U.S. Small Business Administration
Washington, D.C. 20416

OFFICE OF
INSPECTOR GENERAL

December 1, 2000

Honorable Fred Thompson
Chairman
Committee on Government Affairs
United States Senate
Washington, DC 20510-6250

Dear Chairman Thompson:

In response to your request of October 12, 2000, I am pleased to submit the Office of Inspector General's (OIG) list of the most serious management challenges facing the Small Business Administration (SBA) in FY 2001. You asked for our current assessment of challenges that are particularly vulnerable to fraud, waste, error, or mismanagement, as well as Agency programs or activities that otherwise pose significant risks. Our response is based on specific OIG or General Accounting Office reports, which are referenced in the individual sections, and our general knowledge of SBA programs.

The current list identifies three new challenges and updates those we submitted last year, several of which have been consolidated. The first four focus on Agencywide issues that are critical to SBA's goal of modernizing the Agency—managing for results, modernizing SBA's information systems for loan monitoring and financial management, improving information systems security, and managing human capital.

This year, we do not list oversight of the Small Business Lending Companies (SBLC) as a separate challenge because we no longer consider it to be a major challenge on its own. SBA has agreed with nearly all the recommendations made in the Farm Credit Administration examination reports. Because the Agency has not yet implemented the recommended actions, however, we have included SBLCs in our challenge on improving lender oversight. SBA has established an Office of Lender Oversight that will oversee the SBLC examinations.

While the two challenges on guaranty purchases and lender oversight are essentially the same as last year's, we have brought the discussion up-to-date and modified it to more clearly reflect the issues. SBA is making progress on both challenges, but much of the implementation is still pending. Because cost accounting is now included in SBA's Systems Modernization

Initiative, we have incorporated last year's cost accounting challenge into this year's challenge on modernizing Agency information systems for loan monitoring and financial management.

We also consolidated last year's challenges on loan agent fraud and criminal background checks on business loan borrowers into a single challenge on preventing loan fraud. The legislation needed to conduct criminal background checks on loan agents and on loan applicants, without requiring fingerprints, was proposed by SBA last year, but it was not reported out of the conference committee. The fraud prevention measures cannot be implemented without specific legislative authority, so we hope that the Congress will approve the proposal this year.

In response to your request that we identify programs that have had questionable success in achieving results, we refer you to the three 8(a) Business Development challenges. Except for some updating and clarification, the challenges remain essentially the same as last year. In our view, the problems identified in these challenges limit the program's potential for developing minority businesses because benefits are not equitably distributed among Section 8(a) firms, some participants continue to receive benefits after they are no longer qualified for the program, and many benefits pass through to large businesses.

I want to acknowledge the substantial feedback we have received from Agency managers and staff on these challenges. While OIG and SBA do not fully agree on some issues, the Agency's input helped us ensure that all points of view were given careful consideration and that the narrative discussions were factually accurate.

We have included our responses to your remaining questions in the discussion on each challenge. If you or your staff have any questions, please do not hesitate to call me or Peter McClintock, Deputy Inspector General, at (202) 205-6586.

Sincerely,

Phyllis K. Fong

Phyllis K. Fong
Inspector General

Enclosure

SMALL BUSINESS ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

FY 2001

AGENCY MANAGEMENT CHALLENGES

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AGENCY-WIDE ISSUES

Challenge 1. SBA needs to improve its managing for results processes and produce reliable performance data.

Summary. *SBA needs to develop effective outcome measures, ensure that its performance data are accurate and reliable, and establish systems to manage for results. The Agency has taken steps to identify more program outcomes, improve performance measures, and increase the accuracy of its data. SBA still needs to develop (1) Agency-wide guidance on preparing performance goals and indicators, (2) standards and procedures for data verification and validation, and (3) client surveys and other methods to obtain outcome information.*

SBA has three major goals: (1) help small businesses succeed, (2) help businesses and families recover from disasters, and (3) improve internal SBA management. To comply more fully with the Government Performance and Results Act (GPRA), SBA needs to develop appropriate outcome measures, improve the accuracy and completeness of its data, and institute managing for results processes throughout the organization. SBA reports that it is moving away from output measures, has identified outcome goals and targets of performance, and improved its reporting of results.

Agency-wide: On October 31, 2000, the Chairman of the Senate Governmental Affairs Committee released grades for the FY 1999 Performance Reports submitted by the 24 Chief Financial Officer Act (CFOA) agencies. The grades were based on analyses of the reports conducted by the General Accounting Office (GAO) and the Mercatus Center at George Mason University. The committee focused on (1) how well an agency delivers key performance results, (2) what progress has been made in resolving major management problems that waste tax dollars or impede performance, and (3) how useful the report is in understanding what an agency is accomplishing. The committee gave SBA a D on its performance report. The grade and accompanying assessment indicated that SBA should use outcome goals in its performance plans and reports rather than output goals, document its use of resources to produce outputs and outcomes, and develop performance goals for its ten management challenges.

The Senate Governmental Affairs Committee identified three “key outcomes” in SBA's FY 1999 Performance Report and asked GAO to evaluate how well SBA performed during FY 1999. GAO found that SBA’s FY 1999 Performance Report showed mixed results in meeting the Agency’s goals for the three key outcomes that follow.

- Small businesses become self-reliant and successful in the competitive marketplace. GAO found that the SBA Performance Report included four performance goals related to this key outcome. SBA had mixed results in meeting the goals and associated measures in this area.

- Businesses and families recovering from disasters receive timely assistance. GAO stated that SBA reported one performance goal related to this key outcome. SBA met two of the three targets established for this goal.

- More eligible minority small businesses participate in SBA programs and become successful. GAO again found that SBA had mixed results with the one performance goal related to this key outcome. For the five measures linked to this performance goal, two targets were met, two targets were not met, and one target was not reported on because data were not available.

GAO also noted that SBA's FY 2001 plan discusses ten OIG-identified management challenges facing SBA and includes milestones. In responding to OIG recommendations, SBA developed action plans, tasks, and projected completion dates. Nevertheless, the plan does not include any performance goals and measures that relate to the management challenges in the same format as the rest of the performance plan. Also, GAO noted that while certain weaknesses discussed in SBA's FY 2000 plan were improved in the FY 2001 plan, others continue. The GAO report suggested that SBA make its performance goals more explicit, include more outcomes, comment more extensively on final results, and improve the reliability and validity of the data. Regarding SBA's FY 2000 Performance Report, GAO noted that the performance indicators in SBA's FY 2000 Annual Performance Plan are activity-oriented and do not address GPRA priorities, including program outcomes, customer satisfaction, service quality, or cost.

A team of analysts from the Mercatus Center at George Mason University also ranked the FY 1999 Performance Reports of the 24 CFOA agencies. Rankings were based on whether (1) agency accomplishments were reported in a transparent fashion, (2) the report focused on documenting the agency's tangible public benefits, and (3) there was evidence of forward-looking leadership that uses performance information to devise strategies for improvement. SBA received 32 out of a possible 60 points, ranking it ninth of the 24 agencies.

