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

December 20, 2000

TO: Janet A. Tasker
Associate Administrator
Office of Lender Oversight

FROM: Mary Jeanne R. Martz
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SUBJECT: Advisory Memorandum:
***District Office Perspectives on SBA's Preferred Lenders Program Review Process (00-12-01)***

The Office of Inspector General (OIG) conducted this survey to obtain the views of the district officials on the Preferred Lenders Program (PLP) review process. The results will be considered in an OIG audit of the PLP program that is currently under way. We are providing you with this summary because we thought you might be interested in the perspectives of the field offices on the review process, which is now under your purview.

The survey was conducted during August-September 2000, and 54 of the district offices responded (approximately 80 percent). The survey instrument and the response tabulation for each question are presented in Appendix A.

Please note that the opinions expressed in this memorandum are those of the district office respondents only. They do not necessarily represent the view of OIG, and we have not added perspectives other than those expressed by the survey respondents. If you have any questions, please contact Mark Taylor at 205-6679.

## Background on the Preferred Lenders Program Review Process

The PLP program delegates to participating lenders the authority to underwrite Small Business Administration (SBA) loans subject only to the Agency's eligibility review. While such delegation of authority has freed SBA staff from many of their former responsibilities for underwriting, closing and servicing loans, it has also increased the Agency's need for prudent oversight of these lending institutions. Toward this end, a PLP review process was created in 1998, with teams staffed by a mix of SBA employees and contractors, to periodically review preferred lenders. Review teams meet with lender managers, analyze lending policies and internal controls, and examine case files.

The PLP review process has been considered as a possible model for oversight of regular and certified lenders.[1]

## **Survey Results**

I. Familiarity and Satisfaction with the PLP Review Process

Eighty-nine percent of the respondents considered themselves “fairly knowledgeable” or “very knowledgeable” about the PLP review process. The primary sources for this knowledge were Standard Operating Procedures (SOPs) and Procedural Notices, followed closely by PLP lenders, PLP review officials in Kansas City, and training provided by SBA on the PLP review process. Other sources included copies of PLP reviews, district office staff, their own participation in one or more PLP reviews, and discussions with other district directors.

Over half of the district directors[2] were either “slightly dissatisfied” or “very dissatisfied” with the current PLP review process, and nearly forty percent reported being “fairly satisfied” or “very satisfied.” As revealed in various comments, much of the dissatisfaction stems from the lack of participation by district offices and the high cost of the reviews, particularly for small volume lenders and locally owned banks. One district director noted the particular burden this fee[3] represents for a small, geographically-limited PLP lender that wants to make SBA loans a significant part of its lending strategy. Similarly, another reported that “a $5,000 fee to a small, community-based bank can be more significant to them than a $25,000 fee is to [a large lender].” A third respondent made the point that “each time we increase the cost for our participant lenders, the attractiveness of our programs decreases, banks utilize the program less frequently, costs are transferred to the small businesses through higher interest rates, and we restrict access to capital.” This concern about the cost of the reviews was also evident in responses to a question about lender feedback, where the most frequently checked response was that the review process “is too expensive.” This exceeded the second most frequently checked response (“serves an appropriate purpose”) by a more than two-to-one margin.

II. Scope of the PLP Review Process

Under the current review process, loan files equal to 20 percent of a lender’s annual PLP loan production (up to a maximum of 50 loans), are randomly selected for examination. It is largely a compliance review in which loan files are checked for certain documentation. Seven respondents commented that these reviews do not examine a

[1] With “regular” lenders, SBA analyzes a borrower’s credit factors and decides on the loan’s guarantee. Under the Certified Lenders Program, lenders are authorized to analyze a borrower’s credit factors, but the loan must receive SBA approval before being guaranteed. Under the Preferred Lenders Program, lenders are authorized to analyze a borrower’s credit factors and make the loan guarantee without SBA approval.
[2] Most of the respondents were district directors, but in some cases surveys were completed by other district officials.
[3] The lender fee is based on a sliding scale that corresponds to lender categories based on the number of PLP loans approved for the lender during the previous fiscal year.

sufficiently large sample of loans or, for those loans they do examine, often report deficiencies of a mostly superficial or non-material nature. One district director noted that the size and scope of the reviews is too narrow and concerned with "dotting I's and crossing T's as opposed to risk management." Another believed the review process is inadequate because "it does not really review the credit and soundness of a loan, nor the credit underwriting of the loan." A third respondent echoed these comments by noting that "the scope of the review (i.e., checklist items) does not provide for an adequate assessment on whether the Government's interests are adequately protected." Other comments made the point that some review questions, particularly those on servicing and liquidation, need to be improved to better assess the risks to taxpayers.

