts provided to the allowance on impaired loans have a somewhat different purpose. Thus, the SBA Supervised Lender should detail the treatment of any impaired loans in a footnote to its disclosure documents.

Examiners should recognize that the challenge of an SBA Supervised Lender is to ensure the allowance is reasonable given the loss potential in its loan portfolio. As such, it is not uncommon for lenders and examiners to employ similar techniques, but arrive at slightly different totals for the allowance. If the lender's technique is thorough and the resulting allowance balance is a reasonable estimate, examiners can accept the analysis. It is a very different story, however, when the allowance is not a reasonable estimate of potential loss and therefore insufficient. In such cases, examiners should recognize that disclosures are unreliable and take action to remedy the situation.

Identifying a significant shortfall in the allowance is one problem. The major task thereafter is for the examiner to convince management and the BOD of an SBA Supervised Lender that the allowance is understated. How do you measure if the shortfall is significant? The answer is typically defined by the impact on the balance sheet or income statement. Examiners must employ substantial judgment when determining the proper amount to be allocated to the allowance when a significant shortfall is apparent. Examiners should review the process employed by management to determine how the SBA Supervised Lenders differ with management. For example, industry studies suggest that lenders will incur losses estimated at 50% of the loan balance for doubtful loans and 15% for substandard loans. Does management employ similar loss ratios? Beyond that, management should have some historical experience with smaller loans in the portfolio. Finally, many lenders employ a technique whereby a general provision to the allowance is made for losses that cannot be reasonably predicted, but the provision appears warranted for other reasons. These could include a large increase in loan volume, an increase in delinquencies, or changes in the SBA Supervised Lender's trade area.

s. Examination Objectives – Allowance for Loan Losses Subcomponent

The examination objectives for the allowance for loan losses subcomponent are:

- Determining whether the methodology for estimating credit losses is reasonable;
- Determining compliance with applicable GAAP standards; and
- Determining the reasonableness of the SBA Supervised Lender's recorded allowance.

t. Examination Procedures – Allowance for Loan Losses Subcomponent

The following are procedures for determining and assessing allowance for loan losses:

- Review the SBA Supervised Lender's allowance methodology, including all applicable policies and procedures, to determine whether:
    - the methodology requires a review of all loan assets (including principal and interest) and off-balance-sheet instruments with credit risk;
    - the methodology establishes criteria for estimating probable losses;
    - the methodology is consistently applied from period to period; and
    - the methodology considers all known relevant factors that may affect collectibility.
- Determine whether the methodology segments the loan portfolio into logical risk categories such as past due loans, asset quality classifications, performance classifications, industry concentrations, type of collateral, etc.
- In reviewing factors that affect collectibility, determine if the methodology considers:
    - historical loss experience;
    - changes in volume and amount of loan delinquencies and non-accruals;
    - loan volume trends;
    - current economic conditions in the SBA Supervised Lender's trade area; and
    - changes in loan portfolio characteristics.
- In the SBA Supervised Lender's process for estimating credit losses, determine whether the lender divides the loan portfolio into 1) individually identified impaired loans that are within the scope of SFAS No. 114 and 2) groups of smaller-balance homogeneous loans and other credits that are collectively evaluated for impairment under SFAS No. 5. Examiners should remember that loss estimates under SFAS No. 5 might result in a range of estimates for the allowance wherein SBA Supervised Lender management must exercise considerable judgment in determining the amount to record. On the other hand, impairment measured under SFAS No. 114 is based on a single best estimate and not a range of estimates.
- Review the SBA Supervised Lender's most recent evaluation of the allowance to determine the reasonableness of the recorded balance.
- If a large provision to the account has occurred, determine if the provision was 1) sufficient to offset the potential loss identified, and 2) made in the period when the loss potential was identified. If the provision was not made in a timely manner, determine if corrective measures such as restatement of financials or a footnote in the next disclosure are necessary. In general, however,

examiners should remember that provisions for credit losses should be charged to operating income (regardless of their amount) sufficient to maintain the allowance for losses at an adequate level.

- Review charge-offs over the past year to determine whether they were taken in the period they were identified.
- Review the work of the external auditor to determine whether any criticisms were noted. Examiners should consider a review of the auditor's workpapers if the Report is not clear.
- Review and compare management's practices in determining the sufficiency of loss allowances with those of the financial industry at large.
- Conclude on the adequacy of the allowance for loan losses.

u. Introduction – Asset/Liability Management (ALM) Subcomponent

Asset/liability management involves the planning and directing of the flow of funds through an organization. The need for ALM begins when the SBA Supervised Lender has committed to lend to a borrower. When the loan is made, it must be funded. Upon funding, the lender has an asset, the loan, and a liability, the funds borrowed from a financing source or from capital. In either case of funding, the transaction was made for a profit. Thus, the lender had to determine whether to make the loan, how to price it, where the source of funding would come from, and how to ensure profitable results throughout the life of the loan. Asset quality is a concern as anticipated profit may evaporate if the borrower defaults. Other risks will be discussed in the remainder of this section.

As a simple example, it would be quite risky to price a loan at a rate that is lower than the cost of money to fund the loan. If the funding source is a fixed cost, there never will be a profit on this transaction. This would not be considered good ALM. Also, it would not be a good practice to offer borrowers fixed rate loans and fund them with variable rate sources unless you could swap the sources for fixed rate products. There are mechanisms for interest rate swaps of this nature. This section will also discuss these mechanisms by focusing on interest rate risk identification, measurement, and management. ALM results will directly affect the conclusions reached in four of the other rating components: capital, management, earnings, and liquidity.

v. Examination Criteria – ALM Subcomponent

At present, the SBA Supervised Lenders employ strategies that minimize interest rate risk. Some are subsidiaries of nationally known parents. These parents provide most of the funding for the subsidiary SBA Supervised Lenders. The remaining SBA Supervised Lenders have contracted with commercial banks for lines of credit to fund its loans. In either situation, interest rate risk is at a minimum because most of the SBA Supervised Lender's loans are variable rate. Basically, the independent SBA Supervised Lenders borrow on their lines of credit and repay as borrowers of their loans repay or the loans are sold. Thus, there is little need to worry about the duration of the funding source. Subsidiaries are even more sheltered. They either borrow from the parent in a manner similar to the independent SBA Supervised Lenders borrowing from commercial banks, or the parent makes contributions to the SBA Supervised Lender's capital as the subsidiary grows. This funding is stable and almost totally free of interest rate risk.

The independent SBA Supervised Lender must remain in good financial condition in order to ensure continuation of its funding from bank(s). Typically, the lending banks require that the SBA Supervised Lender meet certain covenants, such as financial ratios, as part of the loan agreement(s). The lending banks also require collateral in the form of loans and other assets. Sometimes the funding banks will waive the financial covenants if collateral is ample. The banks have total discretion in these situations. If an SBA Supervised Lender has deteriorating trends, it may find its lending bank unwilling to continue the relationship or charging a higher interest rate and fees. Any such action would increase interest rate risk as the SBA Supervised Lender has presumably priced its loans considering the cost of funds under the original agreement with the funding bank. Any increase in the cost of the line of credit would narrow the interest rate spread and reduce revenue for the SBA Supervised Lender. The examiner evaluating liquidity is responsible for assessing whether there is any threat to the continuation of the contract between an SBA Supervised Lender and its lending bank.

Fixed rate loans present a different risk for independent SBA Supervised Lenders. Especially if interest rates are rising, those SBA Supervised Lenders borrowing from commercial banks will see their cost of borrowing rise. Many of the SBA Supervised Lenders' funding contracts with commercial banks set the cost of borrowing to the prime rate or London Interbank Offered Rate (LIBOR). If the SBA Supervised Lenders loans are capped at a maximum rate for any extended period while rates rise, the interest rate gap will narrow and thus, income will suffer. Thus, since an independent SBA Supervised Lender's cost of money is tied to prevailing rates which float, the SBA Supervised Lenders borrowing from banks have interest rate risk regardless of the interest rate structure they extend to their borrowers. This may be problematic if the SBA Supervised Lenders offer fixed rate products. However, even if they make variable rate loans, it is a concern.

SBA Supervised Lenders are permitted to make variable rate loans with the SBA's approval. Lending at variable rates may reduce interest rate risk, but examiners must be aware of other potential consequences. Should rates begin to rise and funding costs rise, SBA Supervised Lender management must decide what impact the rate change will have on its portfolio. Variable rate SBA loans fluctuate on the first day of the month and may fluctuate as frequently as monthly. If the SBA Supervised Lender has a daily fluctuation feature in its loan agreement, there may be a squeeze on the interest rate margin until the next interest rate adjustment date for the SBA loans. History has shown that some borrowers will be unable to perform if rates are raised well beyond the original rate. There is also some evidence that, fearing competition, lenders decide to delay the increase to the borrower, or to cap the rate at some level. In any event, the SBA Supervised Lenders have interest rate risk and thus, should have an asset/liability policy to guide the decision making process.

Effective ALM begins with the planning process. Any strategic planning effort should integrate ALM to ensure business goals are attainable. Doing so will facilitate proactive financial planning that allows boards and management to better define performance expectations. Regardless of the economic environment, ALM policy should also establish stable earnings as its principal objective. The ALM policy should include:

- A description of the ALM decision making process and any delegations of authority;
- Explicit limits on interest rate risk exposures;
- Off-balance-sheet parameters and any delegations of authority; and
- Monitoring procedures, internal controls, and reporting requirements.

Directors should ensure themselves that the exposure of earnings and capital to interest rate movements is considered and measured before making strategic decisions and should adopt policies to that effect. Once these policies are developed, the board should ensure that they are effectively communicated to the SBA Supervised Lender's staff. Procedures should be installed, an information system developed, and internal control processes established. As with all other policies, the ALM policy should be reviewed periodically.

In larger, more sophisticated financial institutions the ALM policy delegates ALM decision-making to a group of individuals organized in a committee commonly known as an Asset/Liability Committee (ALCO). The individuals participating on such a committee include managers in the lending, the finance or treasury, the data processing, the marketing, and the audit functions. While ALCOs make decisions, they rarely implement action. The BOD or executive management respond to ALCO proposals, reports, and recommendations. Regardless of the management process adopted, examiners should expect those charged with managing ALM to:

- Have a clearly defined role;
- Receive sufficient oversight by the board and executive management;
- Have a clear understanding of ALM and the specific practices of the SBA Supervised Lender;
- Ensure major assumptions are documented and supported by logical analysis of historical results or board requests;
- Maintain documentation of any planned changes to the balance sheet, the objectives, and the advantages and disadvantages each change could have on operations;
- Ensure the board and executive management are aware of planned changes and their potential consequences; and
- Conduct post-analysis of changes made to determine whether objectives were met and if further changes are necessary.

The examiner evaluating earnings will review the pricing practices of the SBA Supervised Lender. Since product pricing is instrumental in the ALM of the company, communication between examiners regarding pricing is essential. It would be unwise to disregard the cost of funds when setting loan rates.

There is much for the examiner to consider when assigned asset/liability management and evaluating interest rate risk. Interest rate risk is the susceptibility of an SBA Supervised Lender's net interest income and market value of equity to changes in the interest rate environment. Boards and management must understand these potential risks and take actions that ensure the risks are tolerable.

One type of interest rate risk is mismatched repricing periods that result from differences between the maturity (repricing) of assets and liabilities. An example would be a n SBA Supervised Lender that funds fixed rate assets with short-term liabilities, resulting in a liability sensitive position. SBA Supervised Lenders that are liability sensitive will lose income if interest rates rise. As explained above, SBA Supervised Lenders fund themselves through a parent or by borrowing from commercial banks, and their loans are almost exclusively variable rate. Thus, SBA Supervised Lenders may not have significant repricing mismatches unless their variable rate loans have caps on them. Caps represent embedded customer options that provide a ceiling on the variable rate if rates rise. Management should be simulating changes in interest rates in order to be sure risk is not intolerable as a result of mismatches or caps. The more likely risk is that rates will go high enough to cause the borrowers to default and asset quality will suffer.

Another interest rate risk is called basis risk. The concept here is that many loans are *based* on external indices such as prime or LIBOR, while liabilities may be based on a different index or simply priced as the market dictates. If the bases do not move in tandem, a company may suffer risk or reap a reward, depending upon which index moves faster, farther or in an entirely different direction. SBA Supervised Lenders, with their limited sources of funds, may indeed need to monitor basis risk if their funding sources are priced in relation to an external index.

Loan pricing may also be problematic if the method is illogical. Loans that are priced according to the BOD's wishes rather than on the cost of funds are an example. The possibilities of problems are many, but the most obvious is that rates may be set contrary to market conditions or adjusted slower than the market is moving. Any strategy whereby an SBA Supervised Lender prices loans based on the average cost of debt would be problematic because the average cost would lag behind the market. Also, examiners need to be wary of commitments to lend at a certain rate. If the commitment is for an extended period and the rate is fixed, rates could rise before the loan is actually funded. Profit on the transaction would thus suffer. Commitment periods should be kept short to avoid this problem.

Prepayments also create risk for some financial institutions. The primary concern is that the liability that was assumed to provide funding for the loan may live on after the prepayment, if the liability cannot be prepaid concurrent with the prepayment of the loan. Prepayment penalties or up-front fees are common requirements to thwart prepayments. This should not be a major problem for SBA Supervised Lenders since they all have the ability to reduce the liability at the time of the prepayment.

