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**Testimony**

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**SMALL BUSINESS  
ADMINISTRATION**

**Improvements Made, but  
Loan Programs Face  
Ongoing Management  
Challenges**

Statement of William B. Shear, Director  
Financial Markets and Community Investment





Highlights of [GAO-06-605T](#), a testimony to the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

## Why GAO Did This Study

The Small Business Administration's (SBA) purpose is to promote small business development and entrepreneurship through business financing, government contracting, and technical assistance programs. SBA's largest business financing program is its 7(a) program, which provides guarantees on loans made by private-sector lenders to small businesses that cannot obtain financing under reasonable terms and conditions from the private sector. In addition, SBA's Office of Disaster Assistance makes direct loans to households to repair or replace damaged homes and personal property and to businesses to help with physical damage and economic losses.

This testimony, which is based on a number of reports that GAO issued since 1998, discusses (1) changes in SBA's oversight of the 7(a) business loan program; (2) steps SBA has taken to improve its management of information technology, human capital, and financial reporting for business loans; and (3) SBA's administration of its disaster loan program.

[www.gao.gov/cgi-bin/getrpt?GAO-06-605T](http://www.gao.gov/cgi-bin/getrpt?GAO-06-605T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or [shearw@gao.gov](mailto:shearw@gao.gov).

## SMALL BUSINESS ADMINISTRATION

# Improvements Made, but Loan Programs Face Ongoing Management Challenges

## What GAO Found

Since the mid-1990s, when GAO found that SBA had virtually no oversight program for its 7(a) guaranteed loan program, SBA has, in response to GAO recommendations, established a program and developed some enhanced monitoring tools. The oversight program is led by its Office of Lender Oversight, which was established in 1999. Strong oversight of SBA's lending partners is needed to protect SBA from financial risk and to ensure that qualified borrowers get 7(a) loans. In addition to its bank lending partners, loans are made by Small Business Lending Companies (SBLC)—privately owned and managed, non-depository lending institutions that are licensed and regulated by SBA. Since SBLCs are not subject to safety and soundness oversight by depository institution regulators, SBA has developed such a program under a contract with the Farm Credit Administration. Over the years, SBA has implemented many GAO recommendations for lender oversight and continues to make improvements toward addressing others.

Since the late 1990s, SBA has experienced mixed success in addressing other management challenges that affect its ability to manage the 7(a) loan program. With respect to using information technology to monitor loans made by 7(a) lenders, between 1997 and 2002, SBA was unsuccessful in developing its own system to establish a risk management database as required by law. However, SBA awarded a contract in April 2003 to obtain loan monitoring services. Regarding SBA's most recent workforce transformation efforts begun in 2002, GAO found that SBA applied some key practices important to successful organizational change but overlooked aspects that emphasize transparency and communication. SBA has implemented some related GAO recommendations for improvements in those areas. SBA has also made good progress in response to GAO recommendations addressing financial management issues.

With respect to SBA's administration of its disaster loan program after the September 11, 2001, terrorist attacks, GAO found that SBA followed appropriate policies and procedures for disaster loan applications in providing approximately \$1 billion in loans to businesses and individuals in the disaster areas, and to businesses nationwide that suffered economic injury. GAO's preliminary findings from ongoing evaluations of SBA's response to the 2005 Gulf Coast hurricanes indicate that SBA's workforce and new loan processing system have been overwhelmed by the volume of loan applications. GAO identified three factors that have affected SBA's ability to provide a timely response to the Gulf Coast disaster victims: (1) the volume of loan applications far exceeded any previous disaster; (2) although SBA's new disaster loan processing system provides opportunities to streamline the loan origination process, it initially experienced numerous outages and slow response times in accessing information; and (3) SBA's planning efforts to address a disaster of this magnitude appear to have been inadequate.

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Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to be here today as you consider the effectiveness of the Small Business Administration (SBA). Established by Congress in 1953 to fulfill the role of several previous agencies, SBA's purpose is to promote small business development and entrepreneurship through business financing, government contracting, and technical assistance programs. In addition, SBA's Office of Disaster Assistance (ODA) makes loans to households to repair or replace damaged homes and personal property, and to businesses to help with physical damage and economic losses. For over a decade, SBA has been centralizing some functions to improve efficiency and has moved more toward partnering with outside entities, such as private-sector lenders, to provide direct services to small businesses. Significant changes in SBA's management of its loan programs, information technology, human capital, and financial resources have occurred, and we have studied various aspects of these changes.

My statement today is based on a number of reports that we have issued over the past decade addressing SBA's administration of its major loan guarantee and disaster loan programs. I will discuss (1) changes in SBA's oversight of the 7(a) business loan program; (2) steps SBA has taken to improve its management of information technology, human capital, and financial reporting for business loans; and (3) SBA's administration of its disaster loan program after the September 11, 2001, terrorist attacks and the recent Gulf Coast hurricanes.