Programs: OIG audits and inspections have focused on SBA's implementation of performance measurement requirements and the reliability of the performance data for major Agency programs. The three audits completed to date have found that SBA's performance measures and data accuracy could be improved. For example, the reporting of the number and dollar amount of Small Business Investment Company (SBIC) financings made each year was inaccurate because investment activity was reported on the basis of the dates on which the investments were reported to SBA rather than when they were made. About 26 percent of the financings reported for FY 1999 were from FYs 1994 to 1998. However, according to the Investment Division, the reported result, when adjusted for FY 1999 financings that were reported in FY 2000, understated the actual percentage and dollar amount of financings that should have been reported in FY 1999 by at least six percent. Also, data relating to business ownership by women and minorities, as reported by the SBICs, were not supported by documentation.

The Surety Bond Guaranty (SBG) audit found that the program's performance data were reliable but recommended improvements in data collection and presentation. A Section 7(a) GPRA audit, however, found that some of the program's performance data are not reliable, due primarily to an absence of effective validation and verification strategies and methods. Moreover, loan quantity indicators used are not a valid measure of output because they are loans approved rather than actual loans made or disbursed.

An OIG inspection of SBA loan processing centers found some uncertainty in the Office of Financial Assistance concerning what constitutes adequate data verification. A recent inspection of SBA's Office of Entrepreneurial Development (OED) found inconsistencies in counting clients in its small business counseling and technical assistance programs that appear to overstate the efforts of some service providers. A common unit of measurement is needed. Although it is difficult to attribute outcome measures such as a small business' increased sales or hiring to OED efforts, SBA needs to develop outcome measures to determine the intermediate or long-term results of OED services. The simplest approach is for OED to periodically survey a sample of clients drawn from all service provider programs.

Action Needed

- SBA's Office of Policy, Planning and Evaluation (OPPE) needs to develop specific guidance concerning the preparation of organizational performance goals and indicators.

- OPPE should develop and promulgate standards and procedures for data verification and validation.

- To ensure consistency in service provider reporting, OED should issue specific guidance to the providers on how to count (1) clients served, and (2) client counseling and training sessions. To report program performance as accurately as possible, OED should use the number of clients served and the number of counseling and training sessions as its principal output measures.

- To obtain outcome information, OED should develop a client survey that it can administer periodically.

Action Taken

- SBA managers have agreed with all of the recommendations included in OIG GPRA audit reports. Agreement on the actual implementation of several SBIC recommendations is pending.

- SBA has agreed with the recommendations in the processing centers report but final action is also pending.

- The OED inspection was only recently issued, and SBA has not yet indicated the actions it plans to take.

Reports

SBA OIG, *Results Act Performance Measurement for the Small Business Investment Company*, Audit Report #0-25, September 6, 2000.

SBA OIG, *Results Act Performance Measurement for the Surety Bond Guarantee Program*, Audit Report #0-26, September 25, 2000.

SBA OIG, *Results Act Performance Measurement for the Section 7(a) Business Loan Program (draft)*

SBA OIG, *Coordination and Performance Measurement in SBA's Entrepreneurial Development Programs,* Inspection Report #00-09-02, September 29, 2000.

SBA OIG, *Advisory Memorandum: Data Issues Regarding the Processing Centers,* Inspection Report #00-09-01, September 28, 2000.

U.S. Senate, Governmental Affairs Committee, *Senator Thompson Unveils Agency Performance Report Grades*, News Release, October 31, 2000.

U.S. Senate, Governmental Affairs Committee, *Summary of FY 1999 Performance Report Information: Small Business Administration*, June 2000.

George Mason University, Mercatus Center, *Performance Scorecard: Which Federal Agencies Inform the Public?* May 3, 2000.

Significant Open Recommendations

- Because all of the OIG reports are newly issued, OIG recommendations have not yet been implemented.

Challenge 2. SBA faces significant challenges in modernizing its major loan monitoring and financial management systems.

Summary. *SBA has ambitious plans to upgrade its systems for loan monitoring and financial management, but implementing those plans will require sustained commitment to achieve objectives and overcome systems development obstacles. The Agency has identified modernizing these systems as a major priority and has made progress in developing information technology procedures and controls. SBA needs to continue to formulate and implement sound procedures for system development and acquisition to enable more effective and efficient loan monitoring and financial management.*

SBA needs to ensure that its planned systems for loan monitoring, lender oversight, and financial management are developed, integrated, and implemented efficiently and effectively, so that intended objectives are achieved and numerous risks are minimized. These risks relate primarily to a wide range of functional and regulatory requirements, including systems security, data integrity, electronic records management, and cost control.

SBA's strategic goals depend heavily on new information systems. To achieve these goals, the Agency has engaged in an ambitious set of systems development and acquisition projects, collectively referred to as the Systems Modernization Initiative (SMI). To support its credit programs, the Agency is developing the Loan Monitoring System (LMS) which is intended to address challenges such as higher levels of lending activity, increased lender authority and responsibility, outsourcing of loan servicing, credit reform, and loan asset sales. Another major component of SMI is the Joint Accounting and Administrative System (JAAMS), which is intended to address financial management and administrative activities, including procurement and grants management, human resources, accounting, budgeting, and financial operations and reporting. Overall, SMI is a multi-million dollar project currently scheduled for completion in 2003.

LMS is crucial to the successful resolution of several management challenges related to the Agency's loan programs. Specifically, it should help to ensure consistent application of guarantee purchase requirements, improve loan monitoring and lender oversight, and promote the safe operation of Small Business Lending Companies. Currently, SBA's system to capture and summarize information needed to provide the Agency with data for loan monitoring is not as efficient and technologically advanced as it could be. Under LMS, information such as loan volume, origination quality, delinquency rates, default rates, and recoveries should be more readily available and accurate, and provide for more sophisticated analyses. LMS should provide information that will allow SBA to more easily identify lenders with potential problems and provide better oversight to ensure that lenders' actions are in the best interest of the Government.

JAAMS is intended to provide SBA with an integrated financial management system and help the Agency address a number of other financial and administrative challenges. For example, flaws in SBA's financial reporting system, which include the lack of an integrated standard general ledger, have previously been reported as a material weakness. JAAMS should allow for the integration of program and accounting data to provide more timely and accurate financial reports and enhance program analysis. It should also provide for increased accountability over transactions and compliance with the Federal financial management system requirements.

SMI is also intended to address a previously reported management challenge-that SBA needs to develop and implement a program-based cost accounting system. Over the past 4 years, SBA has developed a cost allocation system, based on employee time surveys and financial data from its accounting system, to help determine the cost of major programs and activities. With enhancements planned under SMI, this system should further improve the Agency's ability to conduct detailed program evaluations and measure efficiency, thereby enhancing programmatic decision-making and resource allocations.

Action Needed

SBA needs to implement sound planning and system development/acquisition procedures. A May 2000 General Accounting Office (GAO) report contained the following recommendations to accomplish this:

- Adopt policies and procedures and define processes for investment selection, control, and evaluation;

- Develop a systematic process for architecture development, establish policies and procedures for architecture maintenance, and set a target date for implementation of the maintenance process;

- Develop a plan to institutionalize and enforce Agency-wide use of SBA's Systems Development Methodology (SDM); and

- Establish policies, procedures, and processes for software development and software acquisition and develop a mechanism to enforce them. These policies, procedures, and processes need to address areas such as requirements management, project planning, project tracking and oversight, software quality assurance, configuration management, acquisition planning, solicitation, contract tracking and oversight, product evaluation, and transition to support.