The risks discussed above will impact each SBA Supervised Lender differently based on its respective mode of operations. It is important that the information systems of each SBA Supervised Lender provide the flexibility to measure and control these risks. Information systems should tell the SBA Supervised Lender what percentage of their loans are variable rate, the cost of funds on any given day, the profit margin of loans versus the cost of funds, and other useful data. The systems should indicate what its interest rate exposure is and allow for simulation of interest rate changes. The systems should also allow the SBA Supervised Lender to simulate financially stressing the balance sheet to forecast sensitivity to interest rate changes. Finally, the systems should allow the SBA Supervised Lenders to implement strategies and forecast results. Absent systems with the capability and flexibility described, companies will be unable to monitor and manage the risk through ALM practices. Also, the BOD will not be properly advised of the risk and rewards of these practices.

w. Examination Objectives – ALM Subcomponent

The examination objectives for the ALM subcomponent are:

- Ensuring that the leadership of the company understands the concept of ALM and is actively reviewing the risks associated with it.
- Determining whether the SBA Supervised Lender has adequate processes to identify, monitor, and manage risks associated with ALM.
- Ensuring that the BOD receives sufficient information and, in turn, provides policy direction to management regarding ALM.
- Determining the extent of interest rate exposure and ensure risk is accurately measured and properly managed.

x. Examination Procedures – ALM Subcomponent

The following model procedures are provided to facilitate the evaluation of ALM. Consistent with risk-based examination principles, examiners should add, delete, or modify these procedures as needed. For example, examiners may want to scale back the review of ALM significantly if an SBA Supervised Lender receives its funding from a major parent in the form of capital contributions. It would be wise, however, to review the parent's annual report to be certain the parent has the financial strength to provide funding for the SBA Supervised Lender on a continuous basis.

Obtain and review policies and reports related to ALM, such as ALM procedures, business plans, interest rate measurement reports, simulations or shock results, and any ALCO minutes or reports. The examiner would also need to learn about the pricing practices of the company through discussion with the examiner evaluating earnings or by reviewing documentation related to pricing strategy and performance.

Through discussion with appropriate management officials, learn whether there are changes pending as a result of interest rate exposures, the projected interest rate environment, results from any simulations or shocking, or any external factors.

Determine whether ALM strategies are developed in coordination with overall business planning and budgeting processes by reviewing the planning documents to learn if they discuss risks in current operations and the projected impact the new strategies will have on the risks.

Determine whether the ALM policy provides clear guidance to the staff, that it emphasizes stable earnings, establishes acceptable interest rate risk exposure tolerance levels, details delegations, and outlines monitoring and internal controls.

Ensure the BOD reviews ALM policies at least annually, ensuring the policies remain pertinent to the SBA Supervised Lender's operations.
If the SBA Supervised Lender has an ALCO, determine its effectiveness by assuring it has a clearly defined role, receives proper direction from the board, provides clear and accurate reports regarding risk exposures and potential remedies, provides shock results and suggests rate adjustments, compares performance results to planned results, and has implemented proper internal controls.

Determine the number and amount of variable rate loans and identify any customer options such as caps.

Determine what percentage of the loans is funded from capital versus any external funding sources.

If the SBA Supervised Lender funds loans via a line of credit with another financial institution, determine if the funding rate varies according to an external index and whether the SBA Supervised Lender's variable rate loans are tied to the same index. If not, determine if there are safeguards in place to ensure the indices move in tandem. (Note: Most SBA variable rate loans are tied to the Wall Street Journal prime rate.)

If the SBA Supervised Lender borrows its funding from another financial institution, determine if there are any significant time delays before funding ends and when a loan is paid off (as in the discussion regarding prepayment). Assess the frequency of prepayments to determine if the timing delay is a problem.

If the SBA Supervised Lender has any fixed rate loans, determine if the loans are funded with matching rate sources. If not, is the sensitivity managed to control risk?

Determine if the information systems adopted provide accurate data in order to measure interest rate risk. Do the systems allow the SBA Supervised Lender to simulate different interest rate environments or shock the balance sheet? Verify some of the computations to test validity. Was the simulation or shocking appropriate for the SBA Supervised Lender?

Determine whether interest rate assumptions are logical, and that the assumptions are the same for all strategic and operational plans.

Determine whether the reports to the BOD regarding interest rate risk are of good quality, useful, and timely.

Ensure that all assets, liabilities, and off-balance-sheet items are used when interest rate risk is measured.

Discuss the stability of funding sources with the examiner evaluating liquidity. Determine whether the SBA Supervised Lender considers potential price changes for funding in its interest rate risk management.

Review fee and penalty policies to determine whether they are used to offset interest rate risk.

If the SBA Supervised Lender is an active seller of portions of loans, determine if proceeds derived from loan sales are incorporated into any interest rate risk analysis. Similar analysis is needed for servicing fee income.

Determine whether internal controls are sufficient to ensure ALM practices are valid, decisions are documented, testing is valid, results are measured versus those planned, and necessary Corrective Actions are initiated.

Considering all of the information gathered from previous procedures, formulate tentative conclusions regarding the ALM process. If criticism is warranted, ensure the cause, effect, and condition are addressed, and determine how the criticism will affect other examination areas.

Discuss preliminary Findings with the EIC and the examiners evaluating capital, earnings, management, and liquidity as appropriate.

Discuss the scope of the evaluation and concerns about the ALM process with proper management officials. Obtain a response regarding causes for the concerns and any anticipated Corrective Actions.

Conclude on the ALM processes.

y. Introduction – Valuation/Accounting for Servicing Rights, Assets & Residual Interests Subcomponent

For lenders active in the secondary market, accurate valuation and accounting for servicing rights assets and residual interests must be evaluated.

z. Examination Criteria – Valuation/Accounting for Servicing Rights, Assets & Residual Interests Subcomponent

Valuation of the SBA Supervised Lender's holdings, partial asset sales and rights/responsibilities of the residuals may have significant impact on overall asset quality, and must therefore be examined. In accordance with 13 CFR §120.420-435, SBA Supervised Lenders may sell those portion(s) of guaranteed loans which are not guaranteed by SBA, utilizing a securitization structure which is satisfactory to SBA, and with SBA's prior written consent.

aa. Examination Objectives – Valuation/Accounting for Servicing Rights, Assets & Residual Interests Subcomponent

The objectives to be achieved in review of Valuation and Accounting for Servicing Rights, Assets and Residual Interests are to:

- Determine the adequacy of loan asset sales management including policy and procedure, external audit follow-up, and risk identification;
- Determine if loan asset sales and recorded residual assets and liabilities are valued and accounted for in accordance with GAAP.

ab. Examination Procedures – Valuation/Accounting for Servicing Rights, Assets & Residual Interests Subcomponent

- The following should be accomplished prior to the onsite examination.
- Review previous examination Findings, if any, related to loan asset sales and retained interests and management's response to those Findings. Modify scope and approach section as necessary to follow-up on prior Findings.
- Via telephone conversation with the institution, and a review of the most recent annual audited financial statements, determine:
    - Whether the SBA Supervised Lender typically sells the guaranteed portions of SBA loans;
    - Whether the SBA Supervised Lender has securitized any non-guaranteed portions of SBA loans; and
    - Whether the SBA Supervised Lender's disclosures regarding servicing rights assets and residuals from securitizations meet the requirements of FAS 140.
- Modify the examination advance letter to the SBA Supervised Lender based on the discussions with management and the review of the most recent audited financial statements, to incorporate any such SBA Supervised Lender activities related to servicing and residual assets.

- If the external auditors review the major operational areas involved in loan asset sales and valuation of retained interests, review the most recent engagement letter, external audit report, and management letter.
- Determine whether the external auditors rendered an opinion on the effectiveness of internal controls related to loan asset sales and whether management promptly and effectively responds to the external auditor's concerns and recommendations.
- Assess management's response to any audit Findings on servicing rights and residual assets.
- Review the SBA Supervised Lender's written policies or procedures related to loan asset sales and retained interests to determine if there have been any changes since the last examination.
- Determine whether the company has and is following adequate policies and operating procedures for loan asset sales and retained interests 13 CFR §120.421-435).
- Review and test (test sales for at least one month) the SBA Supervised Lenders valuations and accounting treatment for the sale of guaranteed loans. Determine whether:
    - Assumptions used (discount rate, normal cost of servicing, etc.) to determine fair value of servicing rights asset, and cost of normal servicing are reasonable;
    - The SBA Supervised Lender properly allocated the previous book carrying amount between the assets sold, assets retained, and the servicing rights asset based on fair market values on the date of transfer;
    - The recognition of gain or loss on assets sold and write-down of the unguaranteed loans was properly recorded in the financial records;
    - The institution included deferred origination costs (FAS 91) in the allocation of previous carrying values. If not, determine whether the institution wrote down the deferred origination costs when the guaranteed portions were sold;
    - The process for amortizing the servicing rights asset and (if appropriate) the write-down (deferred gain) of the non-guaranteed portion is in accordance with FAS 140; and
    - The process for testing the servicing rights asset for impairment uses reasonable assumptions and methodology.
- Review and test (test at least one recent securitization) the SBA Supervised Lenders valuation and accounting treatment for the sale (securitization) of non-guaranteed loan portions. Determine whether:
    - Assumptions are reasonable and calculations are documented;
    - Loan sales accounting was in accordance with FAS 140;

- For Interest Only (IO) strips and residual assets;
- Verify that the methodology for valuing the IO and residuals is consistent with the cash flow specifications in the securitization agreement;
- Review the "Servicer's Certificate" that the company submitted to the trustee regarding the securitization balances and the calculation of the required balance in the spread account;
- Determine whether the company's valuation considers changes in expected cash flows due to current and projected volatility of interest rates, default rates, and prepayment rates;
- Verify that IO strips are recorded at fair market value consistent with available-for-sale or trading securities; and
- Review impairment test results for servicing rights assets, IO strips, and any other residuals. Determine whether impairment is assessed frequently (e.g., at least quarterly).

- Conclude on the valuation and accounting for servicing rights, assets and residual interests.

6. Management Examination Component

a. Introduction – Management and Operations Subcomponent

The leadership provided by the BOD and management of an SBA Supervised Lender is the most important component of the examination. The actions of management are manifest in every operational area. Management needs to understand how external factors will impact the SBA Supervised Lender and take decisive action. Even with enormous foresight and experience, management must exercise sound judgment and carefully weigh the costs, benefits, risks, and rewards of each decision.

Several different factors indicate the adequacy of leadership. Policies adopted by the BOD are important factors. Also significant are the systems, processes, and functions established by management. Examiners must determine if management has fulfilled its duties and responsibilities. They must evaluate the qualifications of management, and whether management has generated adequate financial results. Yet it is the BOD who decides the SBA Supervised Lender's strategic direction, adopts policies, provides leadership, and promotes the SBA Supervised Lender to the public. Oftentimes, the promotional efforts of the directors raise or lower the reputation of a financial institution.

Examiners must remember that the BOD's and management's *performance* should strongly influence judgment of the sufficiency of leadership. For example, policies may be well thought out and very necessary. However, it is management's proper implementation of these policies that will be the basis for evaluation. Conversely, policies may be ill advised for the SBA Supervised Lender. Management must comply with the policies set by the board. In this case the BOD is accountable for the results.

The remainder of this section will be devoted to the roles of management and the BOD as well as their respective evaluation.

b. Examination Criteria – Management and Operations Subcomponent

First and foremost, management is responsible for complying with the SBA Loan Program Requirements promulgated by the SBA. Controls must alert staff throughout the SBA Supervised Lender when reports are due to the SBA and what limits must be monitored. For example, the SBA has mandates regarding the amount of capital to be held by all SBLCs. Management should establish a higher minimum so that action can be taken before a violation occurs.

Since the BOD and executive officers collectively constitute the managing body of the SBA Supervised Lender, it is important to recognize the differences in their duties and responsibilities. They will be discussed below:

Board of Directors (BOD)

As the policymaking body, the BOD bears the ultimate responsibility for the conduct of the SBA Supervised Lender's affairs. Directors have a fiduciary duty to represent the SBA Supervised Lender to the maximum benefit of the SBA Supervised Lender's stockholders. While they are not day to day operators, the directors must dedicate sufficient time to fulfill their responsibilities and must remain free of financial difficulties that might tarnish the SBA Supervised Lender's reputation.

The BOD delegates day-to-day management of the SBA Supervised Lender's affairs to the officers and employees. However, failure to provide the necessary guidance to the officers and employees or broader permissiveness than is wise could be considered an abdication of the board's duties. Conversely if the directors should immerse themselves too deeply in the day-to-day operations, they will find it difficult to hold the officers and employees accountable for results. The BOD must safeguard the stockholders' interests through lawful, informed, and diligent administration of the SBA Supervised Lender.

Appointment of a chief executive officer (CEO) is one of the most important decisions made by the BOD. Directors must exercise due care to ensure that the appointed CEO has sufficient qualifications and integrity to effectively manage the SBA Supervised Lender and its staff. Once a CEO is appointed, the board must ensure that the CEO's duties and responsibilities are clearly defined. Measurable performance standards must be established for the CEO. Then, the board of director's must ensure the CEO's performance is formally appraised on a periodic basis. For the board to ignore the CEO's performance would be to abdicate its responsibilities. At least one other officer should report directly to the board, the internal auditor. It is also beneficial to have the credit review officer, if a different individual, report directly to the board.

To capitalize on their individual expertise, board members often carry out their responsibilities through participation in appropriate committees. Committees should have documented missions. Also, it is prudent to rotate committee members to increase each director's understanding of different business aspects. Examiners should scan the board meeting minutes to determine members' attendance. Excessive absenteeism may indicate an inability to devote appropriate time to the SBA Supervised Lender's affairs. The minutes will also evidence which directors participate and which refrain from activities.

A board split into factions may be very dangerous. Studies have indicated that a fragmented BOD is one of the most frequent causes of bank failures. Examiners should take due care to note any evidence of such a division and ascertain if it is effecting the board's decision making and leadership ability.