In summary:

- Since the mid-1990s, when we found that SBA had virtually no oversight program for its 7(a) guaranteed loan program, SBA has, in response to our recommendations, established a program and developed some enhanced monitoring tools. The oversight program is led by its Office of Lender Oversight (OLO), which was established in 1999. Strong oversight of SBA's lending partners is needed to protect SBA from financial risk and to ensure that qualified borrowers get 7(a) loans. In addition to its bank lending partners, loans are made by Small Business Lending Companies (SBLC)—privately owned and managed, non-depository lending institutions that are licensed and regulated by SBA. Since SBLCs are not subject to safety and soundness oversight by depository institution regulators, SBA has developed such a program under a contract with the Farm Credit Administration. Although we have not comprehensively reviewed the 7(a) program in some time, over the years, SBA has

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implemented many of our recommendations for lender oversight and continues to make improvements toward addressing others.

- Since the late 1990s, SBA has experienced mixed success in addressing other management challenges that affect its ability to manage the 7(a) program. With respect to using information technology to monitor loans made by 7(a) lenders, between 1997 and 2002, SBA was unsuccessful in developing its own system to establish a risk management database as required by law. However, SBA awarded a contract in April 2003 to obtain loan monitoring services. Regarding SBA's most recent workforce transformation efforts begun in 2002, we found that although SBA applied some key practices important to successful organizational change, it overlooked aspects that emphasize transparency and communication. SBA has implemented some related recommendations for improvements in those areas. SBA has made good progress in response to our recommendations addressing financial management issues.
- With respect to SBA's administration of its disaster loan program after the September 11, 2001, terrorist attacks, we found that SBA followed appropriate policies and procedures for disaster loan applications in providing approximately \$1 billion in loans to businesses and individuals in the disaster areas, and to businesses nationwide that suffered economic injury. Our preliminary findings from ongoing evaluations of SBA's response to the 2005 Gulf Coast hurricanes indicate that SBA's workforce and new loan processing system have been overwhelmed by the volume of loan applications. We identified three factors that have affected SBA's ability to provide a timely response to the Gulf Coast disaster victims: (1) the volume of loan applications far exceeded any previous disaster; (2) although SBA's new disaster loan processing system provides opportunities to streamline the loan origination process, it initially experienced numerous outages and slow response times in accessing information; and (3) SBA's planning efforts to address a disaster of this magnitude appear to have been inadequate.

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## Background

SBA was established in 1953, but its basic mission dates to the 1930s and 1940s when a number of predecessor agencies assisted small businesses affected by the Great Depression and, later, by wartime competition. The first of these, the Reconstruction Finance Corporation, was abolished in

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the early 1950s; SBA was established by the Small Business Act of 1953,<sup>1</sup> to continue the functions of the previous agencies. By 1954, SBA was making business loans directly to small businesses and guaranteeing loans banks made, making loans directly to victims of disasters, and providing a wide range of technical assistance to small businesses.

Today, SBA's stated purpose is to promote small business development and entrepreneurship through business financing, government contracting, and technical assistance programs. SBA also serves as a small business advocate, working with other federal agencies to, among other things, reduce regulatory burdens on small businesses. Most SBA financial assistance is now provided in the form of guarantees for loans made by private and other institutions, but the agency's disaster program remains a direct loan program and is available to homeowners and renters that are affected by disasters of any kind; and to all businesses, regardless of their size, to cover physical damages.

At the end of fiscal year 2005, SBA had authority for over 4,000 full-time employees and budgetary resources of approximately 1.1 billion.<sup>2</sup>

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## SBA Has Developed and Continues to Improve an Oversight Program for Its Business Loan Program

Providing small businesses with access to credit is a major avenue through which SBA strives to fulfill its mission. The 7(a) loan program, which is SBA's largest business loan program, is intended to serve small business borrowers who cannot obtain credit elsewhere.<sup>3</sup> Because SBA guarantees up to 85 percent of each 7(a) loan made by its lending partners, there is risk to SBA if the loans are not repaid.

SBA is to ensure that lenders provide loans to borrowers who are eligible and creditworthy. Therefore, strong oversight of lenders by SBA is needed to ensure that qualified borrowers get 7(a) loans and to protect SBA from financial risk. As of September 30, 2005, SBA's portfolio of 7(a) loans totaled \$43 billion. In administering the 7(a) program, SBA has evolved from making loans directly to depending on lending partners, primarily

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<sup>1</sup>Pub. L. No. 83-163, tit. II, 67 Stat. 232 (July 30, 1953), as amended, which was withdrawn as part of that Act and made a separate Act known as the "Small Business Act" by Pub. L. No. 85-536, 72 Stat. 384 (July 18, 1958) (*codified at* 15 U.S.C. §§ 631 – 657e).

<sup>2</sup>Budgetary resources include new budget authority and unobligated balances of previous budget authority.

<sup>3</sup>15 U.S.C. § 636(a).

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banks that make SBA guaranteed loans.<sup>4</sup> SBA's other lending partners are Small Business Lending Companies (SBLC)—privately owned and managed, non-depository lending institutions that are licensed and regulated by SBA and make only 7(a) loans. Unlike SBA's bank lending partners, SBLCs are not generally regulated by financial institution regulators.<sup>5</sup>

Since the mid-1990s, when SBA had virtually no oversight program for its 7(a) guaranteed loan program, the agency has established a program and developed some enhanced monitoring tools. We have conducted four studies of SBA's oversight efforts since 1998 and made numerous recommendations related to establishing a lender oversight function and improving it. Although we sometimes repeated recommendations in more than one report because SBA had not acted to address them, SBA has now addressed many of the outstanding recommendations and is in the process of addressing others.

