MEMORANDUM REPORT
SURVEY OF RISK MANAGEMENT BY INDUSTRY CODE

Audit Report Number 4-37

August 11, 2004

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.

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

AUDIT REPORT
Issue Date: August 11, 2004
Number: 4-37

To: Janet Tasker
Associate Administrator, Office of Lender Oversight

From: Robert G. Seabrooks [FOIA Ex. 6]
Assistant Inspector General for Auditing

Subject: Memorandum Report - Survey of Risk Management by Industry Code

Attached is a copy of the subject report. The report contains one finding and one recommendation. You agreed with the recommendation and provided comments concerning portions of the report. As a result of your comments, we modified certain passages in the report. A written evaluation of your comments is included as part of the report and your comments have been included as an attachment.

The finding in the report is the conclusion of the Office of Inspector General's Auditing Division. The finding and recommendation are subject to your review and corrective action in accordance with existing Agency procedures for audit follow-up and resolution.

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

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

Any questions you may have regarding this report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-[FOIA Ex. 2].

Attachments

INTRODUCTION

The purpose of this memorandum report is to provide you with the results of our survey of SBA's risk management efforts using industry codes. We initiated a survey to determine if SBA's procedures identify and control the level of financial risk posed by loans to various types of businesses.

BACKGROUND

The Small Business Administration (SBA) is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of Government-guarantied loans. To be eligible for the Section 7(a) loan program, an applicant must be a small business. Small businesses are entities that meet the size standards for their industries as designated by the applicable industry codes contained in Title 13 of the Code of Federal Regulations, Part 121.201.

Prior to October 2000, SBA used the four-digit Standard Industry Classification (SIC) codes to classify each loan. This coding system was developed to facilitate the collection, tabulation, presentation, and analysis of data relating to establishments and to promote uniformity and comparability in the presentation of statistical data. In October 2000, SBA adopted the North American Industry Classification System (NAICS) codes into its table of small business size standards. Both the SIC and the NAICS codes and other data are reported to SBA by the lender for each loan and maintained in SBA's loan accounting system database. The database also contains information about each loan's status, such as whether the loan is current, paid-in-full, or charged off, the borrower's gender and ethnicity, the lender, the use of proceeds, and the responsible district office. The data can be sorted and analyzed to identify trends and other details about the loan portfolio.

The Office of Lender Oversight (OLO) has responsibility for monitoring Section 7(a) business loans to identify and analyze risk. This is accomplished through lender reviews and analysis of lender and loan data. The Office of Financial Assistance monitors lenders based on field office input and reviews of requests for guaranty purchases of defaulted loans. The SBA share of outstanding balances for 7(a) loans in the portfolio is $28.7 billion as of January 31, 2004.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our survey was to determine if SBA's procedures identify and control the level of financial risk posed by loans made under each SIC/NAICS code. At our request, SBA's Office of the Chief Information Officer extracted from SBA's loan accounting system a special listing of 317,242 loans - all Section 7(a) loans approved October 1, 1996, through June 9, 2003. We eliminated those loans that were cancelled or committed, which resulted in an analytical base of 257,354 loans or 81 percent of the loans originally provided to us with a gross loan amount of $55,575,204,455. For analysis purposes, we segregated the analytical base into three groups. The first group included 172,117 loans with valid SIC codes. The second group included 84,936 loans with both SIC and NAICS codes. The SIC codes for these loans did not appear to be valid (they were 9999 or 0), so we used the NAICS codes. The third group consisted of 301 loans that had SIC codes that also appeared not to be valid (they were 9999 or 0) and did not have NAICS codes. The 301 loans were not used in our analyses.

Interactive Data Extraction Analysis software was used to analyze the data for each group of loans. Verification fieldwork was conducted in Atlanta, GA; Fresno, CA; and Little Rock, AR during the period May 2003 through September 2003. The survey was performed in accordance with generally accepted Government Auditing Standards.