Executive Management

As mentioned above, the CEO is the single most important member of the executive management team. The CEO is accountable to the BOD. Thus, the CEO is the most likely person to challenge the board on unwise plans. Often times the CEO sits on the board, frequently serving as chairman. This provides the CEO with an avenue to have substantial input into the direction of the SBA Supervised Lender.

Executive officers are charged with implementing the policies adopted by the BOD and carrying out the board's wishes. In part, they accomplish this by establishing systems, processes, and specific internal control procedures to ensure that objectives are achieved. They must also fully inform the board of results. If the outcomes are below expectation, the board will ask executive management to initiate Corrective Action. Examiners should pay close attention to the level of information that the management team provides to the board. Either too little or too much information may be damaging. Too little information may not keep the board sufficiently advised. Conversely, too much information may confuse them.

Executive management can also delegate certain duties to their subordinates. Yet, like the directorate, management is still accountable for results. Accordingly, executive management has the difficult chore of selecting the right people for the tasks at hand. Fair and helpful performance appraisals indicate a disciplined approach to managing subordinates. If that fails, changes will need to be made. A needs determined educational program should also be in place. This will assure subordinates have the appropriate knowledge to succeed in assigned and future duties.

The CEO and executive management team must have the technical expertise necessary to assist the board in directing the SBA Supervised Lender. For this reason, it is those with such technical talents who are charged with drafting future plans, either strategic or operational. Extreme competition in the lending business demands thoughtful and thorough SBA Supervised Lender planning for the future. As it has been said in other sections of this SOP, projections for increased loan volume require lenders to have a funding source for such growth. Also, only solutions that consider future consequences will prevent interest rate maturity mismatches. If management fails to develop plans and to correspondingly budget sufficient funds, the SBA Supervised Lender will not thrive.

An SBA Supervised Lender's performance with respect to asset quality and portfolio management, earnings and capital sufficiency, funds management, and compliance with law and SBA Loan Program Requirement is largely the result of decisions made by the organization's leadership. Consequently, Findings and conclusions for these components made during the examination will strongly influence the evaluation of management. While this approach is logical, examiners must also be aware of external matters that can impact the SBA Supervised Lender's condition. An interest rate rise that was not predicted by major economic advisers would hurt the earnings of most financial institutions. Conversely, financial institutions can thrive in positive economic conditions despite the fact that policy and procedures are inadequate. An examiner judgment is essential to the evaluation of management.

c. Examination Objectives – Management and Operations Subcomponent

The objectives of the Management and Operations subcomponent section are:

- Determining if management's processes and systems are sufficient to ensure safe and sound operations and compliance with laws and regulations.
- Determining management's adherence to safe and sound business practices and compliance with laws, regulations, and enforcement actions.
- Determining the adequacy of management’s processes, controls and staffing to support current and planned loan portfolio acquisitions.

d. Examination Procedures – Management and Operations Subcomponent

The examination procedures are provided to assist examiners in the evaluation of management. Consistent with risk-based examination principles, examiners should add, delete, or modify these procedures as circumstances warrant.

- Evaluate actions to address the applicable examination’s Findings and recommendations cited in the most recent ROE.
- Discuss the condition and performance of the loan portfolio with the examiner(s) assigned the loan portfolio management evaluation to determine the effectiveness of management's processes and systems in achieving adequate results.
- Discuss the financial condition and performance of the institution with the examiner(s) assigned the finance evaluation to determine the effectiveness of management's processes and systems in achieving adequate results.
- Discuss the SBA Supervised Lender’s compliance with laws and SBA Loan Program Requirements with the examiner(s) assigned the compliance evaluation to determine the effectiveness of management's processes and systems in ensuring compliance with laws and SBA Loan Program Requirements.
- Conclude on the adequacy of management's systems and processes.
- Review the strategic planning methodology. Evaluate the following areas:
    - Strategic and operational planning;
    - Policy formulation;
    - Monitoring the condition and performance of the institution for all major operational areas;
    - Monitoring compliance with policies, laws, and SBA Loan Program Requirements; and
    - Achieving Corrective Actions and implementing audit, review, and examination recommendations.
- Obtain the institution's organizational chart and identify the key executive officers and their responsibilities.

- Compare the results of operations to the standards, objectives, and direction established by the board to determine if the CEO and executive management are adequately implementing the direction set forth by the board.
- Review the impact of loan portfolio acquisitions on the company to ensure that safe and sound operations are maintained in recognition of significant increases in the loan portfolio serviced.
- Review the information reported to senior management and determine if executive management is kept adequately informed about activities and potential operational or financial problems.
- Discuss tentative conclusions and examination Findings with examiners responsible for the assets, finance, and compliance evaluations.

e. Introduction - Internal Controls Subcomponent

A strong internal control system provides the framework to accomplish numerous management objectives; safeguarding assets, ensuring accurate financial disclosures, compliance with law and SBA Loan Program Requirements, and preventing fraud, waste, and abuse. Effective internal controls ensure actions taken are in accord with those planned. Internal controls should identify exceptions as they occur.

There are costs attached to the development of controls and for the reasonable assurances they provide. The concept of reasonable assurance recognizes that the cost of these controls should not exceed the expected benefits. However, cost benefit analysis by management will be judgmental at best, as it is very difficult to determine the potential costs resulting from absent controls. It is also understood that internal controls will be increasingly formal, and therefore more expensive, as the size and complexity of an organization grows.

The BOD and executive management of each SBA Supervised Lender are responsible for the development and adoption of controls. Effective internal controls require a suitable environment. All employees must possess a positive attitude toward and awareness of proper controls. Employees should also understand and embrace the management's actions.

Strategic preparation, operational planning and written policy and procedures define a SBA Supervised Lender's objectives, the strategies intended to achieve them, and the operating practices of the SBA Supervised Lender. Such direction provides the BOD with a control system for accountability of operations and use of resources. Control mechanisms reside in the company's management information systems, external audit, internal audit, and internal credit review. Finally, the SBA

Supervised Lender's directorate should recognize the examination team as another mechanism to ensure that proper controls are in place.

Examiners will test the controls in each operational area during the course of the examination. Improper or absent controls reflect poorly on the performance of management. Furthermore, the controls in place in each SBA Supervised Lender influence the scope of examinations. Good controls will allow examiners to minimize testing, whereas poor controls require expanded testing.

f. Examination Criteria - Internal Controls Subcomponent

13 CFR§120.471 requires each SBLC to maintain and preserve accurate financial records. Records must be kept current. In accordance with 13 CFR§120.472, the SBLCs must also furnish several reports to the SBA. These reports must be accurate and submitted in accordance with prescribed timeframes. The same citation also requires that each SBLC submit an audited annual financial statement prepared by a Certified Public Accountant (CPA). Such records and submissions will never be accurate and timely unless the SBLC develops and employs necessary controls.

Each SBLC is required to retain an external auditor to produce an annual financial statement. The auditor will perform numerous tests of internal controls in order to certify the statement. Accordingly, it would be wise for the examiners to coordinate with the external auditors of each SBA Supervised Lender in order to ascertain the auditor's procedures and concerns. Most auditors will permit examiners to review their workpapers. A dialogue with the external auditors will provide the examiners with the confidence levels necessary to scope examinations.

The SBA Supervised Lender's organizational structure will provide the overall framework for controls needed to ensure effective planning, direction, and control of operations. Each structure should include an internal audit program. Larger SBA Supervised Lenders will require more comprehensive internal audit practices and will likely employ an internal auditor. Smaller SBA Supervised Lenders must have controls in place as well. However, cost/benefit analysis will dictate that such controls be simple. The smaller SBA Supervised Lenders may not have full-time, internal audit personnel. Rather, they might use officers to perform audits or reviews on a rotating basis. In either case, SBA Supervised Lenders must prove to the external auditor that controls are effective in order to earn a certified opinion. In general, proper controls will dictate that no individual will have the authority to perform or approve all requirements of a particular transaction or process. For example, the same individual should not perform both duties concerning the custody of assets and maintain the assets' records. Further, the duties of requisition, approval, execution, and recording a transaction should not be done by one individual.

A qualified external auditor is an accountant who holds a valid and unrevoked certificate as a CPA. Although difficult to determine, competence is important. It would be wise for the SBA Supervised Lender to retain a CPA firm familiar with the operations of financial institutions. The CPA will review the operations and controls of each SBA Supervised Lender to ensure the company is operating in compliance with GAAP. Among other things, GAAP requires that controls be in place to ensure the production of true and accurate financial statements. Typically CPAs work throughout the year, often reviewing quarterly disclosures before opining on the annual report of the company. Auditors may opine as follows:

Unqualified

States that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with GAAP.

Qualified Opinion

States that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, result of operation, or cash flows of the company in conformity with GAAP.

Adverse Opinion

States that the financial statements do not present fairly the financial position, results of operation, and cash flows of the company in conformity with GAAP.

Disclaimer of Opinion

Preparer disclaims or disavows one or more components of the financial statements as

If the CPA intends to issue a qualified or adverse opinion or a disclaimer of opinion, the CPA should set forth all material reasons for issuing or disclaiming the opinion. Examiners should expect to see unqualified opinions. Examiners may also see instances of explanatory language that will not affect the unqualified opinion but may explain any peculiarities. If the examination reveals that an SBA Supervised Lender did not receive an unqualified opinion, the EIC must ensure sufficient coverage of any area(s) subject to qualification. In the highly unlikely circumstance that the opinion is adverse, the EIC should immediately contact the Office of Lender Oversight (OLO) and Office of General Counsel before proceeding.

When conducting audits, external auditors will consider examination reports produced by the SBA as confidential sources of evidential matters. The bulk of an auditor's evidence and the focus of their audits will be the internal controls in place at the applicable SBA Supervised Lender. Therefore, the talent and the discipline of those involved in the internal controls practices of a company will determine the scope of a CPA's audit and influence the opinion. The CPA evaluates the effectiveness of a company's internal control structure, policies, and procedures in determining the risk of material misstatement in financial statement assertions, or violations of law or SBA Loan Program Requirements.

Given its role in preventing internal control deficiencies, all SBA Supervised Lenders should adopt an effective internal audit and review program. Again, the scope of this program will differ depending on the size and complexity of the company's operations. Regardless of the program's depth, the staff devoted to the program should possess the competence to conduct reviews; independence to express their findings; ability to use sound judgment in establishing scopes, choosing tests, applying standards and planning adequately; capability to supervise assistants; and aptness to gather sound evidence. On the subject of independence, it is wise to have the internal auditor, or the individual evaluating a particular program or operation, report straight to the BOD. Because of their fiduciary duty, the directors may, at any time, request an assessment of a particular area. For example, the board may request an assessment of whether staff is complying with adopted policy. The BOD may also ask if the SBA Supervised Lender is operating in compliance with law and SBA Loan Program Requirement. The board could certainly ask if staff is taking the most efficient approach to accomplish assignments. Thus, those managers responsible for evaluating controls may want to query the board as they prepare their audit or review schedule.

A word of caution is appropriate at this juncture. If examiners find that an SBA Supervised Lender has changed external auditors since the last examination, the examiners should investigate the cause of the change. It may be as simple as a significant cost reduction. However, there may be other reasons that would impact the examiner's judgment on internal controls. This would be particularly true if the change was made during the conduct of an audit. Usually, this results from a major disagreement that might indicate disclosure troubles or a more extreme concern about the SBA Supervised Lender's viability. The examiners should obtain views from both sides in this disagreement. Extreme concerns registered by the departing CPA should be brought to the attention of SBA management. In addition, it is usually unnecessary to determine if the CPA is independent. Any CPA that has borrowed from an SBA Supervised Lender or that has any financial interest in the SBA Supervised Lender in question would not be considered independent.

An effective management information system (MIS) should play an important role in determining compliance and monitoring operations. As such, the MIS is an important tool in the internal control program of any company. In this context, MIS could be automated or manual. In either case, the system should be the mechanism used to obtain, transact, and report information needed to operate effectively. Accordingly, the MIS should provide the BOD with data sufficient to:

- Monitor performance relative to the business plan and policy objectives;
- Monitor compliance with reporting requirements as outlined in policy and delegated authorities;
- Monitor compliance with laws, SBA Loan Program Requirements and SOPs;
- Reflect the financial condition and performance of the company;
- Reflect the values of the loan portfolio, other assets, and liabilities;
- Identify operational irregularities, deficiencies, or inefficiencies; and
- Determine the status of Corrective Actions on previously recognized problems.

If the MIS fails to provide the information described above, changes in the MIS are in order. The SBA Supervised Lender's directors should ensure that the MIS provides them with the information they need to monitor and oversee operations. Examiners should take action to alert the board to any systemic deficiencies.

g. Examination Objectives - Internal Controls Subcomponent

The objectives of the Internal Controls subcomponent section are:

- Determining the adequacy of the internal control systems;
- Ensuring the financial statements are fairly stated; and
- Ensuring compliance with law and SBA Loan Program Requirements.

h. Examination Procedures - Internal Controls Subcomponent

The following procedures are provided to facilitate the examination of internal controls. It should be noted that examiners evaluating different areas might be testing controls in that particular area. For example, the examiners analyzing loans will be testing the SBA Supervised Lender's internal classification system. Similarly, the examiner(s) evaluating the allowance for loan losses will be testing the SBA Supervised Lender's process for estimating potential losses. Accordingly, Findings elsewhere during the examination should be considered in the evaluation of internal controls. Consistent with risk-based examination concepts, examiners should add, delete, or modify the following procedures as needed.