Thirty-three percent of the respondents recommended that the review process should include a more thorough review of credit underwriting, while thirty-one percent believed that it should be left as it is. Only eleven percent stated that a review of PLP lender safety and soundness should be added. [4] This may be because, as one respondent noted, bank regulators already perform periodic safety and soundness reviews and it would be duplicative for SBA to perform a similar review. One district director did comment, however, that he believed it important for reviewers to take a comprehensive look at all the lender's statistical ratios, such as those calculated from numbers on the lender's balance sheet, along with the items on the compliance checklist.

Other comments reflected what some perceived as too much emphasis in the reviews on technical compliance, paperwork omissions, and other items considered relatively insignificant, and not enough emphasis on assessing the quality of loan processing, servicing and liquidation. One district director noted that many items on the compliance checklist would not result in a loss to SBA if not performed. Other items, however, are clearly more important and should receive greater weight, such as an infraction that could result in the loss of all or part of the Agency's guarantee.

## III. Composition and Training of PLP Review Teams

Under the current review process, PLP lenders are reviewed by teams consisting of contract reviewers and SBA employees from the Kansas City PLP Review Branch. If district office personnel were to be assigned this responsibility, however, the strong consensus (88 percent) among survey respondents was that the most efficient way to make such assignments would be based on geographical proximity to PLP lenders. District officials were evenly divided, however, on whether the reviews should be conducted by district office personnel only, or by a combination of contract reviewers and district office personnel. Only four percent of the respondents believed that contract reviewers reporting to the Review Branch should conduct them, as with the current system. When asked to identify the three most important skills or types of training PLP reviewers should have, they chose (1) loan officer experience, (2) lender relationship skills, and (3) on-site PLP review training.

[4] A post-inspection follow-up found discrepancies in these numbers in the original report. While they did not change the conclusions of the survey, they are now correct.

## IV. Possible Conflict Between Marketing and Oversight Responsibilities

Districts market SBA programs to lenders and attaining district lending goals depends on those lenders making SBA-guaranteed loans. Oversight, however, involves holding these lenders accountable for the decisions they make and the documentation maintained to support those decisions. By a large margin, the district officials believed there is "little significance" (49 percent) or "no significance" (40 percent) to the problem of a possible conflict of interest resulting from district office personnel conducting the PLP reviews of lenders within their districts. There were numerous comments supporting the professionalism of SBA field staff and their ability to separate marketing and oversight responsibilities and conduct an unbiased review. One respondent noted that it is in the district office staff's best interests to be concerned with the performance of their lenders and to conduct a professional review that may determine problem areas and recommend appropriate changes in lender policy. Another commented that the supposed "conflict of interest" would be no greater than that of district office staff conducting, as they do now, reviews of *non*-PLP lenders with whom they have a relationship.

## V. Perceived Advantages to Greater District Office Participation

Twenty-four respondents pointed out the advantages of greater district office participation in the PLP review process, particularly if a combination of outside contractors and district office staff conducts the reviews. One district official suggested that reviews of local PLP lenders should be done by the cognizant district office, while reviews of national PLP lenders operating in a particular district should be conducted by a combination of contractors and district office staff. The district official further noted that such an arrangement would likely reduce review costs yet retain the advantages of objectivity and standardization that come with having outside contractors leading the reviews. Several survey respondents commented that placing impartial contractors on the team offers consistency and uniformity in the application of the reviews, a valid concern when administering a review process of many diverse lenders nationwide.

Seven district officials asserted that having familiar district office personnel as part of a review team can help maintain the relationship with a local lender. Such personnel are more knowledgeable about area economic conditions and likely to have a better understanding of a particular lender's practices after what is often many years of relationship-building. As one district director put it, district offices "have a marriage, not a one-night stand" with their local lenders. District office staffers may have a better understanding of SBA policies and procedures than outside contractors and can interject some qualitative judgment into the compliance process. In the words of one respondent, the staff can look beyond the current review format's "cookie cutter approach" to the training and background of the individuals originating PLP loans. Amplifying these comments, another district director noted that the contractors have no SBA experience. Several respondents commented that review teams need people who have experience in making, servicing, and liquidating SBA loans. One respondent observed that district office staff have such experience and can offer insights into what their PLP lenders are doing and where to look for particular vulnerabilities.