Government Auditing Standards require that the validity and reliability of computer-processed data be tested when that data is significant to the audit results.[1] Data are reliable when they are complete, accurate, and the results meet intended purposes and are not subject to inappropriate alteration. Reliability does not mean that computer-processed data are error-free. We assessed the validity and reliability of selected data elements in the loan accounting system.[2]

Using a statistical sample of 233 loans from the universe, we traced the selected data elements to source documents to determine data accuracy and completeness. We identified an error rate of 5.46 percent and concluded that the data were sufficiently reliable for the purposes of our survey work.

[1] U.S. General Accounting Office, Government Auditing Standards, GAO/OCG-94-4 (June 1994), paragraph 6.62.
[2] A data element is a unit of information with definable parameters (for example, a social security number) sometimes referred to as a data variable of a data field.

RESULTS OF SURVEY

We concluded that, at the time of our review, SBA did not have procedures to routinely identify and control the level of financial risk by industry code and that this type of analysis would be beneficial. Subsequent to our review, OLO incorporated industry code analysis in its oversight activities. Per OLO, a monthly portfolio analysis report is prepared with tables and charts of data by industry groups and includes data on concentrations and performance metrics by industry. Also, OLO stated that the redesigned risk based review process for on-site examinations includes an analysis of industry concentrations in the lender's portfolio. SBA personnel could not provide evidence that they routinely identified and analyzed financial risk by industry code. We believe that analyzing dollars at risk by industry codes is an appropriate tool to identify trends and potential problem areas deserving management's review.

Industry codes with the greatest concentration of risk

Our analysis identified those industry codes with the largest number and dollar amount of loans at risk[3]. For the 956 SIC codes in our analytical base, the highest level of risk was concentrated in four codes which represented 18 percent of the loans and 24 percent of the dollars. One SIC code, 5812 - eating places, accounted for 12 percent of the loans and 10 percent of the dollars. For the 1,126 NAICS codes, the highest level of risk was concentrated in three codes which represented 12 percent of the loans and 20 percent of the dollars. The following table shows the concentration of risk.

Table 1

Industry Codes with the largest Number of Loans and Dollar Amounts					
Industry Description	**Industry Code**	**No. of Loans Approved**	**% of Population**	**Guaranty Disbursed Gross Amount**	**% of Total Gross Disbursed Amount**
Population	**SIC CODES**	**172,117**	**100**	**$ 38,351,948,813**	**100**
Eating Places	5812	19,822	12	3,883,678,670	10
Grocery Stores	5411	4,736	3	1,237,298,136	3
Hotels and Motels	7011	3,736	2	2,775,355,421	7
Gas Service Stations	5541	3,397	2	1,706,133,373	4
Totals		**10,522**	**18**	**$9,602,465,600**	**24**
Population	**NAICS CODES**	**84,936**	**100**	**$17,223,255,642**	**100**
Restaurants *	722110 722211	7706	9	1,616,700,991	9
Gas Stations with Convenience Stores	447110	1,521	2	869,405,803	5
Hotels and Motels (except Casinos)	721110	1,295	2	1,037,618,966	6
Totals		**13,459**	**12**	**$3,521,725,760**	**20**

* For the purposes of this report, two NAICS codes, 722110 full service restaurants and 72221 limited service restaurants, were combined due to their industry similarity.

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[3] Risk as relates to this report is defined as SBA's loan guarantied amount at the time the loan was disbursed..

Liquidation and charge-off activity by industry code

We analyzed the data to identify those industry codes with the largest dollar amount of charge-off and liquidation activity. We identified the four SIC and the two NAICS codes with the largest dollars in charged-off and liquidation status. These codes represented 27 percent of the charged-off dollars and 31 percent of the liquidation dollars in our analytical base. With one exception, each industry code's percentage of the total dollars charged off or in liquidation exceeded the code's percentage of the total dollars disbursed in the analytical base. We noted that each of the NAICS codes was related to one of the SIC codes, e.g., SIC code 5812 – eating places and NAICS codes 722110 and 722211 – full and limited service restaurants.