- Through discussions with management, determine the control environment espoused by management and the BOD. Have proper controls been emphasized to employees? Are all employees held accountable for their actions? Is proper reporting and disclosure considered important? Does management relay the importance of complying with law, SBA Loan Program Requirements and SOPs?
- Determine whether management has established a performance evaluation system that holds employees accountable and assures reliability. Do employee job descriptions delineate specific duties, reporting relationships, and constraints?
- Determine the suitability of the policy prescribing the internal control procedures to be followed by all employees. Be sure custody functions and authorizing functions (over disbursement of funds and withdrawal of securities) have at least dual controls.
- Determine the competence of those involved in control processes including education backgrounds, continuing education, compensation, and performance evaluations. Is turnover heavy?
- Determine the independence of the internal audit or review functions. Do they report directly to the BOD? Are they evaluated by the board or by a committee of the board? If otherwise, are there compensating strategies that prevent undue influence?
- If the SBA Supervised Lender has an internal auditor, determine if the individual is a member of senior management, both in title and in practice. Does the internal auditor meet regularly with the BOD to ascertain the board's audit desires?
- If the SBA Supervised Lender has loan production offices, determine if internal controls extend to those remote locations.
- Review audits or reports produced by those responsible for internal control oversight to determine if any deficiencies were identified. If there were deficiencies, was agreed upon remedial action taken? If not, why?
- Review management letters sent by the external auditor to

determine if any deficiencies were identified. Were internal control breakdowns the cause? Was Corrective Action agreed upon and initiated?

- Based upon the results of steps 8 and 9, select the areas posing the greatest risk and test the controls in place to monitor results in these areas. Have sufficient controls been adopted?
- Evaluate the internal control processes that are integral to a successful program. Ensure reporting to the board including: the MIS, the audit or review program, and supervisory review of employee performance. Substantiate the effect of both preventative and detective control components through observation and testing. If the processes in these areas are faulty, discuss the situation with the EIC so that the other examiners will be aware of the deficiencies in these critical areas.
- Evaluate the BOD's use of internal audit or review functions to make appropriate inquiries into areas such as compliance with laws, SBA Loan Program Requirements and SOPs, compliance with board policies, the financial condition and performance of the company, and the efficiency of the organization.
- Test the workpapers of the internal auditor/reviewer to ensure the scope and work completed were sufficient to attain the audit/ review objectives.
- Evaluate the frequency of internal audits/reviews to ensure sufficient coverage considering the cost, concern, and the potential for material errors.
- Review the personnel files of those involved in the internal control program to ensure they possess the necessary education, commitment to continuing education, and work experience. Does staff possess a CPA or similar certification?
- Determine whether internal control staff is asked to develop policies or procedures, prepare records, or ascertain the other activities that they would normally review and appraise.
- If internal control deficiencies are discovered or reported by examiners evaluating different areas that were not identified by the internal staff, determine the cause for the omission.
- Determine if the BOD requires the external auditors to submit an engagement letter before commencing an audit activity. Review the board minutes to learn whether the board discusses the scope of the audit included in the engagement letter. Does the board object to any activity for an unusual reason? Or was the objection due to a plausible reason such as a recent internal review or if the board wishes an activity expanded.
- Conclude on the adequacy of the board's actions to address concerns raised by the internal auditor/reviewer or the external auditor.
- If the SBA Supervised Lender retains an independent contractor to

conduct credit reviews, ensure the BOD dictates the remedial response.

- Review all correspondence related to the SBA Supervised Lender's contract with the CPA to ensure that there is no questions of independence.
- Review the opinion of the CPA in the most recent annual audit. If the opinion was anything but unqualified meet with both the external auditor and the internal auditor/reviewer to determine the cause(s) and anticipated Corrective Action.
- Determine if the external auditor omitted certain procedures in the scope and why the scope was reduced.
- If possible, even if the audit is favorable, meet with the external auditor (perhaps via the phone) to discuss audit coverage going forward, Findings during the most recent audit, or significant issues discussed.
- Determine whether the external auditor evaluated the effectiveness of the SBA Supervised Lender's internal control structure, policies, and procedures and if he focused on preventing/detecting material misstatements.
- Conclude on the BOD's responsiveness to the external auditor.
- Review the cause of any change in CPAs and determine the reason. If the CPA was changed while the audit was in process, meet with the former CPA to learn the reason from their perspective. If it is the result of a critical concern, alert the AA/OLO or designee.
- Conclude on the adequacy of the internal/external audit coverage to reduce the likelihood that serious problems will go undetected. Review the information provided in the SBA Supervised Lender's MIS to determine if the information is accurate, complete, and user friendly.
- Determine if the BOD periodically discusses the adequacy of the MIS in meeting internal control needs.
- Discuss the internal control environment, the audit and review functions, and the MIS with the examiners evaluating other areas to determine if they have noted any deficiencies.
- Weigh the results of the examination Findings related to internal controls and conclude on their adequacy.

7. Earnings Examination Component

a. Introduction

Some SBA Supervised Lenders are owned by larger firms, while others are owned by shareholders. Regardless, all owners look to the earnings of the SBA Supervised Lender to assess the quality of their investment. Earnings of impressive quantity and quality offset the risks of charge-offs, litigation costs, or fraud to lender's capital. Confidence will not be built and dividends will not be paid if an SBA Supervised Lender cannot earn sufficient returns to provide a capital cushion that assures vitality.

An SBA Supervised Lender's principle sources of income are interest on loans remaining in their portfolios, gains realized from the sale of loans, and fees earned for origination and servicing. An SBA Supervised Lender's ability to continue to extend credit profitably depends on its ability to build capital from solid earnings performance. Therefore, examiners must determine whether an SBA Supervised Lender is pricing its loans commensurate with the risk posed. In addition, SBA Supervised Lenders need to ensure the returns they obtain from loan sales are sufficient to cover costs and build retained earnings. It is also important for examiners to evaluate the expense structure of an SBA Supervised Lender. Any and all expenses incurred by an SBA Supervised Lender must be considered when an SBA Supervised Lender prices its products. In coordination with the examiner evaluating asset/liability management, a thorough evaluation of interest rate risk exposure must be conducted.

Non-recurring earnings are those that are a one time event. Any one-time gains of this nature must be considered when an examiner evaluates the stability of earnings. An example would be if the SBA Supervised Lender sold the building it occupied and owned, then leased it from the new owner. The one time gain certainly improves year to date earnings, but does the gain really say anything about the SBA Supervised Lender's ability to generate profits over an extended period?

b. Examination Criteria

Given that the interest and fees earned on loans and the profit from sales of loans are the primary ways that SBA Supervised Lenders generate earnings, examiners must evaluate the pricing decisions behind these activities. Each SBA Supervised Lender should have a business plan adopted by the BOD and a budget to carry it out. These are important documents for examiners to review as they often indicate targeted rates of return. Have the targets routinely been met? Were the targets appropriate given the risk absorbed? Given the SBA's public mission, does the business plan indicate risk tolerance levels?

Quantity of Earnings

Key statistical measures used when evaluating earnings quantity are the return on average assets, return on equity, and net interest margin. The return on average assets ratio discloses the success a lender achieves using assets to generate income. The return on equity ratio measures the amount of income generated compared to the lender's capital base. The net interest margin ratio is an indicator of loan pricing effectiveness.

Another important factor an examiner must consider in evaluating the quantitative results is the SBA Supervised Lender's capital position and needs. If capital is insufficient to support lender goals and risks, higher earnings would be the likely objective. On the other hand, an ample capital position may allow a lender to become a "best rate" leader in its territory.

Quality of Earnings

Examiners must also determine the quality of earnings. If an SBA Supervised Lender is getting an impressive return on its new loans, but the loans default, the quality of the earnings from interest earned would not be rated highly. Examiners should also evaluate whether the gains on the sale of loans contribute sufficient returns. It is also important to remember that SBA Supervised Lenders focusing on the sale of loans to fund their operations must be able to continue to make loans to sell. Will the market support this effort? Some SBA Supervised Lenders pay dividends to stockholders. Others pay distributions to their parent, while others pay interest and principle on subordinate notes. Are the earnings of the SBA Supervised Lenders sufficient in quantity and quality to meet the obligations?

Stability of Earnings

Each SBA Supervised Lender will adopt a product pricing policy that will ensure the consistent pricing of loans. Of course, any pricing strategy must consider the cost of funds available for lending. Adherence to the pricing strategy must be evaluated. Furthermore, history has shown that many lenders are disinclined to raise rates after a certain level on adjustable rate loans in a rising rate environment. Some stop when it appears that any further increase will threaten the borrower's repayment capacity. Regardless of the reason, earnings will be under pressure if interest rates are rising and adjustable rate loans are capped or if a decision is made to cap them or to delay corresponding changes in rates charged. On the other hand, simply passing on the interest rate risk to the borrowers may effect earnings quality, since the increases could, in fact, result in borrowers' default due to incapacity. The SBA Supervised Lenders ability to modify the interest rate terms depends on the financing source. Those SBA Supervised Lenders using the Secondary Market to finance the guaranteed portion will have limited ability to make changes to increase or decrease the interest rate or to control the timing of the change.

There are other stability issues that must be evaluated. Are the interest bearing liabilities of the same duration as the interest bearing assets? If there is a disparity, the SBA Supervised Lender may have to take action to ensure a constant margin between the interest earned and the interest paid. Since the SBA Supervised Lenders have very limited, yet reliable, sources of funds, this should not be a difficult effort. Given the way SBA Supervised Lenders are funded, there should be no loan prepayment risk, nor should there be any significant mismatches in the duration of assets and liabilities.

Many of the SBA Supervised Lenders securitize their loans or sell participations and retain the servicing responsibilities. The fees generated for servicing loans sold may be significant to the earnings of the SBA Supervised Lenders. Examiners should review the trend of such earnings to ensure earned fees are in accordance with any planned amounts. The examiner evaluating Loan Portfolio Management will be evaluating the quality of servicing. If buyers become dissatisfied, earnings may be threatened.

Asset quality could certainly have an impact on the stability of earnings. For example, many loans placed on non-accrual will have a negative impact on earnings. This may even effect prior periods if interest accrued has to be backed out. SFAS 114 and SFAS 118 will also impact earnings if an SBA Supervised Lender chooses to declare any loans impaired. Any unexpected provisions to the allowance for loan losses would certainly impact the profit picture. Allowance reversals would have a positive effect, but the examiner of that area must ensure such an action is justified. Accordingly, a constant dialogue with the examiner(s) reviewing the loan portfolio and the allowance for loan losses would be prudent.

c. Examination Objectives

The objectives of the Earnings component section are:

- Assessing management's business planning, focusing on the logic of the earnings targets;
- Evaluating current earnings including the sources and any risks identified;
- Evaluating the quality of the earnings composition;
- Determining the stability of the earnings stream; and
- Concluding on the effectiveness of management's planning, forecasting, adjusting, and controls.

d. Examination Procedures

The following are suggested procedures for examining earnings, given that the earnings evaluation can begin during the pre-examination phase. Consistent with risk-based principles, examiners may modify these procedures as the circumstances of the SBA Supervised Lender dictate.

- Review the SBA Supervised Lender's business plan focusing on the earnings projections. Also evaluate any pricing strategies adopted.
- Review earnings information for the current period, as well as the SBA Supervised Lender's budget, and any earnings analysis completed by the SBA Supervised Lender. Compare projected to actual earnings and determine basis for any differences.
- Evaluate current earnings by determining whether:
    - Current income was sufficient to cover expenses and any necessary provisions to the allowance for loan losses, and still provide net income;
    - Fee income trends are favorable;
    - Income performance met business plan targets; and
    - Any dividends, distributions to the parent, or payments to subordinate debt holders that may be due.
- Review earnings for the same period in the prior year and at least three previous years to detect any trends.
- Discuss Findings with examiners evaluating asset/liability management, capital, allowance, and loans to discuss your preliminary Findings.
- Review the composition of earnings by determining if there are any non-recurring income or expense items to consider. Determine whether there have been any provisions to or reversals from the allowance.
- Compare the non-interest expenses to average loans for the current period and several previous periods to learn whether such expenses are increasing.
- Evaluate the trends of fee income earned. Is fee income significant to earnings performance? Is fee income increasing? Discuss the quality of servicing with the examiner evaluating Loan Portfolio Management.
- To gauge stability, determine if the loans are funded by sources with similar maturities, known as matched funding, or whether management employs other techniques to cure mismatches. If the latter is true, discuss the risks taken with the examiner evaluating asset/liability management.
- Through discussions with the examiners reviewing the loans, determine whether there are any additional risks to earnings from

that area such as deteriorating loan quality, increased loss provisions, new non-accrual loans, or timing problems in connection with prior charge-offs. Remember that loss provisions, non-accruals and charge-offs can affect prior earnings if it is discovered that they were not transacted in the period of discovery. In addition, non-accruals may have recent interest payments reversed.

- Analyze the total expenses of the SBA Supervised Lender to determine if they are in line given the income generated and peer averages.
- Determine if there any further threats to earnings such as pending litigation or planned capital outlays for new premises.
- Calculate the SBA Supervised Lender's return on assets and return on equity ratios and compare these ratios with those of the other SBA Supervised Lenders. Determine if there are reasons for the differences.
- Given the information gained from the steps above, conclude Findings on the management of earnings considering product pricing, planning and budgeting, preservation of the income stream, and the control of non-interest expenses.

8. Liquidity Examination Component

a. Introduction

Sufficiently liquid funds are necessary to meet all obligations and to increase the SBA Supervised Lender's assets. Liquidity is also necessary to compensate for any decreases in capital. For example, the SBA Supervised Lender would need sufficiently liquid funds to pay any dividends declared by the BOD. Sufficient liquidity ensures that the SBA Supervised Lender will be more likely to sustain unexpected demands for funds.