Prior to December 1997, SBA's procedures required annual on-site reviews of lenders with more than three outstanding guaranteed loans. But in a June 1998 study, we could not determine from the district offices' files which lenders met this criterion and should have been reviewed.<sup>6</sup> In the five SBA district offices we visited, we found that about 96 percent of the lenders had not been reviewed in the past 5 years and that some lenders participating in the program for more than 25 years had never been reviewed. When we did our study, SBA was implementing a central review program for its "preferred" lenders (those SBA certifies to make loans without preapproval).<sup>7</sup> The Small Business Programs Improvement Act of

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<sup>4</sup>Within the 7(a) program, there are three classifications of lenders—regular, certified, and preferred lenders. The Small Business Administration continues to provide final approval of loans made by its regular lenders. Certified lenders have the authority to process, close, service, and may liquidate SBA guaranteed loans. Preferred lenders are given full authority to make loans without prior SBA approval.

<sup>5</sup>Small Business Lending Companies that are subsidiaries of bank holding companies are subject to Federal Reserve Board oversight.

<sup>6</sup>See GAO, *Small Business Administration: Few Reviews of Guaranteed Lenders Have Been Conducted*, GAO-98-85 (Washington, D.C.: June 11, 1998).

<sup>7</sup>The percentage of loans accounted for by preferred lenders represented about 30 percent of 7(a) loan approvals and 50 percent of loan volume in 1997.

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1996 required SBA to review preferred lenders either annually or more frequently.<sup>8</sup>

In our 1998 report, we recommended that SBA establish a lender review process for all of its 7(a) lenders, including the SBLCs. In 1999, SBA established OLO and charged it with, among other duties, managing lender reviews, including safety and soundness examinations of SBLCs. In the same year, SBA contracted with the Farm Credit Administration—the safety and soundness regulator of the Farm Credit System—to perform examinations of SBLCs. Numerous deficiencies were identified in those first examinations, but the SBLCs and SBA responded positively to address the recommendations. SBA continues its contracting arrangement with FCA.

It was during our 2000 study on oversight of SBLCs that we first recommended that SBA clarify its authority to take enforcement actions, if necessary, against SBLCs, and to seek any statutory authority it might need to do so.<sup>9</sup> We made this recommendation again in 2002 and in 2004 and included a call to clarify procedures for taking actions against preferred lenders as well. We recommended that SBA provide, through regulation, clear policies and procedures for taking enforcement actions against preferred lenders or SBLCs in the event of continued noncompliance with its regulations. During this time, SBA sought appropriate authority from Congress to take enforcement actions against SBLCs similar to those of other regulators of financial institutions, such as cease-and-desist and civil money penalty powers. Congress provided SBA enforcement authority over non-bank lenders in late 2004, and SBA announced related delegations of authority in the Federal Register in April 2005 to clarify responsibilities within the agency.<sup>10</sup> SBA officials have told us that they will issue related regulations in 2006.

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<sup>8</sup>The assessments are to include, among other things, defaults, loans, and recoveries of loans made by the lender. Pub. L. No. 104-208, div. D, title 1, § 103(h), 110 Stat. 3009, 3009-728 (Sept. 30, 1996) (*codified at* 15 U.S.C. § 634 note).

<sup>9</sup>GAO, *Small Business Administration: Actions Needed to Strengthen Small Business Lending Company Oversight*, GAO-01-192 (Washington, D.C.: Nov. 17, 2000).

<sup>10</sup>See Small Business Reauthorization and Manufacturing Assistance Act of 2004 (Pub. L. No. 108-447, div.K, § 161, 118 Stat. 2809, 3458 (Dec. 8, 2004) (*codified at* 15 U.S.C. § 650); and 70 Fed. Reg. 21262, 21263 (Apr. 25, 2005).

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Our 2002 study focused more broadly on the relatively new OLO and found that the agency had made more progress in developing its lender oversight program.<sup>11</sup> OLO had developed guidance, centralized the lender review processes, and was performing more reviews of its lenders. We did, however, find some shortcomings in the program and made recommendations for improving it. For example:

- While elements of the oversight program touched on the financial risk posed by preferred lenders, weaknesses limited SBA's ability to focus on, and respond to, current and future financial risk to its portfolio. Neither the lender review process nor SBA's off-site monitoring adequately focused on the financial risk lenders posed. The reviews used an automated checklist to focus on lenders' compliance with SBA's 7(a) processing, servicing, and liquidation standards. The reviews did not provide adequate assurance that lenders were sufficiently assessing borrowers' eligibility and creditworthiness. We recommended that SBA incorporate strategies into its review process to adequately measure the financial risk lenders pose to SBA, develop specific criteria to apply to the "credit elsewhere" standard, and perform qualitative assessments of lenders' performance and lending decisions.<sup>12</sup> By 2004, as I will discuss in a moment, we found that SBA had made progress in its ability to monitor and measure the financial risk lenders pose but had not developed criteria for its credit elsewhere standard.
- Although SBA had taken a number of steps to develop its lender oversight function, the placement of its OLO within the Office of Capital Access (OCA) did not give OLO the necessary organizational independence it needed to accomplish its goals. OCA has other objectives, including promoting the lending program to appropriate lenders. We recommended that SBA make lender oversight a separate function and establish clear authority and guidance for OLO. SBA has taken several steps to address this recommendation but has not made OLO an independent office. In the 2005 delegations of authority published in the Federal Register, SBA specified that a Lender Oversight Committee (comprised of a majority of senior SBA officials outside of OCA) would have responsibilities for reviewing reports on lender-oversight activities; OLO recommendations