Table 2

SIC Codes with the Largest Amount of Charged-Off and Liquidation Dollars

Industry Description	SIC Code	Charged-off Amount	%	No. in Charged-off Status	Amount to Liquidation	%	No. in Liquidation Status
Eating Places	5812	$151,114,845	14	1,640	$277,139,732	13	1,335
Gasoline Service Stations	5541	56,882,357	5	170	179,075,388	8	287
Grocery Stores	5411	46,019,983	4	359	84,725,127	4	291
Hotels and Motels	7011	29,130,167	3	79	146,608,963	7	178
Totals		$283,147,352	27	2,248	$687,549,210	31	2091
Population		$1,047,025,219	100	10,496	$2,178,931,922	100	9,637

Table 3

NAICS Codes with the Largest Amount of Charged-Off and Liquidation Dollars

Industry Description	NAICS Code	Charged-off Amount	%	No. in Charged-off Status	Amount to Liquidation	%	No. in Liquidation Status
Full & limited service restaurants	7222110 722211	$ 5,175,414	14	53	$ 55,945,096	13	252
Gas Stations with Convenience Stores	447110	3,429,206	9	8	41,894,367	9	67
Totals		$ 8,604,620	24	61	$ 97,839,463	22	319
Population		$36,267,455	100	386	$ 444,736,587	100	2,104

Risk concentration by field office

We further analyzed the data to determine whether those SIC and NAICS codes with the largest amount of dollars in charge-off or liquidation status were concentrated in particular district offices. We found that one district office, Dallas/Ft. Worth, had the largest percentage of dollars in charged-off status for six industry codes and in liquidation status for five industry codes. The percentage of the total dollars charged off or in liquidation status exceeded the percentage of the total dollars disbursed for this office for each of the six industry codes. We noted that the Houston District Office had the second largest charged-off percentages for three of the six industry codes. As both the Dallas and Houston offices are in Texas, these results may be indicative of a regional condition.

Charge offs

For one SIC code, 5541, about 67 percent of the total dollars charged off were from loans assigned to the Dallas/Ft. Worth District Office. This percentage was three times greater than the percentage of dollars disbursed by this office for this SIC code. For the related NAICS code (447110), 70 percent of the dollars were charged off which was more than six times greater than the percentage of dollars disbursed by this office. The district offices with the next largest amount of charged-off loans for these industry codes were Houston and Minnesota. The percentages of total dollars charged off for these offices were only 3 and 11, respectively.

Table 4

District Offices with the Highest Percentage of Charge-off Activity									
SIC CODE		**Percent of Dollars**			**Percent of Dollars**			**Percent of Dollars**	
	District Office	Disb. *	Charge-Off **	**District Office**	Disb *	Charge-Off **	**District Office**	Disb *	Charge-Off **
5812 eating places	DFW	4	10	Houston	3	5	Los Angeles	3	4
5541 gas stations	DFW	20	67	Houston	8	3	Oklahoma	1	2
5411 grocery stores	DFW	13	23	Houston	5	6	Los Angeles	8	6
7011 Hotels and Motels	DFW	6	19	Richmond	3	8	Colorado	4	6
NAICS CODE									
722110 722211 restaurants	DFW	5	15	Colorado	3	10	St. Louis	1	9
447110 gas stations w/ “C” stores	DFW	11	70	Minnesota	1	11	Houston	4	6

* See Table 1 – Guaranty disbursed gross amount for each industry code.
** See Tables 2 & 3 – Charged-off amount and liquidation amount for each industry code.

Liquidations

For five of the six industry codes, analyses showed a concentration for the percentage of dollars in liquidation at the Dallas/Ft. Worth District Office. For three industry codes, this office had a significantly greater percentage of dollars in liquidation status than the district office with the next largest percentage of dollars in liquidation. Also, for one NAICS code (447110), the percentage of dollars in liquidation for the Dallas/Ft. Worth District Office was almost three times greater than the percentage of dollars disbursed.