Action Taken

- SBA has taken steps to strengthen and institutionalize its "Information Technology (IT) Planning and Investment Control Process," to improve selection and control of IT projects in a portfolio environment, and to improve formulation of the IT budget. This should help the Agency meet the requirements of the Clinger Cohen Information Technology Management Reform Act.

- To address past criticisms and help support its strategic goals, the Office of the Chief Information Officer recently developed and has started implementing SDM. SDM is a set of procedures and quality controls intended to reduce risks in the development of new information systems and ensure that new systems function as intended by owners and stakeholders.

- SBA has included development and implementation of a cost accounting system in its SMI plans. In addition, SBA has developed a cost allocation methodology to assign costs to each major program, activity, and function.

- The Agency has completed an IT architecture document and established procedures for its maintenance.

- SBA has developed configuration management procedures for SMI projects.

Reports

SBA OIG, *SBA's FY 1999 Financial Statements*, Audit Report #0-06, February 29, 2000.

SBA OIG, *SBA's FY 1999 Financial Statements-Management Letter, Audit* Report #0-13, March 29, 2000.

SBA OIG, *SBA's Proposed Systems Development Methodology*, Audit Report #0-15, March 30, 2000.

SBA OIG, *SBA's Financial Reporting Process*, Audit Report #0-20, July 11, 2000.

GAO, *Information Technology Management: SBA Needs to Establish Policies and Procedures for Key IT Processes*, GAO/AIMD-00-170, May 31, 2000.

GAO, *SBA Loan Monitoring System: Substantial Progress Yet Key Risks and Challenges Remain*, GAO/AIMD-00-124, April 25, 2000.

GAO, *Financial Management: Status of Financial Management Issues at the Small Business Administration*, GAO/AIMD-00-263, August, 29, 2000.

Significant Open Recommendations

- SBA has accepted all significant recommendations in this area. Continued efforts, however, are needed to implement them into day-to-day operations. The recommendations most relevant to SMI as a whole are detailed above under **Action Needed**.

Challenge 3. Information systems security needs improvement.

Summary. *SBA operations depend heavily on the Agency's information systems, and the security of those systems is critical. The Agency has made a substantial commitment of resources for enhancing computer security, providing technical staff support, and developing security training. SBA needs to fully implement its Agency-wide systems security program, to include assessing risks, establishing and updating policies and controls, promoting awareness, and evaluating security effectiveness.*

SBA's programs and activities depend heavily on computerized systems. The Agency is engaged in several initiatives, such as paperless loan applications, use of digital signatures, expanded Internet access, and electronic data interchange, that will increase its reliance on such systems. While information technology can result in a number of benefits, such as information being processed quickly and communicated almost instantaneously, it also increases the risk of fraud, inappropriate disclosure of sensitive data, and disruption of critical operations and services.

In 1997, the General Accounting Office (GAO) designated information security as a Government-wide high risk area because of growing evidence indicating that controls over computerized operations were not effective and risks were increasing. The FY 1999 audit of SBA's financial statements and an audit of the Agency's implementation of Presidential Decision Directive (PDD) 63 disclosed that while SBA has made significant progress in this area, improvements are still needed. Specifically, improvements are needed in the areas of entity-wide security program and planning, access controls, application software development and program change controls, system software, segregation of duties, and service continuity.

Action Needed

SBA needs to fully implement and maintain an ongoing information security program aimed at understanding and reducing its information security risks. This program should include assessing risks, implementing appropriate policies and controls, promoting awareness, and monitoring and evaluating policy and control effectiveness.

Action Taken

Examples of actions SBA has taken since 1999 include:

- Committed over $1.2 million dollars in personnel and contract support to enhance the Agency's computer security program;

- Increased the number of authorized personnel for IT security from two to nine, and acquired additional contractor support to conduct security reviews;

- Issued an updated computer security policy document that incorporated security policies covering the latest Agency technology, including client servers, e-mail, and the Internet;

- Documented the computer security program and produced guidance documents and templates for the performance of computer security functions within the Agency;

- Completed certification and accreditation reviews for eight of the most sensitive systems;

- Developed a security training program; and

- Continued work on developing critical infrastructure protection and security plans required by PDDs 63 and 67.

Reports

SBA OIG, *Audit of SBA's FY 1999 Financial Statements-Information Systems Controls,* Audit Report #0-16, April 25, 2000.

GAO, *Information Technology Management-SBA Needs to Establish Policies and Procedures for Key IT Processes,* GAO/AIMD-00-170, May 31, 2000.

SBA OIG, *SBA's Planning and Assessment for Implementing Presidential Decision Directive 63*, Audit Report #0-27, September 26, 2000.

Significant Open Recommendations

- The audit of *SBA's FY 1999 Financial Statements-Information Systems Controls* included a number of specific recommendations aimed at implementing an Agency-wide information systems security program. As described above under **Action Taken,** the Agency has taken a number of key steps in that direction. Because of the long-term nature of implementing a security program, final action on some of the recommendations is not scheduled until 2001, and further audit work will be performed to evaluate the Agency's ongoing efforts.

- The following recommendations from SBA's audit on *Planning and Assessment for Implementing Presidential Decision Directive 63* have been accepted, but not yet fully implemented.

  - Perform vulnerability assessments on all critical cyber-based infrastructure.

  - Complete remedial plans for vulnerabilities identified by the risk assessments.

  - Develop a multi-year funding plan.

  - Include infrastructure assurance functions in the strategic planning and performance measurement framework.

Challenge 4. Maximizing program performance requires that SBA fully implement its human capital management strategies.

Summary. *The nature and scope of SBA's work has changed significantly, requiring a different set of skills in the Agency's workforce to maintain productivity. SBA has prepared an analysis that projects future workforce needs, expanded training and candidate development programs, and contracted for a workload and staffing study. The Agency needs to continue to develop its workforce planning, retraining, and other human capital management activities to ensure optimal performance of its employees.*

Managing and investing in human capital has emerged as an important issue throughout the Federal Government. The Comptroller General describes Federal workforce problems as an impending crisis, as well as the "missing link" in efforts to improve performance and accountability. Human capital management is especially important for SBA. Over the last decade, small business practices, products, and needs have been transformed and SBA has made major changes in its delivery of goods and services. For example, SBA now uses public-private partnerships to perform the loan origination, servicing, and liquidation functions that SBA personnel formerly handled. At the same time, SBA has decreased its workforce by more than 20 percent. Now SBA must change the way it manages and uses human capital. The Agency has fully accepted this challenge.

To accomplish its vision of "a modernized SBA" capable of adapting to changes in the economy and small business needs, SBA has determined that it must (1) change its core functions to include business outreach, marketing, and improved partner relationship management–relying more extensively on outsourcing, privatization, streamlining, and re-engineering; (2) improve internal controls and external program oversight; (3) upgrade and modernize its information systems; (4) use the Internet and e-commerce to increase accessibility to customers when and where they need assistance; and (5) prepare its workforce for the future-especially through training and relocation-to put customers first, make effective use of partnerships and technology, and achieve results.