## VI. PLP Review Scheduling and Team Assignments

Nearly two-thirds of the respondents believed that district offices should be given the authority to assign their personnel to PLP reviews teams, and various comments reflected their reasons. One respondent noted that either the district director or associate district director for economic development is the best qualified to designate staff based on their technical expertise and communications skills. These officials also know the work flows and scheduling requirements of their offices, and this puts them in the best position to make the assignments. Another respondent noted the multiple priorities that district offices must weigh, but giving those offices the autonomy to schedule reviews with the appropriate field personnel would help ensure that the reviews "get maximum attention and do not conflict with other priorities and district office functions/events."

On the question regarding who should have the authority to schedule PLP reviews, opinions differed. Thirty-one percent believed such authority should lie with the district offices, while an equal percentage said it should lie with the PLP Review Branch in Kansas City. Twenty-one percent believed such authority should lie with the Office of Capital Access/Office of Lender Oversight. Rather than the calendar dictating the scheduling of a review, one district director suggested that SBA adopt an approach like that of the non-PLP lender review process, whereby the timing of reviews is predicated upon portfolio performance. Similarly, another respondent suggested that the reviews be scheduled based on "early warning signs" rather than having the review frequency dependent on a seemingly arbitrary timeframe. Still a third noted that PLP reviews under the current process are "too frequent for our better lenders and not frequent enough for our poorer lenders."

When asked about the criteria that SBA should primarily use as a basis for its decision to renew a lender's PLP status, approximately 55 percent of the respondents checked "a system with all of the above [PLP review ratings, lender performance statistics, and total PLP loan volume] having equal weight." Another 25 percent thought these three items were indeed the best criteria for making PLP renewal decisions, but recommended that they not have equal weight.

## VII. Perceived Importance and Uses of PLP Reviews

Despite certain criticisms of the current PLP review process, particularly about the lack of district office participation and the cost of the contractor-led reviews, 57 percent of respondents believed the reviews were "fairly important" and 28 percent believed they were "very important." Only 15 percent thought they were "not very important." The most frequent uses of the PLP review ratings were to identify training needs and to renew or expand lenders' PLP status. Some respondents, however, indicated that nothing ever seems to happen as a result of a review, with one commenting that "there appears to be no teeth to the process." Indeed, 89 percent of respondents indicated that they were not aware of any lender's PLP status being terminated as a result of the review rating. Many district officials would apparently support such sanctions, for when asked what should be done to better protect the Government's interests, the most frequently checked response was to "terminate lenders with consecutive 'minimal in compliance' or 'not in compliance' review ratings." One respondent suggested that a lender's PLP status should be suspended or not renewed if its currency rate is under 90 percent or its repurchase rate is over five percent. Another suggested that PLP lenders be required to fund a loss reserve in the event of guarantee repairs or denials, with the reserve amount dependent on the size of their PLP portfolio and their PLP repurchase rate.

When questioned regarding whether SBA's oversight of the PLP lenders adequately protects the Government's interests, 55 percent answered "yes," while 45 percent answered 'no." Responses were also fairly evenly divided as to who is the main beneficiary of the PLP reviews, with 30 percent checking "PLP lenders" and 28 percent checking "SBA headquarters." Thirty-three percent checked "Other," writing in such comments as "all of the above" [PLP lenders, district offices, SBA headquarters], "everyone," and "the Agency and the taxpayers."

## VIII. Conclusions

When asked if they believe SBA is "going in the right direction with the PLP review process," more than three-quarters of survey respondents answered affirmatively. Several qualified their answer, however, by noting they were satisfied the Agency was going in the right direction *only* if that direction was to give more responsibility for PLP review to the district offices. It was evident from their responses that giving field staff more input into the reviews, while also making the process more substantive, less compliance checklist-oriented, and less costly, would improve district office satisfaction with the process. Survey results further indicated that district officials believed PLP oversight could be strengthened by having the review process more thoroughly examine a lender's credit underwriting practices and procedures for loan servicing and liquidation. Finally, most of the respondents believe the marketing of SBA loan programs to the Agency's preferred lenders would not interfere with the district offices' ability to maintain their objectivity in conducting fair and impartial reviews of those lenders.

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