The primary sources of liquidity for an SBA Supervised Lender are loan sales, lines of credit with commercial banks or alternative financiers, and cash. A brief description of each will follow.

Loan Sales

The SBA Supervised Lenders generally make only loans carrying the SBA guarantees. Most have a practice of securitizing the guaranteed portions of the loans and selling the resulting security in the capital markets. Some of the larger SBA Supervised Lenders even package the unguaranteed portions of the loans, securitize them, and sell them in the capital markets. These sales provide liquid funds for the SBA Supervised Lenders. The SBA Supervised Lender must also meet currency rate requirements set forth in 13 CFR 12 §120.425(c), to maintain its PLP delegated lender status.

Lines of Credit

Many of the SBA Supervised Lenders have established lines of credit with commercial banks in their territory. The SBA Supervised Lenders can draw on the line under agreed upon conditions. The SBA Supervised Lenders pay a certain rate and, often, a user fee for this ability. Typically, these lines of credit must be renewed on an annual basis. In addition, all assets owned by the SBA Supervised Lender usually secure the lines of credit.

Cash

Cash comes into the corporation due to cash flow from various sources. Examples include the sale of loans, payments from borrowers, and any payment for servicing fees the SBA Supervised Lender might receive.

Of course raising additional capital, whether it be equity or debt, would provide additional funds. Given the lengthy process to complete a capital sale, raising capital is not considered a typical primary or secondary source of liquidity.

b. Examination Criteria

Availability of lines of credit. For many SBA Supervised Lenders, lines of credit are very important sources of funds and, thus, liquidity. Because these lines are collateralized, the institutions offering these lines maintain an awareness of their borrowers' financial conditions (the SBA Supervised Lender's financial condition). If an SBA Supervised Lender's financial condition deteriorates, its line of credit may become more expensive at the next renewal. In the extreme situation, the bank granting the line of credit may terminate the line at the first opportunity. This would be problematic for an SBA Supervised Lender with no other sources of liquidity, especially if no other bank wanted to transact business.

Agreements between SBA Supervised Lender and creditor bank(s). Depending on the SBA Supervised Lender's reliance on borrowed funds supporting the operation, an increase in the cost of the line may restrict an expected dividend or curtail lending activity. Lenders need inexpensive sources of liquidity. Examiners must evaluate the agreement between the SBA Supervised Lender and its creditor bank to determine the cost of the line, and any unusual performance criteria with which the SBA Supervised Lender may struggle. Examiners should be particularly sensitive to any communication from the bank that expresses dissatisfaction with the SBA Supervised Lenders performance.

Projection of long-term liquidity demands. Examiners should also be alert to any unusual or unexpected demands, real or potential, on liquidity. One potential demand is pending litigation. Another example is a parent's request for a distribution from its subsidiaries. Any contingent liabilities such as commitments and unused lines of credit must also be considered as they represent potential exposure to the SBA Supervised Lender. In cases where there are potential demands, examiners must assess the likelihood that a draw on liquidity will occur.

Forecast of short-term liquidity demands. The ordinary demands on liquidity for an SBA Supervised Lender include funding loan commitments, paying dividends or distributions, and servicing debt. The examiner must estimate the near term outflows to determine if there are sufficient short-term sources. Further matters for the examiner's consideration involve operating expenses. Operating income routinely covers these expenses. However, any SBA Supervised Lender that becomes unprofitable must rely on liquidity to pay expenses.

It is important to note that the securitizations discussed above are sold on a non-recourse basis. Therefore, there is no potential liquidity threat once the unguaranteed portions are sold. Examiners do have to be wary of the satisfaction of the buyers of the subordinated traunches containing unguaranteed loans. If they are dissatisfied with their investment because too many of the loans default, they may try to argue that the loans were poorly serviced by the SBA Supervised Lender. However, even if they claim no improper action, they are still dissatisfied with their investment. This could be harmful if the markets reflect that one or more SBA Supervised Lenders make poor credit decisions, sell the loans, and losses occur.

Examiners should evaluate whether management understands the importance of maintaining adequate liquidity. It is also important to assess whether management properly manages the maturity relationship between assets and liabilities to ensure effective cash flow management. The alternative to building liquidity can be costly. However, excess liquidity, carrying large amounts of cash earning little profit, may cause other problems.

Some of the SBA Supervised Lenders are subsidiaries of large, well-known companies. As a result, there is some thought that these SBA Supervised Lenders have an unlimited source of liquidity. Correspondence between the two parties should provide some insight. If this is a solid conclusion, the scope of the evaluation of liquidity should be reduced.

c. Examination Objectives

The objectives of the Liquidity component section are:

- Assessing the sufficiency of the SBA Supervised Lender's present liquidity position given its liquidity demands;
- Determining the stability of sources of liquidity; and
- Concluding on the effectiveness of liquidity management.

d. Examination Procedures

The following examination procedures are provided to facilitate the examination of liquidity. Consistent with risk-based examination principles, examiners should add, delete, or modify these procedures as circumstances warrant.

- Evaluate actions to address the applicable examination's Findings and recommendations on liquidity cited in most recent Report.
- Determine the primary sources of liquidity for the SBA Supervised Lender.
- If the SBA Supervised Lender borrows from another financial institution or its parent company, review the agreement and recent correspondence between the creditor and the obligor to determine if there are any problems between the two. Determine when the line will be renewed. Review the cost history of the line in order to determine if an increase can be expected at the next renewal.
- Identify loan covenants in any lending agreements with other financial institutions.
- Conclude on the SBA Supervised Lender's compliance with loan covenants included in its credit line documentation.
- Review the most recent disclosure and the board minutes since the last examination to determine if there are any forthcoming large demands on liquidity.
- If the SBA Supervised Lender is a subsidiary of a large company, determine if the parent company intends to provide liquidity on an as needed basis. If the history of the relationship between the two indicates funding is readily available and there is no change in philosophy, consider eliminating many of the following steps.
- Determine if the SBA Supervised Lender has secured alternative sources of funding in the event that the existing line of credit is canceled or not renewed.
- Coordinate with the examiners of the other operational areas to determine how their results will impact the SBA Supervised

Lender's liquidity. Is the SBA Supervised Lender profitable? Will there be any required provisions to the allowance? Are there any cash flow difficulties? Will there be any loan sales?

- Obtain information from management on any trends, projections, or plans that would impact liquidity. Inquire about securities sold and whether any buyers have expressed concerns.
- Ask OGC for a list of any pending litigation and an assessment of potential payoffs.
- Obtain a list of contingent liabilities (e.g. letters of credit) to determine whether any will, in fact, become near term liabilities.
- Review the list of loan commitments to determine if funding sources can meet these obligations.
- Review cash balances to determine if too much cash is held on hand for extended periods.
- If an SBA Supervised Lender participates in securitizing, review currency rate for acceptability with 13 CFR §120.425(c).
- Weigh the results of liquidity examination and form tentative conclusions regarding the adequacy of liquidity.

9. Compliance Examination Component

a. Introduction

The compliance review component of the risk-based review is focused on those areas of SBA lending that are uniquely SBA requirements. These areas are not associated with credit and portfolio management activities but with eligibility and other Agency and/or program specific requirements (e.g. borrower eligibility, reporting, and others, as stipulated).

b. Examination Criteria

Each SBA Supervised Lender must demonstrate that it is in compliance with SBA lending requirements, in accordance with 13 CFR §§120.100-397, §120.452-453, §120.474, §120.500-554 and SOP 50-10(4). The criteria upon which the assessment of the SBA Supervised Lender's compliance is performed is listed below. The criteria listed are not all inclusive and during the course of the review, additional criteria may be identified, as well as certain criteria may be determined not to apply. The criteria are as follows:

- Borrower Eligibility;
- Reporting to SBA; and
- Any other Compliance matters identified.

c. Examination Objectives

Making loans guaranteed by SBA imposes unique loan origination, servicing, liquidation, and reporting requirements on the SBA Supervised Lender. The objective of the compliance component of the review is to determine whether the SBA Supervised Lender is knowledgeable of these unique SBA requirements and maintains a lending program that meets these requirements so that only loans eligible for an SBA guaranty are made. An additional objective of the compliance component is to assess whether the SBA Supervised Lender meets SBA program and reporting requirements.

The review objectives of the Compliance component include:

Determination as to:

- Knowledge and application of eligibility requirements set forth in 13 CFR §§120.100, 120.103, 120.110, 120.111, 120.120, 120.130, 120.131 and SOP 50-10(4), Subpart A, Chapter 2;
- Accuracy of “Guaranty Loan Status & Lender Remittance Form”, SBA Form 1502 reporting;
- Timeliness of SBA Form 1502 reporting and accuracy of remittances (including all fees);
- Resolution of issues on SBA Form 1502 exception reports;
- Accurate and timely reporting and remittance of any required daily SBA Form 1502 reports for sold loans;
- Accurate and timely reporting and remittance of any unscheduled transactions;
- Remittance of guaranty and all other fees accurately; and
- Remittance of guaranty and all other fees in a timely manner.

d. Examination Procedures

The following procedures are provided as guidance in conducting the compliance component of the review. The procedures are not an exhaustive list. They will be expanded, contracted and adapted, as warranted within SBA’s sole discretion based on (i) the circumstances of the individual SBA Supervised Lender, particularly if there are program and operational changes, (ii) changes in economic conditions, and (iii) Agency policy changes.

The compliance review is conducted and compliance assessed, on the basis of (1) a review of a sample of loan files, selected in accordance with Chapter 2, Paragraph 12 of this SOP, for compliance with SBA eligibility requirements; and (2) review and analysis of the SBA Supervised Lender’s 1502 reporting to SBA.

Borrower Eligibility

Review each loan based upon applicant (borrower), project and SBA Supervised Lender file management. Review issues include eligibility requirements, as applicable, to the type, delivery method, size, and any other parameters defined by SBA. Compile individual incidences of deficiency, and analyze to determine if any patterns of deficiency exist, as follows:

- Identify all compliance deficiencies in each sample file reviewed, and determine if there are patterns of deficiencies among all files, reviewing for the following:
- Determine whether all principal owners of the business are eligible and of good character as demonstrated on "Statement of Personal History", SBA Form 912 (13 CFR §§120.100 and 120.150(a) and SOP 50-10(4), Subpart A, Chapter 2);
- Determine whether the SBA Supervised Lender obtained SBA Form 912, Statement of Personal History, on all persons required (SOP 50-10(4), Subpart A, Chapter 6, Paragraph 4.d.)
- Identify that the applicant business is small by SBA size standards (13 CFR §120.100(d) and Part 121 and SOP 50-10(4), Chapter 3);
- Determine whether credit is not otherwise available on reasonable terms from non-Federal sources without guaranty provided by the SBA (13 CFR §120.101 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 3);
- Determine whether desired funds are available from the personal resources of any owner of 20% or more of the equity of the applicant, including limits on outstanding personal liquid assets, and if available are injected (13 CFR §120.102 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 4);
- Determine whether the business is for profit, domestic operation, and otherwise eligible in accordance with SBA SOP (13 CFR §120.100(a) and (b) and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 2);
- Determine whether the applicant has ever caused prior loss to the Government from prior federal financial assistance (13 CFR §120.110(q) and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 8.q.);
- Identify all use of proceeds of the loan as eligible, including funds used to purchase any portion of rental real estate, pay debts or change ownership of the applicant business (13 CFR §§120.120, 120.130, 120.131, 120.160(d), 120.201 and 120.202 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 10);
- Identify that any franchise financing is eligible (SOP 50-10(4), Subpart A, Chapter 3, Paragraph 3.e.);

- Determine whether all principal owners of the business are U.S. citizens or eligible resident aliens (SOP 50-10(4), Subpart A, Chapter 2, Paragraph 15.h.);
- Identify any actual or apparent conflicts of interest or preferences (13 CFR §§120.110(o), 120.140, 120.453(a) and SOP 50-10(4), Subpart A, Chapters 2 and 3, and Subpart D, Chapter 3, Paragraph 7.a.(4)(j));
- Determine whether all SBA delegated program-specific eligibility issues (e.g. PLP, SBA*Express*) are met (13 CFR §§120.450-455; SOP 50-10(4), Subpart D, Chapter 3, Paragraph 7.a. and SBA*Express* Program Guide, Paragraph 5.A.);
- Determine whether all Community*Express* loan applicants are eligible and have received pre-and post-closing technical and management assistance arranged and, if necessary, paid for by SBA Supervised Lender (Community*Express* Program Guide, Paragraphs 6, 7 and 9.A.);
- Identify any other SBA statutory, regulatory or SOP violations of eligibility;
- Compile a list of all eligibility deficiencies by issue type and by errors per file, and identify any trends of deficiencies which warrant lender attention; and
- Compile a list of material eligibility deficiencies by loan file number and reason for deficiency. (Material Deficiency is defined in Chapter 2 of this SOP.)

Reporting and Payments to SBA

Compare the SBA Form 1502 Report submissions for the most recent three months to the loan transcripts for the loans in the review sample to determine accuracy of SBA Supervised Lender's reporting, including accuracy of loan: status; outstanding guaranteed loan balance; and paid-to-date information. Summarize any risk implications of errors in reporting; i.e. inaccurate reporting to SBA, etc. Determine whether SBA Supervised Lender is providing SBA accurate loan payment information.

Review SBA Supervised Lender's transmittal records for SBA Form 1502 reports for the most recent three months to determine timeliness of reporting to SBA's Fiscal and Transfer Agency (FTA). (The month-end SBA Form 1502 Report is due on the third business day following the end of the month with a two-day grace period).

Review the SBA Supervised Lender's Automated Clearing House (ACH) or manual payments records for the past three months to determine that remittances have been paid accurately and in a timely manner to the FTA. The remittance of scheduled receipts must be made by the third business day following the end of the month with a late fee being assessed on the second day following the due date.