SBA recognizes that workforce transformation is an iterative and continuous process. Under its FY 2001-2006 Strategic Plan goal of “Modernizing the SBA,” a key objective is “investing in our personnel to create a motivated, creative, competent and productive workforce.” Strategies include: (1) improving workforce skills by retraining approximately 1,700 personnel; (2) changing workforce deployment, using some workforce relocation; (3) providing succession planning and leadership training; (4) conducting annual personnel surveys; and (5) improving human resource management and information systems. While SBA has taken steps to better manage its human capital activities, including activities in workforce planning, leadership, talent development, and fostering a performance culture to meet this challenge, more remains to be done in each of these areas.

Action Needed

In July 2000 congressional testimony, the General Accounting Office (GAO) pointed out that SBA has begun to take the steps necessary to better manage its human capital activities, "undertaking various workforce planning activities, including developing competency models and related training for some core functions and realigning and deploying some staff." Nevertheless, GAO concluded that SBA needs to do more, including:

- Completing its efforts to identify the knowledge, skills, abilities, and other characteristics its employees will need to perform successfully in SBA's new business environment;
- Estimating the number of employees that need skills training;
- Developing a succession plan for senior leaders and reinstating candidate development programs for those leaders; and
- Ensuring that employees receive adequate training to perform their jobs well.

Action Taken

SBA reports that it has:

- Issued a comprehensive "Workforce Transformation Plan" that lays out current workforce numbers and skills, and estimates the number of employees who will be needed by types of skills in the future;
- Issued a contract to conduct a workload and staffing analysis of SBA headquarters;
- Provided leadership training to 134 SBA executives and senior managers and trained more than 200 supervisors in leadership competencies;
- Reinstated candidate development programs for executives and district directors for succession planning; and
- Completed competency models for Marketing and Outreach Specialist, and Public Information Officer positions, and trained more than 300 employees in the needed skills.

Reports/Testimony

GAO, *Small Business Administration: Steps Taken to Better Manage its Human Capital, but More Needs to be Done,* GAO/T-GGD/AIMD-00-256, July 20, 2000

Significant Open Recommendations

- No formal recommendations have been made on this issue.

LOAN PROGRAMS

Challenge 5. Field offices do not consistently apply guaranty purchase requirements.

Summary. *OIG audits have shown that SBA field offices do not consistently follow Agency requirements when purchasing guaranties from lenders after loan defaults, resulting in purchases that may not be justified and unnecessary expenditures for the Agency. In response to this concern, SBA reports that it has taken steps to establish a purchase review and follow-up process mechanism, a guaranty repair tracking system, an early warning system, and improved procedures and training. The Agency needs to (1) ensure that it denies liability or reduces the guaranty when a lender fails to comply with SBA requirements and (2) continue to develop a reporting process for guaranty repairs.*

A 1997 OIG audit report on business loan guaranty purchases found that SBA did not consistently apply its procedures when purchasing guaranties. Inappropriate purchase activities may result from unclear guidelines or inconsistent application of these guidelines. In addition, OIG believes that these purchases may occur because of a possible conflict between the competing goals of maintaining good relationships with lenders for the purpose of increasing loan volume and fully or partially denying liability on a guaranty when the lender has not complied with SBA requirements. The 1997 audit, which sampled loans purchased in FY 1995, found 17 of 58 (29 percent) of the decisions either were not supported by sufficient documentation to make an informed decision or resulted in paid claims when information in the file suggested the claim should have been denied or reduced. A statistical projection of the audit results indicated that an estimated $102.9 million in purchases were not supported by sufficient documentation at the time the decision was made, and guaranties totaling up to $16.2 million should not have been honored.

Audit reports issued in FY 2000 on four early defaulted loans showed that lenders did not originate the loans in accordance with SBA requirements or prudent lending practices. The audits found that SBA purchased two of the loan guaranties even though the lenders did not properly evaluate discrepancies in financial information or adequately secure the loan, or had already reimbursed the borrower for ineligible expenses. The audits further showed that the lender for the two other loans did not properly evaluate cash flow, verify equity injection, or obtain support showing that the loan proceeds were used for authorized purposes. The lender withdrew its request for a guaranty purchase on one of the loans and the other loan is being reviewed by SBA.

Action Needed

- Ensure that the Agency denies liability or reduces its payment on the guaranty when a lender has failed to comply with SBA requirements.

- Implement an automated system for tracking circumstances where field offices record guaranties that have been repaired and where lenders have released SBA from guaranty liability when questions exist regarding the appropriateness of a lender's actions.

- Review and update purchase procedures.

Action Taken

The Agency has implemented procedures to improve the guaranty purchase process for the Section 7(a) program and reports that it has taken or plans the following actions.

- The Agency has implemented procedures to review, on a sample basis, 10 percent of all guaranty loan purchases (up to 300 per year) processed by field offices, including loans identified by OIG during lender/loan reviews, or otherwise, as potentially problematic for purchase. This review should improve the guaranty purchase process for the Section 7(a) program, and help to identify areas where revision to existing purchase guidelines is necessary. Of the 71 loans reviewed thus far (purchased between October 1, 1999 through March 30, 2000), the review team found 22 loans requiring further follow-up to determine whether the Agency should have fully or partially denied its liability on the loans because of lender processing, servicing, or liquidation errors or omissions.

- SBA has established a tracking system to follow up on purchase reviews. The tracking system will track purchases where the review teams disagreed with the action of the field office. The reports will show pertinent information about the loan, including the field office and the originating or servicing issue(s) that the review team believes should have precluded a guaranty purchase in part or in total. The system will enable SBA to track the actions and provide trend data for policy changes and staff training.

- SBA has begun development of a Guaranty Repair Tracking System. The system will allow SBA staff to identify issues that may result in an adjustment to SBA's guaranteed percentage of a loan ("repair"), a lender's voluntary release of its guaranty, or a full denial of liability of the Agency's obligation to purchase the loan from a participating lender. The system should enable SBA to track all repairs entered into by Agency staff nationwide, both by SBA field offices and by lenders. In addition, SBA reports that as part of the systems modernization effort, SBA will incorporate more sophisticated technology to collect and analyze data related to purchases. This will include data to track both guaranty repairs and lenders' voluntary releases of guaranties.

- SBA has begun revision of its Standard Operating Procedure (SOP) and the development of a training course. To improve the guaranty purchase process, SBA is revising purchase instructions in its SOP. This is part of the Agency-wide Systems Modernization Initiative (SMI), and will include a complete revision of the loan processing, servicing, and liquidation SOPs. Also as part of SMI, SBA is developing training for SBA staff and participating lenders that will emphasize the requirements of sound guaranty purchase processing.

- SBA has modified the Delinquent Loan Collection System to identify loans where an audit or other review has shown that a lender has an origination or servicing deficiency significant enough to affect the guaranty purchase. According to SBA, the system will identify the type of guaranty issue(s) and display a warning message indicating the loan has an outstanding guaranty issue(s). A cumulative monthly guaranty repair report will be developed to show all loans having an identified guaranty issue or a guaranty purchase problem that was resolved through a repair action. The reports will be used to determine which lenders have high rates of origination or servicing problems affecting guaranty purchases. SBA expects to begin collecting data in the Delinquent Loan Collection System in December 2000.