Table 5

District Offices with the Highest Percentage of Liquidation Activity									
		Percent of Dollars			**Percent of Dollars**			**Percent of Dollars**	
SIC Code	**District Office**	Disb. *	Liquid. **	**District Office**	Disb. *	Liquid. **	**District Office**	Disb. *	Liquid. **
5541 gas stations	DFW	20	30	Houston	8	10	Michigan	4	6
5411 grocery stores	DFW	13	17	Georgia	7	8	Michigan	2	7
7011 hotel / motels	DFW	6	10	Georgia	4	7	Arizona	3	6
5812 eating places	No district office concentration for this code								
NAICS CODE									
722110 722211 restaurants	DFW	5	7	Santa Ana	4	6	San Antonio	1	6
447110 gas stations w/ "C" stores	DFW	11	30	Houston	4	13	Michigan	8	11

* See Table 1 – Guaranty Disbursed Gross Amount for each industry code.
** See Tables 2 & 3 – Charged-off amount and liquidation amount for each industry code.

Risk concentration by lender

The analysis showed that there was a concentration of risk for one lender for loans attributed to the Dallas/Ft. Worth District Office. For three of the four SIC codes, a significant portion of the dollars charged off or in liquidation status were for loans processed by Bank United (see exhibit A). These loans represented between 21 and 58 percent of the dollars charged off for SIC codes 5411, 5541, and 5812. Also, for SIC codes 5411, 5541, Bank United represented 18 and 72 percent, respectively, of the dollars in liquidation status (See Exhibit A).

Early Loan Defaults

For each Industry code, a sizeable portion of the total dollars charged off or in liquidation status were from loans that were considered early defaults. Per SBA, an early default is a loan that defaults within 18 months of the date of final disbursement.[4] As shown in Table 6, early defaulted loans comprised more than 45 percent of the dollars charged off for each of the four SIC codes and more than 80 percent for each of the NAICS codes.

[4] Per SBA Policy Notice 5000-831, dated October 2, 2002

Table 6

Early Default Percentages For Industry Codes								
SIC Code	**5812 eating places**	**%**	**5541 gas stations**	**%**	**5411 grocery stores**	**%**	**7011 hotels/motels**	**%**
Dollars Charged-off	$151,114,845	100	$ 56,882,357	100	$ 46,019,983	100	$ 29,130,167	100
Early Default* Dollars	76,279,543	53	32,801,470	58	21,301,543	46	14,356,953	49
Dollars to Liquidation	277,139,732	100	179,075,388	100	84,725,127	100	146,608,963	100
Early Default Dollars	57,560,285	21	38,855,354	22	14,705,368	17	22,356,992	15
NAICS Code	**722110 / 722211 full and limited service restaurants**				**447110 gas stations with convenience stores**			
Dollars charged-off	$ 5,175,414			100	$ 3,429,206			100
Early Default* Dollars	4,621,121			89	3,149,233			92
Dollars to Liquidation	55,945,096			100	41,894,367			100
Early Default Dollars	42,289,653			76	31,246,532			75

Loss Rates by District Office

Our analysis showed that while the loss rate for each of the four SIC codes, as well as the average loss rate for our analytical base, was less than SBA's benchmark of [FOIA Ex. 2], the loss rates applicable to the four SIC codes for some district offices were significantly above the benchmark. We did not compute loss rates for the NAICS codes as the loans were processed too recently to provide reasonable results.

Table 7

District Offices with Largest Loss Rates Highest Rated Industries for Charge-off and Liquidation Activity						
SIC Code	**5812**	**%**	**5541**	**%**	**5411**	**%**
Dallas/Ft. Worth						
Gross Disbursed Amount	$ 165,163,766		$ 348,073,651		$ 163,737,067	
Charge-off Amount	14,388,604	9	38,302,489	11	10,708,997	7
Houston						
Gross Disbursed Amount	$ 98,652,202		$ 138,721,651		$ 66,153,611	
Charge-off Amount	8,050,501	8	1,726,261	12	2,915,113	4
Los Angeles						
Gross Disbursed Amount	$ 135,578,718		$ 53,482,986		$ 102,810,586	
Charge-off Amount	6,571,687	5	800,505	2	2,861,395	3

Management Discussion

We discussed our survey results with personnel from the Office of Lender Oversight. They stated that industry codes are included in the current oversight process and are a risk factor in any given portfolio. They currently look at the top 25 industry groups in the 7(a) and 504 loan portfolios. Management also stated that it was in the process of implementing its Loan Monitoring System and will wait to see what that yields.