Determine whether all transmittals include all required payments and fees, including secondary market fees, basis points fees, late fees and/or prepayment fees.

Review exception reports received by the SBA Supervised Lender during the most recent three-month period to determine timeliness of necessary Corrective Action taken by the SBA Supervised Lender. Determine whether SBA Supervised Lender responds to error/exception reporting to successfully resolve any such errors.

Identify any steps SBA Supervised Lender management has taken to resolve any patterns or trends, and any additional steps required to meet SBA standards.

Review loan transcript for each loan in the review sample to identify any unscheduled "daily remittance transactions" (on sold loans) due, and compare to the appropriate "daily" SBA Form 1502 Report to assess accuracy and timeliness of remittances. Unscheduled transactions on sold loans include such items as payoffs, late payments, and interest only payments.

Review ACH records to identify any unscheduled transactions remitted to determine if they were made in a timely manner. Reporting and remittance of unscheduled receipts must be made by the second business day following the receipt of good funds. The reviewer must determine if the funds were "good" at the time of receipt, i.e. cash, wired or on deposit with the SBA Supervised Lender, in which case they must be remitted by the second business day following receipt. Regarding "paper" funds drawn on another institution, for review purposes, remittances made by the fifth business day following of the receipt would be considered timely. Conclude whether SBA Supervised Lender is providing SBA accurate information on unscheduled transactions.

Other Compliance Characteristics

Determine whether the guaranty fee was paid in accordance with 13 CFR §120.220 and SOP 50-10(4), Subpart B, Chapter 1, Paragraph 15. Determine whether all SBA requirements regarding collateral have been met and determinations regarding sufficiency of collateral have been made (13 CFR §120.150(h) and SOP 50-10(4), Subpart A, Chapter 4, Paragraph 1.h.).

Determine whether SBA Supervised Lender has verified any required borrower injection prior to disbursement (13 CFR §120.150(f) and SOP 50-10(4), Subpart A, Chapter 4, Paragraph 1.f.).

Determine whether SBA Supervised Lender has obtained any required personal guaranties, appraisals, environmental assessments, flood insurance, or other required insurance, prior to disbursement (13 CFR §§120.160(a), (b) & (c), §120.170 and SOP 50-10(4), Subpart A, Chapter 5).

Determine whether SBA Supervised Lender required, obtained and reconciled IRS tax transcripts for any applicant when required by SOP (13 CFR §120.191 and SOP 50 10(4), Subpart A, Chapter 6, Paragraph 4.f.).

Determine whether SBA Supervised Lender followed SBA requirement for site visit or other intensive servicing activity when loan is 60-days or more past due, or there is other reasons for concern (SOP 50 51 2, Chapter 8, Paragraph 8.B.).

Determine whether SBA Supervised Lender has followed all SOP requirements regarding management of liquidation cases, including preparation of a liquidation plan, timely site visits, use of current appraisals, consideration of environmental issues, and preparation of a wrap-up report at conclusion of liquidation (SOP 50 51 2, Chapter 8, paragraph 11).

Identify whether SBA Supervised Lender has forwarded all recoveries on repurchased loans within 15 days of receipt (SOP 50 51 2, Chapter 8, paragraph 25.).

Conclusion

Conclude on the SBA Supervised Lender's compliance with SBA's requirements for (i) eligibility; (ii) payment reporting processes, procedures and implementation, and (iii) other listed compliance requirements.

Chapter 5

Certified Development Company (CDC) Risk-based Reviews

1. Introduction

This chapter addresses the on-site risk-based review process for all 504 loan program CDCs. The risk-based review process focuses on performance and operational factors that allow SBA to assess the quality of a CDC's lending operations. SBA determines the nature and scope of the review for each CDC individually depending upon the SBA lending activity and actual or expected performance of an individual CDC. Subsequent sections of this chapter describe the review objectives and criteria for each of the review components that will be used in reviews of CDCs. The review components for CDCs are (i) portfolio performance, (ii) SBA management and operations, (iii) credit administration, and (iv) compliance.

2. Portfolio Performance Review Component

a. Introduction

The analysis of portfolio performance focuses on an evaluation of a CDC's SBA loan portfolio to assess historical, current and projected performance and to identify the risk characteristics of the portfolio. This analysis considers a CDC's performance compared to the portfolio, to SBA defined peers and to itself over time (trends). While the criteria and procedures identified are not an exhaustive list and may be modified during review planning or on-site activities, they provide reasonably complete list of the processes used evaluate this component. The procedures are not mandated rules to be rigidly followed by the reviewers. The lending business is a dynamic one, requiring reviewers to use their judgment to tailor review practices to individual situations. Reviewers can add, delete and/or modify procedures as appropriate, with approval of the AA/OLO or designee when a CDC's particular circumstances and risk characteristics warrant. (Electronic mail is an acceptable means of obtaining the written approval of the AA/OLO or designee.) Any criteria added, deleted or modified for a particular review should be so identified in the Report, along with the reason for the change.

b. Review Criteria

The review criteria used for portfolio performance are described below, and are in accordance with 13 CFR §120.825-826 and §120.853. The criteria are not all inclusive and during the course of the review, additional criteria may be identified as well as certain criteria may be determined not to apply.

The purpose of the portfolio performance review also is to establish a picture of the CDC's SBA portfolio risk characteristics, using predictive credit scoring as the measure of credit risk. This allows SBA to predict debenture purchases over a 12-24 month period. SBA aggregates the CDC's loan scores, analyzes the CDC's 504 loan performance and compares it to SBA's portfolio and peer group performance for the 504 loan program.

The portfolio performance criteria are:

- Summary of Key Statistics;
- Loan Production Activity;
- Comparative Performance Analysis;
- Credit Quality; and
- Any other Risk Characteristic(s) identified in the Plan.

c. Review Objectives

The objective of the Portfolio Performance component is to assess the performance of a CDC's loan portfolio and the demographics of the 504 portfolio, and to determine whether the CDC is failing to meet any portfolio performance requirements set forth in statute, SBA Loan Program Requirement or Notice.

d. Review Procedures

Procedures are provided as guidance in conducting each component of the review. The procedures are not an exhaustive list. They will be expanded and contracted as warranted based, at SBA's sole discretion, based on (i) the circumstances of the individual CDC, particularly if there are program and operational changes, (ii) changes in economic conditions, and (iii) Agency policy changes.

The Portfolio Performance review procedures are designed to analyze portfolio characteristics such as growth rates, performance, industry and geographical concentrations, determinations that CDC is meeting any portfolio performance requirements of Agency SBA Loan Program Requirements or SOP, and to assess portfolio credit quality (as measured through credit scores). The review procedures include analysis and comparison of SBA and CDC data.

Summary of Key Performance Statistics

Identify the CDC's outstanding SBA loan portfolio and program composition.

Analyze the CDC's portfolio composition, portfolio performance rates, and delivery method (e.g. ALP, PCLP) performance characteristics. Identify any significant variations, fluctuations or performance trends in the individual delegated loan program(s) for further assessment. Analyze CDC's loans with repurchased debentures to establish a basic picture of those projects which have repurchased debentures but are still within the purview of the CDC's control.
Identify any significant characteristics of the loans with repurchased debentures, or trends of increasing numbers, for further assessment.

Loan Production Activity

Analyze the annual production (numbers and dollars), delivery method break-down, average loan size, and discuss any trends or significant period-to-period fluctuations.

Comparative Performance Analysis

- Compare the CDC's SBA loan portfolio performance to overall SBA portfolio and peer group, and past trends of CDC itself, at least over two prior years.
- Identify and analyze outstanding portfolio performance (in numbers and dollars) by loan payment status (e.g. current, delinquent, catch-up) and delivery method, and in comparison to SBA's portfolio, program and peer group performance rates, as available.
- Identify and analyze any deviation of performance in the CDC's portfolio or in any particular program as compared to the available standards (SBA portfolio and peer).

Repurchased Debentures

Identify and analyze the outstanding active repurchase portfolio (in numbers and dollars), and trends over two fiscal years, as available.

Industry Concentrations

- Identify and analyze industry concentration(s) within the CDC's portfolio, and risk implications; i.e. significant percentage of dollars in one or more industries.
- Compile a table of industry concentrations for loan portfolio (numbers and dollars).
- Compare to SBA portfolio and peer averages, if available.
- Analyze concentrations of 20% or more identifying the risk implications of such concentrations.

Early Defaults

Identify early debenture repurchases and analyze risk implications (early debenture repurchase defined as repurchase within 3 years of disbursement).

Repurchased Debentures Trends

Identify any trends in the portfolio of purchased debentures. Consult available Agency data regarding CDC's repurchased debenture activity for both the past one-year and five-year periods.

Other Segmentation

Identify and analyze any other segmentation of the portfolio with risk implications, as available.
Compile a table of any other concentrations (i.e. new versus existing business, loans generated by loan agents, etc.), as available, and compare to any available applicable standards.

Credit Quality

- Compare CDC's SBPS data to SBA's portfolio average, and discuss risk implications; i.e. significant deviation from the SBA portfolio average, positive or negative trends, quarter-to-quarter and/or year-to-year fluctuations, etc.
- Analyze stratification of CDC's portfolio by credit score ranges and discuss proportions of predicted at-risk loans, both low and high, and risk implications; i.e. percentage of portfolio at high risk, trend over time, etc.
- Analyze Projected Purchase Rate (PPR), and compare to SBA portfolio and peer averages.

Other Risk Characteristics

Identify and analyze any other risk characteristics as noted in the Review Plan through any other evaluations or other research.

Conclusion

Discuss all portfolio performance preliminary Findings with management. Conclude on the portfolio performance of the CDC.

3. SBA Management and Operations Review Component

a. Introduction

The management and operations review component provides an overall assessment of a CDC's SBA lending operations. It assesses the adequacy of the CDC's SBA lending operation management, including defined lending and decision making authorities; lending policies and procedures; management oversight and internal controls; ability to plan operationally and respond to changing circumstances; managerial expertise, leadership and administrative ability; and overall compliance with laws and SBA Loan Program Requirements for the 504 loan program.

CDC should have SBA lending delegations of authority and oversight responsibilities. CDC's SBA program should also provide guidance to CDC's management on the identification of and response to changes in external factors affecting the viability of CDC's existing programs and services, including anticipated changes in economic conditions, markets, and competition.

The CDC should have 504 portfolio-related functional and operating guidance as evidenced by the development and implementation of program policy and procedure, operating goals and budgets, growth planned, business development and marketing plans and clear delegations of management and loan approval authority.

b. Review Criteria

- CDC Organization;
- Regulatory Organizational Requirements;
- Delegations of Authority;
- Operating Plan and Performance;
- Internal Controls and Oversight;
- External Oversight; and
- Any other Risk Characteristic(s) identified in the Plan.

c. Review Objectives

The objective of the Management and Operations component is to assess the completeness and effectiveness of the CDC's management of its SBA loan program, as evidenced by, for example, the adequacy of its lending policies, procedures, operations and internal controls.

The review objectives for the CDC's SBA Management and Operations include:

- Determine completeness of CDC's organizational guidance, including policies, procedures and other operational direction applicable to the CDC's SBA loan program;
- Assess implementation of policies and procedures;
- Identify demonstrated competence, leadership, and administrative ability by CDC's SBA program management;
- Identification and dissemination of delegated (i.e., PCLP) lending and exception approval authority delegations throughout the SBA department;
- Determine sufficiency of knowledgeable SBA loan personnel;
- Determine if training is adequate to maintain well-informed SBA loan personnel;
- Evaluate CDC's ability to respond to changes in SBA programs and requirements;
- Assess management's performance in maintaining up-to-date and reliable operating policy, procedure, SBA budgets and performance reports;
- Assessment of management's ability to respond to and effectively implement changes in SBA programs and requirements;
- Assess adequacy of internal controls internal loan review and SBA compliance review activities;
- Determine adequacy and effectiveness of independent oversight (i.e., independent audit, depending upon size of portfolio) of the SBA operation; and
- Determine whether CDC meets all organization requirements of 13 CFR §120.820-120.830.

A CDC's portfolio performance, credit administration practices for both performing and problem loans, and compliance is largely affected by the result of decisions made by management. Findings and conclusions in these other components, made during the course of the review in these areas, will strongly influence evaluation of management. However, an "acceptable" assessment in one does not necessitate an acceptable assessment for SBA Management and Operations. Judgment in evaluating this component is essential. For example, in positive economic conditions, a CDC's portfolio performance can be strong even though policies, procedures and controls may be inadequate.

d. Review Procedures

This assessment is conducted through review and analysis of (i) the CDC's governance documents, (ii) structure of 504 program governance, (iii) operational and management policies and procedures, (iv) underwriting and loan monitoring policies and procedures, and (v) exception to policy processes. This assessment is then tested through observations and interviews with CDC's management.

CDC Organization

Review organizational chart and identify the chain of command from highest level of CDC management to the SBA department management. How does BOD/senior management maintain its awareness of and direction over SBA operations through its chain of command?
Identify what meetings, reports and other methods of communication are conducted to accomplish direction of SBA operations, and obtain documentation or records of these meetings, reports, and methods.
Are there any policy or procedural weaknesses which must be corrected by CDC in the direction of the SBA 504 loan program?