Reports

SBA OIG, *Business Loan Guarantee Purchases*, Audit Report #7-5-H-011-026, September 30, 1997.

SBA OIG, *Vincent R. Forshan Medical Corporation*, Audit Report #0-12, March 28, 2000.

SBA OIG, *Dixieland Events/TA Mingo Farms*, Audit Report #0-05, February 14, 2000.

SBA OIG, *Roshni Foods*, Audit Report #0-10, April 23, 2000.

SBA OIG, *Stop One Convenience Store #2*, Audit Report #0-17, April 28, 2000.

Significant Open Recommendations

- The 1997 audit report contained some recommendations with which the Agency disagreed. However, the Agency proposed alternative solutions that it is in the process of implementing, as described in the **Actions Taken** above.

Challenge 6. SBA needs to continue improving lender oversight.

Summary: *As SBA becomes increasingly dependent on private lenders to carry out business loan functions, an effective lender oversight program is critical for ensuring that lender activities serve Agency objectives and comply with all rules and procedures. SBA has established an Office of Lender Oversight, completed the second round and started the third round of Preferred Lender Program (PLP) reviews, completed the second cycle of safety and soundness examinations of the non-depository Small Business Lending Companies (SBLCs), and begun development of a comprehensive loan monitoring system. The Agency needs to ensure that all non-PLP lenders are reviewed periodically on a consistent basis, fully implement the loan monitoring system, establish baseline goals and measures for lender processing errors, and compare actual performance to goals.*

Private lenders are performing an increasing percentage of the loan underwriting, servicing, and liquidation functions that were previously performed by SBA staff. To ensure compliance with Agency requirements, SBA should continue to refine its newly designed lender oversight program, increase its ability to identify lenders needing improvements in their performance, and ensure that borrowers comply with the terms of the loan agreement.

A summary OIG audit report on Section 7(a) loan processing issued in 1999 found that lenders did not consistently comply with 22 key processing procedures. Of 240 loans reviewed, 170 procedural non-compliances were noted for 118 loans. The deficiencies involved ineligible purpose of the loan, adverse change in financial condition not reported to SBA, lack of repayment ability, lack of required capital injection, and use of proceeds for an unapproved or ineligible purpose. The audit results showed that 26 loans (11 percent) totaling $7 million had deficiencies that could cause SBA to question part or all of the guaranty if a purchase request were received from a lender. Four of five non-compliances with SBA requirements occurred when SBA had limited or no oversight of lenders' processing and disbursing actions. Increasing lender oversight could reduce the non-compliances. According to SBA guidelines in place at the time, district offices should have visited each lender annually unless a waiver was justified. Out of 147 lenders in our sample, only 44 (30 percent) received field visits by district office personnel during FYs 1996 and 1997.

In July 1998, the General Accounting Office (GAO) reported that in five district offices visited, SBA had not performed an on-site review of about 96 percent of the lenders in the past 5 years. Further, in some cases there was no evidence that lenders who had issued SBA loans for 25 or more years had ever received an on-site review. GAO concluded that SBA had no systematic means, without conducting periodic on-site reviews, to ensure that lenders' actions did not render loans ineligible, uncreditworthy, or uncorrectable, thus increasing the risk of loss to the Agency. Lender monitoring is particularly important as SBA moves from direct involvement in loan approvals to increased reliance on participating lenders to perform loan origination, servicing, and liquidation.

In September 1999, the Farm Credit Administration (FCA) issued a comprehensive summary report that was based on individual examinations of 14 SBLCs. The report included 15 recommendations for improving and strengthening oversight of the SBLC program. SBA concurred with 14 of the recommendations but has not yet implemented the recommendations.

SBA does not currently have a comprehensive system to capture and summarize lender information to provide the Agency with adequate performance measurement data for lender and loan monitoring. Information on loan volume, loan origination, delinquency rates, default rates, and liquidation is not readily available. Comprehensive reporting and analysis of such information in a consistent and integrated manner would allow SBA to better identify lenders with potential problems and provide appropriate oversight to ensure that lenders' actions are in the best interest of the Government.

Action Needed

- Ensure that all non-PLP lenders are reviewed periodically and on a consistent basis, the results are documented, and recommendations are made to correct any problems found.

- Implement a comprehensive loan monitoring system that will enable SBA to better evaluate the quality of a lender's SBA portfolio. Factors to be considered should include loan volume, loan origination, loan seasoning, and delinquency and default rates.

- Establish baseline goals and measures for lender processing errors and periodically compare performance to goals.

- Implement the strategic plan for lender oversight.

Action Taken

- SBA has established an Office of Lender Oversight and recently appointed an Associate Administrator to head it. In October 2000, a draft strategic plan was developed that will serve as a basis for developing a Standard Operating Procedure for lender oversight. SBA is currently working on staffing the office. The PLP Review Branch has been transferred to the Lender Oversight Office. SBA officials stated that Lender Oversight is working with the Office of Field Operations to develop and implement a plan to use teams of district office personnel to assist in conducting PLP compliance reviews to supplement contractor resources. The office plans to generate a Portfolio Management Report and a Lender Benchmark Report. The Portfolio Management Report will be a comprehensive analysis of portfolio trends for each loan program. The Lender Benchmark Report (already in existence for Section 504 Program loans) will track each lender's performance in accordance with specified risk parameters. When the office becomes fully operational, one of the functions will be to monitor loan compliance to assess current risk to SBA's portfolio and individual lenders.

- PLP lenders are reviewed annually by the PLP Review Branch with contractor help. In March 2000, SBA completed a review of the 369 PLP lenders in the second cycle and is currently working on the third cycle of PLP reviews. As of September 30, 2000, SBA had completed approximately 132 PLP reviews in the third cycle. According to SBA, non-PLP lenders are reviewed by the district offices at least once every 3 years, with priority determined by an individual lender's performance. The district offices use the same software application to evaluate non-PLP lenders as is used to evaluate PLP lenders. SBA stated that as of September 30, 2000, the Agency had completed approximately 300 non-PLP lender reviews and is developing a plan to coordinate the oversight of PLP and non-PLP compliance reviews.

- SBA is continuing to conduct Quality Service Reviews (QSRs) of all district office functions. These reviews are designed to ensure that critical program risk areas are reviewed and to inform management of any problems or issues. Another goal of the QSR is to identify "best practices" of the district office being reviewed and share the practice(s) with other district offices. SBA completed 12 reviews in FY 2000.

- SBA has initiated steps to develop and implement a comprehensive loan monitoring system to evaluate lender performance. The system will collect data on lenders such as delinquency default rates, liquidations, loan payments, and loan originations.

- SBA has implemented an examination program for the Agency's 14 Small Business Lending Companies. So far, two full cycles of safety and soundness examinations have been completed.

- SBA modified the PLP certification renewal process to strengthen the process for evaluating lender performance is evaluated in terms of loan origination and processing.