Conclusion

The periodic analysis of industry codes to monitor risk within the loan portfolio would be a beneficial tool for identifying potential and actual risk. While SBA management has identified risk by SIC code for both the Section 7(a) and Section 504 lending programs, they were not doing this type of analysis on a routine basis at the initiation of our review. As demonstrated in this report, analyses of this nature cannot only identify risk at the industry code level, but also at the regional, district office, and lender levels. In addition, SBA could combine the industry code analysis with other data elements to identify risk levels in specific types of loans or borrowers. The transformation to NAICS codes from SIC codes will further enhance this type of analysis as the NAICS codes better describe the type of businesses.

[FOIA Ex. 5].

Recommendation

We recommend that the Office of Lender Oversight include an analysis of industry codes as a part of its loan and lender monitoring system to identify potential areas of financial risk and to better focus its limited oversight resources.

Management Response

The Associate Administrator for Lender Oversight stated that while her office agrees with the recommendation and has already included such analysis in its oversight activities, she disagreed with several conclusions and analyses presented in the report. She stated that OLO identifies and analyzes risk, but does not manage it and does not make program management determinations. She disagreed that OLO did not have procedures to routinely identify and control the level of financial risk by industry code. She stated that OLO does have procedures in place to routinely identify and analyze the level of financial risk by industry code and that an analysis of the 7(a) portfolio by industry code is conducted monthly as part of the Monthly Portfolio Analysis Report. She disagreed that combining the liquidation and charge-off activity by SIC and NAICS codes would result in a greater concentration of risk. She believes the level of concentration would remain the same. Lastly, she stated that the definition of risk, as defined in the report, should be clarified.

Evaluation of management's response

The actions cited by the Associate Administrator concerning the recommendation are acceptable. Based on her comments, we modified portions of the audit report. We changed the report's presentation of the scope of OLO's responsibility, added statements about OLO's current procedures for industry code analyses, deleted our statement concerning the increased concentration when combining SIC and NAICS codes, and expanded the definition of risk, as used in the report. We do not agree that OLO was routinely identifying and analyzing the level of financial risk by industry code when our survey started. At that time, LMS was in its initial phase and had not been fully implemented. OLO and OFA personnel could not provide evidence that they routinely identified and analyzed financial risk by industry code.

EXHIBIT A

Lenders with the Largest Percentage of Charge-off Dollars
Per Selected Industry Codes for the Dallas/Ft. Worth District Office

Industry Code	5812 Eating Places	%	5541 Gas Stations	%	5411 Grocery Stores	%	7011 Hotels	%	722110 722211 Restaurants	%	447110 Gas Stations w/C Stores	%
Charge-off Amount:	$14,388,604	100	$38,302,489	100	$10,708,997	100	$5,549,358	100	$782,267	100	$2,412,843	100
							No Concentration					
Bank United	2,977,926	21	22,120,662	58	4,155,031	39						
GE Capital Small Business Finance	1,364,241	9			2,664,918	25						
Citizens National Bank			3,475,383	9								
Amresco Independence Funding											1,567,951*	65

Lenders with the Largest Percentage of Liquidation Dollars
Per Selected Industry Codes for the Dallas/Ft. Worth District Office

Industry Code	5812 Eating Places	%	5541 Gas Stations	%	5411 Grocery Stores	%	7011 Hotels	%	722110 722211 Restaurants	%	447110 Gas Stations w/C Stores	%
Liquidation Amount:	$ 11,958,358	100	$53,099,457	100	$ 14,328,800	100	$15,276,099	100	$4,094,699	100	$12,354,668	100
	No Concentration								**No Concentration**			
Bank United			38,129,993	72	2,546,112	18						
Amresco Independence Funding			5,751,951	11			4,378,192	29			3,180,254	26
Gateway National Bank					1,506,963	11						
Transamerica Small Business Capital							3,274,462	21				
CIT Small Bus. Lending Corp.											4,185,543	34