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<sup>11</sup>See GAO, *Small Business Administration: Progress Made but Improvements Needed in Lender Oversight*, GAO-03-90 (Washington, D.C.: Dec. 9, 2002).

<sup>12</sup>15 U.S.C. § 636(a)(1)(A) prohibits SBA from providing financial assistance to an applicant that can obtain credit elsewhere. 13 C.F.R. § 120.101 states, in part, "SBA provides business loan assistance only to applicants for whom the desired credit is not otherwise available on reasonable terms from non-Federal sources."



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for enforcement action; and OLO's budget, staffing, and operating plans. SBA officials believe that these and other measures will ensure sufficient autonomy and authority for OLO to independently perform its duties. These measures appear to provide the opportunity for more independence for OLO, but we have not evaluated how the measures are actually working.

Our most recent review of SBA's oversight efforts, completed in June 2004, focused on the agency's risk management needs and its acquisition and use of a new loan monitoring service.<sup>13</sup> Using an assessment of best practices, we determined that SBA would need to base its capabilities for monitoring its loan portfolio and lender partners on a credit risk management program.<sup>14</sup> Largely because SBA relies on lenders to make its guaranteed loans, it needs a loan and lender monitoring capability that will enable it to efficiently and effectively analyze various aspects of its overall portfolio of loans, its individual lenders, and their portfolios. While SBA must determine the level of credit risk it will tolerate, it must do so within the context of its mission and its programs' structures. Since SBA is a public agency, its mission obligations will drive its credit risk management policies. For example, different loan products in the 7(a) program have different levels of guarantees. These and other differences influence the mix of loans in SBA's portfolio and, consequently, would impact how SBA manages its credit risk.

Such a credit risk management program would likely include a comprehensive infrastructure—including, skilled personnel, strong management information systems, and functioning internal controls related to data quality—along with appropriate methodologies and policies that would ensure compliance with SBA criteria.

In 2003, SBA contracted with Dun and Bradstreet for loan monitoring services. These services could enable the agency to conduct the type of monitoring and analyses typical of "best practices" among major lenders, and are recommended by financial institution regulators. The services SBA obtained reflect many best practices, particularly those related to infrastructure and methodology, and can facilitate a new level of

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<sup>13</sup>See GAO, *Small Business Administration: New Service for Lender Oversight Reflects Some Best Practices, but Strategy for Use Lags Behind*, GAO-04-610 (Washington, D.C.: June 8, 2004).

<sup>14</sup>"Credit risk" is the risk of financial loss due to borrower default.

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sophistication in SBA's oversight efforts.<sup>15</sup> The services also give SBA a way to measure the financial risk posed by its lending partners, and analyze loan and lending patterns efficiently and effectively. However, SBA did not develop the comprehensive policies it needed to implement the best practices as we recommended.

SBA officials have told us that they have taken steps to address this recommendation. For example, the management plan governing the agency's relationship with Dun and Bradstreet addresses a process for continuous improvement. SBA has also established the Lender Oversight Committee and a Portfolio Analysis Committee to review portfolio performance. SBA officials told us that these committees meet frequently. They also described the type of analyses of the loan portfolio and individual lenders made available for review and discussion by the committees, and provided examples of these analyses. Although these developments could provide the tools for risk management that we envisioned, we have not evaluated them.

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## SBA Has Experienced Mixed Success in Addressing Other Management Challenges to Its 7(a) Loan Program

Since the late 1990s, SBA has taken steps to address other management challenges that affect its ability to manage its business loan program and the technical assistance it provides small businesses. Information technology, human capital, and financial management have posed challenges for SBA, as we have noted in special reports to Congress.<sup>16</sup>

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<sup>15</sup>The best practices include continuous improvements in the service and its tools, frequent and routine portfolio reviews, and active involvement of senior managers in reviewing how the information from the service is used.

<sup>16</sup>GAO, *Major Management Challenges and Program Risks: Small Business Administration*, [GAO-03-116](#) (Washington, D.C.: Jan. 2003); see [www.gao.gov/pas/2005](http://www.gao.gov/pas/2005) for a 2005 update. We first addressed these management challenges in 2001. See GAO, *Major Management Challenges and Program Risks: Small Business Administration*, [GAO-01-260](#) (Washington, D.C.: Jan. 2001).