Reports

SBA OIG, *Summary Audit of Section 7(a) Loan Processing*, Audit Report #0-03, January 11, 2000, and eight related district office reports.

SBLC Examination Reports

GAO, *Few Reviews of Guaranteed Lenders Have Been Conducted*, GAO/GGD-98-85, June 11, 1998.

Significant Open Recommendations

- The January 2000 OIG report contains a recommendation that SBA establish baseline goals and measures for all lender processing errors and periodically compare performance to goals. With respect to PLP lenders, the recommendation has been addressed with the implementation of the actions described above. SBA has agreed to take appropriate action to fully implement the recommendation by September 30, 2001.

8(a) BUSINESS DEVELOPMENT

Challenge 7. More participating companies need access to business development and contracts in the 8(a) Business Development program.

Summary. *The bulk of the dollar value of 8(a) Business Development (BD) contracts go to a relatively small number of companies in the program. SBA is participating in a recently formed interagency task force designed to, among other things, improve business development initiatives, including access to contracts. The Agency needs to give greater emphasis to business development assistance and ensure a more equitable distribution of contracting opportunities to program participants.*

The purpose of the 8(a)BD program is to assist eligible small disadvantaged business concerns to compete in the American economy through business development. A small number of 8(a)BD program participants obtain significant contract awards, while others receive little or no contract benefit. This occurs, in part, because SBA has not placed sufficient emphasis on business development activities to enhance the ability of 8(a)BD participants to compete for contracts. In addition, an ever-changing Federal contracting arena, coupled with other socio-economic factors, has created an environment where reengineering of the 8(a)BD program is needed.

The Federal Acquisition Streamlining Act of 1994 streamlined the Federal Government's $200 billion a year acquisition system and dramatically changed the way the Government buys its goods and services. The Federal Government is seeing an increase in larger contracts that often are not suitable for small businesses to perform as prime contractors. Agencies are also using streamlined procurement practices such as multiple award contracts, Government-wide acquisition contracts, Federal supply schedules, and credit card purchases. At the same time, the 8(a)BD program contract mechanisms have not been modernized to successfully work with the new acquisition methods authorized by procurement reform.

During FY 1999, when there were almost 6,000 companies in the 8(a)BD program, 50 percent ($3 billion) of the dollar value of the contracts and modifications went to just 243 (4 percent) of the participants. Each of the top 10 companies (in terms of dollar value of 8(a)BD contracts and modifications) received an average of $56 million in Section 8(a) contracts and modifications in FY 1999, with one company receiving over $119 million. Almost 3,700 Section 8(a) companies were not awarded any contracts or modifications during the same period. Program officials note, however, that the 8(a)BD Program does not guarantee every participating firm will receive a contract during each year of its participation. These officials reported that approximately 70 percent of Section 8(a) firms have received at least one contract during their tenure in the program, which can extend up to 9 years.

Action Needed

- Refocus the 8(a)BD program to emphasize business development, develop criteria defining "business success," and graduate participants once they reach those levels.

- Develop a mechanism that ensures contracting opportunities are more equitably distributed to 8(a)BD program participants.

Action Taken or Planned

- SBA plans to develop methodologies to improve access to contracting opportunities for 8(a)BD firms and provide enhanced business and procurement assistance to 8(a)BD firms. SBA plans to do this by refocusing the role of the district office staff to place their highest priority on helping inform firms about the Federal procurement process, Federal and non-Federal contracting opportunities, and best practices in procurement changes. SBA is planning on sending out a new 8(a)BD Standard Operating Procedure (SOP) to the field during calendar year 2001.

- To address needed reform and achieve major improvement in the results of the 8(a)BD program, the Department of Defense Change Management Center, SBA, and the Office of Management and Budget (OMB) jointly sponsored the formation of a Rapid Improvement Team (RIT). RIT, comprised of key stakeholders and interested staff from SBA, was asked to identify breakthrough opportunities and recommend actions for Federal Government-wide 8(a)BD program improvement. The process began November 1, 2000.

- RIT will focus on the following areas:

  - Section 8(a) company competitiveness;

  - Section 8(a) program eligibility;

  - Section 8(a) contracting process; and

  - Evaluation metrics to determine program success.

- SBA plans to propose several significant changes that it believes will make the 8(a)BD program more acceptable to procuring agencies and less cumbersome to administer. Those changes fall into four broad categories.

  - Reduce cumbersome regulations and administration, and streamline the program so that it is easy for all to use.

  - Reduce or eliminate some unrealistic expectations, and focus on facilitating business development initiatives, including access to Federal agency contracts.

- Reduce the time, effort, and energy spent on firms that are not yet ready for Federal agency contracting, and increase the number of socially/economically disadvantaged firms that are capable of meeting acquisition team needs.

- Reduce or eliminate SBA's role of having sole responsibility for developing firms, and create a Federal Government-wide program coordinated by SBA that leverages all agencies' resources to promote growth of Section 8(a) firms.

- RIT's goals are to make key changes to reinvent the Section 8(a) program quickly and efficiently while maintaining its historical mission to promote the growth of socially and economically disadvantaged small businesses.

Reports

SBA, *FY 1999 Federal Managers Financial Integrity Act (FMFIA) Report to the President and the Congress.*

Significant Open Recommendations

- SBA identified concentration of contracts as a material weakness in its FMFIA report. There are no open OIG recommendations relating to this challenge. RIT will address this challenge using a Government-wide approach that includes OMB and the Department of Defense to address business development, contracting, and eligibility issues for the 8(a)BD program.

Challenge 8. SBA needs clearer standards to determine economic disadvantage.

Summary. *New standards for determining economic disadvantage should be established to effectively measure diminished capital and credit opportunities–the definition included in the law. SBA anticipates issuing procedural guidance on the definition of "economic disadvantage" based on revisions to be made by a new interagency task force (see Challenge 7). The Agency should (1) redefine "economic disadvantage" using objective, quantitative, qualitative, and other criteria that effectively measure capital and credit opportunities, and (2) provide sufficient training to SBA staff responsible for evaluating companies.*

The Small Business Act requires that participants be socially and economically disadvantaged, and defines "economic disadvantage" as "diminished capital and credit opportunities compared to owners of similar businesses that are not disadvantaged." SBA, however, has not adequately determined what constitutes diminished capital and credit opportunities. Section 8(a)(6)(A) of the Small Business Act states that "In determining the degree of diminished credit and capital opportunities, the Administration shall consider, but not be limited to, the assets and net worth of such socially disadvantaged individual[s]." According to SBA regulations, when considering diminished capital and credit opportunities, SBA is to review such factors as personal income, personal net worth, and the fair market value of all assets. SBA is also to compare the financial condition of the company with other small businesses in the same primary industry classification. While SBA obtains information on a number of factors when determining economic disadvantage, such as comparisons with Robert Morris Associates figures for businesses, it relies primarily on the net worth of the individual. Net worth by itself, however, does not show whether an individual has diminished capital and credit opportunities.

SBA regulations allow individuals with a net worth of up to $750,000 (after excluding the equity in their home and 8(a)BD business) to remain in the program and be classified as economically disadvantaged. The $750,000 limit appears to have been set, without the use of empirical data. Further, an SBA review found that many Agency employees did not possess the range of skills required to conduct financial analyses. Participants may therefore receive benefits for which they do not qualify.