***Charge-off amount represented by 3 loans. Two loans charged-off for this lender.**

Attachment 1

DATE: July 7, 2004

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

FROM: Janet A. Tasker
Associate Administrator for Lender Oversight

SUBJ: Management Response to OIG Draft Survey of Risk Management
By Industry Code

This memorandum provides management's response to Office of Inspector General's (OIG) Draft Survey of Risk Management by Industry Code. While Lender Oversight agrees with the recommendation in the survey and has already included such analysis in its oversight activities, we disagree with several of the conclusions and analysis presented by OIG in the survey.

The following specific actions have been taken by the Office of Lender Oversight to accomplish the recommendation:

1. The Office of Lender Oversight produces a monthly portfolio analysis report for both the 7(a) and 504 loan portfolios. The monthly portfolio reports include tables and charts with data and information on each portfolio by industry groups. Included in these presentations are data on concentrations as well as performance metrics by industry grouping.

2. The redesigned risk based review process for on-site reviews includes a category for portfolio performance. One aspect analyzed in this category is industry concentrations. A lender's SBA portfolio is sorted by industry concentration to assess whether any significant concentrations exist. If so, the lender's expertise in and knowledge of the specific industries along with its ability to manage those concentrations is assessed as part of the review process.

While Lender Oversight agrees with OIG's recommendation, the survey contains a number of factual errors and inaccuracies. These items are identified below:

- <u>Page 1, Background, Third Paragraph</u>. The Office of Lender Oversight has responsibility for monitoring 7(a) business loans to identify and analyze risk. Lender Oversight does not manage risk. Lender Oversight provides input to but does not make program management determinations. Additionally, Lender Oversight plays no role in the review of requests for guaranty purchases of defaulted loans.   Finally, the last sentence should be re-stated as follows to avoid confusion – "The SBA share of outstanding balances for 7(a) loans in the portfolio is $28.7 billion as of January 31, 2004."

- Page 3, Results of Survey, First Paragraph. We disagree with OIG's conclusion that SBA did not have procedures to routinely identify and control the level of financial risk by industry code and that this type of analysis would be beneficial. OLO does have procedures in place to routinely identify and analyze the level of financial risk by industry code. LMS provides accurate industry codes for most of the 7(a) loan portfolio via the Dun and Bradstreet data base. Analysis of the 7(a) portfolio by industry code is conducted monthly as part of the Monthly Portfolio Analysis Report. This paragraph also states that Lender Oversight ranks the portfolio for aggregated dollars at risk. Lender Oversight ranks SBA lenders based on the aggregated dollars at risk in their portfolio of SBA guaranteed loans, not the entire portfolio.

- Page 3, Industry codes with the greatest concentration of risk, First Paragraph. The first sentence refers to the "dollar amount of loans at risk." There is also a footnote defining "risk." It is not clear what risk is referring to and the definition should be expanded to clarify the ambiguity, e.g., SBA's loan guaranteed amount of outstanding balance, MIS status, purchases, and/or charge-offs, etc.

- Page 4, Liquidation and charge-off activity by industry code, First Paragraph. The paragraph concludes that as the NAICS code analysis and the SIC code analysis resulted in the same percent of loans to eating places and restaurants being charged off and liquidated thus the concentration of risk would be greater if the codes were combined. Lender Oversight believes the concentration of risk would be the same if the two were combined. The two codes would still represent the same percentage of the new total.

Please feel free to contact me at 202-205-[FOIA Ex. 2] should you need additional information or have any questions regarding these comments.

cc: Ronald Bew, ADA, Capital Access
Calvin Jenkins, Deputy ADA, Capital Access
James Rivera, AA, Financial Assistance
Michael Pappas, AA, Field Operations

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