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## SBA Has Made Advancements in Information Technology Critical to Business Loans

SBA has now acquired the ability to monitor its portfolio of business loans through its arrangement with Dun and Bradstreet, as mentioned earlier. SBA took this positive step after an unsuccessful attempt to establish a risk management database as required by the Small Business Programs Improvement Act of 1996.<sup>17</sup> We monitored the agency's progress as it attempted to meet this challenge on its own. When we reviewed SBA's plans in 1997, we found that it had not undertaken the essential planning needed to develop the proposed system.<sup>18</sup> We periodically reported on SBA's progress in planning and developing the loan monitoring system since 1997.<sup>19</sup> From 1998 to 2001, SBA's estimate for implementing the system grew from \$17.3 million to \$44.6 million. By 2001, SBA had spent \$9.6 million for developmental activities, but had never completed the mandated planning activities or developed a functioning loan monitoring system.

In 2001, Congress did not appropriate funds for the loan monitoring system and instead permitted SBA to use reprogrammed funds, provided that SBA notify Congress in advance of SBA's use of the reprogrammed funds.<sup>20</sup> Congress also directed SBA to develop a project plan to serve as a basis for future funding and oversight of the loan monitoring system. As a result, SBA suspended the loan monitoring system development effort. Of the \$32 million appropriated for the loan monitoring system effort, about \$14.7 million remained. In 2002, SBA contracted for assistance to identify alternatives and provide recommendations for further developing a loan monitoring system. This effort led to SBA awarding a contract to Dun and Bradstreet in April 2003 to obtain loan monitoring services, including loan and lender monitoring and evaluation; and risk management tools. The

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<sup>17</sup>Pub. L. No. 104-208, div. D, title I, § 102,110 Stat. 3009-724, 3009-725, (Sept. 30, 1996) (codified at 15 U.S.C. § 633(b)(3)).

<sup>18</sup>GAO, *Small Business Administration: Better Planning and Controls Needed for Information Systems*, [GAO/AIMD-97-94](#) (Washington, D.C.: June 27, 1997).

<sup>19</sup>GAO, *Small Business Administration: Mandated Planning for Loan Monitoring System Is Not Complete*, [GAO/AIMD-98-214R](#) (Washington, D.C.: June 30, 1998); *Small Business Administration: Planning for Loan Monitoring System Has Many Positive Features but Still Carries Implementation Challenges*, [GAO/T-AIMD-98-233](#) (Washington, D.C.: July 16, 1998); *SBA Loan Monitoring System: Substantial Progress Yet Key Risks and Challenges Remain*, [GAO/AIMD-00-124](#) (Washington, D.C.: Apr. 25, 2000); *Loan Monitoring System: SBA Needs to Evaluate the Use of Software*, [GAO-02-188](#) (Washington, D.C.: Nov. 30, 2001).

<sup>20</sup> See Pub. L. No. 107-77, 115 Stat. 748, 796-799 (Nov. 28, 2001); and H.R. Conf. Rep. No. 107-278 at 164 (2001).

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contract includes four 1-year options at an average cost of approximately \$2 million a year.

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## SBA Has Applied Key Practices but Overlooked Transparency and Communication During Its Workforce Transformation

In 2001 we reported on SBA's organizational structure and the challenges it presented for SBA to deliver services to small businesses.<sup>21</sup> We reviewed how well SBA's organization was aligned to achieve its mission. We found a field structure that did not consistently match with SBA's mission requirement. This was caused by past realignment efforts during the mid-1990s that changed how SBA performed its functions, but left some aspects of the previous structure in place. Among the other weaknesses we identified were:

- ineffective lines of communication;
- confusion over the mission of district offices; and
- complicated, overlapping organizational relationships.

SBA began realigning its organization, operations, and workforce to better serve its small-business customers in the 1990's. With less responsibility for direct lending and a declining operating budget, SBA streamlined its field structure by downsizing its 10 regional offices, moving the workload to district or headquarters offices, and eliminating most of the regional offices' role as the intermediate management layer between headquarters and the field. SBA created the Office of Field Operations, largely to represent the field offices in headquarters and to provide guidance and oversight to field office management. In 2002, the agency planned to approach its 5-year transformation efforts in phases, testing a number of initiatives in order to make refinements before implementing the initiatives agencywide. These efforts are ongoing. SBA's current transformation objectives are to:

- streamline ODA by realigning offices, employees, and space to better serve disaster victims and leverage use of the new disaster loan processing system;

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<sup>21</sup>GAO, *Small Business Administration: Current Structure Presents Challenges for Service Delivery*, GAO-02-17 (Washington, D.C.: Oct. 26, 2001).

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- centralize all 7(a) loan processing in two centers to standardize procedures and reduce the workforce required for this program;
  - centralize all 504 loan liquidations in two centers to standardize processing and increase efficiency;
  - centralize disaster loan liquidations in one center to standardize processing and increase efficiency; and
  - transform the regional and district offices by standardizing their size and function.

In October 2003, when we reported on SBA's transformation, SBA was near completion of the first phase of its transformation process.<sup>22</sup> This initial phase aimed to

- transform the role of the district office to focus on outreach to small businesses about SBA's products and services, and link these businesses to the appropriate resources, including lenders; and
- centralize some of its loan functions to improve efficiency and the consistency of its loan approval and liquidation processes.