Regulatory Organizational Requirements

- Identify that CDC membership meets the requirements of 13 CFR §120.822:
    - Having at least 25 members (13 CFR §120.822(a));
    - The membership must meet annually (13 CFR §120.822(a));
    - No person or entity owns or controls more than 10% of the voting membership (13 CFR §120.822(a));
    - No employee or staff of the CDC can qualify as a member of the CDC for the purpose of meeting the membership requirements (13 CFR §120.822(a));
    - Must be represented by all of the four required groups in areas of (i) Government, (ii) Financial Institutions, (iii) Community Organizations, and (iv) Businesses (13 CFR §120.822(b));
    - Members must be responsible for actively supporting economic development in the Area of Operations and must be from one of the four groups specified in 13 CFR §120.822(b); and
    - CDC operating as a Multi-State must meet the membership requirements for each State (13 CFR §120.822(c)).
- Identify any insufficiencies with regard to13 CFR §120.822 organizational requirements.
- Identify that the BOD meets the CFR requirements of:
    - Be composed of at least three of the four membership groups with no single group controlling (13 CFR §120.823);
    - Have no CDC staff as a voting member of the BOD except for the CDC manager (13 CFR §120.823);

- Have at least one member, other than CDC manager, with commercial lending experience (13 CFR §120.823(a));
  - Meeting quarterly (13 CFR §120.823);
  - Conduct all decisioning with a quorum of at least five voting directors (13 CFR §120.823);
  - Conduct all votes on loan approvals or servicing actions with at least one director with commercial loan experience, other than CDC manager, present and voting (13 CFR §120.823); and
  - If BOD has an established Loan Committee, that Loan Committee meets all criteria of 13 CFR §120.823(a) and (b).
- Identify that the professional management and staff meet the CFR requirements of:
  - Full time professional management including at least an Executive Director (or equivalent) who manages daily operations (13 CFR §120.824); and
  - Employment of full-time professional staff qualified by training to market the 504 program, package and process loan applications, close loans, service and if authorized by SBA, liquidate the loan portfolio and sustain a sufficient level of service and activity in the Area of Operations (13 CFR §120.824).
- Determine that the Operating CDC has:
  - At least one salaried professional staff member available full time (13 CFR §120.824(a));
  - Obtained SBA pre-approval for any contracts to manage, market, package, process, close, service or liquidate SBA loans (13 CFR §120.824(b));
  - Separately listed telephone number (13 CFR §120.826 and SOP 50 10 43, Subpart H, Chapter 4, paragraph c.(1));
  - Maintenance of financial records and minutes of all meetings (13 CFR §120.826 and SOP 50 10 4e, Subpart H, Chapter 4, paragraph 5.c.(1));
  - Availability of documents pertaining to the 504 loan portfolio available at the CDC’s principal office (13 CFR §120.826 and SOP 50 10 4e, Subpart H, Chapter 4, paragraph c.(2));
  - Any changes in address, telephone, offices, directors, professional staff, by-laws or articles of incorporation must be reported to SBA field office within 30 days (13 CFR §120.826 and SOP 50 10 4e, Subpart H, Chapter 4, paragraph 5.d.(1)); and
  - Resumes, “Statement of Personal History” SBA Form 1081 and fingerprint cards Form FD 258 must be filed on all new

associates and staff (13 CFR §120.826 and SOP 50 10 4e, Subpart H, Chapter 2, paragraph 1.d.(2)).

- Determine that the CDC has the financial ability to operate and sustain its operations continuously, with reliable sources of funds (13 CFR §120.825).
- Determine that CDC meets the following requirements of:
  - Receive SBA approval of at least four 504 loans in two consecutive fiscal years (13 CFR §120.828(a)); and
  - The CDC's portfolio maintains a minimum average of one job opportunity per an amount of 504 loan funding that will be specified by SBA from time to time in a Federal Register Notice (13 CFR §120.829(a)). ("Job Opportunity" is defined in 13 CFR §120.802 as "a full time (or equivalent) permanent job created within two years of receipt of 504 funds, or retained in the community because of a 504 loan.")
- Identify that CDC meets reporting requirements to SBA of:
-
  - Annual report submitted within 180 days after CDC's fiscal year end (13 CFR §120.830(a));
  - Reporting of any involvement in any legal proceedings (13 CFR §120.830(c));
  - Reporting of any organizational status changes (13 CFR §120.830(d));
  - Reporting of any changes in any condition that affects CDC's eligibility to continue to participate in the 504 program (13 CFR §120.830(c)), and
  - Quarterly service reports on each loan 60 days or more past due (13 CFR 120.830(f)).
- Identify any other deficiencies with regard to or failure to meet regulatory requirements.
- For Non-Profit CDCs: Determine if CDC meets the requirements of the Single Audit Act Amendments of 1996 (31 USC 7501-7507) and revised OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations.
- Determine whether any long-range planning demonstrates a significant change to the CDC's approach to its SBA program. Describe the proposed change(s) and management's intent. Is it prudent?
- Determine if management is knowledgeable of SBA lending requirements.

Delegations of Authority

Determine that delegations related to the SBA program for loan approval and servicing authority are approved by the BOD or senior management, and that documentation related to the delegations confirms this. Determine that CDC management communicated its delegations to the SBA portfolio staff to meet the goals and objectives of senior direction? Assess what internal controls exist to ensure that exceptions to delegations are properly handled?

Operating Plan and Performance

- Describe CDC's business plan for SBA lending, including SBA loan program goals.
- Determine if SBA business plan is realistic in terms of CDC's capacity, expertise and lending infrastructure.
- Describe and analyze materials and methods employed to periodically compile and communicate the SBA financial results, production data, portfolio performance, repurchase and liquidation information to senior CDC management. Obtain reports (or copies) of reporting which demonstrates this reporting.
- Determine whether reporting is sufficient to manage SBA lending operations.
- Determine what the CDC does to train and maintain proficiency in lending for its SBA personnel.

Internal Controls and Oversight

- Determine the nature and frequency of the internal activities that provide oversight data and information to the SBA management.
- Identify the types of independent review being used to oversee the SBA lending program (i.e. internal and external audits). (This is *not* reporting, but *review independent* of the loan program management).
- Review any internal audit reports or compliance examinations of SBA lending operation and review Findings and recommendations for deficiencies.
- Determine what action(s) has been taken by CDC to address any identified deficiencies.

External Oversight

To what extent is the SBA program and/or the SBA loan portfolio subjected to third party/independent examination, review or audit over past three years or since most recent SBA review?

Obtain and review copies of available independent reports, reviews or audits on CDC's SBA portfolio. Review report Findings and recommendations for deficiencies. Determine what actions taken by CDC to address deficiencies and results achieved.

Conclusion

Discuss all management and operations Findings with CDC management. Conclude on adequacy of SBA program management.

4. Credit Administration Review Component

a. Introduction

Credit Administration evaluates a CDC's SBA program from the perspective of the actual lending operation. This component of the review assesses how loans are originated, closed, serviced, and, if authorized by SBA, how problem loans are managed either through workouts and restructuring and/or liquidation.

b. Review Criteria

In accordance with 13 CFR §120.826 and 848, each CDC must be able to demonstrate that it can package and process, close and service, and if authorized by SBA, liquidate and litigate 504 loans. The SBA's small business lending criteria is further outlined in 13 CFR §120.101, 120.102, 120.120, 120.150-120.195, 120.800, 120.860, 120.861, and other related SBA Loan Program Requirements and SOP provision, as amended by SBA from time to time. The criteria upon which the assessment of the CDC's credit administration practices for performing loans are listed below. The criteria are not all inclusive and during the course of the review, additional criteria may be identified as well as certain criteria may be determined not to apply. The credit administration criteria include:

- Creditworthiness;
- Collateral;
- Closing;
- Regular Servicing;
- Collection Practices;
- Intensive Servicing and Liquidation;
- Loans with Repurchased Debentures;
- Other Portfolio Management Items; and
- Other Risk Characteristics as identified in the Plan.

c. Review Objectives

The objective of the review of CDC's credit administration practices is to assess CDC's ability to package and process, close and service, and if authorized by SBA, liquidate and litigate 504 loans. This assessment includes an analysis of CDC's credit policies and procedures, as well as analysis of a sample of performing loans and intensive servicing of non-performing assets, in accordance with paragraph 12 of Chapter 2. This also includes analysis of recovered collateral to identify systemic features of the loan portfolio that pose an unnecessary risk of loss to the Agency, and to assess effectiveness of the management and staff in managing these risks related to the CDC's SBA program. The review procedures utilize the CDC's loan policies and procedures and individual file review to determine if loan originations, loan monitoring and collection activities are (i) in accordance with CDC's discretionary policy and SBA policy, and (ii) demonstrate prudent CDC practice.

The Credit Administration review will evaluate:

- CDC's organizational structure within which CDC performs marketing, packaging and processing, closing and servicing, and if authorized by SBA, liquidating and litigating 504 loans;
- CDC's ability to(i) exercise approval authority, including exception approval authority, (ii) document approvals, and (iii) review for the proper level of approval authority;
- CDC's ability to determine the creditworthiness of each applicant, in accordance with SBA policy, through consideration of (i) repayment ability, (ii) capitalization sufficiency, (iii) sufficiency of working capital, (iv) management ability of principals, (v) credit history of applicant and/or principals, (vi) adequacy of collateral, as assessed in accordance with SOP, and (vii) closing of the loan and debenture in accordance with SOP requirements, and as applicable, through use of qualified closing personnel, as required by SOP;
- CDC's ability take appropriate servicing actions, including but not limited to actions that result in an exchange or reduction of lien priority, or release of collateral;
- CDC's ability to maintain an effective tickler systems for Uniform Commercial Code (UCC) continuations, annual review of borrower financial statements or other prescribed routines for review of the account relationship, and insurance renewals;
- CDC's ability to report loans that are not performing "as agreed" to SBA and, as applicable, to senior management of the CDC;
- CDC's effectiveness of the implementation of policy and procedure related to SBA requirements regarding the adequacy and effectiveness of the following workout and liquidation activities, when liquidation authority is approved by SBA:
- Servicing resources to properly perform workout and liquidation activities throughout geographic area served by the CDC;

- Legal resources to properly perform workout and liquidation activities throughout geographic area served by the CDC;
- Reasonableness of workout actions taken by CDC that resulted in an apparent increase in risk;
- Basis for and documentation required to transfer a loan into liquidation status, other than when required pursuant to an SBA "adverse event";
- Adherence to SBA requirements related to mandatory transfer to liquidation status;
- Response to notices of bankruptcy and other legal actions that might hamper workout or liquidation activities;
- Actions to be taken to remedy deficiencies, inadequacies, or to seek rectification of legal and regulatory violations by the borrower;
- Documentation related to efforts to be made to resolve liquidation cases prior to commencing efforts to take possession of the collateral or seek performance by the guarantors;
- Documentation of efforts to be made to control collateral in a timely manner;
- Reasonableness of the process to be employed to determine net realizable value of collateral;
- Reasonableness of delegated authority to release or abandon collateral;
- Reasonableness of delegated authority to compromise with, or agree to release of guarantors; and
- Documentation of procedures to be employed to dispose of acquired collateral;
- CDC's requirements to report loans that are in "workout" or "liquidation" status to senior management and the BOD; Determine whether:
    - Any aspect of CDC's credit administration policy is in direct conflict with SBA policy, and if so; how does CDC propose resolution;
    - CDC's delegations of authority are adequate to ensure appropriate credit administration of the SBA portfolio;
    - The CDC's risk rating system is adequate;
    - CDC uses of loan agents and what risk factors arise from this; and
    - Overall effectiveness of CDC's internal controls.

d. Review Procedures

The following procedures are provided as guidance in conducting the credit administration component of the review. The procedures are not an exhaustive list. They will be expanded and contracted and adapted, as warranted, within SBA's sole discretion based on (i) the circumstances of the individual CDC, particularly if there are program and operational changes, (ii) changes in economic conditions, and (iii) Agency policy changes.

The adequacy of a CDC's credit administration practices are assessed and evaluated through a review of written lending policies and procedures and discussions with management and CDC staff. A review of individual loan files, sampled in accordance with paragraph 12 of Chapter 2, is also performed to ascertain the degree to which lending policies and procedures are followed. The adequacy of a CDC's credit administration practices will be evaluated based upon prudent business lending practices for commercial lending.

Creditworthiness

Determine whether the CDC's SBA loan policy establishes requirements for creditworthiness that, at minimum, include positive determination of repayment ability, sufficient cash flow to fund operations, adequate management ability, adequate capitalization and satisfactory credit history consistent with 13 CFR §120.150 and SOP 50-10(4), Subpart H, Chapter 13.

Determine whether CDC's policies and practices adhere to SBA's credit elsewhere requirement set forth in 13 CFR §120.101 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 3.
Determine whether CDC's SBA credit policy demonstrates the ability to evaluate and process SBA loans in accordance with 13 CFR § 120.150-120.195, 120.801, 120.826, 120.841, and 120.848, and SOP 50-10(4), Subpart H, Chapter 18.

Review sample of loans to determine whether CDC is adhering to all loan policies and all SBA loan policy requirements, and identify and provide examples of any Material Deficiencies or patterns of deficiencies.

Collateral

Determine whether CDC's loan policy establishes requirements for SBA collateral that, at minimum, meets SBA collateral requirements contained in 13 CFR §120.934 and SOP 50-10(4), Subpart H, Chapter 14.
Review sample of loans to determine if CDC is adhering to SBA's policy and requirements regarding collateral, and identify and provide examples of any Material Deficiencies or patterns of deficiencies.

Closing and Disbursement

Determine whether the CDC's policy and procedures define the requirements that must be met before closing and funding is allowed, including use of authorized closing attorney in preparation of all required closing instruments, obtaining all required executed loan documents, meeting all loan authorization conditions, identification that all requirements of the first lien holder are met, identification that the interim lien holder payoff is funded appropriately, verification of borrower's contribution, verification of correct use of proceeds, verification of perfection of all lien and guaranty requirements, obtaining all required insurance policies, including any applicable assignments and/or acknowledgements; and verification that first lien holder has executed all required agreements.