According to SBA officials, defining and implementing standards for determining economic disadvantage of the individual has been time-consuming and ineffective in accomplishing its intended goal of ensuring that adequate government resources were afforded to developing firms. Economic disadvantage was always difficult to define and often failed at its task of helping to redirect resources. SBA officials believe that in the post-Federal Acquisition Streamlining Act (FASA)/Federal Acquisition Reform Act (FARA) era, economic disadvantage is dated, ineffective, and largely inapplicable to the essential goal of the 8(a) BD program, which is the development of firms.

Action Needed

- Redefine "economic disadvantage" using objective, quantitative, qualitative, and other criteria that effectively measure capital and credit opportunities.

- Provide sufficient financial and analytical training to business opportunity specialists to enable them to evaluate a company's business profile and competitive potential.

Action Taken or Planned

- SBA added provisions to the regulations to prevent 8(a)BD applicants and participants from transfering assets to family members.

- Annual review procedures were modified and training was provided to SBA field staff.

- As stated in last year's management challenges, the 8(a)BD program assembled a task force to address certain aspects of economic disadvantage. The task force's working committee was to develop recommendations to define "economic disadvantage" by June 30, 2000. While the working committee met weekly and drafted a recommendation and a review guide, the recommendation and review guide were not approved by two of the three offices represented on this committee. The committee no longer meets and the Rapid Improvement Team (RIT) (see RIT in Challenge 7) replaced this activity.

- According to 8(a)BD officials, SBA, the Department of Defense, and the Office of Management and Budget have entered into an agreement whereby a team of Federal agency representatives will identify key issues and make recommendations for improvement in the following areas: (1) making Section 8(a) firms competitive in today's business environment; (2) Section 8(a) program eligibility; (3) the Section 8(a) contracting process; and (4) evaluation metrics to determine program success. Based on the results of the RIT, SBA officials plan to issue draft procedural guidance by September 30, 2001, to ensure an objective and comprehensive review of a Section 8(a) applicant and/or participant's economic status in determining economic disadvantage.

Reports

SBA OIG, *Section 8(a) Program Continuing Eligibility Reviews*, Audit Report #4-3-H-006-021, September 30, 1994.

Significant Open Recommendations

- The September 1994 audit report contained 13 recommendations. Twelve of these recommendations have been resolved and do not require any further action. SBA still needs to modify the criteria used for determining one aspect of economic disadvantage.

Challenge 9. SBA needs to clarify its rules intended to deter 8(a) Business Development participants from passing through procurement activity to non-8(a) Business Development firms.

Summary. *SBA's rules, while restricting the amount of a contract that a Section 8(a) firm may pass through to a non-Section 8(a) firm, allow many non-participating companies to receive substantial financial benefit. SBA intends to include value-added resellers as a legitimate industry under North American Industry Code. SBA needs to tighten the definition of "manufacturing" to preclude the pass-through practice of making only minor modifications to the products of other manufacturers.*

The 8(a) Business Development (BD) program is intended to be used exclusively for business development purposes to help small businesses owned by "socially" <u>and</u> "economically" disadvantaged persons compete on an equal basis in the mainstream of the American economy. To ensure that the business development aspects of the program accrue to its participants, SBA has rules to restrict the amount of a Federal contract that may be performed by a non-participant. Nevertheless, OIG audits have found that many non-8(a)BD companies benefit from the program.

An SBA rule requires that supply contracts be filled either by the manufacturer of the end product or by a company that meets SBA's criteria for a "non-manufacturer." SBA's definition of a manufacturer, however, has been liberally interpreted to allow a small business to make only a minor modification to a finished product manufactured by another company. The product that is manufactured by the non-8(a)BD company is considered to be a "basic material" for the new product. Therefore, the 8(a)BD company is credited with creating a new product. This occurs frequently with computer equipment, and OIG audits have found instances where 80 percent or more of the contract costs are realized by large computer manufacturers. Agency officials stated that a company providing such work should be classified as "Value Added Reseller" instead of "manufacturer." Typically, according to these officials, these procurements require the contractor to "modify" or "add value" to a finished product by enhancing its functionality and features.

A June 1998 OIG audit report recommended that SBA "provide definitive guidance and definitions to evaluate the manufacturing criteria at 13 CFR 121.406." The Agency agreed with the recommendation and stated that it planned to solicit comments from the business community and have specific discussions with businesses in computer-related industries. As of November 2000, SBA still had not clarified the manufacturing criteria.

Action Needed

- Tighten the definition of "manufacturing" to preclude the practice of making only minor modifications to the products of other manufacturers.

Action Taken or Planned

- SBA proposes to define value-added resellers (VARs) as legitimate categories of business. SBA has already published a notice in the Federal Register seeking comment on value-added resellers. The 8(a)BD program will use this information and work with the Office of Size Standards to develop an appropriate size and category for value-added resellers.

- A notice providing guidance to the field on the practice of making minor modifications to the products of others was to have been issued by June 30, 2000. While program officials have drafted various versions of this notice, the notice has not been issued because it was not clear. Program officials plan on requesting further public comments and determining how these concerns can be resolved.

Reports

SBA OIG, *Audit of the Administration of the Section 8(a) Program Work Performance Requirements*, Audit Report #3-2-C-002-033, March 31, 1993.

SBA OIG, *Audit of the National Oceanic and Atmospheric Administration Computer Workstation Contract*, Audit Report #8-7-002-017, June 18, 1998.

Significant Open Recommendations

- The 1998 report recommendation to provide specific guidance and definitions to evaluate manufacturing criteria has not been implemented. While 8(a)BD program officials have developed various drafts of this guidance, they have been unable to obtain consensus within the Agency as to what the guidance and definitions should include.

FRAUD DETERRENCE AND DETECTION

Challenge 10. Preventing loan fraud requires additional measures, including the necessary legislative authority and funding.

Summary. *Fraud in the business loan program could be reduced by obtaining criminal background information on prospective borrowers and on loan packagers and other for-fee agents. SBA submitted a proposal for the legislation necessary to conduct the background checks, but it was excluded from the reauthorization bill by the congressional conference committee. The Agency needs to resubmit the legislative proposal, establish a loan agent registration process, and track loan agent association with individual loans.*

Obtaining additional background information from loan agents and business loan borrowers could reduce the incidence of fraudulent loans. While the fraud identified thus far is a small percentage of SBA's total portfolio, the dollar amounts are significant.

A. <u>Loan Agents</u>: Loan agents provide referral and loan application services to prospective borrowers or lenders for a fee. Some agents, particularly loan packagers, have been involved in a variety of fraudulent schemes, such as submitting false tax returns or other financial data, charging the borrower excessive fees, using fictitious names on SBA forms, exaggerating their ability to obtain loan approval, acting in illegal collusion with officials of lending institutions, conspiring with borrowers to submit false loan packages, and performing other illegal acts. These schemes, which have been copied from one fraudulent agent to another, have resulted in borrower defaults that in turn caused loan purchases by SBA and, ultimately, losses to the taxpayers.