We found that the agency had applied some key practices important to successful organizational change, but had overlooked aspects that emphasize transparency and communication. For example, SBA had top leadership support and a designated transformation-implementation team, but the makeup of the team was not communicated to employees and stakeholders, and the team's leadership was not always consistent. Also, SBA had developed a transformation plan that contained goals, anticipated results, and an implementation strategy—but the plan was not made public, and employees and stakeholders were not apprised of the details of the plan. Also, certain aspects of the plan were revised, causing further confusion among non-management employees. Further, SBA had developed strategic goals to guide its transformation, but these goals were not linked with measurable performance goals that would demonstrate the success of the agency's plan to expand the focus of the district offices on marketing and outreach.

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<sup>22</sup>GAO, *Small Business Administration: Progress Made, but Transformation Could Benefit from Practices Emphasizing Transparency and Communication*, [GAO-04-76](#) (Washington, D.C.: Oct. 31, 2003).

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Based on our findings and the possibility that further progress could be impeded by budget and staff realignment challenges, we recommended that SBA:

- ensure that implementation leadership is clearly identified to employees and stakeholders;
- finalize its transformation plan and share it with employees and stakeholders;
- develop performance goals that reflect the strategic goals for transformation, and budget requests that clearly link resource needs to achieving strategic goals;
- use the new performance management system to define responsibilities;
- develop a communication strategy that promotes two-way communication; and
- solicit ideas and feedback from employees and the union, and ensure that their concerns were considered.

SBA officials have told us of the Administrator's increased efforts to communicate with staff by holding agencywide meetings with employees, for example. In addition, the agency plans to finalize a transformation plan and share it with employees in June. These actions could address some of the recommendations we made to SBA, but we have not documented or evaluated the efforts.

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## SBA Addressed Major Financial Management Issues, but Additional Steps are Necessary to Sustain Progress

SBA has made good progress towards addressing financial management issues that for several years prevented it from obtaining an unqualified audit opinion on its financial statements. We reported on some of these issues in our January 2003 report on SBA's loan sales.<sup>23</sup> Specifically, we found that SBA lacked reliable data to determine the overall financial results of its loan sales. Further, because SBA did not analyze the effect of loan sales on its remaining portfolio, we reported that its credit program

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<sup>23</sup>GAO, *Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain*, GAO-03-87 (Washington, D.C.: Jan. 3, 2003). Between fiscal years 1999 and 2003, SBA conducted seven loan sales, divesting itself of about 166,000 loans with an outstanding balance of about \$5.7 billion. Approximately 86 percent of the amount sold was from disaster assistance loans.

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cost estimates for the budget and financial statements may have contained significant errors. In addition, SBA could not explain unusual account balances related to the disaster loan program, which indicated that the subsidized program was expected to generate a profit. These issues raised concerns about SBA's ability to properly account for loan sales and to make reasonable estimates of program costs.

In response to our findings and several recommendations, SBA conducted an extensive analysis to resolve the issues we identified and implemented a number of corrective actions. For example, SBA developed a new cash-flow model to estimate the costs of its disaster loan program, and implemented standard operating procedures for annually revising the cost estimates for its credit programs. SBA also revised its approach to determine the results of loan sales and found that loans were sold at losses, which was contrary to the original determination that the sales generated gains. These findings prompted SBA to eventually discontinue its loan sales program. We reviewed the improvements made by SBA and reported in April 2005 that the loan accounting issues we previously identified were resolved, and that the new cash-flow model improved its ability to prepare more reliable cost estimates and to determine the results of prior loan sales.<sup>24</sup> However, we recommended additional steps that would improve the long-term reliability of the cost estimates, such as routine testing of the model. According to SBA officials, steps have been taken to address each of our recommendations, including the development of policies and procedures on how to operate and test the model.

These improvements helped SBA achieve an unqualified audit opinion on its fiscal year 2005 financial statements, which represents significant progress from prior years. However, for fiscal year 2005 SBA's auditor continued to note weaknesses in SBA's overall internal controls. The auditor noted three areas involving internal controls that are considered to

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<sup>24</sup>GAO, *SBA Disaster Loan Program: Accounting Anomalies Resolved but Additional Steps Would Improve Long-Term Reliability of Cost Estimates*, [GAO-05-409](#) (Washington, D.C.: Apr. 14, 2005).

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be weaknesses.<sup>25</sup> The first area, which the auditor considered to be a significant weakness, related to financial management and reporting controls. Specifically, the auditor found that SBA needed to improve its funds management (i.e., canceling loan amounts not disbursed and closing out grants), its review process for accounting transactions, and its financial statement preparation process. The other two less significant control weaknesses related to SBA's ODA administrative expenditure controls and agencywide information system controls. While these internal control weaknesses were not severe enough to impact SBA's audit opinion for fiscal year 2005, it is important for SBA to address them to help ensure that SBA continues to be able to generate reliable financial data.