Determine whether the CDC's closing policy demonstrates the ability to close and disburse SBA loans in accordance with 13 CFR § 120.826, 120.848 and 120.960 and SOP 50-10(4), Subpart H, Chapter 22 and SOP 70 50 3, Legal Responsibilities, Chapters 4 and 5.

Determine if CDC confirmed that borrower made all required cash or property contributions in accordance with 13 CFR §120.910-913, and SOP 50-10(4), Subpart H, Chapters 13 and 15.

Review sample of loans to determine if CDC is adhering to loan policy and SBA requirements regarding closing and disbursement, and identify and provide examples of any Material Deficiencies or patterns of deficiencies.

Regular Servicing & Assessment of Continued Creditworthiness

- Describe CDC practices for evaluating continued creditworthiness, (e.g., annual financial statement analysis, credit modeling for portfolio management purposes, etc.).
- Determine whether policy for continued monitoring of the SBA portfolio is, at minimum, in accordance with any loan authorization requirements.
- Determine whether CDC's policy for loan servicing is consistent with 13 CFR § 120.826, 120.848 and 120.970 and SOP 50 50(4), Chapter 11.
- Determine whether adequate controls exist to ensure required insurance coverage in place, including any applicable assignments and/or acknowledgements are obtained, and all required insurance policies are renewed as necessary.
- Determine whether adequate controls exist to ensure required lien positions are obtained and renewed, as necessary.
- Describe and determine procedures for processing borrower servicing requests.

- Review sample of loans to determine if CDC is adhering to loan policies and SBA requirements, including those contained in 13 CFR §120.826 120.848 and 120.970 and SOP 50-50(4), Chapter 11, regarding regular servicing and portfolio management, and identify and provide examples of any Material Deficiencies or patterns of deficiencies.

Intensive Servicing/Liquidation

The CDC must be approved by SBA to engage in workout, liquidation or litigation of 504 loans. When the CDC lender has such authority, the following additional procedures apply:

Determine whether the CDC's policy and procedure establish a basis upon which to evaluate CDC's collection practices including collection procedures for past due and delinquent loans and procedures for collecting and deferring loans and for transferring loans from regular servicing to intensive servicing and/or liquidation, and are consistent with 13 CFR §120.826, 120.848(f) and 120.970,

Determine if CDC's policy and procedures establish a basis upon which a loan will be subjected to intensive servicing or liquidation action, and such intensive servicing or liquidation includes workouts, site visits, liquidation plans, control, possession and/or protection of collateral; and access to counsel, and are consistent with 13 CFR §120.826 and 120.848(f) and 120.970;

Review a sample of loans to determine if CDC is adhering to loan policy and SBA requirements regarding management of collections, intensive servicing and liquidation accounts, and identify and provide examples of any Material Deficiencies or patterns of deficiencies in accordance with 13 CFR §120.826, 120.848(f) and 120.970.

Loans with Repurchased Debentures

Determine whether CDC's policies and processes to manage purchased debentures are consistent with non-purchased debenture financings. Review a selection of loans with repurchased debentures to determine that CDC has well-defined action plan events for pursuit of payments, with timelines and responsibilities for various categories of intensive attention.

Other Portfolio Management Items
Consistency/Conflict with SBA Policy

Identify if any stated CDC policy is in conflict with SBA Loan Program Requirements, policies and/or procedures. If any are so identified, what actions, if any, must be taken to address the conflict(s)? Reviewer must be mindful of this while conducting analysis of all CDC policies and procedures related to the SBA loan portfolio and its individual SBA loans and their administration.

Risk Rating System

- Evaluate policies for internal grading and/or risk rating SBA loans, and practices for rating loans at regular intervals through life of loan (at least annually).
- Determine how these rating systems affect CDC's SBA portfolio management.
- Identify the person responsible for maintaining accurate risk ratings?
- Review management reports containing grades or risk ratings of all SBA loans.

Effectiveness of Internal Controls

Review any checklists or other practices which assist in ensuring that all files are managed consistently and correctly, and in accordance with policy.
Describe any serious gaps in internal controls which indicate a weakness.

Use of Loan Agents

- Does the CDC routinely or on an ad hoc basis use loan agents in originating its SBA loans?
- Determine whether CDC's policies and procedures establish a basis for routine or ad hoc use of loan agents (packagers, referral agents, brokers, etc.) in originating SBA loans.
- Determine whether loan agent-originated loans are fully meeting SBA standards, including those regarding creditworthiness.
- For CDCs with active loan agent relationships, obtain list of loans referred by loan agents, and analyze loans referred by loan agents to determine whether performance trends and/or credit quality is comparable to book of business originated directly by CDC.
- Determine that SBA form 159, "Fee Disclosure Form and Compensation Agreement" has been completed, as applicable, for each loan in which a loan agent has had participation.
- Determine whether additional file review is appropriate to fully assess loan agent activity. If so, review a small selection of loan files for loans originated by loan agents to determine if each decision was reached in accordance with SBA's policies and to better evaluate CDC's use of loan agents.

Conclusion

Discuss all credit administration Findings with management.
Conclude on the adequacy of credit administration of the SBA portfolio.

5. Compliance Review Component

a. Introduction

The compliance review component of the risk-based review is focused on those areas of SBA lending that are uniquely SBA requirements. These areas are not associated with credit and portfolio management activities but with eligibility and other Agency and/or program specific requirements (e.g. borrower eligibility, reporting, and others, as stipulated).

b. Review Criteria

Each CDC must be able to demonstrate that it is in compliance with SBA lending requirements, in accordance with 13 CFR §120.100-195 and 120.860-941 and SOP 50-10(4). The criteria upon which the assessment of the CDC's compliance is performed are listed below. The criteria are not all inclusive and during the course of the review, additional criteria may be identified as well as certain criteria may be determined not to apply. The criteria are as follows:

- Borrower Eligibility;
- Reporting to SBA; and
- Any other Compliance matters identified.

c. Review Objectives

Making loans guaranteed by SBA imposes unique loan origination, servicing, liquidation, and reporting requirements on the Lender. The objective of the compliance component of the review is to determine whether the Lender is knowledgeable of these unique SBA requirements and maintains a lending program that meets these requirements so that only loans eligible for an SBA guaranty are made. An additional objective of the compliance component is to assess whether the Lender meets SBA program and reporting requirements.

The review objectives of the Compliance component include determinations as to:

- Knowledge and application of eligibility requirements set forth in 13 CFR §§120.100, 120.103, 120.110, 120.111, 120.120, 120.130, 120.131 and SOP 50-10(4), Subpart A, Chapter 2;
- Whether CDC has submitted its annual report within 180 days of its fiscal year end, in accordance with 13 CFR §12.830, and if not, why not.
- Determine whether the most recently submitted Annual Report and Operational Review reflect accurately the status of the management, operations and financial condition of the 504 CDC;
- Whether the Central Servicing Agent (CSA) monthly "45-day delinquent report" is handled in accordance with CSA requirements;
- Whether CDC notifies SBA of detailed analysis, plan and steps to be taken to bring borrower current for 45-day delinquent accounts;
- Whether CDC reports to CSA in a timely fashion all negotiated catch-up agreements; and
- For PCLP CDCs, whether the loan loss reserve accounting accurate and does it reconcile to CDC's loan transaction record to identify and reconcile any discrepancies. When necessary, contact the applicable SBA field office to fully determine nature of discrepancies

d. Review Procedures

The following procedures are provided as guidance in conducting the compliance component of the review. The procedures are not an exhaustive list. They will be expanded, contracted and adapted, as warranted within SBA's sole discretion based on (i) the circumstances of the individual lender, particularly if there are program and operational changes, (ii) changes in economic conditions, and (iii) Agency policy changes.

The compliance review is conducted and compliance assessed, on the basis of (1) a review of a sample of loan files, selected in accordance with Chapter 2, Paragraph 12 of this SOP, for compliance with SBA eligibility requirements; and (2) review and analysis of the CDC's required reporting to SBA.

Borrower Eligibility

Review each loan based upon applicant (borrower), project and lender file management. Review issues include eligibility requirements, as applicable, to the type, delivery method, size, and any other parameters defined by SBA. Compile individual incidences of deficiency, and analyze to determine if any patterns of deficiency exist, as follows:

Identify all compliance deficiencies in each sample file reviewed, and determine if there are patterns of deficiencies among all files, reviewing for the following:

- Determine whether 504 project meets specified economic development goals in accordance with 13 CFR §120.862
- Determine that the 504 project meets job opportunity criteria in accordance with 13 CFR §120.829;
- Determine whether all principal owners of the business are eligible and of good character as demonstrated on "Statement of Personal History", SBA Form 912 (13 CFR §§120.100, 120.150(a) and SOP 50-10(4), Subpart A, Chapter 2);
- Determine whether the Lender obtained SBA Form 912, Statement of Personal History, on all persons required (SOP 50-10(4), Subpart A, Chapter 6, Paragraph 4.d.);
- Identify that the applicant business is small by SBA size standards for 504 program (13 CFR §120.301(b));
- Determine whether credit is not otherwise available on reasonable terms from non-Federal sources without guaranty provided by the SBA (13 CFR §120.101 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 3);
- Determine whether desired funds are available from the personal resources of any owner of 20% or more of the equity of the applicant, including limits on outstanding personal liquid assets, and if available are injected (13 CFR §120.102 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 4);
- Determine whether the business is for profit, domestic operation, and otherwise eligible in accordance with SBA SOP (13 CFR §120.100(a) and (b) and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 2);
- Determine whether the applicant has ever caused prior loss to the Government from prior federal financial assistance (13 CFR §120.110(q) and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 8.q.);
- Identify all use of proceeds of the loan as eligible, including funds used to purchase any portion of rental real estate, pay debts or change ownership of the applicant business (13 CFR §§120.120, 120.130, 120.131, 120.160(d), 120.201 and 120.202 and SOP 50-10(4), Subpart A, Chapter 2, Paragraph 10);
- Identify that any franchise financing is eligible (SOP 50-10(4), Subpart A, Chapter 3, Paragraph 3.e.);
- Determine whether all principal owners of the business are U.S. citizens or eligible resident aliens (SOP 50-10(4), Subpart A, Chapter 2, Paragraph 15.h.);
- Identify any actual or apparent conflicts of interest or preferences (13 CFR §§120.110(o), 120.140, 120.453(a) and SOP 50-10(4),

Subpart A, Chapters 2 and 3, and Subpart D, Chapter 3, Paragraph 7.a.(4)(j));

- Determine whether all SBA delegated program-specific eligibility issues (e.g. ALP, PCLP) are met (13 CFR §120.840-846; SOP 50-10(4), Subpart H, Chapters 6 and 7); and
- Identify any other SBA statutory, regulatory or SOP violations of eligibility.

Compile a list of all eligibility deficiencies by issue type and by errors per file, and identify any trends of deficiencies which warrant lender attention.

Compile a list of material eligibility deficiencies by loan file number and reason for deficiency. A Material Deficiency in the context of a 504 loan is one which demonstrates increased financial risk to SBA.

Reporting to SBA

- Compare most recently submitted Annual Report (as required by 13 CFR §120.830) to internal records and reports to determine that it accurately reflects the status of the management, operations and financial condition of the 504 CDC;
- Determine whether the Annual Report was submitted in accordance with time requirement of 13 CFR §120.830, and if not, why not;
- Obtain the CSA monthly "45-day delinquent report" for the most recent three months, to identify loans more than 45-days past due, and review a sample of these files to determine that CDC has notified SBA of required analysis, plan and steps to be taken to bring borrower current for any such 45-day delinquent accounts;
- Determine whether internal CDC records of servicing status of all problem loans (or a sample) has been reported to Colson in a timely fashion on all negotiated catch-up agreements;
- For Premier Certified Lender Program (PCLP) CDCs, obtain the loan loss reserve accounting report(s) for the most recent three months, and compare to CDC's loan transaction record to identify and reconcile any discrepancies, in accordance with 13 CFR §120847. As necessary, contact the applicable SBA office to fully determine nature of discrepancies.
- For PCLPs, determine that all required loan loss payments from reserve fund have been made to SBA, in accordance with 13 CFR §120.847(i).

Other Compliance Characteristics

- Determine that all SBA requirements regarding collateral have been met, and determinations regarding sufficiency of collateral, when applicable, have been met (13 CFR §120.934).
- Determine that CDC has verified any required borrower injection prior to disbursement (13 CFR §120.910).
- Determine that CDC has obtained any required appraisals, environmental assessments, flood insurance, or other required insurance, prior to disbursement (13 CFR §§120.160(b),(c), 170).
- Determine that CDC required and reconciled IRS tax transcripts for any applicant when required by SOP (SOP 50 10 4e, Subpart A, Paragraph 4.f).
- Determine that CDC obtained executed SBA Form 1506 Servicing Agent Agreement (SOP 50 10 4e, Subpart H, Chapter 22).
- Determine that CDC followed SBA requirement for site visit or other intensive servicing activity when loan is 60-days or more past due, or there is other reasons for concern (SOP 50 51 2, Chapter 8, Paragraph 8.B).
- As applicable to delegation of authority, determine that CDC has followed all SOP requirements regarding management of liquidation cases, including preparation of a liquidation plan, timely site visits, use of current appraisals, consideration of environmental issues, and preparation of a wrap-up report at conclusion of liquidation (SOP 50 51 2, Chapter 8, Paragraph 11).
- Identify that CDC has forwarded all recoveries on repurchased loans with 15 days of receipt of any (SOP 50 51 2, Chapter 10, Paragraph K.3).

Dated:

Steven C. Preston,
Administrator