Over the almost 5 years ending October 31, 2000, in the business loan program, OIG has initiated criminal investigations involving approximately $90 million in loan applications handled by 18 loan agents. There are more than 170 potential individual subjects of these investigations. Allegations involving loan agents continue to be reported to OIG. Moreover, because the Internet allows ready access to a national audience, dishonest loan agents can expand the scope of their fraudulent activities. At the same time, the Agency may not have adequate staff to monitor loan agent activity.

A March 1998 OIG inspection report identified efficient ways to reduce fraud by loan packagers and other loan agents. Criminal background checks should be conducted on all loan agents, and legislation is needed to enable SBA to use social security numbers for background checks. If able to conduct criminal background checks on loan agents, SBA would have access to information on prior criminal activity which could indicate an individual's propensity to engage in fraudulent activities.

In addition, SBA and OIG have agreed that it would be helpful if the Agency maintained a database linking loans to individual packagers. With such data available on an automated basis, when SBA identifies a circumstance of potential fraud, the Agency would be able to identify other loans packaged by the same individual and thus would be able to more readily locate other loans where similar fraud may have occurred. Therefore, as part of the Agency's systems modernization effort, data elements will be included that will identify any packager involved in a loan application.

Action Needed

- Submit a legislative proposal that (1) requires all loan agents to provide SBA with the information necessary to conduct criminal background checks, including social security numbers, and (2) authorizes SBA to conduct criminal background checks on loan agents.

- Identify all loan agents through a registration process and track their association with individual loans. Registration includes maintaining identifying data and background information on loan agents. However, registration does not imply Agency endorsement.

Action Taken

- SBA submitted a legislative proposal which the Senate Small Business Committee voted to include in the SBA reauthorization bill for FY 2001. The conference committee, however, voted out the House version that did not contain the proposal. OIG will recommend that the proposal be resubmitted for the FY 2002 legislative cycle.

- The establishment of a loan agent tracking system is tied to the development of a Partner Information Management System (PIMS). PIMS is to be incorporated into the loan monitoring system of the Systems Modernization Initiative. The first phase of PIMS was completed by June 30, 2000. SBA Form 159, which contains information on loan agents, is being revised to clarify the requirements for agents to notify SBA of their loan participation. If the necessary legislation is enacted, the form will be further revised to include additional loan agent identification data.

- SBA expects the loan agent criminal background check system to be operational six months after the passage of the proposed legislation if adequate staff resources are available.

Report

SBA OIG, *Loan Agents and the Section 7(a) Program*, Inspection Report #98-03-01, March 31, 1998.

Significant Open Recommendations

- Final action has not been completed because of the lack of statutory authority.

B. <u>Borrowers in Business Loan Programs</u>: OIG work has shown that borrowers who do not disclose their criminal histories have higher rates of default on SBA loans than those who either disclose their records or have no criminal histories. SBA currently performs name checks to help identify individuals with criminal histories but does not have sufficient statutory authority to perform full criminal background checks on a routine basis. As a result, the Agency cannot always identify individuals with criminal histories and this may result in higher losses to SBA.

Past OIG studies have revealed problems with the accuracy of the criminal history information provided by loan applicants on SBA Form 912, *Statement of Personal History*. To determine the extent of the problem, OIG initiated proactive investigations called Operations Cleansweep and Cleansweep II. Operation Cleansweep showed that almost 12 percent of the defaulted loans involved borrowers who failed to disclose their criminal records. A number of audits have also documented misrepresentation by borrowers of their criminal histories. Most recently, an audit of 240 loans found that eight percent of the 429 borrowers failed to disclose their criminal records.

After Cleansweep II, OIG estimated, based on a lending level of about $11 billion per year, that the potential loss to the Government stemming from these false certifications could exceed $27 million. To avoid significant losses, criminal background checks are needed on all applicants.

Both Congress and SBA’s Administrator have expressed support for a more rigorous check of an applicant's criminal history. The Small Business Reauthorization Act of 1997 (Public Law 105-135) authorized an expanded check on criminal histories of loan applicants. Subtitle D – Miscellaneous Provisions, Section 231, Subsection B, Background Checks, states that

> Prior to the approval of any loan made pursuant to this subsection . . . the Administrator **may** verify the applicant’s criminal background, or lack thereof, through the best available means, including, **if possible**, use of the NCIC computer system at the Federal Bureau of Investigation [emphasis added].

While useful, the law does not **require** a criminal background check on every applicant. Unless an agency is granted a Special Purpose Code (SPC) allowing access for administrative purposes, the Federal Bureau of Investigation's National Crime Information Center can be used to check on an applicant's criminal history only in support of a criminal investigation. To obtain an SPC, the requesting agency must have a legislative requirement. The language contained in Public Law 105-135 does not meet this test.

Verification of the criminal history of each business loan applicant would allow SBA to: (1) detect fraudulent applications early in the process, so they may be referred for appropriate criminal and/or civil action; (2) reduce the Government's losses by preventing fraudulent loans from being disbursed; and (3) provide a heightened level of deterrence through increased enforcement actions. OIG believes there is no more effective or efficient method available to achieve these goals without seriously disrupting the flow of the loan process. OIG estimates that the start-up cost for initiating such a verification program would be approximately $1 million, and processing such requests could be done in a manner that would minimize loan processing delays.

Action Needed

- Legislation authorizing SBA to conduct criminal background checks on all business loan applicants.

- Sufficient funding to permit OIG to perform background checks on all business loan applicants in a timely manner.

Action Taken

- The Senate Small Business Committee voted to include the legislative proposal in the SBA reauthorization bill for 2001. The conference committee, however, voted out the House version of the bill that did not contain the proposal. OIG intends to resubmit this legislative proposal for the FY 2002 legislative cycle.

- The $1.0 million requested for borrower background checks was not included in the current budget package. OIG will recommend that the request be included in SBA's FY 2002 budget submission.

Reports

SBA OIG, *Fraud Detection in SBA Programs,* Inspection Report #97-11-01, November 24, 1997.

SBA OIG, *7(a) Loan Processing in the Atlanta District Office*, Audit Report #87F019014, May 13, 1998.

SBA OIG, *7(a) Loan Processing in the Buffalo District Office*, Audit Report #87F019018, July 8, 1998.

SBA OIG, 7(a) Loan Processing in the New Jersey District Office, Audit Report #88F003019, July 13, 1998.

SBA OIG, 7(a) Loan Processing in the Madison District Office, Audit Report #87F020022, July 22, 1998.

SBA OIG, *7(a) Loan Processing in the Los Angeles District Office,* Audit Report #88F002028, September 30, 1998.

SBA OIG, 7(a) Loan Processing in the Colorado District Office, Audit Report #9-05, February 22, 1999.

SBA OIG, 7(a) Loan Processing in the North Carolina District Office, Audit Report #9-04, February 10, 1999.

SBA OIG, 7(a) Loan Processing in the Kansas City District Office, Audit Report #9-16, August 4, 1999.

SBA OIG, *Operation Cleansweep Memorandum*, August 21, 1996.

Significant Open Recommendations

- Final action has not been completed because of the lack of statutory authority.