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## SBA Provided Disaster Loans in Response to September 11th and Now Is Responding to the Gulf Coast Hurricanes

Disaster assistance has been part of SBA since its inception, and SBA's physical disaster loan program is the only form of assistance not limited to small businesses.<sup>26</sup> Through the ODA, SBA provides low-interest, long-term loans to individuals and businesses to assist them with disaster recovery. Unlike the 7(a) program, the disaster loan program provides loans directly to disaster victims. Businesses can apply for "physical loans" to repair or replace business property to pre-disaster conditions, as well as economic injury disaster loans (EIDLs) to obtain working capital funds to meet their normal operating expenses. The maximum loan amount for both physical business loans and EIDLs is \$1.5 million, but SBA was given federal authority and supplemental appropriations to increase the amount for 9/11 disaster loans. Homeowners and renters can also apply for loans to cover their uninsured losses. The maximum amount available for home loans is \$200,000, and personal property loans to replace items such as automobiles, clothing, and furniture are available up to \$40,000.<sup>27</sup> SBA offers terms of up to 30 years for repayment. According to SBA, although

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<sup>25</sup>There are two types of internal control weaknesses. A "reportable condition" is a significant deficiency in the design or operation of internal controls that could adversely affect the organization's ability to provide reasonable assurance on the reliability of its financial reporting, performance reporting, and compliance with laws and regulations. The more significant weakness, referred to as a "material internal control weakness," is a reportable condition that does not reduce to a relatively low level the risk that errors, fraud, or noncompliance involving significant amounts may occur and may not be detected in a timely manner, by employees in the normal course of performing their assigned functions.

<sup>26</sup>The economic injury disaster loan (EIDL) program under 15 U.S.C. § 636(b)(2) covers small business concerns and small agricultural cooperatives located in a disaster area.

<sup>27</sup>13 C.F.R. § 123.105.



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ODA aims to provide loan funds to disaster victims as quickly as possible, its focus is on long-term recovery, and not on emergency relief.

Since SBA provides low-interest loans, the agency is required to determine whether each applicant is able to obtain financial assistance at reasonable rates and terms from non-government sources prior to assigning an interest rate. A higher rate applies for physical loan applicants if they are determined to have other credit available, and economic injury loan applicants are ineligible if they have other credit available. Physical business loans—where the applicant has credit available from other sources—are also subject to a maximum 3-year term for repayment.<sup>28</sup> SBA also has standard procedures and requirements for disaster loans, including verification of losses claimed, verification of repayment ability, and collateral to secure loans for economic injury loans over \$5,000 or for home loans or physical disaster business loans over \$10,000.<sup>29</sup> SBA verifies losses for physical loans and also deducts certain forms of compensation, including insurance recoveries, from the eligible loan amount. Federal Emergency Management Agency (FEMA) is the coordinating agency for presidential disaster declarations, and most disaster victims register with FEMA initially before receiving a referral to SBA.<sup>30</sup> SBA can review FEMA’s information to determine if an applicant has already received federal assistance or insurance proceeds to avoid duplication of benefits.<sup>31</sup> If insurance reimbursement is undetermined at the time of application, SBA can approve a loan for the total replacement cost, but any insurance proceeds must be assigned to SBA to reduce the loan balance. In considering any loan, SBA must have reasonable assurance that the loan can be repaid. To make this determination, SBA examines federal tax returns and income information and reviews credit reports to verify the manner in which an applicant’s obligations, including federal debts, have been met. One of the reasons that SBA may decline a loan application is

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<sup>28</sup> 13 C.F.R. § 123.203(a).

<sup>29</sup> 13 C.F.R. § 123.11.

<sup>30</sup> Non-business disaster victims initially register with the Federal Emergency Management Agency (FEMA) and are directed to apply for an SBA disaster assistance loan if they meet certain basic criteria. Business owners are also encouraged to register with FEMA. Applicants not approved for an SBA loan are referred back to FEMA for possible grant assistance.

<sup>31</sup> ODA’s new Disaster Credit Management System (DCMS) has a direct link to FEMA’s database, which allows SBA to conduct the duplication of benefits (DOB) review electronically.

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unsatisfactory history on a federal obligation. The law does not require collateral for disaster loans, but SBA policy establishes collateral requirements in order to balance the agency's disaster recovery mission with its responsibility as a lender of federal tax dollars. For example, for physical disaster loans over \$10,000, applicants are required to provide collateral that will best secure the loan, and multiple loans totaling over \$10,000 also require collateral to secure each loan. Real estate is the preferred form of collateral, but SBA will not automatically decline an application if the best available collateral is insufficient in value to secure the loan.

Following the terrorist attacks of September 11<sup>th</sup>, SBA provided approximately \$1 billion in loans to businesses and individuals in the federally declared disaster areas and to businesses nationwide that suffered related economic injury.<sup>32</sup> Home and business owners in the federally declared disaster areas received just under half of the disbursed loans; the remainder went to eligible businesses around the country. Congress and SBA made several modifications to the programs in response to complaints from small businesses. For example, the EIDL program was expanded to the entire country and to industries that had not previously been covered, size standards for some eligible business were changed, and loan approval and disbursement were expedited.<sup>33</sup>

In 2004, in response to concerns that about half of the loan applications submitted by small businesses were declined or withdrawn, we reviewed a representative sample of these applications and found that SBA had followed the appropriate policies and procedures in making loan

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<sup>32</sup>GAO, *Small Business Administration: Response to September 11 Victims and Performance Measures for Disaster Lending*, [GAO-03-385](#) (Washington, D.C.: Jan. 29, 2003).

<sup>33</sup>SBA was given supplemental appropriations to make loans after September 11th and the 2005 Gulf Coast hurricane disasters.

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decisions.<sup>34</sup> We compared SBA's loan requirements to those of selected nonprofit agencies in the New York area that provided financial assistance to local small businesses following the disaster. Generally, we found that SBA had loan requirements that were similar to these nonprofits, but the nonprofits' programs allowed some additional flexibility to address the particular needs of their small business constituents.

We also currently have work under way to identify and assess the factors that have affected the SBA's ability to respond to victims of Hurricane Katrina and the other 2005 Gulf Coast hurricanes in a timely manner.<sup>35</sup> As part of our work, we are evaluating how SBA's new Disaster Credit Management System, which has been in use since January 2005, affected SBA's response. As the primary federal lender to disaster victims, including individual homeowners, renters, and businesses, SBA's ability to process and disburse loans in a timely manner is critical to the recovery of the Gulf Coast region. As of February 25, 2006, SBA faced a backlog of about 103,300 applications in loan processing pending a final decision, and the average time these applications had been in process was about 94 days. During the month of March, SBA continued to process applications. By March 25, 2006, SBA had mailed out more than 1.6 million loan applications, received over 350,000 completed applications, processed more than 290,000 applications, and disbursed about \$600 million in disaster loan funds. Although SBA's current goal is to process loan applications within 7 to 21 days, as of March 25, 2006, SBA faced a backlog of about 55,000 applications in loan processing pending a final decision and the average age of these loan applications was about 88 days. SBA also has more than 43,000 loan applications that have been approved but

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<sup>34</sup>GAO, *Small Business Administration: SBA Followed Appropriate Policies and Procedures for September 11 Disaster Loan Applications*, [GAO-04-885](#) (Washington, D.C.: Aug. 31, 2004). In addition to SBA disaster loans, Congress allowed SBA to collect reduced annual fees on 7(a) loans made by lenders to small businesses "adversely affected" by the terrorist attacks and their aftermath (see Pub. L. 107-117, § 203, 115 Stat. 2230, 2297-2298 (Jan. 10, 2002)). These loans were designated by SBA as "Supplemental Terrorist Activity Relief" or STAR, loans. When the STAR program expired on January 10, 2003, approximately \$3.7 billion in STAR loans had been approved. In a review of the STAR loan program, SBA's Office of Inspector General found that most lender files did not contain sufficient information to demonstrate that borrowers were adversely affected by the attacks and their aftermath, and that SBA did not establish specific requirements to review or verify lenders' STAR justifications. See SBA, Office of Inspector General, *Audit of SBA's Administration of the Supplemental Terrorist Activity Relief (STAR) Loan Program*, Rept. No. 6-09 (Washington, D.C.: Dec. 23, 2005). We did not review the STAR program.

<sup>35</sup> Hurricane Katrina struck the Gulf Coast on August 29; Hurricanes Rita and Wilma struck the U.S. Mainland on September 24 and October 24, respectively.

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have not been closed or fully disbursed. As a result, disaster victims in the Gulf Region have not received timely assistance in recovering from this disaster and rebuilding their lives.

Based on our preliminary analysis of SBA's disaster loan origination process, we have identified several factors that have affected SBA's ability to provide a timely response to Gulf Coast disaster victims. First, the volume of loan applications SBA mailed out and received has far exceeded any previous disaster. Compared with the Florida hurricanes of 2004 or the 1994 Northridge earthquake, the hurricanes that hit the Gulf Coast in 2005 resulted in the issuance of roughly two to three times as many loan applications. Second, although SBA's new disaster-loan processing system provides opportunities to streamline the loan origination process, initially it experienced numerous outages and slow response times in accessing information. However, we have not yet determined the duration and impact of these outages on processing. SBA officials have attributed many of these problems to a combination of hardware-and telecommunications-capacity limitations as well as the level of service SBA has received from its contractors. Third, SBA's planning efforts to address a disaster of this magnitude appear to have been inadequate. Although SBA's disaster planning efforts focused primarily on responding to a disaster the size of the Northridge earthquake, SBA officials said that it initially lacked the critical resources such as office space, staff, phones, computers, and other resources to process loans for this disaster. SBA has participated in disaster simulations on a limited basis only and it is unclear whether previous disaster simulations of category 4 hurricanes hitting the New Orleans area were considered.

We are also assessing other factors that have affected SBA's ability to provide timely loans to disaster victims in the Gulf region including: workforce transformation, the exercise of its regulatory authority to streamline program requirements and delivery to meet the needs of disaster victims, coordination with state and local government agencies, SBA's efforts to publicize the benefits offered by the disaster loan program, and the limits that exist on the use of disaster loan funds.

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Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

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## Contacts and Acknowledgments

For further information on this testimony, please contact William B. Shear at (202) 512-8678. Individuals making key contributions to this testimony included Katie Harris, Assistant Director, and Bernice Benta.

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# Selected GAO Products

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*SBA Disaster Loan Program: Accounting Anomalies Resolved but Additional Steps Would Improve Long-Term Reliability of Cost Estimates.* [GAO-05-409](#). Washington, D.C.: April 14, 2005.

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